Buying Up – *When the New Property has a purchase price that is higher than the sale price of your Old Property.*

Buying Down – *When the New Property has a purchase price that is lower than the sale price of your Old Property.*

Using the TaxPak Buy-Down Example

Now let's crunch some numbers! To illustrate the method for completing Part III of Form 8824, we included an example that will make these concepts more understandable and help you successfully report your 1031 exchange to the IRS.

We start with a specific type 1031 exchange where the taxpayer sold one property and purchased a new one for a lower price. We call this a ***buy-down***.

Within our example we have included illustrations of sample WorkSheets so you can see actual calculations. Your 1031TaxPak includes blank WorkSheets for the numbers in your own exchange. The individual WorkSheets flow together in a larger calculation, so they will be *most helpful when completed in order.*

1031TaxPak Example

On December 20, 2013, Fred and Sue Jones sold a rental house in Vail, CO, for $100,000. They originally bought this house on January 10, 2001 for $47,000, and spent $3,000 on remodeling in 2004. They have taken $18,456 in depreciation. They still owe $40,000 on this house. They did a 1031 exchange, and on March 12, 2014 they closed on the purchase of their new rental house in Naples, FL, for $80,000, using the proceeds held by *the 1031 Exchange Experts' llc* for their exchange, and got a new loan for $40,000. Fred and Sue had $10,000 of closing costs (real estate commissions, title insurance, etc.) on the sale of their Old Property, and $2,000 of closing costs on the purchase of their New Property. Their New Property was identified to the *1031 Experts'* on February 04, 2014.

Old Property
rental house
123 Main Street,
Vail, CO

New Property
rental house
456 Center Street,
Naples, FL

Purchase price on 01/10/2001 = $47,000
Capital improvements = $3,000
Depreciation = $18,456
Sale price on 12/20/2013 = $100,000
Outstanding mortgage = $40,000
Closing costs = $10,000
Exchange proceeds = $50,000
Exchange proceeds = sale price: $100,000; minus closing costs: $10,000; minus mortgage payoff: $40,000 = $50,000.

Purchase price on 03/12/2014 = $80,000
Exchange proceeds used = $50,000
New loan = $40,000
Closing costs = $2,000
Identification date = February 04, 2014

WorkSheet #1

Calculating the Basis of the Old Property.

To begin, you first need to determine the ***basis*** of the Old Property; this is the starting point for calculating the gain from the sale of your Old Property. The first component of the basis is the original cost of your Old Property. In order to calculate the ***adjusted basis***, items like ***capital improvements*** increase the basis and ***depreciation*** decreases the basis.

Basis *– The amount of an individual's investment in the property for tax purposes.*

Adjusted Basis *– The basis of your property adjusted for items like* capital improvements *and* depreciation.

Capital Improvements *– An addition to, or partial replacement of, property that adds to its value. These improvements lengthen the time you can use it or adapt it to a different use. For example, replacing and upgrading windows, or changing a warehouse into office space.*

Depreciation *– An annual income tax deduction that allows you to recover the cost or other basis of certain property over the time you use the property. It is an allowance for the wear and tear and deterioration of the property.*

WorkSheet #1 is used to determine the adjusted basis of the Old Property you sold. **IRS Publication 551** discusses basis calculations in more detail. You can download this publication at 1031TaxPak.com.

WorkSheet #1 - Calculation of Basis

A. Original purchase price		$ 47,000
B. ADD: Increases to basis		
Capital improvements to your property	$ 3,000	
Assessments against your property		
Casualty losses - the costs of repairing your property		
Other -		
C. Total increases to basis (Sum of "B")		3,000
D. SUBTRACT: Decreases to basis		
Insurance proceeds received from casualty		
Depreciation deductions	18,456	
Other -		
E. Total decreases to basis (Sum of "D")		18,456
F. Adjusted basis (Line A + Line C - Line E)		31,544

WorkSheet #2
Calculating the Exchange Expenses.

The next step is to compile your ***exchange expenses***. They're the costs that you paid to sell your Old Property and purchase the New Property. To find these costs, look at both ***settlement statements*** from the sale of the Old Property and the purchase of the New Property.

***Exchange Expenses** – The closing costs incurred in a 1031 exchange to sell the Old Property and buy the New Property. For example: real estate commissions, legal fees, title insurance, etc.*

***Settlement Statement** – This is the document prepared to outline the flow of money in a real estate closing. It begins with the sale/purchase price, then lists all the expenses and credits for the buyer and seller. Often a HUD-1 form is used.*

WorkSheet #2 is used to consolidate and compute the exchange expenses. In this WorkSheet, we give you the corresponding ***HUD-1*** line numbers for each expense.

WorkSheet #2 - Calculation of Exchange Expenses

			HUD-1 Line #
A. Exchange expenses from sale of Old Property			
Commissions	$ 6,000		700
Loan fees for buyer	1,000		800
Title charges			1100
Legal fees			1107
Title insurance	1,000		1108
Recording fees & transfer costs	500		1200
Tax & doc stamps and transfer taxes			1200
Additional Charges -			
Survey costs	450		1300
Pest inspections	500		1300
Courier fees	50		1300
Exchange fees to the QI	500		1300
B. Total exchange expenses from Old Property		$ 10,000	
C. Exchange expenses from purchase of New Property			
Commissions			700
Loan fees paid by you for seller			800
Title charges			1100
Legal fees	1,000		1107
Title insurance			1108
Recording fees & transfer costs	500		1200
Tax & doc stamps and transfer taxes			1200
Additional Charges -			
Survey costs			1300
Pest inspections	500		1300
Courier fees			1300
Exchange fees to the QI			1300
D. Total exchange expenses from New Property		2,000	
E. Total exchange expenses (Line B + Line D)		12,000	

Some expenses are not considered exchange expenses. The HUD-1 line numbers and the expenses that are excluded from exchange expenses can be found in **Table 1 - Allocation of Settlement Costs** on our web site at 1031TaxPak.com.

***HUD-1** – A federally required form that must be used in real estate closings that involve lender financing. It is so universally used that it is often used as the settlement statement, even when it's not required.*

WorkSheet #3
Basic Fact Gathering on the Old *Property.*

Now that we've completed the complicated calculations, we're ready for some basic fact gathering. These facts will be used to prepare Form 8824.

WorkSheet #3 compiles the information you need about your Old Property, including the ***fair market value*** of the property you sold. Form 8824 uses the term 'fair market value' to mean the sale price of your Old Property.

Fair Market Value (or FMV) *- The IRS term for the sales/purchase price. Most of the time, the sales/purchase price and fair market value are the same number. They differ if you sold your Old Property or bought your New Property for a price that is significantly higher or lower than what the property is really worth. While this makes for interesting court cases, it seldom happens in normal circumstances. If you are one of those affected by this, feel free to call us at 866-694-0204.*

WorkSheet #3 - Information About Your Old Property

A. Description of Old Property	RENTAL HOUSE
B. Address	123 MAIN ST., VAIL, CO
C. Date Sold	12/20/2013
D. Adjusted basis of Old Property from WorkSheet #1 (Line F)	31,544
E. Fair market value or sales price	100,000
F. Date Old Property was originally purchased	01/10/2001

WorkSheet #4
Basic Fact-Gathering on the New *Property.*

WorkSheet #4 compiles the information you need about your New Property. Again, fair market value is the IRS term for "purchase price."

The ***identification date*** (line "D" below) for your New Property is the date that you submitted your 45-day identification form to us – whether you faxed or mailed it to us. If you mailed it to us, use the post-mark date.

Identification Date *– The date you sent your written list to us identifying the property(ies) you were planning to purchase. You probably used the 45-Day Identification Form. If you did not complete this form, and you purchased the property before Day 45, then the* ***closing date*** *of your New Property IS the identification date.*

WorkSheet #4 - Information About Your New Property

A. Description of New Property	RENTAL HOUSE
B. Address	456 CENTER ST., NAPLES, FL
C. Date purchased	03/12/2014
D. Date New Property was identified	02/04/2014
E. Fair market value or purchase price	80,000

WorkSheet #5
Calculating the Debt on the Old and New Properties.

> ***Debt** – Any liability that is associated with the Old or New Properties.*

The last bit of information you need to prepare Form 8824 is the amount of ***Debt*** that was paid off on the Old Property and the amount of new debt you have on the New Property.

When is the liability associated with the property? Most often, the property itself is the security for the loan, clearly making it associated with the property. But it is not necessary that the debt be a lien against the property. For example, payments made on unsecured debt to a friend or relative is considered debt as long as the debt is related to the property. Also considered debt are payments made to your bank for advances on a credit line where the money is used for the property.

> ***Loans Assumed** –*
>
> *Can be:*
>
> *1. Any liability that the 'other party' took over on your behalf,*
>
> *OR...*
>
> *2. The amount of the outstanding mortgage that was paid off with the sale proceeds from your Old Property,*
>
> *OR...*
>
> *3. The amount of the mortgage on your New Property.*

However, payments to yourself to repay money you put into the property *are not debt.* Neither are advances on a credit line secured by the property that were used for some purpose other than the property.

When referring to the debt associated with your Old and New Properties, the IRS uses the term ***loans assumed***. Don't let this confuse you. Just walk through our WorkSheets and you will determine the correct amounts for these items on Form 8824.

WorkSheet #5 is used to record the affects of debt on your exchange.

WorkSheet #5 - Debt Associated with Your Old and New Property

A. Loans assumed by other party on your Old Property or debt paid off on the Old Property $ 40,000

B. Loans you assumed on your New Property or new debt on the New Property $ 40,000

WorkSheet #6
Calculating the Net Cash Received or Paid.

> ***Cash** – The actual money that, after your exchange was complete, was either paid out of your pocket or received by you. Simply put: "after the dust has settled, the amount of money that you ended up paying or receiving."*

Next we calculate the net amount of ***cash*** that was paid or received. WorkSheet #6 does this. In some cases the WorkSheet shows that you received cash when in fact the cash was used to pay closing costs. Don't worry, this gets factored out later.

WorkSheet #6 - Calculation of Net Cash Received or Paid

A. Purchase price of New Property from WorkSheet #4 (Line E)	$ 80,000	
B. SUBTRACT: New debt on the New Property from WorkSheet #5 (Line B)	40,000	
C. Net cash paid for the New Property (Line A - Line B)		$ 40,000
D. Sales price of the Old Property from WorkSheet #3 (Line E)	100,000	
E. SUBTRACT: Debt paid off on the Old Property from WorkSheet #5 (Line A)	40,000	
F. Net cash received from the Old Property (Line D - Line E)		60,000
G. Total net cash received, if Line F is greater than Line C (Line F - Line C) (otherwise, write "0")		20,000
H. Total net cash paid, if Line C is greater than Line F (Line C - Line F) (otherwise, write "0")		0

WorkSheet #7 – Calculating Line 15 on Form 8824.

We are near the end! To finish our example, we need to make detailed calculations that will be used to complete **Lines 15 and 18** on Form 8824. To do these calculations, we will refer to the work already completed in WorkSheets 1-6. At the conclusion of our example we will also work through the line-by-line completion of Form 8824 in WorkSheet #9.

For most exchanges, your calculations on Form 8824 will begin on **Line 15.** In simple terms, **Line 15** is calculating the value of everything you received as part of the exchange in addition to your New Property. For example, it factors in any other property received or debt assumed. It also factors in the net effect of any exchange expenses that were incurred during the exchange.

The purpose of WorkSheet #7 is to determine if you have any taxable gain. The IRS calls this gain ***boot***. Boot can come from two sources: 1) cash you received or 2) net debt relief. In other words, *cash boot* or *debt boot.*

> ***Boot*** *– The IRS word for the gain that is taxable. It can either come from the cash you received in the exchange OR the net amount of debt relief that came from your exchange.*

The most common type of cash boot occurs when you take cash out of the exchange. Cash boot also occurs when there is cash left over at the end of the exchange. It is possible to have cash boot even though you didn't receive any cash.

For example, if you had $1,000 in repairs on your Old Property that were paid at closing, the IRS considers this $1,000 'boot' because it 'came to you.' In other words it is taxable, although in this case you can take a deduction on your tax return for $1,000 in repair expenses. So in the big picture, you do have cash boot (even though you didn't

WorkSheet #7 - Calculation of Form 8824, Line 15

A. Net cash received from WorkSheet #6 (Line G)		$ 20,000
B. Debt paid off on Old Property from WorkSheet #5 (Line A)		40,000
C. Debt on your New Property from WorkSheet #5 (Line B)	$ 40,000	
D. ADD: Net cash paid from WorkSheet #6 (Line H)	0	
E. Total (Line C + Line D)		40,000
F. Net debt relief, but not less than 0 (Line B - Line E)		0
G. Boot received (Line A + Line F)		20,000
H. Total exchange expenses from WorkSheet #2 (Line E)		12,000
I. Lesser of boot or exchange expenses (Lesser of Line G or Line H)		12,000
J. Total boot in excess of exchange expenses (Line G - Line I)		8,000 Carry to Line 15, Form 8824

receive the cash personally), but you don't have a tax liability. The moral here is that if your calculations show that you have boot, don't panic. In your overall tax picture, you may not need to pay tax on this amount.

Net ***debt relief*** occurs when the debt you paid off on the Old Property is less than the new debt on the New Property. However, the story doesn't end here. Contrary to some, this does not automatically result in debt boot. Additional cash from any other source that you put into the exchange for the purchase of the New Property offsets the debt that was paid off on the Old Property. Therefore, if the amount of new debt plus the additional cash put into the exchange is higher than the debt that was paid off on the Old Property, you do not have debt boot.

> ***Debt Relief*** *– The net amount of debt that was paid off in your exchange. The amount of taxable debt relief is affected by the amount of additional cash that you put into the exchange.*

WorkSheet #8 – Calculating Line 18 on Form 8824.

On Form 8824, **Line 18**, you are asked to calculate the basis of the Old Property given up. This calculation also leads to determining the basis of your New Property. The basis of your New Property equals the basis of your Old Property, plus the buy-up (or increase) to your New Property, plus the sum of your exchange expenses.

WorkSheet #8 works through this calculation for you.

WorkSheet #8 - Calculation of Basis of New Property for Form 8824, Line 18

A. Basis in your Old Property from WorkSheet #1 (Line F)			$ 31,544
B. Total exchange expenses from WorkSheet #2 (Line E)	$ 12,000		
C. SUBTRACT: Boot received from WorkSheet #7 (Line G)	20,000		
D. Exchange expenses not used, not less than 0 (Line B - Line C)		0	
E. Loans on your New Property from WorkSheet #5 (Line B)	$ 40,000		
F. ADD: Net cash paid from WorkSheet #6 (Line H)	0		
G. Amount you put into New Property (Line E + Line F)		40,000	
H. Debt paid off on Old Property from WorkSheet #5 (Line A)		40,000	
I. Net increase in your investment (Line G - Line H)			0
J. Basis in New Property (Line A + Line D + Line I)			31,544 Carry to Line 18, Form 8824

Fresh forms and more info at www.1031TaxPak.com

WorkSheet #9 – Completing Form 8824.

Now it's time to fill in the blanks on Form 8824. In WorkSheet #9, we have given you a quick reference to complete this final task. The only new calculations at this point are the realized and recognized gains. **Line 19** of Form 8824 calculates realized gain. Realized gain is the actual amount of 'profit' or gain you received from the sale of your Old Property. It is NOT how much gain you pay tax on – remember: that is called *recognized gain.*

WorkSheet #9 - Completing Form 8824

Line 1	WorkSheet #3 (Line A)	RENTAL HOUSE
Line 2	WorkSheet #4 (Line A)	RENTAL HOUSE
Line 3	WorkSheet #3 (Line F)	01/10/2001
Line 4	WorkSheet #3 (Line C)	12/20/2013
Line 5	WorkSheet #4 (Line D)	02/04/2014
Line 6	WorkSheet #4 (Line C)	03/12/2014
Line 7	Check the appropriate box	
Lines 8-11	See Page 6 of the Guide Book * The **actual** GuideBook; NOT this buy-down example.	
Lines 12-14	Complete if other property is involved	
Line 15	WorkSheet #7 (Line J)	8,000
Line 16	WorkSheet #4 (Line E)	80,000
Line 17	**ADD:** Line 15 and 16	88,000
Line 18	WorkSheet #8 (Line J)	31,544
Line 19	**SUBTRACT:** Line18 FROM Line17	56,456
Line 20	Smaller of Line 15 or 19, but not less than 0	8,000
Line 21	If buying down, then WorkSheet #10 (Line C)	8,000 * WorkSheet #10 explains this adjustment.
Line 22	**SUBTRACT:** Line 21 FROM Line 20, but not less 0	0
Line 23	**ADD:** Line 21 and Line 22	8,000
Line 24	**SUBTRACT:** Line 23 FROM Line 19	48,456
Line 25	**ADD:** Line 18 and Line 23, then **SUBTRACT:** Line 15	31,544
Line 26-38	Not applicable to 1031 exchanges	

Deferred Gain *– The amount of realized gain that is rolled forward into your New Property. No tax is paid at this time on the deferred gain.*

In our buy-down example, the realized gain is the purchase price of Fred and Sue's New Property calculated on **Line 17** ($88,000) minus their basis in the property calculated on **Line 18** ($31,544). Their realized gain is $56,456 ($88,000 minus $31,544). The amount of this deferred gain actually makes sense when you think about what happened: the Old Property sold that has a basis of $31,544 for $100,000. This resulted in a gain of $68,456. When Fred and Sue take this gain and subtract the costs incurred to sell the Old Property and to buy the New Property of $12,000, and subtract the $8,000 of recognized gain calculated on **Line 23**, you arrive at the same deferred gain of $48,456 that is calculated on **Line 24** of Form 8824. The amount of your recognized gain also makes sense: you bought down by $20,000 (from $100,000 to $80,000), but you had closing costs of $12,000. So, the net taxable amount is $8,000 ($20,000 minus $12,000).

WorkSheet #10 – Calculating Depreciation Recapture
(FOR BUYING DOWN ONLY)

Because you have a taxable gain, complete WorkSheet #10 to figure the character of the gain. The character of the gain determines which tax rate (recapture or non-recapture) you use to calculate your actual tax liability. The federal recapture tax rates are higher than non-recapture rates because the IRS allows you to offset ordinary income by reporting depreciation in the prior tax years while you held the property.

WorkSheet #10 – Calculation of Recapture for Form 8824, Line 21

A.	Depreciation taken in prior years from WorkSheet #1 (Line D)	$ 18,456
B.	Taxable gain from WorkSheet #7 (Line J)	$ 8,000
C.	**Total Recapture (Lesser of Line A or Line B)**	$ 8,000
		Carry to Line 21, Form 8824

Congratulations!

You've conquered the task of calculating your exchange! Now send your signed and completed 2-page 8824 Form along with your tax return to the IRS.

We hope this information and the WorkSheets provided are helpful. If you got stumped along the way or have follow-up questions, contact us at **taxpak@expert1031.com**. Or call us 24/7, nationwide toll-free, at **866-694-0204**. As always, *the Experts'* are available to assist you.

For other issues that may affect the reporting of your exchange, see page 19 of the main GuideBook.