

Taking The Mystery Out of the Tax Deferred Exchange


Chapter 14



The 1031 Tax Deferred Exchange

The 1031 Internal Revenue Code (IRC) tax deferred exchange has been created to encourage investors to move disposable cash at a maximum profit.


This is accomplished by deferring the taxes on the profit from one investment upon the disposition of that investment when the tax payer is investing in another investment. There are guidelines and rules.



The Problem With The Tax Deferred Exchange


The problem with the 1031 IRC tax deferred exchange is that people try and accomplish the exchange with two people and two properties. This is called the Two-Way Exchange.

99.9% of Tax Deferred Exchanges are accomplished using the 3-Way Exchange.



The Three-Way Exchange is the most common use of The Tax Deferred Exchange

The “Goat Story” is a good analogy of a real exchange. If you use the “Goat Story” or the “Automobile Story” to fall back on you’ll have two constant references you can refer to.



Ordinary work is an example of exchange.

Worker's exchange or trade their time, effort, and talent for something else. The something else is normally money.

Money made this exchange a good deal simpler than it was before money was universally accepted.



The “Goat Story”

Go back in time, if you will, to 800 BM. (Before Money) Imagine that I have a Cow that you would really like to have and you reasoned that one cow was worth two goats.

Before money bartering was a way of life but it was complicated. When someone worked their wages were paid in commodities. When they needed other things, other commodities, they had to trade what they had for what they needed.



The “Goat Story”

This bartering system was a complicated way of life. It was time consuming. Worse when they went to trade for what they needed the person who had what they needed often didn't want or need what they had.



The “Goat Story”

You own two goats but you would like to trade one of your two goats for a cow.

I have three cows and I would like a horse.

You try and exchange your goat for one of my cows but I already have six goats, I don't want another goat.



The “Goat Story”

We both want to do something so we get together and we come up with this plan.

We know a guy, Bill, who has six horses and it looks as if he could use a goat.

We contact him to see if he is interested.



The “Goat Story”

Bill wants to something as well. Bill would like to trade a horse for a goat.

We set the exchange up. You trade me a goat for one of my cows, now I have seven goats and two cows.

I trade bill a goat for a horse, now I have a horse, two cows and six goats.



The “Goat Story”

That’s the 3-Way exchange. You have the cow you wanted, I have the horse I wanted and bill has the goat he wanted.

It is very similar with real property. In real property exchanges, exchanges that are tax deferred, we normally have three players.

Exchanger — Seller — Buyer



The Automobile Story

The 1031 IRC (Internal Revenue Code) tax deferred exchange is very similar to the situation that exists when we trade a car in to a dealers.



The Automobile Story

You are driving down the street and you pass your friendly car dealers show room and in the window of the showroom is a brand new Mercedes Benz, you decide to stop and “just take a look”. You pull up to the showroom window and you park, go into the dealership and look longingly at the new Mercedes as you eagerly explore all of the wonderful features.



The Automobile Story

The dealer walks in as asks, “can I be o assistance?”. You quickly reply, “no just looking”.”but while your hear how much for this car?” ...”\$85,000” he replies ...”You really like it don’t you?” you nod and reply “yes but that’s too much”. The dealer looks out the showroom window “that your Lincoln”?



The Automobile Story

“Yes you reply”, he queries further
“Paid for?” “Yeah, paid for” you
counter. He reaches into his pocket and
gets out a little Blue Book “\$16,500” he
smiles. What did he just do? He just
appraised your old car, your Lincoln.



The Automobile Story

What did he just do?

He appraised your Lincoln.

Now really tempted you offer “Yes but I don’t have the other \$68,500”.

“No Problem” he replies \$1,200 a month.”



The Automobile Story

You pause for just a moment, searching your mind to determine if your budget can work in \$1,200 a month for your automobile needs.“great, I’ll take it”.



The Automobile Story

We sign the pink slip of the Lincoln, deeding the Lincoln to the car dealer. Sign some loan papers and drive off in our new Mercedes.

WHAT DID WE JUST DO?

We traded up. We exchanged the equity in our Lincoln for the Mercedes and got a new loan to make up the difference.



The Automobile Story

You are finished, you are the exchanger. You drive off happily in your new car.

Driving down the street with his brother-in-law, looking for a new set of wheels, is “B” the Buyer.

He sees your old car on the car dealers used car lot and says to his brother-in-law “stop let me take a look at that one”.



The Automobile Story

“B” the buyer stops to look at your old car. The dealer approaches with “like it don’t you.” The story repeats itself.

“B” puts what cash he has as a down payment, gets a new loan, and drives off with “his new car”, your old car.



The Automobile Story

That completes the 3-Way exchange automobile example. The only difference in the exchange of the automobiles and two pieces of property is that in the exchange of the real property you will vaguely know the three players as well as you will close all the transactions on the same day whenever possible.



The Automobile Story

The Parties to the Exchange.

1. You the Exchanger, only exchanged, you exchanged your old car for the new car and a loan.
2. The buyer only bought. He bought your old car, put cash as a down payment, and got a new loan.
3. The dealer is “S” the seller. He sells you the Mercedes, takes your Lincoln and sells your Lincoln to “B” the buyer.



Logical Sequence

Exchanges have a logical sequence.

There is a logical sequence to the transactions we accomplish in real estate. This is true of the 1031 IRC Tax Deferred Exchange as well.

This exchange can be reduced to four logical steps.



4 Logical Steps

- Step 1: Find the Real Fair Market Value of the Exchange Building.
- Step 2: An Exchange only listing. Then market the building.
- Step 3: Sell the building with the “Exchange Only Clause”.
- Step 4: Find an Up leg, make an offer, get it accepted, put it in escrow, close the escrow on the buildings.



Find the Market Value

The first and most critical step in the exchange is to find the real “FAIR MARKET VALUE” of the property to be exchanged. Do an appraisal/Fair Market Analysis. Do net sheets to see if the exchange is viable. You will need the “Adjusted Tax Bases” for this step.



Exchange Only Listing

The second step is to list the building on an exchange only basis. This can give you problems when the exchanger gets tired of looking for the up-leg, the exchange to property. You write a normal offer, with the closing predicated on the close of the down-leg or the property exchanged from.



Sell The Building

The third step is market and sell the building. It is critical that you at least have a valid offer, better yet is to have the down-leg in escrow before you even think of an up-leg.

Once the building has been sold, the walk through been done and accepted, most of the contingencies removed your exchanger is ready to seriously look for an up-leg property.



Find the Up-Leg

The fourth step is to make an offer on the up-leg, put it into escrow, then close the down-leg and the up-leg.

Recognize that the seller of the up-leg building may become the seller of the exchangers' original building. The seller of the down-leg.



Finding the Tax Basis

- Before you entertain the 1031 Tax Deferred Exchange you will want to find the Adjusted Tax Basis of the down-leg and make sure the Tax Deferred Exchange is practical, feasible and necessary.
If there is a loss or no gain on the down-leg you won't want an exchange.



Finding the Tax Basis

The “Adjusted Tax Basis” of any real property is the original cost, less any depreciation that has been taken, plus any capital additions that have been made;

Initial Cost – Depreciation + Capital Improvements = Adjusted Tax Basis



Costs in the Exchange

Your after sale tax basis would take into account the cost of selling the property. So we really have the selling price reduced by the disposition costs.

The acquisition costs on the new property would be added to that tax basis.

There is no penalty for using funds in the building for disposition and acquisition costs.



Finding The Tax Basis

You will normally be able to find the tax basis of any property on the owners last Income Tax Return, Schedule E.

You will have to adjust it from last December for whichever month you close in in the year of the sale.



Example of Tax Basis

Let's assume that your client purchased a 30 unit building fifteen years ago for \$900,000.

They put 30% down, \$270,000 down, and got a new first trust deed for \$630,000 at 9.75% interest, payable in equal monthly installments of \$5,412.67.

The building is comprised of all 2 Bedroom, 1 Bath units, the rents at purchase were \$275 per unit per month, expense of operation were running 30% of the Gross Scheduled Income, the vacancy factor was 2% of the G.S.I.



Example of Tax Basis

At the end of the year your client took the books and records to the accountant. The accountant informed the client that they could depreciate the building over a period of years for an additional tax write off. This is what the client had to do.



Example of Tax Basis

This is What Your Client Had to Do.

1. Figure out how much the land was worth at the time of the purchase.
2. Figure out how much the improvement was worth at the time of purchase.



Example of Tax Basis

How in the world did you go about finding these values? You found that the County Appraiser had appraised the property it looked something like this.

Land	\$125,000
Improvement	\$375,000
Personal Property	<u>\$ -0-</u>
Total Assessed Value	\$500,000



Find The Ratio

The next thing you need to do is find the ratio of land to improvement. The improvement is the value we are after.

$\frac{\text{Improvement Value}}{\text{Total Value}} = \text{Ratio of building value to total value}$

$$\frac{\$375,000}{\$500,000} = 75\%$$

The Buildings Value is 75% of the Total Value



Find The Building Value

We need to find the improvement value, the value of the building. Once we have the ratio it is simple enough. We multiply the total value by the ratio and we have the value of the improvement.

Improvement Value X Ratio of Improvement to Total Value

$$\$900,000 \quad X \quad 75\% \quad = \quad \$675,000$$



Establish The Economic Life & Depreciation To Use

Economic Life of buildings is set by Congress through the tax revenue codes. This can be complex at times.

Currently it is very simple. Residential Income Property is 27^{1/2} years, straight line only. Commercial Property is 39 Years, straight line only.

Our building is Residential Income Property so we will use 27^{1/2} years Straight Line Depreciation. This Straight Line simply means that the depreciation on a graph would make a straight line. Because the depreciation is the same each year.



Find The Annual Amount of Depreciation

The annual depreciation will be the Improvement Value by the Economic Life ($27\frac{1}{2}$ Years) and we will have the annual depreciation.

$$\text{Economic Life} \frac{\text{Annual Depreciation}}{\text{Improvement Value}}$$

$$27\frac{1}{2} \text{ Years} \frac{\$ 24,545}{\$675,000}$$



The Annual Depreciation Is

The annual depreciation is \$25,545

Each year that the owner owned this building they deducted \$25,545. We now need to find the total depreciation that the owner has taken over the 15 year period.

Annual Depreciation times 15 years, equals the total depreciation.

$$\$25,545 \quad \times \quad 15 \text{ Years} \quad = \quad \$383,175$$

The total depreciation on this building should be \$383,175



Find The Adjusted Tax Basis

The Adjusted Tax Basis will be the Purchase Price of the Building, including the Acquisition Costs less the Accrued Depreciation.

Purchase Price - Total Depreciation = Adjusted Tax Basis

$$\$900,000 - \$383,175 = \$516,825$$

More correctly we would take the improvement value at purchase, subtract the accumulated depreciation and add the land value back in. We would thus arrive at the same figure that we currently have. Note I did not take the acquisition costs into account.



Find The Gain

The gain is the amount that would be recognized as taxable income upon the sale of the property. It is called Potential Gain before the sale, Recognized or Realized Gain after the sale. It is Deferred Gain in a 1031 Tax Deferred Exchange. To find the Gain we have to establish the Adjusted Tax Basis which we have just gone to great lengths to find.

If we establish the current Fair Market Value of the property at \$2,940,000 we will be able to establish our Gain, in this case the Deferred Gain.

Find The Gain

$$\begin{array}{r} \text{Selling Price} - \text{Expenses of Sale} - \text{Adjusted Tax Basis} = \text{Gain} \\ \$2,940,000 - \$216,000 - \$516,825 = \$2,207,175 \end{array}$$

The Estimated or Indicated Gain is \$2,147,175. This means that if the owner sells the property they will have \$2,147,175 that is subject to Federal and State Taxes.

Federal Tax	=	Tax Rate	X	Indicated Gain	
Federal Tax	=	20%	X	\$2,207,175	= \$441,435
State Tax	=	5.5%		Indicated Gain	
State Tax	=	5.5%	X	\$2,207,175	= <u>\$121,395</u>
Total Tax				=	<u><u>\$562,830</u></u>



Taxes or Deferred Gain

Notice that the Adjusted Tax Basis and the Gain had nothing to do with the loans on the building.

Loans can be devastating in a number of ways. Loans do not contribute to the Tax Basis or the Gain, potential or realized, from the disposition of real property.



Estimated Fair Market Value

Now we must find the Estimated Fair Market Value of the building. We'll use the cost approach.

We have 30 units currently renting for \$1,000 each, \$600 in Laundry Income per Month, a 5% vacancy factor, 40% Expenses of Operation, a First Trust Deed in the amount of 70% of Value. We can currently get a 70% Loan at 7 1/2% interest, amortized for 30 years and payable in equal monthly payments.

Estimated Fair Market Value

Gross Scheduled Income	\$360,000	
Vacancy Factor 5%	(\$ 18,000)	
Gross Operating Income	\$342,000	
Expenses of Operation 40%	(\$144,000)	
Net Operating Income	\$198,000	
1 st Trust Deed Payments	(\$184,593)	= \$2,200,000 @7.5%
Sub-Total Net	\$ 13,407	
2 nd Trust Deed Payments	\$ -0-	= <u>\$ -0-</u>
Cash Flow	\$ 13,407	
Total Loans		\$2,200,000
Cash Down Payment 25%		<u>\$ 740,000</u>
Value of Building		\$2,940,000
Estimated Building Value	=	\$2,940,000



Gain

Now we will go through the Gain one more time. Gain is our profit for tax purposes. Gain has many names, names which should denote where the gain lies in relation to the probability of having to pay taxes on the gain.



Types of Gain


Realized Gain = Gain After the Sale

Recognized Gain = Recognized for Tax Purposes

Potential Gain = Gain Before You Sell


Potential Gain = Gain Before You Sell

Deferred Gain = Gain That is Deferred to a
Later Time as in the 1031
Tax Deferred Exchange



Comparing Situations for Client Explanation

Besides learning to do the exchange we need to learn to be able to advise clients why the exchange should be better for them. For this reason we want to compare two situations now. We will use the building we have been talking about in two Situations. In Situation I, we will sell the building pay the taxes, and buy another building. In Situation II, we will exchange our equity into another building. We will keep both buildings for 5 years assuming each appreciates 10% a year for the 5 year period. Then we will sell both buildings, pay the taxes in both examples and see if we have made any financial progress. In both situations the underlying loan is \$510, 938.



Find The Indicated Gain or the Deferred Gain In Situations I and II

Sell Pay Taxes, Buy

Selling Price	\$2,940,000
Sales Expense (\$ 216,000)	
Less Adjusted	
Tax Basis	<u>(\$ 516,825)</u>
Recognized	
Gain	<u><u>\$2,207,175</u></u>

Exchange

Exchange Price	\$2,940,000
Sales Expenses (\$ 216,000)	
Tax Basis	<u>(\$ 516,825)</u>
Deferred	
Gain	<u><u>\$2,207,175</u></u>

Notice the gain is identical in both Situations.



Cash Close of Escrow

The Gain, deferred or recognized, and the cash we get at the close of escrow are two very different numbers. They may be close but they are two very different numbers. One indicates that cash that you will have at the Close of Escrow from which taxes will be paid. The Gain indicates the amount of money that is taxable, but not the taxes.

These numbers are often very close. You should use work sheets when you are figuring the Cash Close of Escrow. You should use work sheets when you are figuring the Taxable Gain. Remember, you can close escrow with a large tax bill and no funds.

Estimated Before Tax Cash of Escrow

Cash Close of Escrow
Situation I Sell Pay Taxes Buy

Cash Close of Escrow
Situation II, Exchange

Selling Price	\$2,940,000
Sales Expense	(\$ 216,000)
Less Loan	<u>(\$ 510,825)</u>
Cash COE	\$2,213,175

Exchange Price	\$2,940,000
Sales Expenses	(\$ 216,000)
Less Loan	<u>(\$ 516,825)</u>
Exchange Cash	\$2,213,175

Estimated Taxes Federal & California

Situation I Sell Pay Taxes Buy

Recognized Gain	\$2,207,175
Federal Tax 20%	(\$ 441,435)
State Tax 11%	<u>(\$ 242,789)</u>
Total Taxes	<u><u>(\$ 684,224)</u></u>

Situation II Exchange Into 2nd Building

Deferred Gain	\$2,207,175
None Now	(\$None Now)
Sales Expenses	<u>(\$ None Now)</u>
Total Taxes	<u><u>\$None Now</u></u>




Estimated After Sale After Tax Cash for Down

Cash Close of Escrow
Situation I Sell Pay Taxes Buy

Cash COE	\$2,213,175
Less Taxes	<u>(\$ 684,224)</u>
Cash for Down	
Payment	\$1,528,951

Cash Close of Escrow
Situation II, Exchange

Cash COE	\$2,213,175
Less Taxes	<u>(\$None Now)</u>
Cash for Down	
Payment	\$2,213,175



The Advantage In An Exchange If There Is An Advantage

The advantage in an exchange is the fact that you are temporarily using the taxes you would have paid to invest in a new project. If that property goes up in value or earns a greater cash flow, before and after taxes, you should come out with an advantage.

Our estimated tax savings of \$684,224 should give us an advantage. How many times would you like to have borrowed tax free, \$684,224, with no payments and you would pay it back if your investment was successful and if you made a profit. If you ultimately lost you wouldn't have to pay the lost taxes.



Total Estimated Cash For Down Payment

Cash Close of Escrow
Situation I Sell Pay Taxes Buy

\$1,528,951

Cash Close of Escrow
Situation II, Exchange

\$2,213,175

Deferring the taxes in the exchange will give us 45% more for the down payment than in Situation I. What we want to do now is see how much more of a building we can buy with the larger down payment. Then if we keep that building for 10 years did the larger building generate more after tax capital.



This Leads Us to Two Situations

This gives us two situations. Situation I where we have sold a building, paid the taxes and are re-investing in a second building.

Situation II where we have Exchanged the building into a second building. In Situation II we have deferred the income taxes that were paid in Situation I.

What we want to decide is which situation is most probably the best financial move for us, or for our clients.



Learning to Estimate Cash Down Payment After Acquisition Costs

The Cash Down Payment, for the exchange property, and for the Sell Pay Taxes building will be taken from the Cash at Close of Escrow.

Cash down payments are a function of the current demand in the market. If the property that you want to exchange into has a great demand then the Cash Down Payment will normally have been driven upward as a percentage of the purchase price.



Acquisition Costs

Acquisition Costs for both Situation I and Situation II will be taken from the Cash at Close of Escrow.


Acquisition Costs are normally 2% to 3% of the purchase price of the new property.

In Both cases we use an interpolation technique. This is a very simple mathematical calculation.



If Down Payments are Currently 30% of the Purchase Price

Simply add the cash down payment 30% and the estimated acquisition costs of 3%, and divide the total cash at the close of escrow by 33%. The Cash Close of Escrow in Situation I is \$1,528,951 and the Cash at Close of Escrow is \$2,213,175 in Situation II. We divide the Cash Close of Escrow CCOE by the down payment as a percentage and the Acquisition Costs as a percentage and we come up with the two being divided by 33%.



Combine The 30% Cash Down Payment and the 3% Acquisition Costs

Cash Down Payment = 30%

Estimated Acquisition Costs = 3%

Here you will add 30% and 3% and come up with 33%.

Second you will divide the Cash from close of escrow by 33% and that will give you the approximate value of the building.

Estimated Building Values Situation I and Situation II

Situation I

Cash Close of Escrow \$1,528,941

Cash Close of Escrow divided by
Down Payment and Acquisition Costs,
in this case 33% = Approximate
Building Value.

$$\frac{\$1,528,941}{33\%} = \$4,633,155$$

Situation II

Cash Close of Escrow \$2,213,175

Cash Close of Escrow divided by
Down Payment and Acquisition Costs,
in this case 33% = Approximate
Building Value.

$$\frac{\$2,213,175}{33\%} = \$6,706,591$$

Once Value Is Estimated Acquisition Costs Can Be Estimated

Once you know the estimated value of the building you simply multiply the estimated value by 3%, the estimated costs, and subtract that 3% figure from the cash you have from escrow.

Situation I

Building Value	\$4,633,155
Building Value	\$4,633,155
Times	<u>3%</u>
Costs	\$ 138,995

Estimate a little higher \$ 143,155

Situation II

Building Value	\$6,706,591
Building Value	\$6,706,591
Times	<u>3%</u>
Costs	\$ 201,198

Estimate a little higher \$ 213,175



Once Costs are Estimated Cash Down Payment Can Be Estimated

Our estimated cash down payment is found by taking the Cash From Close of Escrow and Subtracting the Estimated Acquisition Costs.

Situation I

Estimated Costs	\$ 143,951
Cash From Escrow	\$1,528,951
Less Acq. Costs	<u>\$ 143,951</u>
Estimated Down	\$1,385,000

Situation II

Estimated Costs	\$ 206,591
Cash From Escrow	\$2,213,175
Less Acq. Costs	<u>\$ 213,175</u>
Estimated Down	\$2,000,000

Estimated Value of Buildings

The next thing we do is estimate the value of the building by dividing the down payment by 30%, and rounding the quotient to be more Market Like.

Situation I

Estimated Value \$4,617,000

Adjusted Estimated Value \$4,600,000

Situation II

Estimated Value \$6,706,591

Adjusted Estimated Value \$6,700,000

Estimated Number of Units

We can estimate the number of units simply by estimating the number of units in the building we sold or traded and dividing the per unit value into the estimated value. This will give us an estimated number of units and from this we can create a cash flow model.

We sold our downleg building for \$2,940,000. That building had 30 units. Our per unit value then is \$98,000 per unit.

Situation I

$$\begin{array}{r} \text{Estimated Value} \quad \$4,600,000 \\ \hline \text{Number of Units} \\ \hline \text{Unit Value} / \text{Building Value} \\ \hline 46.94 \text{ Units} \\ \hline \$98,000 / \$4,600,000 \end{array}$$

Situation II

$$\begin{array}{r} \text{Estimated Value} \quad \$6,700,000 \\ \hline \text{Number of Units} \\ \hline \text{Unit Value} / \text{Building Value} \\ \hline 68.37 \text{ Units} \\ \hline \$98,000 / \$6,700,000 \end{array}$$



Estimated Number of Units

Once we have an estimate of value and an estimated number of units we can build a cash flow picture and a five year prognosis of what is likely to happen with the value.

Situation I

47 Units

Situation II

68 Units



Estimated Rents and Annual Gross Scheduled Income

Our original 30 unit building had 2 Bedroom, 2 Bath units renting for \$1,000 per month. We will continue with these two examples earning \$1,000 per month per unit.

We will have a 5% Vacancy Factor, a 35% Expense of Operation, and we will be able to obtain a new loan of 70% LTV (Loan To Value) at 7.5% interest, amortized for 30 years with equal monthly payments.

Estimated Cash Flow At Purchase Situation I & Situation II


	Situation I	Situation II
Gross Scheduled Income	\$ 564,000	\$ 816,000
Vacancy Factor 5%	(\$ 28,200)	(\$ 40,800)
Gross Operating Income	\$ 535,800	\$ 775,200
Expenses of Opera. 35%	(\$ 197,400)	(\$ 285,600)
Net Operating Income	\$ 338,400	\$ 489,600
New 1 st Trust Deed	<u>(\$ 269,757) = \$3,215,000</u>	<u>(\$ 394,357) = \$4,700,000</u>
Cash Flow	\$ 68,643	\$ 95,243
Cash Down Payment 30%	<u>\$1,385,000</u>	<u>\$2,000,000</u>
Estimated Building Value	\$4,600,000	\$6,700,000
Gross Rent Multiplier	8.16 X's	8.21 X's
Capitalization Rate	7.3565%	7.3075%



Cash Flows 5% Increase End Year I

We will have the Gross Scheduled Income increase in value 5% each and every year. We will have the expenses increase 5% each and every year. Finally we will estimate the value of both buildings at the end of the 10th year, pay taxes and see which situation was the more profitable.

These calculations are not something that we go through each and every time we do an exchange. It is an exercise we should go through at least one time so we have a real knowledge of the advantages, and the weaknesses of the tax deferred exchange.



Estimated Tax Basis At Purchase & Exchange

The tax basis at purchase for Situation I will be the Purchase Price and most of the Acquisition Costs. We will simply use the Purchase Price as the Tax Basis is Situation I.

The tax basis at exchange is a little more complicated. In the next slide we will adjust the Tax Basis for Situation I and Situation II.

Adjusted Tax Basis Situations I & II

	Situation I	Situation II
Purchase Price of Building	\$4,600,000	\$6,700,000
Plus Acquisition Costs	\$ 143,951	\$ 213,175
Less Deferred Gain	\$ None	(\$2,207,175)
Adjusted Tax Basis	\$4,743,951	\$4,706,000

The Formula For The Exchanged Into Property

Purchase Price + Acquisition Costs - Deferred Gain = Adjusted Tax Basis



Adjusted Tax Basis Situations I & II

We find the adjusted tax basis so we can take the allotted tax depreciation. This amounts to \$25,000 a year for most investors. The Revenue Act of 1986 allows the building to shelter passive income. The first income that the asset shelters is the cash flow from the investment. Then, with real estate, Active Income, (Regular Income) can be sheltered up to \$25,000 annually.

You should remember that real estate has never been a **GREAT TAX SHELTER**. In most cases tax benefits are minimal but they do enhance the investment.




What Can We Expect For The Next 10 Years

We never know what to expect for any given period of time. We will assume for our exercise that we have an economy that supports the building going up in value 5% each year and expenses increasing 5% each year.

In California we know that California Real estate has a propensity to increase in value 5% annually over a thirty year period.

A plainer way of putting it is we simply don't know. If you can hang onto the real estate long enough you will likely make money.



What Can We Expect at 5% Annual Appreciation For The Next 10 Years


5% Appreciation for 10 years would be stated mathematically like this:

$(1+I)^n = (1+0.05)^{10}$ This simply means 1.05% times itself 10 times or;
 $1.05 \times 1.05 \times 1.05 \times 1.05 \times 1.05 \times 1.05 \times 1.05 \times 1.05 \times 1.05 \times 1.05 = 1.628895$

This problem is a natural for your Y^x on your calculator or if you have a constant you type 1.05×1.05 and $= = = = = = = = = =$ and you get 1.628895.

You can set it up on your N I PV PMT FV keys on any financial calculator.

It is the beginning of you discovering the 6 Functions of \$1.



What Can We Expect at 5% Annual Appreciation For The Next 10 Years

Now we simply multiply our original value by 1.628895 and we will have the five year value in Situation I and Situation II.

Situation I Starting Value	=	\$4,600,000
\$4,600,000 X 1.628895	=	\$7,492,915
Round that to	=	\$7,500,000

Situation II Starting Value	=	\$ 6,700,000
\$6,700,000 X 1.628895	=	\$10,913,594
Round that to	=	\$10,925,000



After Tax Cash Flow Year I

We know we have an estimated cash flow in year 1, but we also have a tax savings against our ordinary income. We can deduct as much as \$25,000 from our regular income and apply that to our Federal and State Marginal Tax Brackets.

When we do that we have what is commonly called after tax cash flow. Our returns for investment properties are in four separate areas.



Tax Basis For Depreciation Year I Situation I and Situation II

Since building depreciation for taxes involves only the improvement we have to establish a value for the improvement and for the land. First you will find the tax basis for both Situations.

	Situation I	Situation II
Cost	\$4,600,000	\$6,700,000
Adjusted Cost Basis	\$4,743,951	\$4,706,000

Improvement Value For Depreciation Situation I & Situation II

	Situation I	Situation II
Adjusted Cost Basis	\$4,743,951	\$4,706,000
Estimated Improvement Value	X 70%	X 70%
Estimated Building Value	\$3,320,766	\$3,294,200

Estimated Annual Depreciation Situation I & Situation II

Annual Depreciation
Depreciable Years / Estimated Building Value

$$27^{1/2} \text{ Years} \frac{\$120,755}{\$3,320,766} \quad 27^{1/2} \text{ Years} \frac{\$119,789}{\$3,294,200}$$

Estimated
Building
Value

\$3,320,766


\$3,294,200



10 Year Values at 5% Annually

Now we will look at the 10 year value of Situation I and Situation II. We'll sell the buildings and find out what our after sale returns will be.

	Situation I	Situation II
Value at Purchase	\$ 4,600,000	\$ 6,700,000
Value End Year I	\$ 4,830,000	\$ 7,035,000
Value End Year II	\$ 5,070,000	\$ 7,385,000
Value End Year III	\$ 5,325,000	\$ 7,756,000
Value End Year IV	\$ 5,590,000	\$ 8,145,000
Value End Year V	\$ 5,870,000	\$ 8,550,000
Value End Year VI	\$ 6,165,000	\$ 8,978,000
Value End Year VII	\$ 6,472,000	\$ 9,427,500
Value End Year VIII	\$ 6,796,000	\$ 9,898,000
Value End Year IX	\$ 7,136,000	\$ 10,395,000
Value End Year X	\$ 7,492,000	\$ 10,914,000



Estimated Annual Depreciation Situation I & Situation II

Since both Situation I and Situation II are more than \$25,000 a year, and our assumption is that our investor is using passive write off, we are limited to \$25,000 in Improvement Depreciation Annually.

The next frame gives us, as brokers, a good format for figuring the annual tax picture of any investment property. We will add the vacancy factor which an accountant wouldn't do. Still, for our purposes it gives us a consistent picture of the "After Tax Cash Flow".

Tax Savings Year I

	Situation I	Situation II
Gross Scheduled Income	\$ 564,000	\$ 816,000
Vacancy Factor 5%	(\$ 28,200)	(\$ 40,800)
Expenses of Operation 35%	(\$ 197,400)	(\$ 285,600)
Interest From Loan Year 1	(\$ 240,120)	(\$ 351,031)
Depreciation	(\$ 25,000)	(\$ 25,000)
Total Deductions	<u>(\$ 490,720) (\$ 490,720)</u>	<u>(\$ 702,431) (\$ 702,431)</u>
Net Tax Loss or Gain	\$ 73,280	\$ 113,569
Estimated Taxes	\$ 29,312	\$ 45,428
40% Marginal Bracket	<u><u>\$ 29,312</u></u>	<u><u>\$ 45,428</u></u>


This example shows us that regardless of the cash flow year 1, the tax write off is zero. There is a taxable income of \$73,280 in Situation I and \$113,569 in Situation II. If the tax payer is in a 40% Marginal Tax Bracket their taxes would be \$29,312 in Situation I and \$45,428 in Situation II.



Four Areas of Return Investment Real Estate

	Situation I	Situation II
Cash Flow	\$ 68,643	\$ 95,243
Tax Savings	(\$ 29,312)	(\$ 45,428)
Equity Buildup	\$ 49,422	\$ 72,250
Appreciation	<u>\$ 230,000</u>	<u>\$ 335,000</u>
Total Returns	<u><u>\$ 318,753</u></u>	<u><u>\$ 457,065</u></u>

The “After Tax Cash Flow” would be \$39,331 in Situation I and \$49,815 in Situation II. In both Situations the Tax Basis was diminished by \$25,000, the maximum allowed for this investor.



Four Areas of Return As A Percentage of Cash Invested

These returns are normally measured by the initial cash investment. There are other methods of measurement that we will look at later. For now we want to see what kind of return we have at the end of our first year.

	Situation I	Situation II
Cash Invested	\$1,385,000	\$2,000,000
Cash Flow	\$ 68,643 = 5%	\$ 95,243 = 5%
Tax Savings	(\$ 29,312) = -2%	(\$ 45,428) = -3%
Equity Buildup	\$ 49,422 = 4%	\$ 72,250 = 4%
Appreciation	\$ 230,000 = 17%	\$ 335,000 = 17%
Total Return	\$ 318,753 = 23%	\$ 457,065 = 23%




Remember The Rule of 72

The “Rule of 72” simply tells us that any compounded rate of return that is divided into the number 72 will give us the number of years it will take any amount of money to double.

This means that if you have a compounded 10% annual return and you divide it into 72 it will tell you that you will double any amount of money in 7.2 years.

$$\frac{72}{\text{Compounded Annual Interest Rate}} = \frac{72}{10} = 7.2 \text{ Years}$$

Any number Annually Compounded Interest Rate will give the same result.



Gross Scheduled Income With 5% Annual Rent Raises

Situation I

Situation II

Rents at Acquisition	\$	564,000	\$	816,000	
End Year I	5% ↑	\$	592,200	\$	856,800
End Year II	5% ↑	\$	621,810	\$	899,640
End Year III	5% ↑	\$	652,930	\$	944,622
End Year IV	5% ↑	\$	685,545	\$	991,853
End Year V	5% ↑	\$	719,822	\$	1,041,446
End Year VI	5% ↑	\$	755,813	\$	1,093,518
End Year VII	5% ↑	\$	793,604	\$	1,143,194
End Year VIII	5% ↑	\$	833,284	\$	1,205,604
End Year IX	5% ↑	\$	874,948	\$	1,265,884
End Year X	5% ↑	\$	918,696	\$	1,329,178

Cash Flow At 5% Annual Raises

The following cash flows are a result of the rents increasing by 5% annually, the vacancy factor remains 5% of the GSI, the expenses remain 30% of the GSI, and the loan payments are static.

			Situation I	Situation II
Cash Flow at Purchase	\$		68,643	\$ 95,243
End Year I	5%	↑	\$ 85,563	\$ 119,723
End Year II	5%	↑	\$ 103,329	\$ 145,427
End Year III	5%	↑	\$ 121,983	\$ 172,416
End Year IV	5%	↑	\$ 141,570	\$ 200,756
End Year V	5%	↑	\$ 162,137	\$ 230,510
End Year VI	5%	↑	\$ 183,731	\$ 261,754
End Year VII	5%	↑	\$ 206,406	\$ 294,559
End Year VIII	5%	↑	\$ 230,213	\$ 329,005
End Year IX	5%	↑	\$ 255,213	\$ 365,173
End Year IX	5%	↑	\$ 281,461	\$ 403,150



Ten Year Tax Savings

The tax savings any year will be the Net Operating Income, less the interest on the loans, and less any depreciation. Since the write off is normally Passive Income we can only take \$25,000 a year. In our 48 % Combined Marginal Tax Bracket the maximum write off in any year will be \$12,000. As the income increases we could get to the point that the only write off the building is generating is sheltering the cash flow from the building.

Net Tax Loss or Gain

Situation I

Situation II

End Year I

NOI	\$355,320	\$514,080
Interest	(\$237,752)	(\$351,031)
Depreciation	<u>(\$ 25,000)</u>	<u>(\$ 25,000)</u>
Tax Loss or Gain	\$ 92,568	\$138,049

End Year II

NOI	\$375,086	\$539,784
Interest	(\$230,086)	(\$347,667)
Depreciation	<u>(\$ 25,000)</u>	<u>(\$ 25,000)</u>
Tax Loss or Gain	\$ 120,057	\$167,117

End Year III

NOI	\$392,758	\$566,773
Interest	(\$221,707)	(\$344,043)
Depreciation	<u>(\$ 25,000)</u>	<u>(\$ 25,000)</u>
Tax Loss or Gain	\$145,051	\$197,730

Net Tax Loss or Gain

Situation I

Situation II

End Year IV

NOI	\$411,327	\$595,112
Interest	(\$212,738)	(\$340,136)
Depreciation	<u>(\$ 25,000)</u>	<u>(\$ 25,000)</u>
Tax Loss or Gain	\$173,589	\$229,976

End Year V

NOI	\$431,293	\$624,867
Interest	(\$203,074)	(\$335,927)
Depreciation	<u>(\$ 25,000)</u>	<u>(\$ 25,000)</u>
Tax Loss or Gain	\$203,819	\$263,940

End Year VI

NOI	\$453,488	\$656,111
Interest	(\$192,660)	(\$331,391)
Depreciation	<u>(\$ 25,000)</u>	<u>(\$ 25,000)</u>
Tax Loss or Gain	\$235,828	\$299,720

Net Tax Loss or Gain

Situation I

Situation II

End Year VII

NOI	\$475,838	\$688,916
Interest	(\$181,436)	(\$326,503)
Depreciation	<u>(\$ 25,000)</u>	<u>(\$ 25,000)</u>
Tax Loss or Gain	\$269,402	\$337,413

End Year VIII

NOI	\$499,970	\$723,362
Interest	(\$169,341)	(\$321,235)
Depreciation	<u>(\$ 25,000)</u>	<u>(\$ 25,000)</u>
Tax Loss or Gain	\$305,629	\$377,127

End Year IX

NOI	\$524,969	\$759,530
Interest	(\$156,307)	(\$315,559)
Depreciation	<u>(\$ 25,000)</u>	<u>(\$ 25,000)</u>
Tax Loss or Gain	\$343,662	\$418,971

Net Tax Loss or Gain

Situation I

Situation II

End Year X

NOI	\$551,218	\$797,507
Interest	(\$142,262)	(\$309,441)
Depreciation	<u>(\$ 25,000)</u>	<u>(\$ 25,000)</u>
Tax Loss or Gain	\$383,956	\$463,066



Estimated Taxes From Situations

Estimated tax savings 48% Marginal Tax Bracket California State and Federal Taxes. Each year will be a loss in Situation I and II

	Situation I	Situation II
Year I	(\$ 44,433)	(\$ 66,264)
Year II	(\$ 57,627)	(\$ 80,216)
Year III	(\$ 69,625)	(\$ 94,910)
Year IV	(\$ 83,323)	(\$ 110,388)
Year V	(\$ 97,833)	(\$ 126,691)
Year VI	(\$113,197)	(\$ 143,866)
Year VII	(\$129,313)	(\$ 161,958)
Year VIII	(\$146,702)	(\$ 181,021)
Year XI	(\$164,958)	(\$ 201,106)
Year X	(\$184,299)	(\$ 222,272)

These negative numbers mean the taxpayer will have to pay that amount in taxes.

After Tax Cash Flows

The After Tax Cash Flow will be the Cash Flow Less Taxes.

	Situation I	Situation II
End Year I		
Cash Flow	\$ 85,563	\$113,723
Tax Savings	<u>(\$ 44,433)</u>	<u>(\$ 66,264)</u>
After Tax Cash Flow	\$ 41,130	\$ 47,459
End Year II		
Cash Flow	\$103,329	\$145,427
Tax Savings	<u>(\$ 57,627)</u>	<u>(\$ 80,216)</u>
After Tax Cash Flow	\$ 45,702	\$ 65,211
End Year III		
Cash Flow	\$ 121,983	\$172,416
Tax Savings	<u>(\$ 69,625)</u>	<u>(\$ 94,910)</u>
After Tax Cash Flow	\$ 52,358	\$ 79,506

After Tax Cash Flows

	Situation I	Situation II
End Year IV		
Cash Flow	\$141,570	\$200,756
Tax Savings	<u>(\$ 83,323)</u>	<u>(\$110,388)</u>
After Tax Cash Flow	\$ 58,247	\$ 90,368
End Year V		
Cash Flow	\$162,137	\$230,510
Tax Savings	<u>(\$ 97,833)</u>	<u>(\$126,691)</u>
After Tax Cash Flow	\$ 64,304	\$103,819
End Year VI		
Cash Flow	\$183,731	\$261,754
Tax Savings	<u>(\$113,197)</u>	<u>(\$146,866)</u>
After Tax Cash Flow	\$ 70,534	\$114,888

After Tax Cash Flows

Situation I

Situation II

End Year VII

Cash Flow	\$206,406	\$294,559
Tax Savings	<u>(\$129,313)</u>	<u>(\$161,958)</u>
After Tax Cash Flow	\$ 77,093	\$132,601

End Year VIII

Cash Flow	\$230,213	\$329,005
Tax Savings	<u>(\$146,702)</u>	<u>(\$181,021)</u>
After Tax Cash Flow	\$ 83,511	\$147,984

End Year IX

Cash Flow	\$255,213	\$365,173
Tax Savings	<u>(\$164,958)</u>	<u>(\$ 201,106)</u>
After Tax Cash Flow	\$ 90,255	\$164,067

After Tax Cash Flows

Situation I

Situation II

End Year X

Cash Flow	\$ 281,461	\$401,150
Tax Savings	<u>(\$ 184,299)</u>	<u>(\$222,272)</u>
After Tax Cash Flow	\$ 97,162	\$178,878



After Tax Cash Flows – Capsulated

Situation I

Situation II

End Year I	\$ 41,130	\$ 47,459
End Year II	\$ 45,702	\$ 65,211
End Year III	\$ 52,538	\$ 79,506
End Year IV	\$ 58,247	\$ 90,368
End Year V	\$ 64,304	\$ 103,819
End Year VI	\$ 70,534	\$ 114,888
End Year VII	\$ 77,093	\$ 132,601
End Year VIII	\$ 83,511	\$ 147,984
End Year IX	\$ 90,255	\$ 164,067
End Year X	\$ 97,167	\$ 178,878



Sell The Properties – Pay Taxes

Next, we want to sell the properties in Situation I and Situation II.

This will tell us which situation makes the most sense and if this Tax Deferred Exchange was better than Sell Pay Taxes and Buy.

You have to develop techniques that will quickly indicate if the tax deferred exchange is profitable in that particular circumstance.

Sell The Properties – Pay Taxes

Estimated Values End of Year 10

	Situation I	Situation II
	47 Units	68 Units
Gross Scheduled Income	\$ 918,697	\$1,329,178
Vacancy Factor 5%	(\$ 45,935)	(\$ 66,459)
Gross Operating Income	\$ 872,762	\$1,262,719
Expenses of Opera. 35%	(\$ 321,544)	(\$ 465,212)
Net Operating Income	\$ 551,218	\$ 797,507
New 1 st Trust Deed	(\$ 462,272) = \$5,250,000*	(\$ 673,596) = \$7,650,000*
Cash Flow	\$ 88,946	\$ 123,911
Cash Down Payment 30%	<u>\$2,960,000</u>	<u>\$4,265,000</u>
Estimated Building Value	\$7,500,000	\$10,925,000
Gross Rent Multiplier	8.164 X's	8.22 X's
Capitalization Rate	7.35%	7.30%

* 8% interest, amortized for 30 years, monthly payments



Sell The Properties – Pay Taxes

	Situation I 47 Units	Situation II 68 Units
Selling Price	\$7,500,000	\$10,925,000
Expenses of Sale 8%	(\$ 600,000)	(\$ 874,000)
Less Loans of Record	<u>(\$2,790,459)</u>	<u>(\$ 4,079,364)</u>
Estimated Net Cash Close of Escrow (COE)	\$4,109,541	\$ 5,971,636

Here we have the net cash at close of escrow. The taxes have not been paid yet. Before taxes our exchange situations is ahead of the Sell Pay Taxes investment by \$1,862,095

Sell The Properties – Pay Taxes

Estimated Adjusted Tax Basis

	Situation I 47 Units	Situation II 68 Units
Basis at Purchase and Exchange	\$4,743,951	\$4,706,000
Less 10 years of Depreciation	<u>(\$ 250,000)</u>	<u>(\$ 250,000)</u>
Adjusted Tax Basis	\$4,443,951	\$4,456,000

Sell The Properties – Pay Taxes

Estimated Taxable Gain

	Situation I 47 Units	Situation II 68 Units
Selling Price	\$7,500,000	\$10,925,000
Less Expenses of Sale 8%	(\$ 600,000)	(\$ 874,000)
Less Adjusted Tax Basis	<u>(\$4,743,951)</u>	<u>(\$ 4,706,000)</u>
Estimated Gain	<u><u>\$2,156,049</u></u>	<u><u>\$ 5,345,000</u></u>

Sell The Properties – Pay Taxes

Estimated Taxes

	Situation I 47 Units	Situation II 68 Units
Estimated Gain	\$2,156,049	\$ 5,345,000
Estimated State and Federal Taxes	<u>X 25.5%</u>	<u>X 25.5%</u>
Estimated Taxes	\$ 549,793	\$1,362,975

Sell The Properties – Pay Taxes

After Sale, After Tax Net Both Situations

	Situation I 47 Units	Situation II 68 Units
Estimated Net Cash Close of Escrow	\$4,109,951	\$5,971,636
Less Estimated State and Federal Taxes	<u>(\$ 549,793)</u>	<u>(\$1,362,975)</u>
Estimated Net After Taxes	\$3,560,158	\$4,608,661

We find that the exchange has achieved a greater return.
\$1,048,503 more than Situation I

10 Year Returns

	Situation I	Situation II
Initial Investment	\$1,385,000	\$2,000,000
End Year I	\$ 41,130	\$ 47,459
End Year II	\$ 45,702	\$ 65,211
End Year III	\$ 52,538	\$ 79,506
End Year IV	\$ 58,247	\$ 90,368
End Year V	\$ 64,304	\$ 103,819
End Year VI	\$ 70,534	\$ 114,888
End Year VII	\$ 77,093	\$ 132,601
End Year VIII	\$ 83,511	\$ 147,984
End Year IX	\$ 90,255	\$ 164,067
End Year X	\$ 97,167	\$ 178,878
After Tax Net		
Cash COE Year X	\$3,560,158	\$4,608,661



Various Returns

	Situation I 47 Units	Situation II 68 Units
Initial Investment		
Internal Rate of Return	12.998%	12.287%
Average Annual Rate of Return	13.311%	12.78%
Simple Rate of Return	30.62%	28.67%



Irony of Returns

The irony of returns is that if the investments are not identical in their beginnings the final results can be quite deceiving.

Here we have a wonderful example, the exchange, making a good deal more money over a 10 year period, giving a greater return at the end of the 10 year period, and the rate of return is less than in the Sell, Pay Taxes, and Buy, situation I. INTERESTING.



Elements of The Tax Deferred Exchange

A Tax Deferred Exchange Can Fall Into Three Categories

1. Entirely Tax Deferred
2. Partially Tax Deferred
3. Entirely Taxable



To Be Entirely Tax Deferred

To be entirely tax deferred, the tax payer cannot receive;


1. Cash
2. Mortgage Relief
3. Boot



To Be Entirely Tax Deferred *continued*

If cash, mortgage relief, or boot are received by the tax payer, it does not necessarily void the exchange. The exchange will likely become a partially tax deferred exchange.

Commissions – Selling Expenses – Acquisition Costs are exempt from taxes in the exchange. These costs are taken from the basis or added to the basis as the case may be. See Internal Revenue Ruling 72-456..



Internal Revenue Service Ruling 72-456

In 1972 the Commissioner of the Internal Revenue Service issued a bulletin which stated that the commissions were exempt when considering cash taken out of the exchange. Later, upon request, the Commissioner went further and said that this should be interpreted to include selling expenses and acquisition costs.



Cash Taken From The Exchange

For the exchange to be totally tax deferred, the exchanger cannot take any cash out of the exchange for himself. Taking cash out of the exchange does not nullify or void the exchange if it is otherwise done properly, it makes the exchange a partially tax deferred exchange, with the cash that was removed from the body of the exchange becoming taxable. This cash would be taxed at whatever rate it would have been taxed at had there been a straight sale.



Paper Carried

Notes in The Exchange

If the exchanger carries paper back, carries a 1st, 2nd or more junior note, and that note is not exchanged through to the seller of the exchange property, or the note sold for cash and the cash used in the exchange the paper would be taxed at whatever rate it would normally be taxed at, and the equity that is exchanged to the new property would be tax deferred.

Currently if a tax payer carries back paper in the sale of a property that paper would be treated as an installment sale for tax reporting purposes.



One Method

Taking Cash From The Exchange

There is only one method of taking cash out of an exchange property.

That is to refinance the property before the exchange or borrow needed money before the exchange.

If the investor refinances in anticipation of the exchange then the refinance would be treated as cash or boot.



Taking Cash From The Exchange

If you were to refinance an investment property 6 months or 1 year before an exchange, and you didn't refinance to take money out of the exchange it would be a legitimate way of extrapolating cash from the exchange property.

By the same token if you exchanged a property and then took a loan out of the new property this would be a legitimate tax free event.



Mortgage Relief

Mortgage relief is when you exchange a building with a loan in a given amount into a building with a loan of a lesser amount.

Mortgage relief is taxed as cash received in the year of the sale or the year of the exchange.

When the mortgages on the new property are equal to, or greater than, the mortgages on the old property there is no mortgage relief.



Even or Up Rules

The easiest rule to use is the “Even or Up Rule”. The even or up rule simply states that the building exchanged into should be greater in value than the building exchanged from. In addition, the mortgage on the exchanged into should be greater than the mortgage on the exchanged from building.

Additionally, any cash added to the exchanged into building would offset any taxable funds.



For a Totally Tax Deferred Exchange

The Exchanged To Building
should be
Equal or Greater In Value
To The Exchanged From Building

The Loans on the Exchanged Into Building
should be
Equal To or Greater Than The Loans On
The Exchanged From Building



“Boot”

Boot is an old Scottish or Gaelic word that means “In Addition To”.

You may have heard this term in an old cowboy movie. Such as “how much do you want for the saddle?” – the questioned replies – “Twenty Five dollars” -- The offeror replies . . . “I’ll give you twenty dollars, my old saddle and this six gun to boot.”

Boot can be anything. In the exchange it simply means unlike property was involved.



“Like for Like Rules”

The like for like rules apply to exchanging real property for “Like Kind” property, in other words, if the property you own is not exchanged for “like kind” property, property that is designated the same by the Internal Revenue Service, you will not have a valid “Tax Deferred Exchange.” The “Like for Like Rules” are really quite simple. The real property has to be exchanged for real property that is to accomplish the same thing, or the same goal.



Like For Like Rules Continued

The owner's intent concerning their reason for owning the property is the important thing. They must exchange the property for property that is like the property they are exchanging into. The exchanged property has to be exchanged into a property that is being held for the same reason.

When you analyze that you will come up with real property being held for investment being exchanged for real property being held for investment.



Like for Like Rules *Continued 3*

Some people interpret this as an apartment building being exchanged for an apartment building, or raw land for raw land. The intent of the Congress was investment for investment.

You couldn't exchange a four plex rented to tenants for a home for yourself.

“Property held for productive use in trade or business, or for investment.”



Personal Residences

Personal residences fall under Internal Revenue Code 1034. Currently 1034 is very liberal. If you live in a home for 2 years of the last five you qualify for an exemption of gain up to \$500,000. Sometimes we run into the situation where an owner lives in one of the apartments in a residential income property. There square footage is important. The square footage of the owner's unit is 1034 property and would qualify for 1034 treatment. The remainder of the square footage would be 1031 and qualify for a deferred exchange.



The Three Way Exchange

The three-way exchange is the most common and the most logical. The three way exchange is the most used exchange. The three way involves three owners and two properties.

If you concentrate on the three way exchange the 4-Way, 5-Way and so on will become very easy for you to understand.

The 2-Way exchange is rare.



Parties to a 3-Way Exchange

Different Authors identify parties in the exchange differently, but normally alphabetically. When your first learning the exchange the following seems to be the easiest to remember.

PARTY “E”	=	EXCHANGER
PARTY “S”	=	SELLER
PARTY “B”	=	BUYER



Parties To The Exchange

Party “E” is the Exchanger. Party “E” exchanges real property that he/she currently owns, into a property that is for sale.

Party “B” is the Buyer. Party “B” buys Party “E’s” building that “E” is exchanging from.

Party “S” is the Seller. In most exchanges there has to be one Seller. Party “S” is selling his real property.



“B” The Buyer

- ◆ “B”, the Buyer only wants to buy. He doesn’t care who he buys from as long as he gets clear title. He is trying to buy “E” the exchangers building, he can buy it from “E” the Exchanger or from “S” the Seller. It is important that you recognize he doesn’t care who he buys the real property from.



“S” The Seller

“S” the seller only wants to sell. He really only wants to sell his real property. If he has to sell his property and another property he may do it, but only if he has no liability for 2nd property he sells, which was his property for a few seconds in escrow. Ideally, “S”, sells his property to “E” the exchanger, and sells “E” the Exchanger’s building to “B” the Buyer.



“E” The Exchanger

“E”, the exchanger wants to exchange his building to defer the payment of taxes. This has the effect of letting him invest his deferred taxes into the new real property, thus maximizing the value of the property, or minimizing the loan on the next property, and if the property goes up in value he will pay taxes on the gain, along with the deferred taxes, but he won't have to pay interest on this deferred tax money.



Who Gets What?

Learning the exchange from a book, without actually doing an exchange is a disadvantage. The most positive way to learn the 1031 Tax Deferred Exchange is to do at least one and preferably several.

Lacking the opportunity to do an exchange you can learn the technique from a book, but it is never as good as the real thing. Like learning to play basketball from a text book.



Who Gets What *page 2*

One of the difficult things in the exchange for brokers/salespersons and escrow officers is to balance the flow of money and notes between the exchanger, seller, and buyer. If you figure a normal net sheet for each principle in the exchange, it simplifies the problem. You will get confused from time to time, with practice balancing the exchange will become second nature to you.



A Hypothetical Exchange

We will put a hypothetical exchange together. We will have an “Exchanger” with a 30 unit building who wants to exchange into a larger building. “E”, the exchanger has found a 64 unit building for sale.

The 64 unit building has been listed by, “S” the seller, the seller of the 64 unit building does not want the 30 unit building. The Seller, “S” will participate in the exchange providing there is not additional liability or costs to them, (INDEMNIFICATION AGREEMENT) and that they will be in the same position as they would be in if they simply sold their building.



A Hypothetical Exchange

“E”, the Exchanger has had their 30 unit building on the market for sometime, and “B”, the Buyer has presented an offer to “E”, the Exchanger, the offer has been accepted by “E”, the Exchanger in writing, with the contingency that “E”, the Exchanger will have to find a building to exchange into before they, “E”, will be able to go through with the exchange.



A Hypothetical Exchange

“E”, the exchanger has to find a building before they will be able to go through with the exchange. The Buyer, “B”, accepts on that basis, and with an additional notation that “B”, the buyer may be buying the building from a third party, a Seller of “E’s” choice, further it is agreed that “B” the buyer will not incur any additional charges or liabilities because of this exchange.



The Elements of the Exchange

“E”

30 Unit
Exchanger
Only
Exchanges
30 Units
To “S” for
the 64 Units

“S”

64 Unit
Seller Only
Sells
Everything
Sells 64 Units
Sells 30 Units

“B”

0 Units
Buyer Only
Buys 30 Units
from “S”,
The Seller



Sequence of The Exchange

1. “B”, the Buyer offers to buy “E”, the exchangers 30 unit building.
2. “E”, the Exchanger, accepts “B”, the Buyers offer providing they can exchange.
3. Escrow is opened on the 30 unit building.
4. “E”, the Exchanger, offers to exchange their equity into “S”, the Sellers 64 unit building.
5. “S”, the Seller accepts “E”, the Exchangers offer.
6. Escrow is opened on the 64 unit building, closing dates are set to coincide with the 30 unit buildings’ closing.



Sequence of The Exchange Continued

At this point “E” the Exchanger is finished, they are the owner of the 64 unit building. At the same time;

7. “E”, the Exchanger gets a new loan on the 64 unit building and deeds their 30 unit building to “S”, the seller. At this point ”S”, the Seller has actually sold their 64 unit building to “E”, the Exchanger, and “S” now owns the 30 unit building.
8. “E”, the Exchanger is getting a new loan on the 64 unit building, “B” the Buyer is getting a new loan on the 30 unit building.
9. “B”, the buyer, and “S”, the Seller, close the escrow on the 30 unit building.



They Name Them So For ???

Exchanges are normally named by the number of people normally, but sometimes the number of buildings involved in the exchange tells you the number of players, not the number of buildings.

In a typical “3 way” exchange we have 3 people or parties, One” the exchanger, Two: the buyer; and Three: the seller.



Balancing of the 1031 Exchange

The exchange is really a paper shuffle. You are selling more than one building and trying to get them to close at the same time.

The owner of the 30 units takes an offer on the thirty units, accepts the offer. Escrow is opened just as if it were a sale, but there are the references to the transaction being a “tax deferred, 1031 IRC, tax deferred exchange”.



Balancing of the 1031 Exchange

The difference in the escrow is the instruction that the seller will be exchanging and that the seller will replace themselves with a seller of their choice, without cost or liability to the new seller, or buyer. There will be an indemnification agreement entered into making it clear that any liability for buildings will stay with the original owners.



Balancing of the 1031 Exchange

The price of the properties in an exchange remain the same as in a normal sale. The commission remain the same as in a normal sale.

Each owner pays their own expenses of sale, and acquisition.

The walk through, books and records, all contingencies are removed as they would be in a normal sale.



End of 1031 Exchange

For Now



Estimated Value of 30 Unit Building



Estimated Value of 64 Unit Building



Sequence of The Exchange