Understanding Basis and Gain

A 1031 Exchange does not require you to replace the full value of the relinquished property, but you cannot do so without tax liability on the portion you did not replace, whether this be debt, depreciation recapture or equity. The intrinsic value of a 1031 exchange is directly related to the amount of deferred gain, thus potential tax, that is offset in the exchange with the purchase of a replacement property.

IMPORTANT: This is a very simplified version of the a portion of the calculation needed to derive tax liability. Consult with your tax advisor, CPA or tax attorney prior to executing a 1031 exchange to determine your tax liability, if any. Your situation may be different and relying on this format may lead to errors.

Basis Calculation:

Original cost basis:	$300,000	
Depreciation Taken:	40,000	(improved property only; would currently be recaptured at 25% rate if property is sold with a gain and a 1031 Exchange not utilized)
Capital Improvements	0	(Capitalized improvements will increase the adjusted basis)
Adjusted Basis	$260,000	

Exchange Price Target:

Sale Price of Property:	$450,000	
Sale Costs:	25,000	(commissions, closing fees, etc. ; basically one-time transaction fees; does not include property taxes)
Net Sale Proceeds:	$425,000	(this is your **TARGET** price for your replacement property)

Replacement Property Examples using Adjusted Basis calculated above.

If cost of Replacement:	$425,000 = or +	(exchange defers $165K in gain and depreciation recapture: $425 - $260 = $165
If cost of Replacement:	$400,000	($25K is taxable to the exchanger, most likely this will be taxed as depreciation recapture and taxed at 25% rather than at the 15% capital gains rate)
If cost of Replacement:	$375,000	($50K is taxable to the exchanger, 25K as depreciation recapture and 25K is taxed as capital gains if qualified)
If cost of Replacement:	$275,000	($150 is taxable, $25K at depreciation recapture rate, $125 at capital gains rate. At this level (only $15K is deferred gain), this would be a marginally beneficial 1031 Exchange but still viable.
If cost of Replacement:	$260,000	(an exchange would have negative benefit as the fee of doing the exchange would not be covered by the tax savings since there would be no deferred tax)