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The Tax-Deferred Exchange

Michael S. Davis, Florida State Counsel

As we handle more and more tax-deferred exchanges in this office, we find that an increasing number of taxpayers do not understand certain basic principles of the exchange. In simple terms, many taxpayers believe that they only have to invest the gain portion of their sale proceeds into the replacement property and that they can retain the basis portion of the sale proceeds. Nothing could be further from the truth under the provisions of our tax code and regulations.

There are three basic rules to be followed to determine the amount of gain in an exchange transaction and to determine the basis of replacement property.

RULE #1:

Rule number one tells us that in order to defer taxable gain in an exchange transaction, the taxpayer must trade up or be equal in both value and equity from the relinquished property to the replacement property.

RULE #2:

The second rule tells us that the taxpayer is taxed on the greater of the trade down in value or equity from the relinquished property to the replacement property, but only to the extent that there may be realized gain from the exchange transaction.

RULE #3:

The third rule tells us that the taxpayer's basis in the replacement property equals the fair market value of the replacement property, less the amount of gain deferred by the taxpayer from the exchange.

A trade down in value or in equity is generally caused by the taxpayer receiving "boot," such as cash, a promissory note and mortgage, or other property in the exchange instead of reinvesting that equity in the replacement

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