OLD REPUBLIC EXCHANGE

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Exchange Basics—"Balancing the Equities"

When an asset is sold for more than its original cost, there is gain which the IRS will tax at the "capital gains tax rate". The amount of capital gain is calculated by taking the selling price of the asset minus its "adjusted basis" (The "adjusted basis" is equivalent to the original cost of the property, plus any amounts expended for capital improvements, minus depreciation) minus selling expenses.

It is important to understand that an asset may be sold at little or no profit, but with capital gain. Capital gains are taxed at either 15% or 20%. The 15% rate applies to taxpayers falling in the 25% to 35% income tax brackets. The 20% rate applies to those in the 39.6% or higher income tax brackets. State capital gains tax may also apply. Additionally, any gain attributable to depreciation is taxed at a hefty 25%.

Section 1031 allows a taxpayer to defer paying capital gains tax if — instead of selling an asset and pocketing the cash — they reinvest the cash into like kind replacement property. Many investors regularly exchange property using tax deferred dollars to diversify their assets and increase their property portfolios. A common mistake, however, is failure to "balance the equities" in their exchange.

What does "balancing the equities" mean? "Balancing the equities" is a term of art and understanding it is essential to deferring all capital gains taxes. "Balancing the equities" means that the debt acquired on the replacement property must be equal to or greater than the debt that was on the relinquished property. Additionally, the cash invested in the replacement property must be equal or greater than the amount of cash from the sale of the relinquished property.

What happens if the equities are not balanced? If the equities do not balance, there will be a taxable consequence. Any cash from the sale of the relinquished property that is not reinvested in replacement property will be taxed. Likewise, if there is less debt on the replacement property than was on the relinquished property, the difference will also be taxed unless the taxpayer adds cash to the transaction to make up that difference.

Taxpayers should bear in mind the following rules:

- Buy replacement property that is equal to or greater in value than the relinquished property;
- Invest all cash proceeds from the sale of the relinquished property into the replacement property;
- Acquire debt on the replacement property that is equal to or greater than the debt that was on the relinquished property or add cash in place of debt.

Taxpayers contemplating 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.

The above rules are illustrated by the following example:

Smith plans on 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 basis is $750,000 (i.e. original purchase price, plus improvements, less depreciation). His gain will be $1,190,000 (i.e. sales price minus adjusted basis minus estimated closing costs). With his current mortgage at $1,000,000 and estimated closing costs of $60,000, Smith will net proceeds of approximately $940,000. Smith plans on acquiring an office building for $3,000,000. Smith would like to defer all of his capital gains taxes by exchanging under Section 1031. Smith can determine if his equities balance by using the following worksheet:

Relinquished Property	
Sale Price	$2,000,000
- Existing Debt	1,000,000
- Closing Costs	60,000
= Cash Proceeds	$ 940,000

Replacement Property	
Purchase Price	$3,000,000
- New Debt	2,060,000
= Cash Down	$ 940,000

Smith's down payment on the replacement property must be $940,000 to avoid receiving taxable cash. Smith has balanced his equities by investing all of his cash and by acquiring equal or greater debt on the replacement property. Smith can pay the additional cost of the replacement property with either a larger loan or with an increased cash down payment.

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