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# How to Calculate Taxable Gain and Avoid Taxes When Doing an Exchange

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When a person or business sells property, that seller may face taxes if the property is sold at a gain. Determining gain on a sale of property can be a complex calculation. A simplified calculation is that gain occurs when someone sells property at a price higher than the price they paid for the property (less depreciation). The taxes on that gain can include capital gains tax including depreciation recapture, net investment income tax and state taxes.

The primary method to avoid payment of these taxes, upon selling a business or investment property, is to do a 1031 exchange. Section 1031 of the internal revenue (tax) code allows a seller to avoid taxes by exchanging the property being sold for a new property that they acquire.  The policy behind Section 1031's tax deferral is that the seller "rolled" their investment from their old property into a new property. Since they did not cash out, no tax payment is due.

As taxpayers are planning their exchange, they often have questions such as:

> How are taxes calculated upon selling property?
> How does the price of the newly acquired property effect taxes during an exchange?
> Can I pocket any cash from the sale and still have tax avoidance when doing an exchange?

The following examples will help explain the answer to these questions by covering how taxable gain is calculated and how to achieve maximum tax deferral when doing a 1031 exchange. Let's start with how to calculate taxable gain. Gain is loosely calculated by figuring the difference between the sale price of the property and the amount paid for the property.[1] For example, if someone bought a property for $1 million and then sells it for $1.5 million their gain is the $500,000 increase in value. Think of this as the amount that they "profited" or made on the sale. That gain is what gets taxed.

Many people get tripped up by trying to throw mortgage financing into the calculation of taxable gain. Any mortgage on a property is not considered in the calculation of taxable gain. Let's look at the same example with mortgage financing and why it doesn't matter when figuring taxable gain.

If the person in the example used an $800,000 mortgage when purchasing the property, they now have $700,000 equity in the property when sold for $1.5 million (assuming no amount is paid down on the mortgage while holding the property). However, their taxable gain is still the $500,000 in "profit" that was made on the sale price over the original purchase price. The person is not taxed on the equity of $700,000. Continuing the example, if the

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[1] A more exact calculation of Gain is subtracting the Adjusted Basis from the Amount Realized. The Amount Realized is the sale price less allowable costs of the sale. Adjusted basis is the amount paid for a property plus the amount of capital improvements less allowable depreciations. Other adjustments such as debt cancellation can affect basis.

person were to pay off their mortgage entirely before selling, then that person will pocket the full equity of $1.5 million upon the sale. That person will still pay tax on their gain of $500,000, not the $1.5 million in equity.

Another helpful example is the case where that same person used a first mortgage of $1 million when purchasing the property and then took out a second mortgage for $500,000 leaving no equity in the property upon selling at $1.5 million. Their taxable gain is still the $500,000. Yes, in that example the owner will walk away from the sale with no cash proceeds, but still possibly faces $500,000 of taxable gain. That person may want to plan ahead to have funds available when tax filing day arrives. Think of the calculation this way, if taxes are calculated based on equity as opposed to gain, everyone would refinance a property to pull out all their equity before selling in order to avoid taxes. That, of course, doesn't happen. These examples show why the amount of equity in a property above the mortgage amount is irrelevant in calculating gain.

## 1031 EXCHANGE

Let's now look at how an exchange helps avoid taxes and how to calculate the answer to some of the above questions. In an exchange, Section 1031 of the tax code allows a person to exchange their property for a new property and avoid payment of taxes otherwise due on an outright sale. In order to achieve maximum tax deferral when doing an exchange, the exchanger must follow two rules:

1. Acquire a new property that has a market value equal or greater than the value of the old property being sold; **and**
2. Do not pocket any cash from the sale of the old property.[2]

If these two rules are followed, then the exchanger will avoid taxes. If either of these rules are violated the exchanger will face taxable gain, usually to the extent of the dollar amount that the rule is violated. These rules lead to a couple other conclusions. Those conclusions are that when acquiring a new property in a 1031 exchange, the exchanger’s basis from the old property is “spent” or applied first to the purchase price of the new property. Then their gain is spent on the purchase price of the new property. If an exchanger spends their entire basis AND gain from the old property in acquiring the new property by buying a new property worth equal or more than the old property, all taxes will be deferred. The second conclusion is that any mortgage on the property is irrelevant for calculating the amount of taxable gain in an exchange, just like in an outright sale.[3] Knowing the amount of the mortgage is only necessary to calculate the amount of cash/equity that is needed to be rolled over into the new property to fulfill rule number two.

The below examples use the same example as above, but now with an exchange applying the two rules:

If the person selling their old property for $1.5 million, then acquires a new property worth $1.5 million and "rolls" all the cash proceeds from their sale into the new property through their exchange (by following the proper exchange procedures), that person has bought a property that is equal in value to their old property and used the entire proceeds from their sale to acquire the new property. That person will avoid taxes.

Let's look at an exchange with property encumbered by a mortgage to better illustrate. Using the same example as above, the exchanger bought the old property for $1 million with a $1 million mortgage and is now selling for $1.5 million. The exchanger will be exchanging into a $1.5 million new property. As long as the exchanger doesn't

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[2] Reg. §§1.1031(b)-1(c), 1.1031(d)-1, 1.1031(d)-2. The value of other property received in an exchange is equivalent to receiving cash for purposes of calculating taxable gain.

[3] Whether gain is part of cash boot or mortgage boot is only needed to be calculated by a taxpayer when filing their tax return since those numbers will need to be noted on their return. They are not needed upfront for an exchanger to determine the amount of taxable gain upon doing an exchange.

pocket any cash from the sale, so the entire $500,000 in equity goes into the new property, then there will be no tax due. The exchanger fulfilled both rules of exchanging, buying equal or up in value and not taking any cash out. The other $1 million to complete the purchase can come from mortgage financing or other cash from the exchanger or a combination of both.

If this exchanger were to purchase a new property for $1.4 million then that exchanger has violated the buy equal or up rule and will likely face tax on the $100,000 lower value. That exchanger rolled over their entire basis from the old property into the new property but only rolled over $400,000 of their $500,000 in gain. The $100,000 of gain that was not rolled over is likely taxable. If an exchanger buys a new property at a price less than the sale price of their old property, that exchanger either pocketed some cash from the sale of their old property or took a smaller mortgage on the new property than the mortgage on the old property. Either outcome is a taxable benefit to the exchanger and is labeled as cash "boot" or mortgage "boot."[4]

There are a few misconceptions about what needs to occur in an exchange to avoid taxes. Many sellers of property believe that they are able to just roll over their gain amount (the $500,000) by buying a new property for that amount. They believe they can receive a return of their initial investment and still avoid tax in an exchange. That is not the case.

Other people believe they only need to roll over their initial investment (the $1 million) and can pocket the $500,000 in an exchange and still have complete tax avoidance. That is also not the case. Remember, any decrease in market price from the old property to the new gets taxed as gain right from the first dollar out.

A third misunderstanding is that only the amount of equity in the property needs to be rolled over to the new property to avoid tax. That is also not correct. Only rolling over the equity amount will likely violate the above rules.

It is important to note, a person can still complete an exchange even if they have partial taxation. In the last example, even though the exchanger pays tax on the $100,000 of taxable boot, they have "rolled" over $400,000 of the $500,000 of gain into the new property, thus avoiding tax on that $400,000. Also note, it is possible for a person to take out a smaller mortgage on the new property yet have maximum tax deferral in an exchange by fulfilling the two rules above. That is done by adding additional cash into the exchange. The exchanger in the example could buy a new property for $1.5 million using the entire $500,000 proceeds from their sale yet have a smaller than $1 million new mortgage (which was the mortgage amount on the old property). Let's say their new mortgage is only for $750,000. How could that happen? Well, they will need to put more of their own cash into the exchange to cover the difference. The exchanger will need to put in $250,000 of their own cash to complete the $1.5 million purchase. Cash into an exchange is allowed to offset debt relief (mortgage boot) caused by a smaller mortgage on the new property. In this case, the exchanger still fulfilled both rules and paid no tax.

In conclusion, to avoid taxes when doing an exchange, an exchanger must spent their entire basis and their entire gain in acquiring their new property by 1) buy a new property of equal or greater value than their sold property and 2) avoid pocketing any cash proceeds from their sale. Both the rules must be followed for maximum tax avoidance.

Please be aware that this information is intended to provide basic information about tax deferred exchanges, and is not a substitute for legal or financial advice. Gain 1031 Exchange Company strongly recommends consulting with a tax or legal advisor before considering an exchange.

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[4] Gain is taxed only to the extent of the total gain on a property had the property been sold as an outright sale and not an exchange. Also, please be aware that certain depreciation recapture rules may apply causing tax such as moving from a depreciable asset with improvements to a non-depreciable asset such as vacant land.