Taking the Mystery Out of
The 1031 IRC Tax Deferred Exchange

Exchanging goes back before recorded history, called bartering, where people exchanged tangible goods for other good, such as two goats for one cow. People recognized a need for a common denominator, something that had a recognized value, was easy to carry around, and would be acceptable in exchange for any other commodity, hence money came upon the world and if you get right down to it when ever we buy something with money we are exchanging the money for whatever it is that we want to buy. Money is really a commodity, a commodity that is more exchangeable than any other commodity on the face of the earth. So, in reality we exchange every day of our lives, and knowing that exchanging is really quite simple once we get some silly notions or prejudgments out of our minds.

ORDINARY WORK IS AN EXAMPLE OF EXCHANGE

When we work, work for pay, we are exchanging, we are exchanging our labor for money and then we exchange the money for the various goods and services that we think we require to maintain whatever existence it is that we have become accustomed to. Exchanging then is something that we do constantly, no big mystery, in fact so common that we don't even think about it, and once we stop and look at it we find that we already understand exchanging, no big mystery. We then have to learn some of the rules, set out by "The Internal Revenue Service" to make certain that our exchange efforts fit into the required text to qualify for tax deferment.

THE BARTER SYSTEM IS SIMILAR

The real problem that most people have with the exchange is that they think that they will simply exchange their building for a larger building that they like and though exchanging is simple, it is rarely that simple. People start out with the idea that they will just trade their building with the owner of a building that they like and he/she will like their building, when they can't find this combination, a building that they like owned by a person who likes and wants their building, they get discouraged and give up, thinking that exchanging is an impossible thing. This feeling about the impossibility of exchanging is not felt only by the exchanging community but by most brokers.

One of the stories I use when training brokers in exchange techniques is a story exemplifying the pure barter system, the story points out why the two way exchange rarely works, why people went to all of the trouble they went to, creating money as the most common most exchanged item, and then they can really learn and understand how to exchange so that it will work for them.

"THE GOAT STORY"

Go back in time if you will to 800 B.M.(Before Money) suppose I had a cow that you would really like to have and you reasoned that one cow was worth two goats. You just happened to own two goats. You come over to my cave and propose that you swap your two goats for my one cow. I have three cows and would really like to trade one of them for something, but I also have six goats, I don't want anymore goats. I tell you what I would really like is a horse. Now, this is the point that most people "would be Exchangors", give up. You are more tenacious than the average so you go out and beat the bushes and find a man who wants two goats, and is willing to trade a horse for the two goats, you trade, bring the horse over to my cave and I trade one of my cows for your horse. Everyone is theoretically happy. We are already in a three way exchange, two goats, a cow and a horse and three of us, or three principals.

IS THE TWO WAY EXCHANGE UNLIKELY?

The two way exchange is very unlikely, you will rarely find an owner who wants to exchange down, and likes the property that you have to exchange down into enough to accomplish the two way exchange. You usually find an owner who only wants to sell and that takes you immediately to the three way exchange. Usually the entire market of exchanging involves 1 to 2% two way exchanges and 98 to 99% three way exchanges. For all practical purposes, forget the 2 way exchange, it just doesn't work well enough to accomplish exchanges on a regular basis.

Before we get into any actual exchange situations I have one more story I use to train brokers/salespeople to help them understand the 1031 I.R.C. Tax Deferred Exchange. I call it the "AUTOMOBILE STORY". In searching for a way to simplify the mechanics of an exchange I tried to think of one of the most common exchanges that we have all done or will do at one time or another, that one common thing is to trade an automobile in for another automobile, usually a new one. The trading in of an automobile is the one situation that all of us are familiar with, and except for the tax rules, it most resembles the 1031 I.R.C. Tax Deferred Exchange.

THE AUTOMOBILE STORY

We have all purchased an automobile at one time or another or we know someone who has. The trade in of a used car and the purchase of a new car is an excellent example of a 3 way exchange. When you understand this you will be able to find out where you are in any exchange. The Automobile Story goes like this;

You are driving down the street and you pass your friendly car dealers show room and in the window of that showroom sits a brand new Mercedes Benz, you decide to stop and "Just take a look." You pull up in front of the showroom window and park, go into the showroom and look longingly at the beautiful automobile. The dealer walks in and asks, "Can I be of assistance?". We quickly reply "no, I'm just browsing, but how much is this car?" -"$55,000 he/she counters with a smile and adds "You really like it don't you?" We nod and reply, "Yes, but $55,000 is must too much." He/she gazes out of the showroom window, sees your car and asks "Is that your Lincoln?" - "Yes" you reply, "Paid for"? he asks, we give him another "yes", he reaches into their pocket and pulls out a little blue book, thumbs through it and says "$16,500" what did he just do. What did he just do? He appraised your car with a little blue book that he and you have come to trust as a ready guide for the appraisal of automobiles. Now tempted and getting more interested by the second we add "yeah but I don't have the other $38,500." "No problem" he counters again, "the payment will be $856.41". We pause for just a moment searing our minds to determine if our budget can stand the $856.41 a month payment and then, "great, I'll take it," we smile. We sign the pink slip on the Lincoln, deed it over to the dealer, sign some more papers and drive off in our new Mercedes.

WHAT DID WE JUST DO?

What did we just do? We traded up, we exchanged our equity in our Lincoln for the Mercedes and got a loan to make up the difference. We have just don an exchange. There is probably no reason for the exchange to be tax deferred, because the car probably went down in value and we sustained a loss, not a gain, but we nevertheless accomplished an exchange.

That is just the beginning of this exchange. You have long since driven off in the new Mercedes, and the dealer has cleaned your Lincoln up and put it on their used car lot. Unknown to you, driving down the street with their brother in law, is a man we'll call party "B" to this exchange, the buyer. He has been looking all over for a new car. He sees your old Lincoln, stops to have a look, meets our friendly Mercedes Dealer and buys your old Lincoln. He gives the Mercedes Dealer $5,000 down and the bank makes a loan for $11,500 for the balance of the selling price.

That completes the three way exchange. The only difference between that exchange and the exchange of two pieces of real property is that with real property you will know who all of the players are, and you will close both sales on the same day whenever it is humanly possible.

HOW MANY PEOPLE WERE INVOLVED IN THIS TRANSACTION?

THREE: =

You + The Car Dealer + The Buyer

Let's give all of the players an easily identifiable name or label.

YOU	=	**"THE EXCHANGER"**	=	**"E", OR PARTY "E"**
THE CAR DEALER	=	**"THE SELLER"**	=	**"S", OR PARTY "S"**
BUYER OF OLD CAR	=	**"THE BUYER"**	=	**"B", OR PARTY "B"**

WHAT DOES EACH PARTY DO"

"E", The Exchanger - Exchanges their equity in their old car for equity in the sellers car and balances the differences with a loan. **"E" only exchanges.**

"B", The Buyer - "B", only buys, he/she doesn't care who from, he/she only wants to buy your car. "B" buys your car from "S" the seller, or the car dealer in this example. **"B" only buys, he/she buys the building that he/she wants, he/she doesn't care who he/she buys the building from, as long as he/she has clear title.**

"S", The Seller - "S", The Seller, only sells, he/she doesn't want any cars for himself, he/she only sells cars to cash out, get money, he/she sells the Mercedes to You, and gets a little money, then he/she sells you old Lincoln to the Buyer, "B", and gets the rest of their money. **"S", is only a seller, he/she only sells and he/she normally sells everything. In real estate, "S" has very little interest in the exchange.**

SYNOPSIS OF OUR EXCHANGE STORIES

"E", is always an exchanger, he/she exchanges one property for another, he/she sells nothing, he/she just exchanges.

"B", is always a buyer, he/she only buys. He/she is not particularly concerned with who he/she buys from, just as long as he/she gets clear title.

"S", is always a seller, he/she only sells, he/she sells their building to you via the exchange, he/she has your building for a time, a moment in escrow, and then he/she sells your building to "B" via a direct sale.

Once you understand the "Automobile Story", you have a complete understanding of the I.R.C. 1031 Tax Deferred Exchange, you only have to adapt your present knowledge to a little different situation, real estate, and learn a few new rules. Don't complicate the exchange, if you get lost, return to the automobile story and find out just where you are.

THERE IS A LOGICAL SEQUENCE TO MAKE THE EXCHANGE WORK

There is a logical sequence in the process of the exchange, a sequence that has the greatest propensity to work. If you follow that sequence you will be successful with the exchange. If the sequence changes in any particular exchange you will be ready to handle that. If you do not follow the most logical sequence you may or may not be successful with exchanging, but the odds are against your success. Not following the logical sequence for fear of jeopardizing your current position is probably the one greatest reason that people shudder at the thought of an exchange. There is no reason for the exchange not to work for you, it works for thousands of real estate brokers/salespersons and owners each and every year, if you follow the sequence, stay in harmony, have a little patience, you will be successful each and every time you ply your efforts to the exchange.

THE FOUR MOST LOGICAL STEPS IN THE "TAX DEFERRED EXCHANGE"

STEP I: "Find the Real Fair Market Value of the Exchange Building"

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/Market Analysis of the property to be exchanged. You can market the property for more than the indicated sales price, but you have to do your evaluations at the actual fair market value to ascertain whether or not the exchange is even viable. Work out a net sheet, on paper exchange into a building similar to the building that you think the buyer will be able to exchange into, if that makes sense then go ahead with the transaction, if it doesn't, you will be spinning your wheels, you won't be able to find a property for the exchanger to go into that will make sense. **You will have to have the "Adjusted Tax Basis" of the property to be exchanged to determine whether or not the exchange is viable.** Once you have determined the "Real Fair Market Value" of the subject Property and ascertain that the exchange is a viable business decision you are ready for step II.

STEP II: An Exchange Only Listing, and Market the Property:

The second step is to list the building on an exchange only basis. A lot of other brokers will not like the exchange only basis, but use it anyway. If your exchanger is serious, you will be able to use the exchange only listing and make it work. The exchange only listing is similar to listing a house with the contingency for the Seller to find another home to buy. If you are paying attention to what you are doing, Practicing Real Estate, you will be able to find a suitable exchange building, usually called the "up-leg", the building you are exchanging out of is usually called the "down-leg".

STEP III: Sell the Building With the Exchange Only Contingency:

The third step is to sell the building. It is critical that the building at least has an offer on it, preferably that it is in escrow. If you haven't sold the exchange building, the downleg, and you make an offer on a suitable upleg, the broker on the upleg will ask if you are in an escrow, if your not, he/she will not want to take their listing off of the market to accommodate you until you find a buyer. Also, you may not be able sell the building for what you think you can and the terms of your offer will have to be modified to meet the reality of your sale. If you have the Owner/Exchanger looking at property before their building is sold, he/she is simply window shopping, he/she may get discouraged and decide not to exchange.

Once the building has been sold, the walk through been done and accepted, the contingencies, as many as possible removed, and an escrow opened, your exchanger is ready to seriously begin looking at property that is suitable for an upleg.

STEP IV: Find an Upleg, Make an Offer, Put it into Escrow:

The fourth step is to find an upleg, make an offer on the building, a regular offer with reference to an exchange. The seller of this building may ultimately be the seller of both buildings, though direct deeding is acceptable today.

Those four basic steps will get you into and through an Internal Revenue Code 1031 Tax Deferred Exchange. It won't even be that bad if you realize that almost everyday something will come up that will make you and the exchanger uncomfortable. Once you have done a couple of exchanges most problems will be eliminated before they ever become problems.

That is the exchange in a nut shell, unfortunately there are several things that you will need to know about taxes, balancing the exchange, and directing the escrow, exchanger, seller and buyer to a successful close. The best advice anyone can give you is **DO IT YOURSELF,** don't rely on escrow or any of the other brokers, loan officers, savings and loans to do the job for you, you have to have reliable access to what is happening in every escrow that is involved. The more properties, principals or escrows that are involved the more difficult the exchange will be to complete. You will have to know the exchangers "Adjusted Tax Basis on the Down-leg", and be able to figure out their adjusted tax basis on the upleg. These are not difficult things to learn, but it is prudent to use worksheets unless you are doing these calculations on a daily basis.

FINDING THE TAX BASIS

Before you get involved in an exchange, you want to make sure that an exchange is economically beneficial. Every year we run across exchanges that have been done unnecessarily, there was no great benefit in using the exchange, and in some cases the exchange was actual detrimental to the overall investment picture. **THE TAX DEFERRED EXCHANGE IS NOT ALWAYS BETTER.** Use this rule, if the Potential Exchanger has taxes to pay, and you defer the taxes via the 1031 Tax Deferred Exchange, and the investor will likely be in a better position economically. **If taxes can be deferred, it is the same thing as borrowing money from the government for investment and paying it back when you get through using it, and paying taxes on the gain if there was any.**

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, or;

INITIAL COST - DEPRECIATION + CAPITAL IMPROVEMENTS = ADJUSTED TAX BASIS

Your after sale Adjusted Tax Basis would take into account the cost of selling the property, or;

INITIAL COST - DEPRECIATION + CAPITAL IMPROVEMENTS - EXPENSES OF SALE = AFTER SALE ADJUSTED TAX BASES

You will normally be able to find the tax basis of any property on the owners last Income Tax Return, on the Schedule "E". It will have been balanced as of December 31, of the previous year, so the actual tax basis will be a little bit lower than that indicated on the tax return. You will still have expenses of sale to deduct, so don't worry unduly about the basis. It will be "Close Enough for Government Work".

Let's explore the "Tax Basis" so that I will know that you have a little better understanding of what it is and how you got there.

EXAMPLE OF TAX BASIS

Let's assume that you or your client purchased a 30 unit Apartment Building fifteen years ago for $900,000. he/she put 30% down, $270,000, and got a new 1st Trust Deed in the amount of $630,000 at 9.75%, payable in equal monthly installments of $5,412.67. The building is comprised of all 2 Bedroom, 1 Bath Units, and their rents at purchase were $275 per unit per month, expenses of operation were running 30% of the Gross Scheduled Income, and the vacancy factor was 2%. At the end of the year the books and records were taken to the accountant, and he/she said that you could depreciate the building, or the improvement over a period of years for an additional tax write-off. This is what you 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.

How in the world did you go about finding these values? You or your client probably took a copy

of the old tax bill, and found that the County where the property is located had already had the County Appraiser appraise the property, breaking down the land and the improvements. You tax bill probably looked similar to this;

Land	$125,000
Improvement	$375,000
Personal Property	$ -0-
Total Assessed Value	$500,000

This total assessed value in days gone by would rarely agree with what we actually paid for the property. Since 1978, or after Proposition 13, the actual assessed value will normally be exactly what you paid for the property. Nevertheless, in either case, from these numbers you will determine a ratio of land to improvement for purposes of depreciation. The Internal Revenue Service loves to use the County Assessors Appraisal, because it is usually to their advantage.

If however they seem to be wrong from a standpoint of ratio, too much value for the land, and too little value for the improvement, we can have a professional appraiser appraise the property for the purposes of depreciation and the Internal Revenue Service will accept that in most cases. You have to remember that the County Assessor did not appraise for purposes of depreciation, the County taxes on the total value, The Los Angeles County Property Assessor, The Orange County Property Assessor, and the San Diego County Assessor have all notified the Internal Revenue Service, verbally and in writing that the purpose of their appraisals are not for depreciation and that the ratio of Land to Improvement should not be used for purposes of depreciation. Still the Internal Revenue Service loves the County Assessors Appraisals. You will often find an appraisal is necessary because of an old ratio that was arrived at in the early 70's, with too high a value for land and too low a value for improvement. The accountant will use figures that are generally acceptable to the I.R.S., figures that will not short the computers out.

FIND THE RATIO

At any rate, once you have the ratios, divide any of the values by the total value and come up with a percentage of improvement to value thus;

Percentage of Improvement to Total Value

Total Assessed Value / Improvement Value

Or;

0.75

$500,000 / $375,000.00 = 75% Improvement Value

From these ratios you have come up with an improvement value of 75% of the total value of the price you have paid for the building. The actual purchase price is the real value of the property. You simply apply this ratio to the actual purchase price to come up with the amount that is depreciable, the improvement value. Thus;

FIND THE IMPROVEMENT VALUE

Real Purchase Price (Times) Improvement Ratio = Depreciable Improvement

In our current example, this would be;

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

For purposes of depreciation the improvement is valued at $675,000.

The reason that you have to separate the improvement from the total value is that the land, in theory, cannot be worn out. Even though the improvement as well as the land will probably increase in value, you will be able to treat it for tax purposes as if it were going down in value. This is really the only "Real Write-Off" that is unearned by invested dollars. All of the other write-off associated with an investment property has to be paid for in actual dollars.

FIND THE ECONOMIC LIFE OF THE IMPROVEMENT

The economic life of an improvement is that period of time that the improvement is estimated to last before it will have to be completely replaced, or the expected useful life of a building before it will have to be torn down and replaced with a new structure. We need to find the economic life of the improvement so that we can determine what amount we can depreciate each year for tax purposes.

In actual practice the economic life of any improvement is set out by the Congress, or the Internal Revenue Service. They give us acceptable economic lives for various structures that can be used for depreciation. These economic lives change from time to time as the different "Revenue Acts" come into being. Following is a synopsis of economic lives over the past 20 years.

SYNOPSIS OF REAL PROPERTY ECONOMIC LIVES, LAST 24 YEARS

1970	-	1980	20 to 50 Years
1981	-	1984	15 Year A.C.R.S.
1984	-	1986	19 Year A.C.R.S.

1986 to Present;

Residential Income Property	=	27.5 Years
Commercial/Industrial	=	39 Years

(There are some exceptions, but you are not likely to run into them)

Since this building was purchased some 10 years ago, the minimum useful life that you or the owner probably used was 20 Year Straight Line. Using this 20 year economic life against the improvement value, we came up with an annual depreciation of;

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

OR;

$$27.5 \text{ Years} \quad / \quad \frac{\$\,33{,}750}{\$675{,}000}$$

Each year then the owner of this building would have deducted $33,750 from earnings of the building to come up with a total amount of taxable income or write-off from the building. It is worth noting that depreciation is not often elective, generally you are required to take the depreciation, especially if you don't need it.

To find the "Adjusted Tax Basis" we would multiply our yearly depreciation by the number of years that we owned that building and subtract that from the purchase price of the building, plus including acquisition costs. This would give us our current adjusted tax basis.

FIND THE AMOUNT OF DEPRECIATION

YEARLY DEPRECIATION X YEARS OWNED = TOTAL DEPRECIATION TAKEN

(This is annualized, in actual practice we would figure it to the month)

OR;

$33,750 X 15 YEARS = $506,250

In our example, $337,500, excluding some additional months for this year, is the total depreciation taken since we purchased the building.

FIND THE ADJUSTED TAX BASIS

Now to find the adjusted tax basis we would subtract the depreciation taken, the $506,250 from our original cost, add any capital improvements, in our example we have made no capital improvements and we would have the following;

ORIGINAL COST – DEPRECIATION TAKEN = ADJUSTED TAX BASIS

OR;

$900,000 – $506,250 = $393,750

More correctly for accounting purposes 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 just have.

Regardless, our Adjusted Tax Basis is $393,750

FIND THE GAIN

The gain is the amount of money that would be recognized as taxable upon the sale of the property, or deferred if the property were exchanged. It is called Potential Gain before the sale, Recognized Gain upon sale and Deferred Gain after an exchange. To find the gain we have to know the "Adjusted Tax Basis" which we have just gone to great lengths to find, and we would have to know the selling price of the property. For purposes of example, we will say that our 30 unit building is now worth $1,000,000. If that is the case, and our expenses of sale will run 7.5% of the selling price, what is our gain.

Simply state the gain is the selling price, less the expenses of sale, less the "Adjusted Tax Basis"

Or;

Selling Price – Expenses of Sale – Adjusted Tax Basis
= Gain

ESTIMATED GAIN

Selling Price of Property	$2,400,000
Less Expenses of Sale	($ 168,000)
Less "Adjusted Tax Basis"	($ 393,750)
Estimated or Indicated Gain	**$1,838,250**

If the property were sold, the tax payer would be in the highest tax brackets, and subject to Federal Taxes in the amount of 20% of the Gain, and in this case State of California taxes of 5% of the gain, and would have a tax bill of; 25%

MARGINAL INCOME TAX BRACKET TIMES GAIN EQUALS ESTIMATED TAXES

FEDERAL TAX	=	28.00%	X	$1,838,250	=	$514,710
STATE TAX	=	9.10%	X	$1,838,250	=	$167,281
TOTAL INCOME TAX DUE UPON SALE					=	**$681,991**

You must **NOTE THAT THE UNDERLYING LOANS HAVE NOTHING TO DO WITH THE TAXES DUE UPON THE SALE OF A BUILDING.** You have to keep loans out of your mind when you are figuring the taxes that will be due upon the sale of any building. It is possible to have refinanced the building to the point that you will not have enough money left at the close of escrow to pay the taxes due.

ESTIMATED FAIR MARKET VALUE OF BUILDING

Staying with the 30 unit building, our rents are currently $750 per month, our vacancy factor is running 2% of the Gross Scheduled Income, Expenses are 35% of the Gross Scheduled Income and the laundry income is $300 per month. The new buyers will have to put 30% down, obtain a new 1st Trust Deed, 70% of value at 10% Interest, amortized over 30 years. The lender will want a near break even to make this loan.

ESTIMATED VALUE OF BUILDING

Gross Scheduled Income	$273,600		
Vacancy Factor 2%	($ 5,472)		
Gross Operating Income	$268,128		
Expenses 35%	($ 95,760)		
Net Operating Income	$172,368		
New Loan	($176,918)	=	$1,680,000
Cash Flow	**($ 4)**		
Total Loans			$1,680,000
Cash Down Payment 30%			$ 720,000
Selling Price of Building			**$2,400,000**

Now we will go through the Gain one more time. Gain is our profit for tax purposes. The Gain will be the selling price, less the current adjusted tax basis, and less the expenses of sale. 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.

REALIZED GAIN	=	Gain after the sale.
RECOGNIZED GAIN	=	Gain Recognized for tax purposes.
POTENTIAL GAIN	=	Gain before you sell.
INDICATED GAIN	=	Gain Indicated when calculated.
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 accomplish the exchange, we need 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 and in SITUATION I, we will sell the building, pay the taxes, buy another building. In SITUATION II, we will exchange our equity into another building. We will keep both buildings for 5 years, assuming that each appreciates 10% annually for the 5 year period, then we will sell the buildings, pay the taxes in both examples and see if we have made any financial progress. In both examples, the current loan on our 30 unit building is $510,938.

FIND THE POTENTIAL INDICATED GAIN OR THE DEFERRED GAIN FOR THE EXCHANGE

SELL, PAY TAXES, BUY		EXCHANGE	
Selling Price	$2,400,000	Exchange Price	$2,400,000
Less Expenses of Sale	($ 168,000)	Less Expenses of Exchange	($ 168,000)
Less Adjusted Basis	($ 393,750)	Less Adjusted Basis	($ 393,750)
RECOGNIZED GAIN	**$1,838,250**	DEFERRED GAIN	**$1,838,250**

LOOKING AT THE CASH AT CLOSE OF ESCROW

The Potential Indicated Gain, or the Deferred Gain, as the case may be, and the actual cash that we get at the close of escrow are two very different numbers. While they may be close as far as the amount is concerned the amount of money that taxes are due on, and the amount of money that you will receive at the close of escrow, or the before tax cash at close of escrow are two very different numbers. In the beginning, if you are not working with worksheets, it is very easy to get the loans and the adjusted tax basis mixed up. Remember, that if the client has recently refinanced the building, it is possible that their after tax net cash upon sale will be a negative, in other words they will have to come up with additional cash to pay the taxes. The Indicated, or Deferred Gain in this example will remain $793,750 regardless of the loans on the property.

The cash at the close of escrow tells us what cash and paper we will have to exchange with or keep. The Gain, tells us what amount of money we will have to pay taxes on, or what the basis of the building we are exchanging into will be.

[The underlying loan on our example building is $510,938 @ 9.75% interest, payable $5,412.67 per month.]

CASH CLOSE OF ESCROW, OR NET BEFORE TAXES

SELL, PAY TAXES, BUY		EXCHANGE	
Selling Price	$2,400,000	Selling Price	$2,400,000
Expenses of Sale	($ 168,000)	Expenses of Exchange	($ 168,000)
Less Loans of Record	($ 510,938)	Less Loans of Record	($ 510,938)
NET CASH C.O.E.	**$1,721,062**	NET CASH C.O.E.	**$1,721,062**

Next we will estimate our taxes in both situations, we will pay them on the Sell Pay Taxes Buy side, Situation I, and we will defer the taxes on the exchange side.

ESTIMATED TAXES, FEDERAL & CALIFORNIA

SITUATION I, SELL PAY TAXES, BUY		SITUATION II, EXCHANGE
Federal	**$700,475**	**NONE NOW.**
State	**$192,374**	**NONE NOW.**
Total Taxes	**$892,849**	**NONE NOW.**

LOOKING AT THE TWO AS TWO SITUATIONS

To get a clear picture of just what is happening here, we will take the cash for purchase in each case and buy another building. We will treat the "SELL, PAY TAXES, BUY" scenario as SITUATION I, and we will treat the "EXCHANGE" scenario as SITUATION II. We will run these investments out 5 more years, assuming 8% annual appreciation on the buildings and 8% annual increases in the rent. Then, at the end of the 5th year we will sell the buildings, pay any taxes due, and find out just how advantageous the "TAX DEFERRED EXCHANGE" is.

CASH FOR NEXT INVESTMENT

	SITUATION I		SITUATION II
CASH C.O.E.	$1,721,062	CASH C.O.E.	$1,721,062
LESS TAXES	($ 892,849)	LESS TAXES	($ NONE NOW)
NET CASH FOR INVESTMENT	**$ 828,213**		**$1,721,062**

By deferring our taxes in the exchange, Situation II, we have 107.80% more cash to invest. In this example, on the exchange side we have $892,849 more to use as a down payment than we do on the Sell, Pay Taxes, Buy side (Situation I) this of course is the exact amount of the taxes that would have been due if we had entered into a straight sale. If we look at this additional capital, as a 30% down payment you can determine that if the down payment is 30%, we can buy $2,976,163 more in real property.

LEARNING TO FIGURE CASH DOWN AFTER ACQUISITION COSTS

It is necessary to learn to figure what you will actually have for a down payment, after the costs of acquisition. In other words, when you purchase real property you have acquisition costs, they normally amount to from 1.5% to 3.5% of the buildings cost, it is not difficult to figure this if you know approximately what the down payment will be as a percentage. You add the percentage down payment and the percentage acquisition costs together and divide that into the actual cash you have for a down payment, this will get you close to the actual building that you will be able to purchase.

For example, if we are assuming that our down payment will be 30%, and that our acquisition costs will be 3% (loan points plus 1.5% will normally be plenty), we will have an adjusted down payment of 33%, if we divide the cash that we have for the down payment by 33%, we will come up with a building value, if we then take 3% of the buildings value and subtract that from the down payment we will have the actual down. You will have to do some interpolation, but it works well.

CASH FOR NEXT INVESTMENT, OR GROSS DOWN PAYMENT

It is important now that we figure out just how much cash we have for the next investment. In Situation I, we will have all of the normal expenses of sale, less the loans of record and less the income taxes that we have to pay, in Situation II, we will have all of the normal expenses, less the loans of record, but we will not have any income taxes to pay now.

	SITUATION I	SITUATION II
Selling Price of Building	$2,400,000	$2,400,000
Less Expenses of Sale	($ 168,000)	($ 168,000)
Less Loans of Record	($ 510,938)	($ 510,938)
Less Income Taxes Due	($ 892,849)	($ None Now)
GROSS CASH FOR DOWN PAYMENT	**$ 828,213**	**$1,721,062**

NET CASH FOR DOWN PAYMENT, AFTER ACQUISITION COSTS

It is a fact that we have acquisition costs when we purchase, or exchange into a new building. These acquisition costs have to be deducted from the Gross Down Payment to find out what our Net Down Payment will be. You know the down payment is 30%, if you estimate that the Acquisition costs are going to be 3%, just add 3% to 30% and come up with 33%, then divide the cash down payment that you have by the 33%, in this case, and you will come up with an approximate exchange building value, round that off, and take 3% of that value for acquisition costs and you should be able to figure the exact value of the upleg.

For example, on the exchange side, you have $1,721,062 for a total cash down, divide that by 33% and you come up with a building value of $5,215,339. There aren't many buildings with that exact dollar value, so round off to $5,000,000 and that is the approximate value of the upleg, the building you are going to exchange into.

	SITUATION I	SITUATION II
AFTER TAX CASH FOR DOWN PAYMENT	$ 828,213	$1,721,062
LESS 3% ACQUISITION COSTS [1]	($ 78,213)	($ 171,062)
NET CASH FOR DOWN PAYMENT	**$ 750,000**	**$1,550,000**

FIND DOLLAR VALUE OF BUILDING

$$\frac{\text{CASH DOWN PAYMENT}}{\text{PERCENTAGE DOWN PAYMENT}} = \text{DOLLAR VALUE OF BUILDING}$$

SITUATION I			SITUATION II		
$ 750,000 / 30%	=	$2,500,000	$1,550,000 / 30%	=	$5,000,000

We can estimate our per unit cost from the building we just sold, or;

$$\frac{\$2,400,000}{30 \text{ Units}} = \$80,000 \text{ Per Unit}$$

Then to find the number of units in each of our new buildings, we divide the purchase price by $80,000 and we will come up with a good approximation of the number of units the exchanger, or buyer will end up with.

SITUATION I			SITUATION II		
$2,500,000 Building Value / $ 80,000 Per Unit Value	=	31.25 UNITS	$5,000,000 Building Value / $ 80,000 Per Unit Value	=	62.5 UNITS
ROUNDED TO 32 UNITS			**ROUNDED TO 64 UNITS**		

FINDING THE CASH FLOW AT PURCHASE FOR EACH BUILDING

Each apartment building is comprised of 2 Bedroom, 1 Bath Units, renting for $750 per unit, per month. Each Unit further generates $10 per month in Laundry Income. The vacancy Factors are 5%, and the Expenses of Operation are 40% of the Gross Scheduled Income. Each building has a new 1st Trust Deed in the necessary amount, at 8% interest, amortized for 30 years.

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[1] I have cheated just a little to make the down payments an even number, in real life they never turn out even.

	SITUATION I, 32 UNITS		SITUATION II, 64 UNITS	
Gross Scheduled Income	$ 291,840		$ 583,680	
Vacancy Factor 5%	($ 14,592)		($ 291184)	
Gross Operating Income	$ 277,248		$ 5547496	
Expenses 40%	($ 116,736)		($ 233,472)	
Net Operating Income	$ 160,512		$ 321,024	
Annual Loan Payments	($ 154,091) =	$1,750,000	($ 303,779) =	$3,450,000
Cash Flow	$ 6,421		**$ 17,245**	
Total Loans		$1,750,000		$3,450,000
Cash Down Payment 30%		$ 750,000		$1,550,000
Purchase Price of Building		**$2,500,000**		**$5,000,000**

FIND THE ADJUSTED TAX BASIS OF THE NEW BUILDINGS

In Situation I, the taxes were paid before the transfer of funds, the adjusted tax basis of the 32 units will be the purchase price of $2,500,000 plus the acquisition costs of $78,213, or $2,578,213. The adjusted tax bases for the 64 units exchanged into in Situation II, will have to be calculated.

	SITUATION I	SITUATION II
Purchase Price of Building	$2,500,000	$5,000,000
Plus Acquisition Costs	$ 78,213	$ 171,062
Less Deferred Gain	($ NONE)	($1,838,250)
ADJUSTED TAX BASIS	**$2,578,213**	**$3,332,812**

THE FORMULA FOR THE EXCHANGED INTO PROPERTY IS

Purchase Price + Acquisition Costs – Deferred Gain = Adjusted Basis

WHAT CAN WE EXPECT OVER THE NEXT 5 YEARS?

We will assume that each building appreciates in value 8% annually for the next five years. We will use 27.5 Year Straight Line Depreciation, but not exceed $25,000 Annually In Write-Off against Active Income. In the fifth year, we will sell both buildings, pay any taxes due and see if the exchange is a better investment vehicle than the "Sell, Pay Taxes, Buy".

BUILDING VALUE END OF 5th YEAR 8% ANNUAL APPRECIATION

SITUATION I	SITUATION II
$3,675,000	$7,350,000

SELL THE BUILDING, ESTIMATED CASH CLOSE OF ESCROW

	SITUATION I	SITUATION II
Selling Price of Building	$3,675,000	$7,350,000
Less Expenses of Sale 7½%	($ 275,625)	($ 550,000)
Less Loans of Record	($1,663,723)	($3,279,910)
CASH CLOSE OF ESCROW	**$1,735,652**	**$3,520,090**

The figures at this point look a great deal more favorable is Situation II, the Exchange. We still haven't figured the taxes to be paid. We will figure the taxes, pay them and see just how far ahead the exchange will put us in this example.

FIND THE ADJUSTED TAX BASIS

We will deduct the allocated write-off for each building, which is the current tax basis X 70% divided by 27½ years. You have to be a little careful here, because the Revenue Act of 1986 allows the building to shelter passive income, but limits the Active Income loss to $25,000 annually, with incomes adjusted gross incomes under $100,000. This means that each building will have to be calculated on its own merit from a tax standpoint, and then you will apply the rules as they fit the investor.

	SITUATION I, 32 UNITS	SITUATION II, 64 UNITS
Adjusted Tax Basis at Purchase	$2,578,213	$3,332,812
Less Depreciation	($ 328,135)	($ 424,175)
Adjusted Tax Basis	**$ 2,250,078**	**$2,908,637**

FIND THE INDICATED GAIN

	SITUATION I	SITUATION II
Selling Price of Building	$3,675,000	$7,350,000
Less Expenses of Sale	($ 275,625)	($ 551,250)
Less Adjusted Tax Basis	($2,250,078)	($2,908,637)
INDICATED GAIN	**$1,149,297**	**$3,890,113**

FIND ESTIMATED TAXES, STATE & FEDERAL

		SITUATION I, 32 UNITS	SITUATION II, 64 UNITS
FEDERAL TAXES	=	$431,610	$1,516,973
CALIFORNIA TAXES	=	$117,689	$ 419,179
TOTAL TAXES DUE THIS SALE		**$549,299**	**$1,936,152**

FIND THE NET AFTER TAX CASH FROM SALE

	SITUATION I	SITUATION II
Net Cash Close of Escrow	$1,735,652	$3,520,090
Less Taxes	($ 549,299)	($1,936,152)
AFTER TAX NET	**$1,186,353**	**$1,583,938**

With all things being equal, except the deferred payment of the taxes in Situation II, Situation II has outpaced Situation I by $397,585 after taxes, in 5 years, or $79,517 per year.

CASH FLOWS & TAX SAVINGS SITUATION I & II, 5 YEARS OF INVESTMENT

It is usually prudent to compute the cash flows, and the tax savings, year by year to make certain that one investment does not have a hidden advantage over the other, something that we didn't show. Following is a summary of Cash Flows and Tax savings, year by year, Situation I, and Situation II. Assume that the owner is in a combined Marginal Income Tax Bracket of 37.3%.

After Tax Cash Flow Year I

	Situation I	Situation II
Cash Flow	$ 6,421	$ 17,245
Tax Savings	$ 9,375	$ 9,375
A.T.C.F.	**$ 15,796**	**$ 26,620**

After Tax Cash Flow Year II

	Situation I	Situation II
Cash Flow	$ 19,262	$ 42,927
Tax Savings	$ 9,375	($ 332)
A.T.C.F.	**$ 28,637**	**$ 42,595**

After Tax Cash Flow Year III

	Situation I	Situation II
Cash Flow	$ 33,131	$ 70,663
Tax Savings	$ 9,375	($ 7,322)
A.T.C.F.	**$ 42,506**	**$ 63,341**

After Tax Cash Flow Year IV

	Situation I	Situation II
Cash Flow	$ 48,108	$100,619
Tax Savings	$ 5,378	($ 19,542)
A.T.C.F.	**$ 53,486**	**$ 81,077**

After Tax Cash Flow Year V

	Situation I	Situation II
Cash Flow	$ 64,284	$132,971
Tax Savings	($ 7,000)	($ 32,743)
A.T.C.F.	**$ 57,284**	**$ 100,228**

AFTER TAX CASH FLOWS, SIDE BY SIDE, YEAR BY YEAR

	SITUATION I	SITUATION II
After Tax Cash Flow Year I	$ 15,796	$ 26,620
After Tax Cash Flow Year II	$ 28,637	$ 42,595
After Tax Cash Flow Year III	$ 42,506	$ 63,341
After Tax Cash Flow Year IV	$ 53,486	$ 81,077
After Tax Cash Flow Year V	$ 57,284	$ 100,228
TOTAL CASH FLOWS 5 YEARS	**$ 197,709**	**$ 313,861**
After Tax Net From Sale Year Five	**$1,186,353**	**$1,583,938**

RETURNS AT VARIOUS RATES, OR MEASURING STICKS

	SITUATION I	SITUATION II
Internal Rate of Return	11.38%	2.07%
Average Annual Percentage Rate	11.63%	2.12%
Simple Average Rate of Return	33.42%	22.05%

Here, on these different rates of return, realize that each percentage as stated above is measured using the same exact data, that the resulting percentage rate is simply the result of the method used. Years ago, we used the Simple Average Rate of Return, then came calculators, calculators have added an all new dimension in calculating rates of return, for example, I haven't even used the Financial Management Rate of Return, (FMRR). The important thing to remember is that you need to use the same measuring stick as the investor you are talking to.

ELEMENTS OF THE TAX DEFERRED EXCHANGE

A TAX DEFERRED EXCHANGE CAN FALL INTO THREE (3) CATEGORIES;

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

THE ENTIRELY TAX DEFERRED EXCHANGE

For the exchange to be entirely tax deferred, the tax payer cannot receive;

1. Cash
2. Mortgage Relief
3. Boot

If cash, mortgage relief, or boot are received by the tax payer, it does not necessarily void the exchange, it simply becomes a partially tax deferred exchange.

Commissions, Selling Expenses, and Acquisition Costs are exempt from taxes in the exchange. They 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 an exchange. Later, upon request, he went further and said that this should be interpreted to include selling expenses and acquisition costs.)

For an exchange to be entirely 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 property, it makes the exchange a partially tax deferred exchange, with the cash that was removed from the body of the exchange becoming taxable. It is subject to taxation at whatever rate it would have been had there been a straight sale.

PAPER CARRIED, NOTES

If the exchanger carries paper back, gets a second or third trust deed that is not discounted and exchanged through to the new building, again the exchange is not void but the paper is taxable at whatever rate it would normally be taxed at, and the equity that is exchanged through is tax deferred, he/she ends up with a partially tax deferred exchange. Currently, if a taxpayer carried back a paper, he/she would be entitled to Installment Treatment.

THERE IS ONE METHOD OF TAKING CASH FROM THE EXCHANGE

There is only one method of taking cash from an exchange property. It should not have been done to extrapolate cash from the property, it should have been done for legitimate reasons other than to take cash from the exchange. If you were to refinance your building and use the cash for some other purpose, then decide to exchange the building say, 6 months or 12 months later, that would be a valid method of extracting cash from a building, **PROVIDING YOU DIDN'T TAKE THE CASH OUT TO KEEP IT OUT OF THE EXCHANGE.** This method could be used before or after the exchange, with the old building, or with the new building. This is a grey area as far as the I.R.S. is concerned.

MORTGAGE RELIEF

Mortgage relief is simply when you exchange from a building with a mortgage in a given amount into a building with a mortgage in a lesser amount than the building you exchanged from. For example, if you exchanged from a building with a $500,000 mortgage, into a building with a $400,000 mortgage, you would have "Mortgage Relief" of $100,000. The mortgage(s) on the new property have to equal the mortgages on the old property. This can be offset however with the addition of cash.

FOR EXAMPLE:

Take the 30 Unit building that we exchanged from in the beginning of this text. It had a loan on it in the amount of $570,646, our equity looked like this;

Selling Price of Building	$2,400,000
Less Expenses of Exchange	($ 168,000)
Less Loans of Record	($ 570,646)
Exchange Equity	**$1,661,354**

Suppose now that we exchanged for a 24 unit building worth $1,920,000 with a $316,246 1st Trust Deed on it, our exchange would look something like this;

Selling Price	$1,920,000

Less Loans of Record	($ 316,246)
Equity	$1,603,754
Plus Acquisition Costs	($ 57,600)
Equity Transferred	**$1,661,354**

The equities, after expenses don't differ at all, but the loan given up was $570,646 and the loan assumed was $316,246, there is a difference of $254,400, this is "Mortgage Relief", and it is taxable, even though you put all of your cash into the building.

"EVEN OR UP RULES"

THE EASIEST RULE TO USE IS THE **"EVEN OR UP RULE"**, THE "EVEN OR UP RULE" SIMPLY STATES THAT THE EXCHANGE UP BUILDINGS DOLLAR VALUE HAS TO BE THE SAME OR GREATER THAN THE BUILDING YOU ARE EXCHANGING. THE LOAN ON THE BUILDING YOU ARE EXCHANGING INTO HAS TO BE EVEN TO THE LOAN YOU HAVE GIVEN UP, OR GREATER. **"EVEN OR UP" WILL KEEP YOU OUT OF TROUBLE EVERY TIME.**

FOR A TOTALLY TAX DEFERRED EXCHANGE;

YOUR EXCHANGE BUILDING SHOULD BE THE SAME PRICE OR GREATER IN VALUE

THE LOAN YOU ARE GETTING ON YOUR NEW BUILDING SHOULD BE THE SAME OR GREATER THAN THE OLD LOAN

(The **"EVEN OR UP"** Rules could be offset by the expenses of sale and the acquisition costs and you would still have a valid exchange.)

REMEMBER: ALL IS FORGIVEN BY CASH THAT IS ADDED TO THE EXCHANGE

"BOOT"

Boot is an old Scotch or Gaelic word meaning, "in addition to". You have heard the term in old cowboy movies no doubt. Such as "How much do you want for the saddle?" "Twenty Five dollars", comes the

answer. "I'll give you five dollars, my old saddle and this pistol to boot." Boot can be anything. In the exchange it simply means unlike property, or personal property for real property.

EXAMPLE OF BOOT

Suppose you were to trade your 30 units worth $2,400,000, with a current underlying loan of $570,646, for a 24 unit building with a loan of $570,646 and a current Fair Market Value of $1,920,000. Knowing the **"EVEN OR UP RULES"**, it is immediately apparent that there is a $446,000 shortage, or deficit, change as we often say.

EQUITY OF 30 UNIT BUILDING

Fair Market Value	$2,400,000
1st Trust Deed	($ 570,646)
Expenses of Sale	($ 168,000)
EQUITY	**$1,661,354**

EQUITY OF 24 UNIT BUILDING

Fair Market Value	$1,920,000
1st Trust Deed	($ 570,646)
Expenses of Sale	($ 134,000)
EQUITY	**$1,215,354**

There is a $446,000 difference in equities, you would want to do something about that, to balance the equities the owner of the 24 units gives you; If this difference were a result of Selling Expenses and Acquisition Costs, it would be all right.

FURNITURE	WORTH	$ 50,000
ROLLS ROYCE	WORTH	$160,000
SAIL BOAT	WORTH	$100,000
TRUST DEED	WORTH	$100,000
GOLD INGOTS	WORTH	$ 36,000
TOTAL VALUE OF PERSONAL PROPERTY		**$446,000**

All of those things would balance your equities, take care of the $446,000 difference in value but each of these items are unlike property, personal property as opposed to real property, and are considered BOOT, and subject to taxes at their fair market value, just as if they were cash. In this case the total boot is $446,000 and that amount is what is taxable. For all practical purposes, the Internal Revenue Service treats these items as if they were cash. If you try and lower the price of the building by saying the Rolls ROYCE, for example, is only worth $40,000, they will take it at its current appraised "Fair Market Value" at the time you received it.

Again, none of these things, by themselves would void the exchange, if the exchange were set up properly in the first place, they would simply give you some tax liabilities that are immediately payable for that tax year. In a case like this you may not have the cash to pay your taxes, the Internal Revenue Service will not take I.O.U.'s or boats for taxes. They will sell them for you to raise the cash, if necessary.

"LIKE FOR LIKE RULES"

The like for like rules simply 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 basic goal. Basically it is your intent as the owner, for example, is the property being held for investment? The law simply states that like kind property in the 1031 I.R.C. tax deferred exchange is property that is being and will be held for investment, trade or business. When you analyses that, you will come up with real property for real property being used for investment. Raw land that you held for investment, in hopes of making a profit, can be exchanged for an Apartment Building, an Apartment Building for a Shopping Center. The key here is that your intent was investment, you hoped to make money, if you didn't, that does not enter into the picture. The key thing again is that the property is being held for trade or investment or more literally, from the code itself;

"Property held for Productive Use in Trade or Business, or for Investment."

Personal Residences:

Your personal residence falls under different guidelines or rules than does your investment property. Personal residences, for tax deferment fall under 1034 of the Internal Revenue Code. If you trade part of the equity of an apartment building for a house that you intend to live in, the taxes will not be deferred under 1031. There are ways around this, for example you can refinance your apartment building and invest the money in whatever you want to invest it in. If you live in part of an apartment building, that proportionate part, usually determined on a square foot basis, will fall under 1034 and the remainder of the building will fall under 1031 in an exchange. There are endless ways of moving legally within 1031 and 1034 to accomplish your ends.

THE THREE WAY EXCHANGE

In the 3-Way Exchange, which is the most common, and the most workable, consequently the most used, we have as the name implies, three parties or people, and usually 2 properties. Once you understand the "Three-Way Exchange" you will be able to, with little effort, work your way through the "Four-Way-Exchange", the Five-Way-Exchange and so on.

THE PARTIES TO A 3 WAY EXCHANGE

You will find different authors identifying the parties to the exchange differently, party "A", party "B", "E"1 etc.. I find it much easier to stay with the following designation of the parties;

PARTY "E"	=	**EXCHANGER**
PARTY "S"	=	**SELLER**
PARTY "B"	=	**BUYER**

Party "E" is the exchanger, party "S" is the seller, and party "B" is simply the buyer, we have to have these three parties somewhere to accomplish a "3-Way-Exchange". You must remember from the outset that the only person who is really concerned with or about the exchange is party "E", the Exchanger. Party "S", the Seller only wants to sell, he/she in fact would probably rather not be in the exchange. Party "B", the Buyer only wants to buy. The only interest the Seller and the Buyer have in the exchange is to the extent that the exchange will help them sell what they want to sell, and buy what they want to buy. This attitude of the Seller and the Buyer creates certain inherent problems with the 1031 exchange.

WHO GETS WHAT?

One of the difficult things in the exchange for brokers/salespersons and escrow officers is being able to balance the flow money and notes between the Exchanger, Seller, and Buyer. If you figure a regular net sheet for each principal in the exchange, it simplifies the problem. You will get confused from time to time, with practice it becomes second nature. If you get confused, return to the Automobile Story, apply what you should have learned from that and you will be able to fit all of the pieces in their respective places. In the meantime, remember, to be totally tax deferred;

THE PARTIES TO THE EXCHANGE

"E" The Exchanger	The Exchanger can only get the building he/she is exchanging into. he/she cannot get "Mortgage Relief, Cash, Notes or other Boot."
"S" The Seller	The Seller sells everything, in our next example the Seller exchanges their 64 units for "E's" 30 Units, then "S" sells the 30 units to "B" the Buyer.

"B" The Buyer — The Buyer buys the 30 units, their only function in the exchange is to buy. he/she doesn't care who he/she buys from as long as he/she gets clear title. Though he/she buys "E's" building, he/she will buy it from "S" the Seller. The Seller is only acting as an accommodator in this instance, all of the negotiations have been done by "E" and "B" prior to entering into the escrow, and any changes in the escrow will be done between "E" and "B".

LET'S PUT A HYPOTHETICAL EXCHANGE TOGETHER FOR CLARIFICATION

"E", the Exchanger has a 30 unit building, he/she has listed it, sold it and it is in escrow. he/she wants to exchange the equity in their 30 unit building into a 64 unit building he/she has found for sale. The 64 unit building has been listed by the Seller, "S". "S", the Seller doesn't want the 30 unit building, he/she only wants to sell their 64 unit building, he/she will participate in the exchange providing there will be no additional or costs to him, **(INDEMNIFICATION AGREEMENT)** and that he/she will be in the same position as he/she would be in if he/she were to simply sell their building.

"E", the Exchanger has had their 30 unit building on the market for sometime and "B", the Buyer has presented and 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 he/she will go through with the sale to "B", the Buyer. "B", the Buyer accepts on that basis, and with the additional notation or agreement that he/she, "B", may be buying the 30 unit building from a Seller of "E's" choice. The Buyer then will be buying the building from a substituted seller, a seller of "E's" choice, further, it is agreed that "B", the Buyer will not incur any additional charges because of the substituted seller, if there is one.

WE HAVE ALL OF THE ELEMENTS OF A 3 WAY EXCHANGE

"E"	"S"	"B"
30 UNIT	**64 UNIT**	**0 UNIT**
EXCHANGER ONLY	**SELLER ONLY**	**BUYER ONLY**
EXCHANGES 30 UNITS	SELLS EVERYTHING	BUYS 30 UNITS FROM
TO "S" FOR 64 UNITS	**64 UNITS AND 30 UNITS**	**"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 he/she 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 building closing first, and the 64 unit building closing as soon as possible thereafter.

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.

   (At this point "E", the Exchanger is finished, he/she owns the 64 units, and that part of the escrow that needs concurrent or semi-concurrent closings is finished.)

8. At the same time that "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 named by the number of parties, or entities involved in the exchange, not the number of buildings that are involved. In a typical "3-Way-Exchange" we have 3 parties, One: the exchanger, Two: the buyer, and Three: the seller. In an unlikely "2-Way-Exchange" we have two exchangers. In a "5-Way-Exchange", we normally have One Buyer, One Seller, and Three Exchangers. You can't usually go by the number of buildings, because one Exchanger may be exchanging into one, two or more buildings.

THE BALANCING OF THE 1031 EXCHANGE

The exchange is really a paper shuffle. It feels exactly as if you are selling more than one building and trying to get them to close on the same day. The owner of the 30 units takes an offer and accepts the offer on the thirty units from the buyer of the thirty units. Escrow is opened just as if there were to be a sale, the difference in the escrow is a reference in the escrow instructions that the seller of the 30 units will be exchanging and the fact that the Seller will replace himself with a seller of their choice. The price of the properties in the exchange is the same as in an ordinary sale. Each Owner pays their normal expenses. The owner of the 30 units pays the expenses of sale on the thirty units and the acquisition cost on the 64 units, since he/she is the Exchanger, the only person in the transaction that is interested in the exchange, he/she will bear the burden of any additional expenses incurred because of the exchange. The owner of the 64 units pays the expenses of sale on the 64 units, and the Buyer pays the acquisition costs on the 30 units. The key is to have the price and terms decided upon by the respective parties, the walk throughs and contingencies removed just as you would in a normal sale. If you are short cash anywhere, in the transaction on the 30 unit, or the transaction on the 64 unit, for a totally tax deferred exchange, the paper will have to be carried by the "S", the Seller. Should the Exchanger have to carry paper, it will not void the exchange, he/she will simply have taxes to the extent of the paper carried, and according to current law, that would fall under the "Installment Sale" for tax treatment. You have the following steps to perform to insure that the exchange will be completed.

■ APPRAISE EACH BUILDING ■

ESTIMATED FAIR MARKET VALUE OF 30 UNIT BUILDING

Staying with the 30 unit building, our rents are currently $750 per month, our vacancy factor is running 2% of the Gross Scheduled Income, Expenses are 35% of the Gross Scheduled Income and the laundry income is $300 per month. The new buyers will have to put 30% down, obtain a new 1st Trust Deed, 70% of value at 10% Interest, amortized over 30 years. The lender will want a near break even to make this loan.

ESTIMATED VALUE OF 30 UNIT BUILDING

Gross Scheduled Income	$273,600		
Vacancy Factor 2%	($ 5,472)		
Gross Operating Income	$268,128		
Expenses 35%	($ 95,760)		
Net Operating Income	$172,368		
New Loan	($176,918)	=	$1,680,000
Cash Flow	**($ 4)**		
Total Loans			$1,680,000
Cash Down Payment 30%			$ 720,000
Selling Price of Building			**$2,400,000**

ESTIMATED NET CASH FOR EXCHANGE AT CLOSE OF ESCROW ON 30 UNITS

It is important now that we figure out just how much cash we have for the next investment. In we will have all of the normal expenses, less the loans of record, plus the acquisition costs, but we will not have any income taxes to pay now.

ESTIMATED AFTER TAX, AFTER ACQUISITION COSTS NET 30 UNITS

Selling Price of Building	$2,400,000
Less Expenses of Sale	($ 168,000)

Less Loans of Record	($ 570,646)
Less Acquisition Costs of 64 Unit	($ 131,354)
Less Income Taxes Due	($ None Now)
GROSS CASH FOR DOWN PAYMENT	**$1,530,000**

ESTIMATED FAIR MARKET VALUE OF 64 UNIT BUILDING

The 64 unit building, our rents are currently $750 per month, our vacancy factor is running 2% of the Gross Scheduled Income, Expenses are 35% of the Gross Scheduled Income and the laundry income is $640 per month. The down payment will be our net from the sale of the 30 units, this amounts to $1,530,000 down, or 29.88% of the purchase price, the exchanger will obtain a new 1st Trust Deed, in the amount of $3,590,000 which represents 70.12% of value at 10% Interest, amortized over 30 years. The lender will want a near break even to make this loan.

Gross Scheduled Income	$583,680		
Vacancy Factor 2%	($ 11,674)		
Gross Operating Income	$572,006		
Expenses of Operation 35%	($204,288)		
Net Operating Income	$367,718		
New 1st Trust Deed	($378,058)	=	$3,590,000
Cash Flow	**($ 10,340)**		
Total Loans			$3,590,000
Cash Down Payment			$1,530,000
Purchase Price of 64 Units			**$5,120,000**

Now we have the values of the buildings, the net cash down payments that will be required, loans etc., we need to know what the seller of the 64 unit building, "S" the Seller, will net at the close of escrow.

ESTIMATED NET FROM ESCROW FROM 64 UNIT BUILDING

In finding this net, we will use 7% for expenses of sale, the building currently has a $450,000 loan against it, that will have to be paid off. Following is the Sellers net from the sale of the 64 unit building.

Selling Price	$5,120,000
Less Expenses of Sale	($ 358,400)
Less Loans of Record	($ 450,000)
Estimated Net Cash From 64 Units	**$4,311,600**

In a regular sale, this is the net the seller could expect, in the exchange, this is the amount that the Seller will net after the sale of the 64 units, and after the sale of the 30 units. It is important to remember that the net that the seller receives should be the same in the exchange as it would be in a normal sale.

THE EXCHANGE

"E" THE EXCHANGER DOES THE FOLLOWING

A. Obtains a new 1st Trust Deed on the 64 units of $3,590,000 at 10% interest, amortized for 30 years, and payable in equal monthly installments of $31,504.82.

B. "E", Deeds their 30 Unit Building to "S", the Seller.

C. "E", gives "S", the Seller no down payment at all.

"S", THE SELLERS NET FROM THE 64 UNITS

CASH FROM NEW 1st TRUST DEED	$3,590,000
EXPENSES OF SALE ON 64 UNITS	($ 358,400)
PAYOFF OLD LOAN ON 64 UNITS	($ 450,000)
"S", THE SELLERS NET FROM 64 UNITS	**$2,781,600**

"S", the Seller now has $2,781,600 in cash and the 30 unit building, or the equity in the 30 unit building. He/she will now sell the 30 units to "B", the Buyer to get the remainder of their cash from the exchange transaction.

"S", THE SELLERS NET FROM THE 30 UNITS

CASH FROM NEW 1st TRUST DEED	$1,680,000
EXPENSES OF SALE ON 30 UNITS	($ 168,000)
PAYOFF OLD LOAN ON 30 UNITS	($ 570,646)

LESS "E's" ACQUISITION COSTS ON THE 64 UNITS	($ 131,354)
PLUS CASH DOWN PAYMENT ON THE 30 UNITS	$ 720,000
"S", THE SELLERS NET FROM THE 30 UNITS	**$1,530,000**

"S", THE SELLERS FINAL NET, CLOSE OF BOTH ESCROWS

30 UNITS	**64 UNITS**
$1,530,000	$2,781,600

You must remember that "S", the Seller, should get the same amount after the close of both escrows that he/she would get when you figure a normal Seller's Net Sheet for a normal sale.

SELLERS TOTAL NET FROM BOTH BUILDINGS

TOTAL NET FROM SALE OF 30 UNITS	$1,530,000
TOTAL NET FROM SALE OF 64 UNITS	$2,781,600
TOTALS FROM THE SALE OF BOTH BUILDINGS	**$4,311,600**

This $4,311,600 is exactly what "S", the Seller would get from the sale of their 64 units, in the exchange the proceeds have to come from both buildings, more a formality than anything, to arrive at their total net at the close of all of the escrows.

If this were a "4-way Exchange", the Seller would have to sell three buildings instead of two, and so on for the 5-way etc..

INDEMNIFICATION AGREEMENT

Since the Seller is really a conduit in the exchange, a paper pusher, and since he/she actually has legal title to the 30 unit building for a few minutes or days, he/she has placed himself in a position of being liable for that building and any problems that might develop with the new buyer. he/she should be concerned with this position of liability. In other words, he/she was the owner of record when the Buyer bought the building, he/she has $4,311,600 in cash, he/she may be in a more suable position than "E" the Exchanger. For this reason you will want to use an "INDEMNIFICATION AGREEMENT" some attorneys have you use them only for the Exchanger, I prefer that the Buyer and the Exchanger hold the Seller harmless in case of a law suite over the performance of the building, in this case the 30 units. What the Indemnification Agreement does is cause the Buyer and the Seller to admit that they do not expect "S", the Seller to be liable just because he/she owned the building for a few minutes or days, that if

there is a problem, the building does not perform as indicated or proposed, that "B", the Buyer will hold "S", the Seller harmless, and only go after "E", the Exchanger who he/she realizes he/she actually purchased the building from. "E", the Exchanger, further agrees that if "B", the Buyer should go after "S", the Seller, he/she will defend "S", the Sellers position.

A TYPICAL INDEMNIFICATION AGREEMENT WE USED TO USE

BUYER'S NAMED further acknowledges that REPLACEMENT SELLER'S NAME has never inspected the property(ies) in this exchange and owned by NAME OF REAL SELLER OR EXCHANGER and assumes no responsibility therefore, and BUYER'S NAMED does hereby agree to indemnify and hold harmless REPLACEMENT SELLER'S NAME from any and all obligations, warranties (expressed or implied) or representations which REPLACEMENT SELLER'S NAME has assumed or agreed to as the "Seller" in said transaction wherein REPLACEMENT SELLER'S NAME may be selling or exchanging. The above indemnity agreement shall also extend to the accuracy of rental statements which EXCHANGER or REAL SELLER is required to furnish to the parties in the above described escrow(s).

REAL SELLER OR EXCHANGER shall furnish rental statements for pro-ration purposes as set forth in this instruction. The parties hereto agree that all tenant deposits as shown therein shall be a debit to USUALLY THE REAL SELLER, BUT COULD BE THE BUYER and a credit to COULD BE THE BUYER, REAL SELLER-EXCHANGER, OR EVEN THE REPLACEMENT SELLER at the close of escrow (same to be adjusted in the subsequent sale and/or exchange escrow(s).

BUYER'S NAME agrees that after the performance of the conditions specified in the escrow instructions as herein contemplated he/she will indemnify and hold REPLACEMENT SELLER'S NAME free and harmless from any liability, costs, loss, damages, fees of a breach of lease, breach of contract, or any other matter related to said property which occurred or is alleged to have occurred after the close of escrow as herein provided, including but not limited to, sums paid or liabilities incurred in settlement of, and expenses paid or incurred in connection with claims, suits, or judgments under this contract and all attorney fees incurred in connection with claims, suits, or judgments under this contract and all attorney fees incurred thereon, expenses paid or incurred in enforcing the terms hereof, in procuring or attempting to procure release from liability, or in recovering or attempting to recover losses or expenses paid or incurred as aforesaid.

BUYER'S NAME agrees that in the event any part of this indemnity clause shall be void under the laws of the place governing the construction hereof, then such part only shall be considered as deleted and the remainder of this clause shall endure in full force and effect.

REPLACED SELLER'S NAME agrees to full cooperation with " NAME OF REAL SELLER-EXCHANGER " and comply with this exchange instruction, but will at no time be put to any additional cost, or expense on behalf of the exchange. Further NAME OF REPLACEMENT SELLER will not be held responsible or liable in any way with " REAL SELLER-EXCHANGER " exchange or any qualification of same by the Internal Revenue Service.

NOTES IN THE EXCHANGE

There are usually some 2nd Trust Deeds that will have to be carried on one or both buildings involved in the exchange. This is particularly true with larger buildings, or when institutional financing is difficult to get, the amount doesn't meet the requirements for the down payment, the down payment is low, or the value of the building is trying

to be maintained with low interest rate secondary paper. The decision has to be made whether the seller will keep only the trust deed on their building, in this case the 64 units, or the trust deeds on both buildings. Ideally he/she would carry both trust deeds if two existed. It is difficult however to get him to carry a trust deed, second or whatever on a building that was not really his. It can be done if it is explained properly, but in most instances the real point of value is never explained to the seller and the note on the 30 units, in this case, would have to be discounted and sold, or "E", the Exchanger would have to carry it himself. The reason that 2nd Trust Deeds become necessary is that getting the 1st Trust Deed required is not normally possible, given the down payment involved, to achieve the full value of the building being sold or exchanged. If you consider the normal down payment to be in the neighborhood of 30%, and that the normal 1st Trust Deed obtainable is 65%, you find 5% short on loans and will have to make the difference up somehow, or sell the building at a lower price. Generally, the value is equalized by carrying secondary paper, or a 2nd Trust Deed.

When this occurs and you balance the exchange, in theory, "S", the Seller would end up with a note on the 30 units and a note on the 64 units. In actual practice it is not usually this way. Usually the Seller will carry the not on their 64 units, gut, for a myriad of reasons, he/she will not carry the note on the 30 units, unfamiliarity with the building, unfamiliarity with the note market that exists, and just plain fear. The idea of carrying a note on their own building does not tickle him to death, but he/she can live with it, carrying a note on someone else's building is unthinkable because of their unfamiliarity with any inherent problems and their lack of incentive to educate himself.

This unfamiliarity of the Sellers will make it necessary to discount and sell one note, and sometimes both notes. Let's go through the exchange with both buildings having 2nd Trust Deeds on them. We will have "S", the Seller carry both notes. Later we will do an example where the note on the 30 unit building is discounted and sold and "S" the Seller retains the note on the 64 units.

THE 30 UNITS IN EXCHANGE WITH 2nd TRUST DEEDS

What we want to do here is learn what can happen with secondary financing. The terms of the sale, exchange will change because of the addition of this secondary paper, the lower down payment and the lower 1st Trust Deed. You must know that we will have to appraise each building again. We have 25% down, a New 1st Trust Deed of $1,560,000 which is 65% of the purchase price, at 10% interest, amortized for 30 years and payable in equal monthly installments of $13,690.12, a 2nd Trust Deed of 10% of the value, in the amount of $240,000 at 10%, interest only, payable in equal monthly installments of $2,000, all due an payable in 7 years.

30 UNITS WITH A 2nd TRUST DEEDS

Gross Scheduled Income	$273,600
Vacancy Factor 2%	($ 5,472)
Gross Operating Income	$268,128
Expenses 35%	($ 95,760)
Net Operating Income	$172,368

1st Trust Deed Payment	($164,281)	=	$1,560,000
Sub-Total Net	$ 8,087		
2nd Trust Deed Payment	($ 24,000)	=	$ 240,000
Cash Flow	**($ 15,913)**		
Total Loans - - - - - - -			$1,800,000
Cash Down Payment - - - - - -			$ 600,000
Selling Price - - - - - -			**$2,400,000**

The cash flow in this case is negative because of the lower down payment, or greater leverage, in this instance a 25% down payment. The amount of the loans are up to $1,800,000 as opposed to $1,680,000 in the last example.

NET FROM ESCROW 30 UNITS

Selling Price	$2,400,000
Less Expenses of Sale	($ 168,000)
Less Loans of Record	($ 570,646)
NET CASH AND PAPER, CLOSE ESCROW	**$1,530,000**
NET PAPER CARRIED OR SOLD	$ 240,000
NET CASH - - - - -	$1,290,000

THE 64 UNITS IN EXCHANGE WITH 2nd TRUST DEEDS

What we want to do here is learn what can happen with secondary financing. The terms of the sale, exchange will change because of the addition of this secondary paper, the lower down payment and the lower 1st Trust Deed. Realize that we will have to appraise each building again. We have 25% down, a New 1st Trust Deed of $3,328,000 which is 65% of the purchase price, at 10% interest, amortized for 30 years and payable in equal monthly installments of $29,205.58, a 2nd Trust Deed of 10% of the value, in the amount of $502,000 at 10%, interest only, payable in equal monthly installments of $4,333.33 all due an payable in 7 years.

64 UNITS WITH 2nd TRUST DEEDS

Gross Scheduled Income	$583,680		
Vacancy Factor 2%	($ 11,674)		
Gross Operating Income	$572,006		
Expenses 35%	($204,288)		
Net Operating Income	$367,718		
1st Trust Deed	($350,467)	=	$3,328,000
Sub-Total Net	$ 17,251		
2nd Trust Deed	($ 50,200)	=	$ 502,000
CASH FLOW - - - - -	**($ 32,949)**		
TOTAL LOANS - - - - - - -			$3,830,000
CASH DOWN PAYMENT - - - - -			$1,290,000
SELLING PRICE OF UNITS - - - -			**$5,120,000**

There is a negative cash flow because of the reduced down payment, 25% in this example. The total loans are up from $3,590,000 in the last example to $3,830,000 in this example. I left the building values the same for ease in understanding.

NET FROM ESCROW 64 UNITS

Selling Price	$5,120,000
Less Expenses of Sale	($ 358,400)
Less Loans of Record	($ 450,000)
NET CASH AND PAPER, CLOSE ESCROW	**$4,311,600**
NET PAPER CARRIED OR SOLD	$ 502,000
NET CASH - - - -	$3,809,600

THE EXCHANGE WITH PAPER

IN THE EXCHANGE WITH PAPER, "E", THE EXCHANGER DOES THE FOLLOWING;

A. "E", the Exchanger, obtains a new 1st Trust Deed of $3,328,000 on the 64 Unit Building, at 10% Interest, Amortized for 30 Years, and payable in equal monthly installments of $29,205.58.

B. "E", the Exchanger, gives "S", the Seller, a 2nd Trust Deed on the 64 Units in the

amount of $262,000 at 10%, Interest Only, Payable in equal monthly installments of $2,183.33, all due an payable in 7 Years.

C. "E", the Exchanger, deeds their 30 unit building to "S", the Seller, and "S", the Seller, deeds their 64 units to "E", the Exchanger.

"E", THE EXCHANGER IS FINISHED AT THIS POINT

"S", THE SELLERS NET FROM THE 64 UNITS

CASH FROM NEW LOAN	$3,328,000
PAYOFF OLD LOAN ON 64 UNITS	($ 450,000)
EXPENSES OF SALE ON 64 UNITS	($ 358,400)
"S", THE SELLERS NET FROM LOAN ON 64	**$2,519,600**
PAPER FROM SALE OF 64 UNITS	$ 262,000
TOTAL CASH & PAPER FROM 64 UNITS	**$2,781,600**

In addition, "S", the Seller, owns the 30 Unit Apartment Building. Therein lies the remainder of their equity which was in the 64 units.

"S", THE SELLER NOW SELLS THE 30 UNIT BUILDING

SELLING PRICE OF 30 UNITS	$2,400,000
Less Expenses of Sale	($ 168,000)
Less Loans of Record	($ 570,646)
NET CASH & PAPER CLOSE OF ESCROW	**$1,530,000**
PAPER CARRIED ON 30 UNIT BUILDING	$ 240,000
NET CASH FROM THE SALE OF THE 30 UNITS	$1,290,000

"S"'s FINAL NET FROM THE SALE OF BOTH BUILDINGS

NET CASH FROM BOTH BUILDINGS

CASH FROM 64 UNITS	$2,519,600
CASH FROM 30 UNITS	$1,290,000
TOTAL CASH	**$3,809,600**

NET PAPER FROM BOTH BUILDINGS

PAPER FROM 64 UNITS	$ 262,000
PAPER FROM 30 UNITS	$ 240,000
TOTAL PAPER	**$ 502,000**

TOTALS, CASH & PAPER, BOTH BUILDINGS

TOTAL CASH	$3,809,600
TOTAL PAPER	$ 502,000
TOTAL CASH & PAPER FROM SALE	**$4,311,600**

These amounts, cash and paper are exactly what the "S", the Seller would have gotten from the sale of their 64 units. The only difference being that he/she has two notes instead of one note. He/she has one note, on the 30 Unit Building for $240,000, and one note on the 64 unit building for $262,000, together they would add up to the note he/she would have had to carry on their 64 unit building. Same terms.

Balancing the exchange with paper is really quite simple if the seller will carry the paper on both buildings, ie., one note on their building and the necessary note on the exchange building. "E"'s cash flow picture will come out better than the projected cash flow because he/she making the payments on only one note, $262,000 at 10% instead of $502,000 at 10%. LET'S TAKE A LOOK AT THE 64 UNITS AS EXCHANGED INTO IN THIS EXAMPLE.

"E"'s CASH FLOW PICTURE AFTER EXCHANGING INTO THE 64 UNITS

Gross Scheduled Income	$583,680		
Vacancy Factor 2%	($ 11,674)		
Gross Operating Income	$572,006		
Expenses 35%	($204,288)		
Net Operating Income	$367,718		
1st Trust Deed	($350,467)	=	$3,328,000
Sub-Total Net	$ 17,251		
2nd Trust Deed	($ 26,200)	=	$ 262,000
CASH FLOW - - - -	**($ 8,949)**		
TOTAL LOANS - - - - - -			$3,590,000
NOTE FROM 30 UNITS AS PART OF DOWN PAYMENT			$ 240,000
CASH DOWN PAYMENT - - - - -			$1,290,000
SELLING PRICE OF UNITS - - - -			**$5,120,000**

This movement of paper and cash from one building to the other and the ultimate adjustment of **"WHO GETS WHAT"**, is a little difficult at first, but becomes easier and easier. After you have done it for the first time, it gets easier and easier. As with all things, if you are doing a lot of complicated exchanges you will get so good at balancing them that it will scare you. In the meantime, go low and slow. It is too easy to forget one part, find your not balancing and end crediting erroneously, when this happens, just start over from the very beginning.

THIS, OF COURSE, IS THE CLASSIC APPROACH

In the late 70's a family named Starker was involved in an exchange where they traded some real property for "Credit on the Books" of a large company, the company was to hold the money, pay interest, and when the Starkers found suitable property they were going to exchange their equity into it. They finally found the property that they wanted, completed the transaction, and filed the transaction as a 1031 I.R.C. Tax Deferred Exchange. The Internal Revenue Service disallowed the exchange because there were no concurrent closings. The Starker's fought the decision and the 9th District Court of Appeals finally concluded that the exchange was valid. (There were several Starker Cases, not worth going into at this late date.) The name for this type of transaction became the "DELAYED EXCHANGE".

This put into motion a whole quandary of delayed exchanges, with tax attorney's trying to set up the unchallengeable "Delayed Exchange". Attorneys tried to pattern the exchange as closely as they could to the actual Starker Exchanges. Initially this led to the assumption that the money had to be places with an Accommodator, someone who would look and act like the company that the Starker's had exchanged to. It was felt that the money from the exchange should never be in the hands of the Exchanger, as this might make it taxable, disallow the exchange, further, the Starker's had to declare the interest on the money that was being held as ordinary income, this led to the idea that you shouldn't get the interest on the money, the Accommodator should. Initially these exchanges were set up so that the accommodator actually purchased the exchange property, the up-leg, and transferred it to the exchanger in a separate escrow. The weakness in the plan was the stability of the Accommodators, everyone was getting into the Accommodator business, few were bonded, and if they were, their bonds didn't normally cover the possible liability that might occur should the accommodator take off. Eventually, this happened, several Accommodators made leave in a southerly direction with exchanger's money. One other problem that was occurring was that the Exchangors would place the exchange money in these accommodator accounts for years, without finding an upleg. Finally, the Internal Revenue Service forged some guidelines to help guide the unwary exchanger.

1. The period from the close of the escrow of the exchanged property had to fit into these guidelines;
   a. You had to identify your up-leg within 45 days from the close of escrow.
   b. You had to close the exchanged into property, the upleg, in not less than 180 days, or before you file your next tax return, whichever comes first.
2. Receiving interest on your funds was alright, but it would be classified as ordinary income.
3. The use of an accommodator was not necessarily needed. Very vague in this area, some tax attorneys feel that you can hold the funds in an escrow account, with your name on it for security, and simply keep the funds isolated from your other funds.

Time Period for Delayed Exchange 180 Days

Close of Escrow --------------- *45 Days* ---------------> *Find Upleg*

--------------- *180 Days* ------------------------------------> *Close Escrow, but Before Filing Next Tax Return.*

These Starkers, their cases and their willingness to fight, eliminated a lot of heartache, and heart palpitations for all of us. Today the Delayed Exchange is the only exchange really used, and with direct deeding, that is deeding from the seller to the exchanger, and the exchanger to the buyer, not from the Exchanger to a Seller or Accommodator, and then the Seller or Accommodator to the buyer.

"DELAYED CLOSE" you may hear the term "Delayed Close", this refers to something that we did years ago, that was to close escrow on one property on Monday and the second property on Friday or some other day as soon as we possibly could. If you here it, forget it, it no threat today.

Today, most people feel that the use of Accommodators is unnecessary, and much to the chagrin of many, this feeling came to late. Their Accommodators are not basking in the Sun in Brazil or some other tropical paradise that does not allow extradition.

And now boys and girls, back to our example of notes in the exchange.. This example would be a workable solution for everyone. Everyone got what they would have gotten before the exchange with the exception of the Exchanger, their position is improved. The problem again is the fact that the Seller will rarely carry the $240,000 note on the 30 unit building. This will in reality strengthen their position as two smaller notes are normally more valuable than one larger note. Should he/she need cash for some reason he/she could more easily sell either of the two smaller notes rather than one large note, and there is always the possibility of the notes being paid off in different years, which in some cases will create less of a tax burden for "S", the Seller, assuming he/she has used the Installment method of reporting the notes on their income taxes.

Now, and for the second or third time, back to the Seller carrying the paper on our exchange property;

IN REAL LIFE THE SELLER IS WARY OF CARRYING THE NOTE ON THE 30 UNITS

In real life, the Seller will carry the $262,000 note on their 64 units, but will want all cash coming from the 30 unit building. He/she simply will be afraid of the $240,000 Note on the 30 units. This gives you several options;

A. Discount and sell the 2nd Trust Deed on the 30 Units, creating all cash to use for the down payment on the 64 units.

B. Have the Exchanger keep the $240,000 note on the 30 units, this will qualify for installment sale treatment and have the net effect of raising the tax basis on the 64 units as well as giving him $24,000 a year to offset the cash flows on the 64 units. This is not a bad position.

These types of exchanges are a little more normal in the real world, but become more complicated when you are trying to show the Exchanger their "After Exchange Position", still you need to be aware of them, and have a working understanding of how to present them to a client.

EXCHANGING WITH DISCOUNTED PAPER

First let us outline the problem so we understand what it is that we are trying to accomplish. You have found a buyer for the thirty unit building. The terms are the same for the buyer as in the previous example where the Exchanger had to carry the $240,000 2nd Trust Deed to accomplish the exchange. Secondly, you make an offer on the 64 unit building. The Seller goes along with the price and terms, except for one thing, he/she will not carry the paper on the 30 unit building. He/she will carry the paper on the 64 units, and he/she will cooperate in every way

in the exchange, providing you include an "Indemnification Agreements" from the Exchanger, and the Buyer of the 30 units, the only part of the exchange that he/she will not go along with is carrying the paper on the 30 units. You have to make the decision to keep the paper on the 30 units, or discount and sell the paper on the 30 units. In this example we will discount and sell the paper on the 30 units.

THE MOST LIKELY STEPS TO COMPLETION ARE AS FOLLOWS;

1. Sell the 30 Unit Building.
2. Figure the Net to the Exchanger From Escrow.
3. Figure your acquisition costs on the 64 unit building.
4. Figure your net after the discounting and sale of the $240,000 2nd Trust Deed on the 30 Units.
5. Write the offer on the 64 units.
6. Complete the Exchange and figure out "WHO GETS WHAT".

STRUCTURING THE SALE OF THE 30 UNITS
WILL BE EXACTLY THE SAME AS IN THE PREVIOUS EXAMPLE

THE 30 UNITS IN EXCHANGE WITH THE 2nd TRUST DEED DISCOUNTED

What we want to do here is learn what can happen with secondary financing. The terms of the sale, exchange will change because of the addition of this secondary paper, the lower down payment and the lower 1st Trust Deed. Again you must realize that we will have to appraise each building again. We have 25% down, a New 1st Trust Deed of $1,560,000 which is 65% of the purchase price, at 10% interest, amortized for 30 years and payable in equal monthly installments of $13,690.12, a 2nd Trust Deed of 10% of the value, in the amount of $240,000 at 10%, interest only, payable in equal monthly installments of $2,000, all due an payable in 7 years.

30 UNIT CASH FLOW WITH PAPER

Gross Scheduled Income	$273,600		
Vacancy Factor 2%	($ 5,472)		
Gross Operating Income	$268,128		
Expenses 35%	($ 95,760)		
Net Operating Income	$172,368		
1st Trust Deed Payment	($164,281)	=	$1,560,000
Sub-Total Net	$ 8,087		

2nd Trust Deed Payment	($ 24,000)	=	$ 240,000
Cash Flow	**($ 15,913)**		
Total Loans - - - - - - -			$1,800,000
Cash Down Payment - - - - - -			$ 600,000
Selling Price - - - - - -			**$2,400,000**

NET FROM ESCROW 30 UNITS

Selling Price	$2,400,000
Less Expenses of Sale	($ 168,000)
Less Acquisition Costs on 64 Units	($ 131,354)
Less Loans of Record	($ 570,646)
NET CASH AND PAPER, CLOSE ESCROW	**$1,530,000**
NET PAPER CARRIED OR SOLD	$ 240,000
NET CASH - - - -	$1,290,000

TO EFFECTIVELY USE THE PAPER, IT WILL HAVE TO BE DISCOUNTED AND SOLD, TURNED INTO CASH .

DISCOUNT & SELL THE 2nd TRUST DEED, PAPER

Even though "S", the Seller, will be the real seller of the 2nd Trust Deed, you will have to find someone who will purchase the note at a discount for cash. You will make the arrangements for him to purchase it form the escrow once it is created, "S", the Sellers, only function is that the of the Seller of the Note, as he/she will be the owner of the 30 units when the note is created. It can be sold in the same escrow, but it is more customary to sell it in a separate escrow at the same escrow company.

To make this 7 year $240,000 10% interest only note sellable to a trust deed buyer, you will have to discount it so that the return is, or annual yield will fit the current market place for discounted 2nd Trust Deeds of that size. Let us say for example that a purchaser of this size note, for 7 years will demand a 20% return on their money before he/she will be interested in buying this note. The $240,000 7 year note at 10% interest, will sell for approximately $150,000 to achieve the 20% annual return that the buyer of 2nd Trust Deeds is demanding in our example. This equates to a $100,000 discount. The value of secondary paper varies from market to market, this would be an average sale at this writing, but you will have to determine the market when you are ready to sell any note.

NET CASH FROM 2nd TRUST DEED

FACE VALUE OF NOTE	$240,000
DISCOUNT NECESSARY TO CONVERT TO CASH 42% ='S	($ 90,000)
NET CASH FROM THE SALE OF THE NOTE	**$150,000**

NEW NET CASH FROM ESCROW

CASH FROM SALE OF 30 UNITS	$1,290,000
NET CASH FROM SALE OF SECONDARY NOTE	$ 150,000
TOTAL CASH FOR EXCHANGE	**$1,440,000**

Discounting the note $100,000 has the same effect on "E", the Exchanger as selling the 30 unit building for $100,000 less, to the buyer the price is the same, as the discount would actually be credited to the buyer of the note and debited from the Exchanger of the 30 Units.

LOGICAL SEQUENCE FOR EXCHANGE INTO 64 UNITS

A. "E", the Exchanger, gets a new loan on the 64 units in the amount of $3,328,000.

B. "E", the Exchanger, gives "S", the Seller a 2nd Trust Deed on the 64 units in the amount of $352,000.

C. "E", the Exchanger, deeds the 30 unit building to "S", the Seller.

"E", THE EXCHANGER IS THROUGH, HE/SHE IS THE OWNER OF THE 64 UNITS.

IT WOULD BE PRUDENT TO LOOK AT "E's" CASH FLOW IN THIS EXCHANGE.

"E's" CASH FLOW PICTURE WITH NOTE DISCOUNT, 64 UNITS

Gross Scheduled Income	$583,680		
Vacancy Factor 2%	($ 11,674)		
Gross Operating Income	$572,006		
Expenses 35%	($204,288)		
Net Operating Income	$367,718		
1st Trust Deed	($350,467)	=	$3,328,000
Sub-Total Net	$ 17,251		
2nd Trust Deed	($ 35,200)	=	$ 352,000
CASH FLOW - - - - -	**($ 17,949)**		
TOTAL LOANS - - - - - -			$3,680,000
CASH DOWN PAYMENT - - - - -			$1,440,000
PURCHASE PRICE OF UNITS - - - -			**$5,120,000**

"S", THE SELLERS NET FROM THE SALE OF THE 64 UNITS

CASH FROM NEW LOAN	$3,328,000
PAYOFF OLD LOAN ON 64 UNITS	($ 450,000)
EXPENSES OF SALE ON 64 UNITS	($ 358,400)
"S", THE SELLERS NET FROM LOAN ON 64	**$2,519,600**
PAPER FROM SALE OF 64 UNITS	$ 352,000
TOTAL CASH & PAPER FROM 64 UNITS	**$2,871,600**

In addition, "S", the Seller, owns the 30 Unit Apartment Building. Therein lies the remainder of their equity which was in the 64 units.

"S", THE SELLER NOW SELLS THE 30 UNIT BUILDING

SELLING PRICE OF 30 UNITS	$2,400,000
Less Expenses of Sale	($ 168,000)
Less Loans of Record	($ 570,646)
NET CASH & PAPER CLOSE OF ESCROW	**$1,661,354**
LESS PAPER CARRIED ON 30 UNIT BUILDING	($ 240,000)
PLUS CASH VALUE OF PAPER SOLD	$ 150,000
LESS "E" s, ACQUISITION COSTS	$ 131,354
NET CASH FROM THE SALE OF THE 30 UNITS	**$1,440,000**

"S", THE SELLERS NET FROM BOTH BUILDINGS

TOTAL CASH & PAPER FROM 64 UNITS	$2,519,600
NET CASH FROM THE SALE OF THE 30 UNITS	$1,440,000
TOTAL CASH FROM BOTH BUILDINGS	**$3,959,600**
PLUS TOTAL PAPER TO "S", FROM 64 UNITS	$ 352,000
TOTAL PAPER TO "S", FROM 30 UNITS	$ SOLD
TOTALS FROM THE SALE OF BOTH BUILDINGS	**$4,311,600**

CASH & PAPER TO "S', THE SELLER, FROM THE SALE OF BOTH BUILDINGS

$4,311,600

"S", THE SELLERS SITUATION

Doing the exchange this way, "S", the Seller ends up with $240,000 less paper to carry than he/she would in an ordinary sale. He/she was going to carry $502,000 on their 64 units, since the paper on the 30 units was sold, turned into cash, "S" has $150,000 more cash and $240,000 less paper, or paper in the amount of $262,000 which he/she is carrying on their 64 units, no paper is carried by "S" on the 30 units. If you are faced with these situations, the discounting of paper, make certain that you point out "S"'s cash advantage over an ordinary sale.

"B", THE BUYERS SITUATION

"B", the Buyer, is in exactly the same situation as he/she was in our first examples. In other words, he/she is still making the payments on the 2nd Trust Deed on the 30 units, he/she is making the payment to the buyer of the 2nd Trust Deed, not to "E", the Exchanger as in our first example.

"E", THE EXCHANGER SITUATION

"E", the Exchanger is the only one who initially appears to have suffered in this type of exchange. He/she has lost the amount that the note has been discounted, or in this case, he/she has lost $90,000 in discounting the note. Since this has to be made up somewhere, you will find that he/she will be making the payments on a 2nd Trust Deed that is $90,000 greater than in our last example, where there was no discounting of notes. Since the interest rate on all of the notes are at 10%, it becomes obvious that "E" will be making payments in an amount $9,000 greater, annually, than he/she would have had "S", the Seller taken the paper on the 30 units. **You must not suffer from the illusion that this is a bad way to use the exchange, it is prudent in some situations, you must determine the end result of each exchange, using the different alternatives, but most, go by "E", the Exchangers feelings.**

WE NEED TO LOOK AT "E", THE EXCHANGERS CASH FLOW SITUATION, ONCE AGAIN, AFTER THIS EXCHANGE

"E's" CASH FLOW PICTURE WITH NOTE DISCOUNT

Gross Scheduled Income	$583,680		
Vacancy Factor 2%	($ 11,674)		
Gross Operating Income	$572,006		
Expenses 35%	($204,288)		
Net Operating Income	$367,718		
1st Trust Deed	($350,467)	=	$3,328,000
Sub-Total Net	$ 17,251		
2nd Trust Deed	($ 35,200)	=	$ 352,000

CASH FLOW - - - - -	**($ 17,949)**	
TOTAL LOANS - - - - - - - - -		$3,680,000
CASH DOWN PAYMENT - - - - - - - -		$1,440,000
PURCHASE PRICE OF UNITS - - - - - - -		**$5,120,000**

Notice again that "E", the Exchangers cash flow is $9,000 less than in the Situation where "E", the Exchanger, carried all of the paper. This is simply because the $90,000 discount on the 2nd Trust Deed on the 30 units has been added to the 2nd Trust Deed on the 64 units, and at 10% interest, this will amount to $9,000 more in payments, annually.

You will face any number of situations in the exchange, the main thing is to improve you or your clients position, don't get bogged down in the discount of notes. Many estates are missing 50% to 100% of their growth potential because someone wouldn't take the discount on the 2nd Trust Deeds that needed to be sold. You have to concentrate on the overall growth within the confines of the
situation that you are working on or in. Think constantly in terms of appreciation.

LOOK AT "S", THE SELLERS NET IN THE TWO EXAMPLES WE HAVE COVERED

	1st EXAMPLE ALL CASH	2nd EXAMPLE DISCOUNTED PAPER
CASH FROM SALE OF 64 UNITS	$2,781,600	$2,519,600
PAPER FROM SALE OF 64 UNITS	$ -0-	$ 352,000
CASH FROM SALE OF 30 UNITS	$1,530,000	$1,440,000
PAPER FROM SALE OF 30 UNITS	$ -0-	$ -0-
TOTALS BOTH EXAMPLES	**$4,311,600**	**$4,311,600**

It becomes apparent that "S", the Seller ends up with the same gross amount of cash, but in different forms. In our first example he/she ends up with all cash, while in our 2nd example, he/she ends up with $3,959,600 in cash and $352,000 as a 2nd Trust Deed on the 64 Units. their total is, in both examples, $4,411,600, but that amount comes to him in different forms, ie., cash and or paper in varying amounts. In our next example, where "S", the Seller carries all of the paper, you will find that he/she will still have the same gross amount, but it will be paper from both buildings, and the cash will be less because of the increased amount of paper that he/she is carrying.

THINK IN TERMS OF APPRECIATION

You will have any number of situations arising from the Tax Deferred Exchanges that you will be

doing. You should be concentrating on improving your position from an economical standpoint, by this I mean don't get bogged down in what you think are losses on discounted notes. Most estates are missing 25% to 300% of their growth potential because someone wouldn't take the discount on the 2nd Trust Deeds that needed to be sold to complete the exchange transaction. **You have to learn to think in terms of appreciation and growth. In our current example, if property increases in value 8% during the next year, your growth with the 30 units would be $192,000, and your growth with the 64 units would be $409,600.** You can see that by giving up the $90,000 necessary to sell the 2nd Trust Deed on the 30 units to complete the exchange, you have gained $217,600 in one year. It would be more profitable if you didn't have to discount the 2nd Trust Deed on the 30 Units to complete the exchange, but since "S", the Seller, usually won't take the 2nd Trust Deed on the 30 units you wouldn't be able to complete the exchange in most cases. This leads us to the situation that will ultimately arise where you, or your exchanger keeps the paper, as boot, collecting the payments on the 2nd Trust Deed on 30 units, which has the net effect of off setting any negative cash flow that you will have on the 64 units. In this case, under current tax law, you would have a partially tax deferred exchange to the extent of the actual cash equity that passes through to the new building, and the 2nd Trust Deed would fall privy to "Installment Sale" treatment as far as taxes are concerned. This can be a very beneficial financial situation if you don't need the additional $150,000 that was raised from the sale of the 2nd Trust Deed. This is worth looking at. First it would be beneficial to look at the two situations as we have put them together thus far, cash flow and tax savings.

THE TWO EXCHANGES COMPARED

Let's take a look at these two situations, in Situation I the paper is simply traded through to the old owner. In Situation II, the paper is discounted $90,000, sold for $150,000 and the $150,000 is added to the cash down payment on the 64 units. We'll run the examples out for our traditional 5 year period, and compare them before taxes, after taxes and after sale.

PURCHASE & YEAR I CASH FLOW

	Paper Traded SITUATION I				Paper Sold SITUATION II			
Gross Sched. Inc.	$583,680				$583,680			
Vacancy 5%	($ 29,184)				($ 29,184)			
Gross Oper. Inc.	$554,496				$554,496			
Expenses 40%	($233,472)				($233,472)			
Net Oper. Inc.	$321,024				$321,024			
1st T. D.	($293,036)	=	$3,328,000	@ 8%	($293,036)	=	$3,328,000	@ 8%
Sub-total Net	$ 27,988				$ 27,988			
2nd T. D.	($ 26,200)	=	$ 262,000	@10%	($ 35,200)	=	$ 352,000	@ 10%
CASH FLOW	**$ 1,788**				**($ 7,212)**			
Total Loans			$3,590,000				$3,680,000	
Note Traded Through			$ 240,000	Note Sold for $150,000				
Cash Down			$1,290,000	Used for part of Down			$1,440,000	
Purchase Price of Building			$5,120,000				$5,120,0000	

ADJUSTED TAX BASIS OF TWO SITUATIONS

Paper Traded **Paper Sold**

	SITUATION I	SITUATION II
Purchase Price of Building	$5,120,000	$5,120,000
Plus Acquisition Costs	$ 131,354	$ 131,354
Less Deferred Gain	($1,000,000)	($1,000,000)
Plus Discount on Note	Note Traded	$ 90,000
Adjusted Tax Basis	**$4,251,354**	**$4,341,354**

ANNUAL DEPRECIATION, SITUATION I, SITUATION II

Here we will use 70% of the Adjusted Tax Basis of the Property as the allocation for improvement, and 27½ year Straight Line Depreciation.

$$\frac{\text{Adjusted Tax Basis X 70\%}}{\text{Depreciable Years}} = \text{Annual Depreciation}$$

SITUATION I, PAPER TRADED THROUGH

$$\frac{\$4,251,354 \text{ X } 70\% = \$2,975,948}{27\frac{1}{2} \text{ Years}} = \$108,216 \text{ Annual Depreciation}$$

SITUATION II, PAPER DISCOUNTED & SOLD

$$\frac{\$4,341,354 \text{ X } 70\% = \$3,038,948}{27\frac{1}{2} \text{ Years}} = \$110,507 \text{ Annual Depreciation}$$

TAX PICTURE, SITUATION I, AND SITUATION II – YEAR 1

Gross Scheduled Income		$583,680		$583,680
Vacancy Factor 5%	($ 29,184)		($ 29,184)	
Expenses 40%	($233,472)		($233,472)	
Interest 1st T.D.	($265,235)		($265,235)	
Interest 2nd T.D.	($ 26,200)		($ 35,200)	
Depreciation	($108,216)		($110,507)	
TOTAL DEDUCTIONS	($662,307)	($662,307)	($673,598)	($673,598)
NET TAX LOSS OR GAIN		**($ 78,627)**		**($ 89,918)**

Note that Situation II has $11,291 more annual write-off than Situation I, this is because of the discount on the 2nd Trust Deed of $90,000, which would have the net effect of having sold the 30 units for $90,000 less, also, because of this $90,000 discount, the purchase had to be balanced by adjusting the 2nd Trust Deed on the 64 units upward by $90,0000.

The write-off will completely shelter the cash flow until the cash flow is greater than the annual write-off. The owner can deduct an additional $25,000 of this Passive Loss against their Active Income. This makes some interesting calculations to accurately preserve the tax basis. We will place the investor, in both Situations I, and II in a 37.3% Combined Marginal Tax Bracket. The $25,000 in passive loss that he/she is allowed will amount to a tax savings of $9,325. Since he/she can use only $25,000 worth of the write-off, their remaining write-off will not be lost, but carried over to subsequent years. This would be their cash After Tax Cash Flow (ATCF) picture for year 1.

AFTER TAX CASH FLOW, YEAR 1, SITUATIONS I, AND II

	SITUATION I	SITUATION II
Cash Flow Year 1	$ 1,788	$ 7,212
Tax Savings year 1	$ 9,325	$ 9,325
After Tax Cash Flow Year 1	**$11,113**	**$16,537**

YEAR II, CASH FLOWS, SITUATIONS I & II

	Paper Traded **SITUATION I**				**Paper Sold** **SITUATION II**			
Gross Sched. Inc.	$630,374				$630,374			
Vacancy 5%	($ 31,519)				($ 31,519)			
Gross Oper. Inc.	$598,855				$598,855			
Expenses 40%	($252,150)				($252,150)			
Net Oper. Inc.	$346,705				$346,705			
1st T. D.	($293,036)	=	$3,300,199[2]	@ 8%	($293,036)	=	$3,300,199 [13]	@ 8%
Sub-total Net	$ 53,669				$ 53,669			
2nd T. D.	($ 26,200)	=	$ 262,000	@10%	($ 35,200)	=	$ 352,000	@ 10%
CASH FLOW	**$ 27,469**				**$ 18,469)**			
Total Loans			$3,562,199				$3,652,199	
Note Traded Through			$ 240,000				Note Sold for $150,000	
Cash Down			$1,290,000				$1,440,000	
Purchase Price of Building			$5,120,000				$5,120,0000	

[2] The 1st Trust Deed in both Situations, would be paid down to $3,300,199 at the end of year 1. In other words, the loan has amortized, or been paid down $27,801 in the 1st year.

TAX PICTURE, SITUATION I, AND SITUATION II – YEAR II

Gross Scheduled Income		$630,374		$630,374
Vacancy Factor 5%	($ 31,519)		($ 31,519)	
Expenses 40%	($252,150)		($252,150)	
Interest 1st T.D.	($262,928)		($262,928)	
Interest 2nd T.D.	($ 26,200)		($ 35,200)	
Depreciation	($108,216)		($110,507)	
TOTAL DEDUCTIONS	($681,013)	($681,013)	($692,304)	($692,304)
NET TAX LOSS OR GAIN		**($ 50,639)**		**($ 61,930)**

AFTER TAX CASH FLOW, YEAR II, SITUATIONS I, AND II

	SITUATION I	**SITUATION II**
Cash Flow Year 1	$27,469	$18,469
Tax Savings year 1	$ 9,325	$ 9,325
After Tax Cash Flow Year 1	**$36,794**	**$27,794**

YEAR III, CASH FLOWS, SITUATIONS I & II

	Paper Traded SITUATION I				**Paper Sold SITUATION II**			
Gross Sched. Inc.	$680,804				$680,804			
Vacancy 5%	($ 34,040)				($ 34,040)			
Gross Oper. Inc.	$646,764				$646,764			
Expenses 40%	($272,322)				($272,322)			
Net Oper. Inc.	$374,443				$374,443			
1st T. D.	($293,036)	=	$3,237,483[3]	@ 8%	($293,036)	=	$3,237,483[14]	@ 8%
Sub-total Net	$ 76,407				$ 76,407			
2nd T. D.	($ 26,200)	=	$ 262,000	@10%	($ 35,200)	=	$ 352,000	@ 10%
CASH FLOW	**$ 50,207**				**$ 41,207**			
Total Loans			$3,532,090				$3,622,090	
Note Traded Through			$ 240,000				Note Sold for $150,000	
Cash Down			$1,290,000				$1,440,000	
Purchase Price of Building			$5,120,000				$5,120,0000	

[3] The 1st Trust Deed in both Situations, would be paid down to $3,270,090 at the end of year 2. In the column that denotes total loans, I have added the current balances of all the loans, for reference.

TAX PICTURE, SITUATION I, AND SITUATION II – YEAR III

	Situation I		Situation II	
Gross Scheduled Income		$680,804		$680,804
Vacancy Factor 5%	($ 34,040)		($ 34,040)	
Expenses 40%	($302,107)		($302,107)	
Interest 1st T.D.	($260,429)		($260,429)	
Interest 2nd T.D.	($ 26,200)		($ 35,200)	
Depreciation	($108,216)		($110,507)	
TOTAL DEDUCTIONS	($730,992)	($730,992)	($742,283)	($742,283)
NET TAX LOSS OR GAIN		**($ 50,188)**		**($ 61,479)**

AFTER TAX CASH FLOW, YEAR III, SITUATIONS I, AND II

	SITUATION I	SITUATION II
Cash Flow Year 1	$50,207	$41,207
Tax Savings year 1	$ 9,325	$ 9,325
After Tax Cash Flow Year 1	**$59,532**	**$50,532**

YEAR IV, CASH FLOWS, SITUATIONS I & II

	Paper Traded SITUATION I				**Paper Sold SITUATION II**			
Gross Sched. Inc.	$735,268				$735,268			
Vacancy 5%	($ 37,763)				($ 36,763)			
Gross Oper. Inc.	$698,505				$698,505			
Expenses 40%	($294,107)				($294,107)			
Net Oper. Inc.	$404,398				$404,398			
1st T. D.	($293,036)	=	$3,202,170[4]	@ 8%	($293,036)	=	$3,202,170[15]	@ 8%
Sub-total Net	$111,362				$111,362			
2nd T. D.	($ 26,200)	=	$ 262,000	@10%	($ 35,200)	=	$ 352,000	@ 10%
CASH FLOW	**$ 85,162**				**$ 76,162**			

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4 The 1st Trust Deed in both Situations, would be paid down to $320201700 at the end of year 3.

Total Loans	$3,464,170	$3,554,170
Note Traded Through	$ 240,000	Note Sold for $ 150,000
Cash Down	$1,290,000	$1,415,830
Purchase Price of Building	$5,120,000	$5,120,0000

TAX PICTURE, SITUATION I, AND SITUATION II — YEAR IV

Gross Scheduled Income		$755,268		$755,268
Vacancy Factor 5%	($ 37,763)		($ 37,763)	
Expenses 40%	($302,107)		($302,107)	
Interest 1st T.D.	($257,722)		($257,722)	
Interest 2nd T.D.	($ 26,200)		($ 35,200)	
Depreciation	($108,216)		($110,507)	
TOTAL DEDUCTIONS	($732,008)	($732,008)	($732,008)	($732,008)
NET TAX LOSS OR GAIN		**$ 23,260**		**$ 11,969**

AFTER TAX CASH FLOW, YEAR IV, SITUATIONS I, AND II

	SITUATION I	**SITUATION II**
Cash Flow Year 1	$85,162	$76,162
Tax Savings Year 1	$ 9,325	$ 9,325
After Tax Cash Flow Year 1	**$94,487**	**$85,487**

YEAR V, CASH FLOWS, SITUATIONS I & II

	Paper Traded SITUATION I	**Paper Sold SITUATION II**
Gross Sched. Inc.	$794,090	$794,090
Vacancy 5%	($ 39,704)	($ 39,704)
Gross Oper. Inc.	$754,386	$754,386
Expenses 40%	($317,636)	($317,636)
Net Oper. Inc.	$436,750	$436,750

1st T. D.	($293,036)	=	$3,1639250[5]	@ 8%	($293,036)	=	$3,163,925[16]	@ 8%
Sub-total Net	$143,714				$143,714			
2nd T. D.	($ 26,200)	=	$ 262,000	@10%	($ 35,200)	=	$ 352,000	@ 10%
CASH FLOW	**$117,514**				**$108.514**			

Total Loans	$3,532,090	$3,622,090
Note Traded Through	$ 240,000	Note Sold for $150,000
Cash Down	$1,290,000	$1,440,000
Purchase Price of Building	$5,120,000	$5,120,0000

[Check Note Sold for $150,000 Against Down Payment ????????]

TAX PICTURE, SITUATION I, AND SITUATION II – YEAR V

Gross Scheduled Income		$794,090		$794,090
Vacancy Factor 5%	($ 39,704)		($ 39,704)	
Expenses 40%	($317,636)		($317,636)	
Interest 1st T.D.	($254,792)		($254,792)	
Interest 2nd T.D.	($ 26,200)		($ 35,200)	
Depreciation	($108,216)		($110,507)	
TOTAL DEDUCTIONS	($746,548)	($746,548)	($757,839)	($757,839)
NET TAX LOSS OR GAIN		**$ 47,542**		**$ 36,251**

AFTER TAX CASH FLOW, YEAR IV, SITUATIONS I, AND II

	SITUATION I	SITUATION II
Cash Flow Year 1	$117,514	$108,514
Tax Savings year 1	$ 9,325[6]	$ 9,325[17]
After Tax Cash Flow Year 1	**$126,839**	**$117,839**

THIS 5TH YEAR, WE WANT TO SELL THE BUILDING IN BOTH SITUATIONS I, AND II PAY THE TAXES, AND COMPARE THE RETURNS ON THE TWO SITUATIONS

BUILDING VALUE, END OF YEAR V, SITUATIONS I AND II

5 The 1st Trust Deed in both Situations, would be paid down to $3,163,925 at the end of year 5.

6 This year, the tax line tells us that you should be paying taxes, but because of the $25,000 annual limitation of passive loss against Active Income, we still have ($106,194) unused shelter in Situation I, and ($125,296) unused shelter in Situation II. This leads to the fact that in both Situations, we have depreciated $125,000 for the five year period.

	SITUATION I			SITUATION II			
Gross Sched. Inc.	$857,617 [7]			$857,617 [18]			
Vacancy 5%	($ 42,881)			($ 42,881)			
Gross Oper. Inc.	$814,736			$814,736			
Expenses 40%	($343,047)			($343,047)			
Net Oper. Inc.	$471,689			$471,689			
1st T. D.	($396,233)	= $4,500,000	@ 8%	($396,233)	=	$4,500,000	@ 8%
Sub-total Net	$ 75,456			$ 75,456			
2nd T. D.	($ 75,000)	= $ 750,000	@10%	($ 75,000)	=	$ 750,000	@ 10%
CASH FLOW	**$ 456**			**$ 456**			
Total Loans		$5,250,000				$5,250,000	
Cash Down		$2,250,000				$2,250,000	
Purchase Price of Building		$7,500,000				$7,500,000	

NET CASH & PAPER, CLOSE OF ESCROW

	SITUATION I	SITUATION II
Selling Price of Building	$7,500,000	$7,500,000
Less Expenses of Sale 7½%	($ 562,500)	($ 562,500)
Less 1st Trust Deed	($3,163,925)	($3,163,925)
Less 2nd Trust Deed	($ 262,000)	($ 352,000)
NET CASH & PAPER C.O.E.	**$3,511,575**	**$3,421,575**

NET CASH FROM THE SALE

	SITUATION I	SITUATION II
TOTAL PROCEEDS FROM SALE	$3,511,575	$3,421,575
PAPER CARRIED	$ 750,000	$ 750,000
TOTAL CASH YEAR OF SALE	**$2,761,575**	**$2,671,575**

TOTAL GAIN AT TIME OF SALE

	SITUATION I	SITUATION II
Selling Price of the Building	$7,500,000	$7,500,000
Less Expenses of Sale	($ 562,500)[8]	($ 562,500)[19]
Less Adjusted Tax Basis	($4,126,354	($4,216,354)

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[7] Rents are up another 8% at the end of year 5, or the beginning of year 6.

[8] Here I show you how the expenses of sale are treated, in actual tax accounting, they would be added to the basis. The basis then will be Original Basis at Exchange – Depreciation Taxes + Sales Costs.

Total Gain	**$2,811,146**	**$2,721,146**

Here, we have that situation where, because of the $750,000 2nd Trust Deed carried on the sale, the $750,000 would be privy to Installment Treatment, which means that the taxes on the note would be due when the note was paid off. This would be fine from an investment standpoint, but what we want to do now is compare the two situations in terms of After Tax Cash Flows, and After tax net from the sale, what we will do is pretend that the sale was an all cash sale, strictly for comparison reasons.

TAXES DUE ON GAIN

	SITUATION I	SITUATION II
FEDERAL TAXES	$1,089,702	$1,054,062
STATE TAXES	$ 300,492	$ 290,593
TOTAL TAXES DUE	$1,390,194	$1,344,655

NET CASH AFTER TAXES, BOTH SITUATIONS

	SITUATION I	SITUATION II
CASH & NOTE C.O.E.	$3,511,575	$3,421,575
LESS TAXES DUE	($1,390,194)	($1,344,655)
AFTER TAX NET FROM SALE	**$2,121,381**	**$2,076,920**

RETURNS, 5 YEARS, SITUATION I, & SITUATION II

	SITUATION I	SITUATION II
CASH INVESTED	($1,530,000)[9]	($1,440,000)
ATCF YEAR 1	$ 11,113	$ 16,537
ATCF YEAR 2	$ 36,794	$ 27,794
ATCF YEAR 3	$ 59,532	$ 50,532
ATCF YEAR 4	$ 94,487	$ 85,487
ATCF YEAR 5	$ 126,839	$ 117,839
TOTAL 5 YEAR ATCF	$ 328,765	$ 298,189
AFTER TAX NET FROM SALE	$2,121,381	$2,076,920

[9] Cash down payment of $1,290,000 and the $240,000 2nd Trust Deed.

RETURNS 5 YEARS

	SITUATION I	SITUATION II
Internal Rate of Return	10.23%	10.89%
Average Annual Percentage Rate	10.56%	11.21%
Simple Average Rate	32.03%	32.99%

The returns come out, roughly the same, it is apparent that it would be better to trade the note through in the initial purchase, but since this is not usually feasible, the second alternative isn't that bad. Let's see what happens if the Seller of the 30 units keeps the 2nd Trust Deed when he/she exchanges the 30 Units for the 64 Units.

EXCHANGER KEEPING THE 2nd TRUST DEED ON THE 30 UNITS

The second possibility when secondary paper is involved in an exchange is that the Exchanger keeps the 2nd Trust Deed on their downleg property, or the property that he/she is exchanging from. In our example, this would have the net effect of lowering the payment and increasing the amount of the 2nd Trust Deed carried by the Seller on the 64 units. It will also increase the negative cash flow on the 64 unit building, in that the leverage would be increased, less of a down payment. The advantage to the Exchanger is that he/she will not have the discount on the 2nd Trust Deed, he/she will qualify for installment treatment on the 2nd trust deed, deferring the taxes due on that portion of the sale until the note is paid off, he/she will have the income from the note to off set any negative cash flows, and since the note qualifies as Passive Income, the 64 unit will shelter the payments on the note to the extent that it is capable of, also, the basis on the 64 units will be higher.

Before we get too deep in this transaction, let's look at the sale of the 30 units again, figure our net from escrow, and then purchase the 64 units. We will then detail the transaction for four years to try and understand the advantages of keeping this 2nd Trust Deed.

30 UNITS WITH 2nd TRUST DEED

Gross Scheduled Income	$273,600			
Vacancy Factor 2%	($ 5,472)			
Gross Operating Income	$268,128			
Expenses of Operation 35%	($ 95,760)			
Net Operating Income	$172,368			
New 1st Trust Deed	($164,281)	=	$1,560,000	@ 10%
Sub Total Net	$ 8,087			
Seller Carried 2nd Trust Deed	($ 24,000)	=	$ 240,000	@ 10%
Cash Flow	**($ 15,913)**			
Total Loans			$1,800,000	
Cash Down Payment 25%			$ 600,000	

Selling Price of 30 Units	**$2,400,000**

CASH FOR DOWN PAYMENT ON 64 UNITS, NET FROM ESCROW, 30 UNITS

Selling Price	$2,400,000
Less Expenses of Sale	($ 168,000)
Less Loans of Record	($ 570,646)
Less Acquisition Costs on 64 Units	($ 131,345)
NET CASH & PAPER CLOSE OF ESCROW	**$1,530,000**
GROSS PAPER, 2nd TRUST DEED, RETAINED BY SELLER	$ 240,000
NET CASH FOR DOWN PAYMENT ON 64 UNITS	**$1,290,000**

PURCHASE THE 64 UNITS

We will now purchase the 64 units with the $1,290,000 cash down payment, this will have the net effect of raising the dollar amount of the 2nd Trust Deed carried by the seller on the 64 units, in the exact amount of the 2nd Trust Deed that the Exchanger is keeping. In this example, the 2nd Trust Deed on the 64 units will be $502,000 at 10% Interest Only, and payable in equal monthly installments of $4,133.33. Remember that the Exchanger will still have the $240,000 2nd Trust Deed on the 30 units, at 10% interest only, payable in equal monthly installments of $2,000. This will have the of lowering the payments on the $502,000 2nd Trust Deed to $2,133.33 per month.

Gross Scheduled Income	$583,680			
Vacancy Factor 5%	($ 29,184)			
Gross Operating Income	$554,496			
Expenses of Operation 40%	($233,472)			
Net Operating Income	$321,024			
1st Trust Deed	($293,036)	=	$3,328,000	@8%
Sub Total Net	$ 27,988			
2nd Trust Deed	($ 50,200)	=	$ 502,000	@ 10%
CASH FLOW	**($ 22,212)**			
TOTAL LOANS			$3,830,000	
CASH DOWN PAYMENT 25%			$1,290,000	
PURCHASE PRICE OF 64 UNITS			**$5,120,000**	

CASH FLOW WITH 2nd TRUST DEED

CASH FLOW FROM 64 UNIT BUILDING	($22,212)
CASH FLOW FROM 2nd TRUST DEED CARRIED ON 30 UNITS	$24,000

EFFECTIVE CASH FLOW YEAR ONE, OR AT PURCHASE **$ 1,788**

GAIN ON 30 UNITS

Sales Price	$2,400,000
Less Expenses of Sale	($ 168,000)
Less Adjusted Basis	($ 393,750)
Potential Gain	**$1,838,250**
Recognized Gain on 2nd Trust Deed	($ 250,000)
Deferred Gain on 30 Units	**$1,598,250**

ADJUSTED BASIS OF 64 UNITS

Purchase Price	$5,120,000
Plus Acquisition Costs	$ 131,354
Less Deferred Gain	($1,598,250)
ADJUSTED BASIS OF 64 UNITS	**$3,653,104**

There are no taxes due on this transaction, at this time, because the gain on the exchange part is deferred and the gain on the $240,000 note is reported on an installment basis, which means that the gain on the $240,000 note will not be recognized until the note is paid off. The interest from the note is Passive Income, and is taxable at the same rate as your Active Income, but it is sheltered by Passive Loss, or if the 64 units has any additional write-off, which it does, the interest from the $240,000 note will be sheltered to the extent that the 64 Units will generate write-off.

ESTIMATED DEPRECIATION FROM THE 64 UNITS

Assuming a 70% improvement value and 27 ½ Year Straight Line Write-off, we will have the following;

$$\frac{\text{Adjusted Basis X Improvement Value}}{\text{Straight Line Depreciation}} = \text{Annual Depreciation}$$

$$\frac{\$3,653,104 \text{ X } 70\%}{27\tfrac{1}{2} \text{ Years}} = \$92,988$$

TAX SAVINGS YEAR I, 64 UNITS

Gross Scheduled Income $583,680

Vacancy Factor 5%	($ 29,185)	
Expenses of Operation 40%	($233,472)	
Interest 1st Trust Deed	($265,235)	
Interest 2nd Trust Deed	($ 50,200)	
Depreciation	($ 92,988)	
Total Deductions	**($671,080)**	($671,080)
NET TAX LOSS OR GAIN YEAR I		**($ 87,400)**

WRITE-OFF USED YEAR I, 64 UNITS

Interest From 2nd Trust Deed Sheltered	$ 24,000
Write-off from Active Income Sheltered	$ 25,000
Total Write-off Used Year I	**$ 49,000**

TAX BASIS DEPLETION, 64 UNITS, YEAR I

Total Write-Off Year I	($107,437)
Total Write-Off Used Year I	$ 49,000
REMAINING YEAR I DEPRECIATION	**($ 58,437)**

TAX BASIS, 64 UNITS, YEAR II

Original Tax Basis	$3,653,104
Tax Basis Used Year I	($ 49,000)
ADJUSTED TAX BASIS, END YEAR I, 64 UNITS	**$3,604,104**

AFTER TAX CASH FLOW YEAR I

Cash Flow From Building	($ 22,212)
After Tax Cash Flow From 2nd Trust Deed	$ 24,000
Tax Savings 37.3% Combined Marginal Tax Bracket	$ 9,325
AFTER TAX CASH FLOW YEAR I	**$ 11,113**

CASH FLOW YEAR II, 64 UNITS, RENTS UP 8%

Gross Scheduled Income	$630,374
Vacancy Factor 5%	($ 31,519)
Gross Operating Income	$598,855

Expenses of Operation 40%	($252,150)
Net Operating Income	$346,705
1st Trust Deed Payments	($293,036)
Sub Total Net	$ 53,669
2nd Trust Deed Payments	($ 50,200)
CASH FLOW YEAR II	**$ 3,469**

TAX PICTURE YEAR II

Gross Scheduled Income		$630,374
Vacancy Factor 5%	($ 31,519)	
Expenses of Operation 40%	($252,150)	
Interest 1st Trust Deed	($262,928)	
Interest 2nd Trust Deed	($ 50,200)	
Depreciation	($ 92,988)	
TOTAL DEDUCTIONS YEAR II	**($689,785)**	($689,785)
NET TAX LOSS OR GAIN YEAR II		**($ 59,411)**

AFTER TAX CASH FLOW YEAR II

Cash Flow From Building	$ 3,469
After Tax Cash Flow from 2nd Trust Deed Payments	$ 24,000
Tax Savings 37.3% Marginal Bracket, Active Income	$ 9,325
TOTAL AFTER TAX CASH FLOW YEAR II	**$ 36,794**

TAX BASIS YEAR III

Adjusted Tax Basis, Beginning Year II	$3,604,104
Tax Basis Used Year II	($ 49,000)
ADJUSTED TAX BASIS BEGINNING YEAR III	**$3,555,104**

CASH FLOW, 64 UNITS, YEAR III UP 8%

Gross Scheduled Income	$680,804
Vacancy Factor 5%	($ 34,040)

Gross Operating Income	$646,764
Expenses of Operation 40%	($272,322)
Net Operating Income	$374,442
1st Trust Deed Payments	($293,036)
Sub Total Net	$ 81,406
2nd Trust Deed Payments	($ 50,200)
CASH FLOW	**$ 31,206**

TAX PICTURE YEAR III

Gross Scheduled Income		$680,804
Vacancy Factor 5%	($ 34,040)	
Expenses of Operation 40%	($272,322)	
Interest 1st Trust Deed	($260,429)	
Interest 2nd Trust Deed	($ 50,200)	
Depreciation	($ 92,988)	
TOTAL DEDUCTIONS YEAR II	**($709,979)**	($709,979)
NET TAX LOSS OR GAIN YEAR II		**($ 29,175)**

AFTER TAX CASH FLOW YEAR III

Cash Flow From Building	$ 31,206
After Tax Cash Flow from 2nd Trust Deed Payments	$ 24,000
Tax Savings 37.3% Marginal Bracket, Active Income	$ 9,325
TOTAL AFTER TAX CASH FLOW YEAR II	**$ 64,531**

TAX BASIS YEAR III

Adjusted Tax Basis, Beginning Year II	$3,604,104
Tax Basis Used Year II	($ 49,000)
ADJUSTED TAX BASIS BEGINNING YEAR III	**$3,555,104**

CASH FLOW, 64 UNITS, YEAR IV UP 8%

Gross Scheduled Income	$735,268
Vacancy Factor 5%	($ 36,763)
Gross Operating Income	$698,505
Expenses of Operation 40%	($294,107)
Net Operating Income	$404,398
1st Trust Deed Payments	($293,036)
Sub Total Net	$111,362
2nd Trust Deed Payments	($ 50,200)
CASH FLOW	**$ 61,162**

TAX PICTURE YEAR IV

Gross Scheduled Income		$735,268
Vacancy Factor 5%	($ 36,763)	
Expenses of Operation 40%	($294,107)	
Interest 1st Trust Deed	($257,722)	
Interest 2nd Trust Deed	($ 50,200)	
Depreciation	($ 92,988)	
TOTAL DEDUCTIONS YEAR II	**($731,780)**	($731,780)
NET TAX LOSS OR GAIN YEAR II		**$ 3,488**

AFTER TAX CASH FLOW YEAR IV

Cash Flow From Building	$61,162
After Tax Cash Flow from 2nd Trust Deed Payments	$24,000
Tax Savings 37.3% Marginal Bracket, Active Income	$ 8,024
TOTAL AFTER TAX CASH FLOW YEAR II	**$ 93,186**

TAX BASIS YEAR IV

Adjusted Tax Basis, Beginning Year II	$3,604,104
Tax Basis Used Year II	($ 49,000)
ADJUSTED TAX BASIS BEGINNING YEAR IV	**$3,555,104**

CASH FLOW, 64 UNITS, YEAR V UP 8%

Gross Scheduled Income	$794,089

Vacancy Factor 5%	($ 39,704)
Gross Operating Income	$754,385
Expenses of Operation 40%	($317,636)
Net Operating Income	$436,749
1st Trust Deed Payments	($293,036)
Sub Total Net	$143,713
2nd Trust Deed Payments	($ 50,200)
CASH FLOW	**$ 93,513**

TAX PICTURE YEAR V

Gross Scheduled Income		$794,089
Vacancy Factor 5%	($ 39,704)	
Expenses of Operation 40%	($317,636)	
Interest 1st Trust Deed	($254,791)	
Interest 2nd Trust Deed	($ 50,200)	
Depreciation	($ 92,988)	
TOTAL DEDUCTIONS YEAR II	**($755,319)**	($755,319)
NET TAX LOSS OR GAIN YEAR II		**$ 38,770**

AFTER TAX CASH FLOW YEAR IV

Cash Flow From Building	$93,513
After Tax Cash Flow from 2nd Trust Deed Payments	$24,000
Tax Savings 37.3% Marginal Bracket, Active Income	($ 5,136)
TOTAL AFTER TAX CASH FLOW YEAR II	**$112,377**

TAX BASIS YEAR IV

Adjusted Tax Basis, Beginning Year II	$3,604,104
Tax Basis Used Year II	($ 49,000)
ADJUSTED TAX BASIS BEGINNING YEAR IV	**$3,555,104**

SELL THE BUILDING END YEAR V, RENTS UP 8%

Gross Scheduled Income	$857,616			
Vacancy Factor 5%	($ 42,881)			
Gross Operating Income	$814,735			
Expenses of Operation 40%	($343,046)			
Net Operating Income	$471,689			
1st Trust Deed Payments	($396,233)	=	$4,500,000	@ 8%
Sub Total Net	$ 75,456			
2nd Trust Deed Payments	($ 75,000)	=	$ 750,000	@ 10%
CASH FLOW	**$ 93,513**			
TOTAL LOANS			$5,250,000	
CASH DOWN PAYMENT			$2,500,000	
SELLING PRICE OF BUILDING			**$7,750,000**	

NET CASH & PAPER CLOSE OF ESCROW

Selling Price of Building	$7,500,000
Less Expenses of Sale 7½%	($ 562,500)
Less 1st Trust Deed	($3,163,925)
Less 2nd Trust Deed	($ 520,000)
Net Cash & Paper Close of Escrow	**$3,253,575**

TOTAL GAIN AT TIME OF SALE

Selling Price of the Building	$7,500,000
Less Expenses of Sale	($ 562,500)
Less Adjusted Tax Basis	($3,555,104)
Total Gain	**$3,382,396**

TAXES DUE ON GAIN

FEDERAL TAXES	$1,315,917
STATE TAXES	$ 363,330
TOTAL TAXES DUE	$1,679,247

NET CASH AFTER TAXES

CASH & NOTE C.O.E.	$3,253,575
LESS TAXES DUE	($1,390,194)
AFTER TAX NET FROM SALE	**$1,863,381**

AFTER TAX NET FROM $240,000 NOTE

The 2nd Trust Deed that we carried on the 30 units is an integral part of this investment, we will pay the taxes on that to see just what we will net, since it is the same year, the taxes will be 39.6% for Federal, and 11% for State.

Note Value & Basis	$250,000
Less Federal Taxes Due	($ 99,000)
Less State Taxes Due	($ 27,500)
After Tax Net From 2nd Trust Deed	**$123.500**

RETURNS, 5 YEARS

CASH INVESTED	($1,530,000)
ATCF YEAR 1	$ 11,113
ATCF YEAR 2	$ 36,794
ATCF YEAR 3	$ 64,531
ATCF YEAR 4	$ 93,186
ATCF YEAR 5	$ 112,377
TOTAL 5 YEAR ATCF	$ 318,001
AFTER TAX NET FROM SALE	$1,863,381
PLUS AFTER TAX NET FROM NOTE	$ 123,500
TOTAL AFTER TAX CASH FROM SALE	**$1,986,881**

RETURNS 5 YEARS

Internal Rate of Return	7.76%
Average Annual Percentage Rate	9.13%
Simple Average Rate	30.13%

With the 1993 Federal Tax Rates hitting 39.6%, these example would show greater returns if they

were run out 7 years instead of 5 years. Still, if our Investor did not sell the notes, he/she would have an annual income of $24,000 from the 2nd Trust Deed of $240,000 carried on the 30 units, and $75,000 annual income from the 2nd Trust Deed carried on the sale of the 64 units, not to mention what kind of interest rate the Investor could generate on the $1,863,381 after tax net from the sale of the 64 units.

CONVERSION OF USE

You can convert personal residences into income producing properties, and you can convert income producing properties into personal residences. Most tax attorneys think that the conversion period is one year, one tax period, others say six months to one year. Personally, I feel one year is the more prudent path. Suppose you own the home that you live in, and you buy another home and move into it. You rent your former residence out. It becomes income producing property, and is privy to all of the benefits of income property. You can depreciate it and so forth, your purchase price being your basis, and then you would select an appropriate improvement value, and depreciate the property. You can move from your home, rent the home, move into an apartment building that you own, live there for two or three years and move back to the home, again using the home as your personal residence. If you were transferred to another city, and this demanded that you change your residence, and you were having problems selling your house, or you knew you were going to move back in a year or two, you could legally rent the property out, declare your knew residence as your residence, but you can't depreciate the old rented residence if you want to keep it as a personal residence under 1034 of the Code. That situation is even "iffy" as far as the code is concerned. The problem being that you would declare your new residence as your personal residence, move back to your old residence, sell the new residence and not replace it.

EXCHANGE WORKSHEET

Name: ______________________ Date: ________
Conveyed: ______________________
Acquired: ______________________

COMPUTE REALIZED GAIN:

1.	FMV of Property Conveyed			$
2.	Adjusted Basis	($)		
3.	Exchange Costs [10]	($)		
4.	Total of [2 + 3]	($)	➤	($)
5.	Realized Gain = [1 – 4]			$

COMPUTE THE RECOGNIZED BOOT:

		CONVEYED		ACQUIRED		TRADE DOWN
6.	FMV [line 1]	$	(–)	$	➤	$ [11]
7.	Less Loans	($)		($)		
8.	Equity [Line 6-7]	$	(–)	$	➤	$

9.	Boot Received [largest in 6 or 8 trade down]	$
10.	Lesser of: Cash Boot [Line 8 Trade-Down] or Costs [line 3]	($)
11.	RECOGNIZED BOOT [line 9 - line 10]	$

COMPUTE THE RECOGNIZED GAIN:

12.	RECOGNIZED GAIN Lesser: Realized Gain [Line 5] or Recognized Boot [Line 11] - Not less than zero	$

COMPUTE THE NEW BASIS:

13.	Fair Market Value of Property Acquired	$
14.	Plus Recognized Gain [Line 12]	$
15.	Less Realized Gain [Line 5]	($)
16	New Basis - Property Acquired [Line 13 + 14 - 15]	$

[10] Use Total Costs, Acquisition Costs and Selling Expenses.

[11] Compute only if upleg is of less value than downleg.