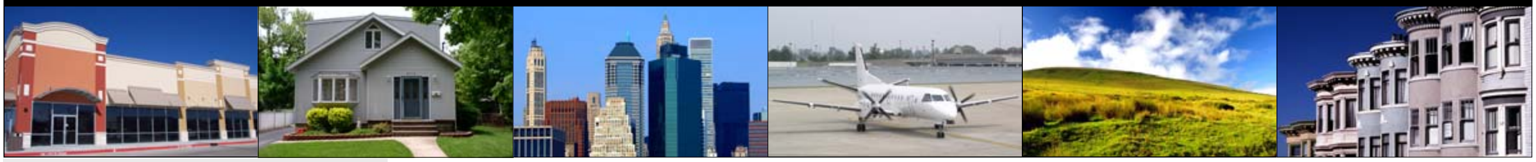
# The Exchange Equation

## "Balancing the Exchange"



### REALIZED GAIN VS. RECOGNIZED GAIN

Whenever property is sold, it is important to make the distinction between realized gain and recognized gain. Realized gain is defined as the net sale price minus the adjusted tax basis. Recognized gain is the taxable portion of the realized gain. The common objective in a tax deferred exchange is disposing of a property containing significant realized gain and acquiring a "like-kind" replacement property so there is no recognized gain. In order to defer all capital gain taxes, an Exchanger must "balance the exchange" by acquiring replacement property that is the same or greater value as the relinquished property, reinvest all net equity and replace any debt on the relinquished property with debt on the replacement property (although a reduction in debt can be offset with additional cash.)

### THE EXCHANGE EQUATION

The Exchanger can quickly calculate whether there will be recognized gain based on the following principals: Taxable "boot" is defined as non like-kind property the Exchanger may receive as part of an exchange. "Cash boot" is the receipt of cash and "mortgage boot" (also referred to as debt relief) is a reduction in the Exchanger's mortgage liabilities on a replacement property. Generally, capital gain is recognized (and therefore taxable) to the extent there is boot.

For a fully deferred exchange, an Exchanger must reinvest all net equity and acquire property with the same or greater debt. Compare the relinquished property with the replacement property in terms of:

1. Value
2. Net Equity (after deducting costs of sale)
3. Debt

| EXAMPLE 1 | Relinquished Property | Replacement Property |
|---|---|---|
| VALUE | $450, 000 | $600, 000 |
| NET EQUITY | $200, 000 | $200, 000 |
| DEBT | $250, 000 | $400, 000 |

The Exchanger is acquiring property of greater value, reinvesting the entire net equity and increasing the mortgage on the replacement property. Analysis: There is no boot and no recognized gain.

| EXAMPLE 2 | Relinquished Property | Replacement Property |
|---|---|---|
| VALUE | $450, 000 | $600, 000 |
| NET EQUITY | $200, 000 | $150, 000 |
| DEBT | $250, 000 | $450, 000 |

The Exchanger keeps $50,000 of the exchange proceeds, reinvesting only $150,000 as a down payment on the replacement property. Analysis: There is $50,000 of "cash boot" which results in recognized (taxable) gain.

| EXAMPLE 3 | Relinquished Property | Replacement Property |
|---|---|---|
| VALUE | $450, 000 | $350, 000 |
| NET EQUITY | $200, 000 | $200, 000 |
| DEBT | $250, 000 | $150, 000 |

The Exchanger acquires property of a lower value and, while reinvesting all equity in the replacement property, acquires less debt in the process. Analysis: The Exchanger has reduced the debt by $100,000 ("mortgage boot") which results in a recognized (taxable) gain of $100,000.

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