



FIGURING BASIS IN A LIKE-KIND EXCHANGE

by Ed Horan, *Certified Exchange Specialist®*

Should I Do an Exchange?

To decide if you want to do a like-kind exchange of your investment real estate, you should determine how much capital gain you will have to pay tax on if you sell the property and do not do an exchange. To determine your capital gain, you need to know your current adjusted tax basis in the property.

The first step is to go back and establish the starting basis when you acquired the property. The starting basis will depend on how you acquired the property. You may have acquired the property as a simple purchase, Grandma may have given it to you as a gift, it may have been inherited, or you may have purchased it as part of a like-kind exchange.

In a simple purchase the starting basis is what you paid for the property (normally the contract price), plus the costs necessary to acquire the property. Unfortunately, costs to obtain financing (like points) or prepayments for insurance, interest, or taxes are *not* included.

If the property was received as a gift, your starting basis is the donor's adjusted basis at the time of the gift. When a property is inherited, your basis is generally the fair market value (FMV) on the date of the individual's death. If you jointly own a property, then your basis will be changed on the death of your co-owner. The new basis will be your adjusted basis plus the current FMV of the joint co-owner's interest on the date of death.

Many investment properties have been purchased as part of a like-kind exchange. For an investment or business property obtained in an exchange after 1990, determining the starting basis is simple. For the tax year that the relinquished property was sold, you filed IRS Form 8824 with your federal tax return. The last line on that form, Line 25, shows the total starting basis for your replacement property or properties. That starting basis was computed simply by taking the acquisition cost for the new replacement property and subtracting the gain deferred. If more than one replacement property is purchased, then a starting basis is assigned to each property based on the ratio of the property's FMV to the total acquisition cost for the replacement properties.

After the starting basis is established, then adjustments must be made to determine the current adjusted basis. The first adjustment is the addition of any improvements made to the property. An improvement is depreciated, while repairs are claimed as expenses on Form 1040, Schedule E, for that year. The basis can also be increased by assessments for local improvements, casualty losses, legal fees to defend title or rezone, and the cost of new utility service lines.

The primary decrease in basis is from depreciation. Residential investment properties are currently depreciated over 27.5 years, while commercial properties are depreciated over 39 years. In most cases to get the current **adjusted basis**, we simply take the starting basis, add the cost of improvements, and subtract all the depreciation taken or allowed on that property.

Once we have the adjusted basis, we can figure the potential **capital gain** if we were to sell the property or the gain that we will defer if the property is exchanged.

To figure our potential capital gain, we take the selling price for our current property, subtract selling costs, and then subtract the adjusted basis. In real estate, capital gain is the sum of the Profit (or Loss) and all the depreciation taken. Currently rental property depreciation is taxed at the 25% recapture rate, and the profit (the difference between the adjusted selling price and the starting basis plus improvements) is taxed at the 15% federal capital gain rate.

To quickly determine your gain and tax, go to www.1031.us and select the Capital Gains Calculator. Also, at www.irs.gov you may get a copy of IRS Publication 551, Basis of Assets.

Once you know your potential capital gain and how much tax you will have to pay Uncle Sam, then you can make the decision whether to do a like-kind exchange or to pay the tax. You should always discuss your decision with your tax advisor as many other aspects of your financial situation may be involved.

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for more information.

Remember, while the capital gain rate is 15%, depreciation taken on rental property is still taxed at the 25% recapture rate.

This publication is designed to provide accurate information on tax-deferred exchanges. The publisher is not engaged in rendering legal or accounting services. If legal or tax advice is required, the services of a competent professional should be sought.

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