# Balancing the Equities in a 1031 Exchange
## The Foundation of Every 1031 Exchange Transaction

When an asset is sold for more than its adjusted tax basis, the amount exceeding the basis is recognized as "gain" and is taxed at the capital gains tax rate. The gain is calculated by taking the net sales price of the asset (sales price less closing costs and commissions) minus its adjusted tax basis. The adjusted tax basis is based upon the original cost of the property plus capital improvements minus depreciation.

IRC Section 1031 enables taxpayers to defer capital gains taxes if the taxpayer, in lieu of selling, purchases "like-kind" replacement property within the appropriate time frames. A common pitfall however, is a failure to *balance the equities* thereby resulting in unwanted tax consequences.

**What does "balancing the equities" mean?**

**Balancing the equities** is an essential component to avoid boot and defer capital gains taxes through a 1031 exchange. While the "general" rules are fairly straightforward, they frequently represent a source of confusion for many taxpayers. Essentially, there are three rules a taxpayer must follow to defer all taxes:

1. The taxpayer must purchase replacement property that is equal to or greater than the relinquished property-It is not enough to just reinvest the *gain* or *basis* in the property being sold;
2. All cash proceeds or *equity* from the sale of the relinquished property must be reinvested into the replacement property; and
3. Acquire debt on the replacement property that is equal to or greater than the debt on the relinquished property OR offset any debt reduction on a dollar for dollar basis with *out-of-pocket cash*.

If the taxpayer fails to balance the equities, there shall be *boot* that will result in taxation. Proceeds from the sale of the relinquished property not reinvested in replacement property will be taxed. Likewise, if the debt on the replacement property is less than the debt on the relinquished property, the difference will also be taxed unless the taxpayer adds cash to make up that difference.

Many taxpayers however, are willing to do a partial 1031 exchange where they essentially *buy-down* and simply pay taxes on the difference. As long as a taxpayer buys property in excess of his *adjusted tax basis*, he will benefit from doing a partial exchange.

**"Balancing the Equities" Example:**

Taxpayer is selling a building for $2,000,000 which he purchased for $800,000. During his ownership, he spent $200,000 on improvements and took $250,000 in depreciation. His adjusted tax basis is therefore $750,000 (original purchase price, plus improvements, minus depreciation).  His estimated


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closing costs are $60,000 and his gain is $1,190,000 (net sales price minus adjusted tax basis). With his current mortgage at $1,000,000, taxpayer will net proceeds of approximately $940,000.

Taxpayer plans on acquiring a new commercial building for $3,000,000 and would like to defer all of his capital gains taxes by exchanging under Section 1031.

Taxpayer can determine if his equities balance by using the following worksheet:

| **Relinquished Property** | | **Replacement Property** | |
|---|---|---|---|
| Sale Price | $2,000,000 | Purchase Price | $3,000,000 |
| – Existing Debt | $1.000,000 | – New Debt | $2,060,000 |
| – Closing Costs | $60,000 | | |
| **= Equity Proceeds** | **$940,000** | **= Cash Down** | **$940,000** |

In the above example, taxpayer has balanced his equities by investing all of his cash and acquiring property that is equal to or greater than the property being sold. Moreover, he satisfied the debt requirement by replacing his existing debt with new debt. It's important to understand that he also could have satisfied the debt requirement by replacing the old debt with additional out-of-pocket cash on a pro rata basis.

As always, investors considering an exchange should always consult their tax advisor to determine their adjusted basis, their anticipated gain, their potential capital gains tax exposure, and whether the equities in their contemplated exchange are balanced.

**For more information:**

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