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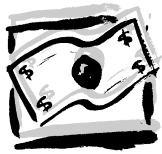
Often investors do not realize taxation on a personal residence is far different than taxation on income or investment property. The Taxpayer Relief Act of 1997 changed Internal Revenue Code treatment for the sale of a personal residence to allow a single taxpayer a $250,000 exclusion from capital gain. Married couples receive a $500,000 exclusion. The taxpayer must have resided in the property two of the last five years. This exemption may be used once every two years.

If an investor sells appreciated property they pay tax. However, property that qualifies for preferential tax treatment under Internal Revenue Code Section 1031 (IRC§1031) is treated quite differently. IRC §1031 states:

“No gain or loss shall be recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of like-kind.”

Therefore, an investor using IRC Section 1031 can exchange raw land for a rental home, an apartment complex for a shopping center or rental houses for an office building. The use of the property is a key factor in determining the tax treatment.



IRC §1031 remained substantially unchanged for the past 50 years until it was clarified with Treasury Regulations in 1991. The Regulations redefined the “Starker” or delayed exchange, including the 45 day identification requirements for replacement property. These Regulations also encourage the use of a Qualified Intermediary, deeming it a “safe harbor.” A “safe harbor” is a term which defines acceptable guidelines so a transaction will be regarded defensible.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 The "15% Myth"

Aimed at easing the public tax burden, this legislation further lowered the capital gains rate to 15% effective for sales after 5/5/03. However, the capital gains rate change is not as straight forward as it may seem. Many investors mistakenly believe all their long term capital gains will be taxed at 15%. While gain from appreciation is taxed at 15%, **gain from depreciation under the Taxpayer Relief Act of 1997 is still taxed at 25%**.

Example:

A property purchased in 1997 for $75,000 is depreciated and later sold for $150,000. At the time of the sale the adjusted basis is $50,000 creating gain of $100,000. Is the capital gain 15%? No! Only gain from appreciation is 15% (i.e., the $75,000 increase in value will be taxed at 15%). ***The remaining gain from depreciation of $25,000 will be taxed at 25%.***

Additionally, most states will apply state taxes over and above the Federal tax rates.

HOLDING PERIODS AND INDIVIDUAL TAX RATES

Holding Period	Sale May 6, 2003 and later
12 months or less	Taxed as ordinary income
MORE than 12 months	Upper Bracket 15% Lower Bracket 5%

- If a taxpayer in the lower tax bracket realizes a large capital gain, they will be forced to recognize part of their gain at the higher 15% rate.
- Corporate tax brackets of 15%-35% remain the same.

Every dollar saved in taxes will allow an investor to purchase 4-5 times as much real estate . . .

This is possible through the use of leverage. Leverage is a method of acquiring real estate worth many times the value of the initial investment. Tax deferment increases leverage. To understand the power of leverage, consider that ten percent appreciation is converted to a 50% profit with a 20% down payment. The following example shows the value of leverage by illustrating the benefit of exchanging versus selling.

Assume an investor sells a fully depreciated property and the capital gain is $200,000. This amount is subject to taxation. Federal tax brackets can range up to 25% for capital gain from depreciation. State taxes can be as high as 10%. Assuming a total tax bracket of approximately 35%, the capital gains tax would be:

$200,000 x 35% = $70,000

If the investor sold property with a gain of $200,000, they would pay taxes of $70,000 and have only $130,000 left to reinvest. On the other hand, the investor who exchanges pays no capital gains tax, leaving the entire $200,000 to reinvest.

	Sale	Exchange
Proceeds	**$200,000**	**$200,000**
Tax Owed	**-70,000**	**0**
Cash to Reinvest	**$130,000**	**$200,000**

If each investor purchases a building with a 20% down payment, using leverage each could buy property worth:

Value	**$650,000**	**$1,000,000**

In a single transaction, the investor who exchanged has $350,000 more property than the investor who sold property.

Nationwide Exchange Capabilities

Starker Services, Inc. (SSI), with over a decade of experience, is the oldest national Qualified Intermediary in the country. SSI is a Qualified Intermediary as specified by the Treasury Regulations.

Commitment to Service

Choosing a Qualified Intermediary can be the most important step in developing a defensible exchange. To ensure the highest level of service, SSI counselors have experience in negotiation, investment analysis, and real estate practice–which is extremely valuable should problems arise. Our senior counselors also possess the important Certified Exchange Specialist designation. A CES® is someone who has demonstrated their knowledge in exchange rules and procedures.

Exchange Knowledge

Starker Services, Inc. has a proven success record in the field of exchanging. Our experience as a Qualified Intermediary is a valuable resource to the investor, real estate agent and even the investor's tax and legal counsel. We have the capability to produce exchange documents and forward them to the appropriate parties, within hours, anywhere in the United States.

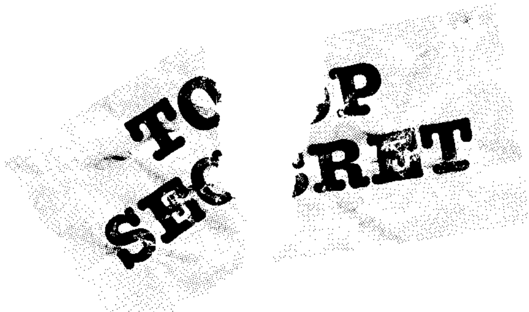
Qualified Intermediary

Starker Services, Inc. must represent the exchangor as both the seller and buyer. In fact, the 1991 Treasury Regulations specify which parties are disqualified from functioning as an Intermediary. With a few exceptions, the following are considered disqualified parties:

(1) A close family member or a controlled corporation, partnership or trust.

(2) Persons considered agents of the investor such as their:

- (A) Employee
- (B) Attorney Accountant
- (C) Investment Banker or Broker
- (D) Real Estate Agent or Broker



Benefits of Exchanging

Prior to 1979, trading properties was at best complicated. Completing a tax deferred exchange meant properties had to be "swapped" simultaneously. Unfortunately, this made exchanging cumbersome and risky, if not impossible.

The 1979 *Starker* decision in the U.S. 9th Circuit Court of Appeals enabled the non-simultaneous or "delayed" exchange to qualify for tax deferral. This gave investors the time necessary to find desirable replacement properties by using an Intermediary.

Treasury Regulations effective June 10, 1991 validated the delayed exchange and simplified the exchange process. These Regulations which included the use of Qualified Intermediaries, were welcomed by real estate owners who were previously uncertain of the viability of exchange transactions.

Many investors have held property for years because a sale translated into paying substantial taxes on their capital gain. Recent changes still do not offset the benefits of exchanging. Typically, as an investor's needs change over the years, the type of investment property they want changes. Relocation, estate building, retirement, desire to increase cash flow, and the need to reduce management responsibilities, could all affect the type of property investors want to own. Under IRC §1031, property owners now have the alternative of moving their investments (and equities) into more desirable or profitable properties.

The true power of exchanging is the ability to meet investment objectives without losing equity to taxation.

Investors often mistakenly believe they must acquire a property exactly like their relinquished property. They are surprised to learn a wide variety of properties can be considered *"like-kind."*

"Like-kind" does not refer to the type of property. Instead, it addresses the intended use of the property. Provided the property is initially acquired and held for either business or investment purposes, it can qualify as a suitable replacement property under IRC Section 1031.

For example, any of the following can be considered "like-kind" property exchanges: a duplex for a fourplex, bare land for improved property, a rental house for a retail center or an apartment building for an office building. Investors do not have to exchange for exactly the same type of property as relinquished.

The Tax Code lists items that are not considered "like-kind" and are expressly excluded from non-recognition. These include: (1) stock in trade or other property held primarily for sale; (2) stocks, bonds, or notes; (3) other securities or evidences of indebtness; (4) interests in a partnership; (5) certificates of trust or beneficial interest; and (6) choses in action. In addition, the Code was amended in 1989 rendering property outside the United States as not "like-kind" to US property.

The **"Napkin Test"** was devised by California tax attorney Marvin Starr of Miller, Starr, and Regalia, Oakland, California to provide investors with a simple way to determine if there is potential taxable "boot" in an exchange transaction.

Boot

"Boot" is a term used to describe *"non like-kind"* property received in an exchange. Cash, notes, personal property, reduction in mortgage (debt relief) are all examples of "boot" and are subject to tax. Most transactions can be restructured to help reduce or eliminate "boot." To avoid "boot", an exchanger must trade across or up in two areas: equity and mortgage.

The Test

Example 1:

	Property A	Property B
Sales Price	$150,000	$225,000
Equity	$50,000	$50,000
Mortgage	$100,000	$175,000

In this example, the exchangor is trading across or up in both areas. This is a completely tax deferred exchange with no "boot."

Example 2:

	Property A	Property B
Sales Price	$150,000	$155,000
Equity	$50,000	$40,000
Mortgage	$100,000	$115,000

Example 2, the exchangor has gone up in sales price and mortgage, but has gone down $10,000 in equity. This will be taxed as "cash boot." An exchangor can always offset mortgage "boot" or debt relief by adding more cash to the transaction, but they cannot offset "cash boot" by increasing the mortgage. The "Napkin Test" applies whether the investor trades into one property or multiple properties.

EXCHANGING CAN RANGE ANYWHERE FROM A SIMPLE SWAP OF TWO PROPERTIES TO A COMPLEX, MULTI-LEG, MULTI-PARTY TRANSACTION INVOLVING CONSTRUCTION AND/OR REVERSE EXCHANGES.

Simultaneous Exchanges

Prior to the 1979 Starker decision, most exchanges were limited to the simultaneous format. In a simultaneous exchange, both properties close the same day. *Since 1991, the only "safe harbor" for a simultaneous exchange is the use of a Qualified Intermediary.*

Delayed Exchanges

The *Starker* decision marked the advent of delayed exchanging. In the delayed exchange, "like-kind" property must be designated within 45 days of the sale closing. The replacement property must be closed by the 180th day. Once the replacement property has been located, the Qualified Intermediary acquires the rights to purchase it and immediately trades the property to the exchangor.

Construction (Improvement) Exchanges

The construction exchange (sometimes termed improvement exchange) is an exchange where the Intermediary retains ownership to the replacement property and improves it. Once construction is complete, the Intermediary trades the property to the exchanger.

Reverse Exchanges

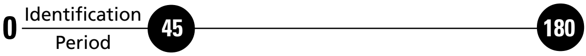
Ideally, an investor will be able to sell the relinquished property first and then close on the replacement property. Circumstances sometimes make it necessary to acquire the replacement property **before** closing on the relinquished property. This can be accomplished through a reverse exchange, now officially sanctioned by the IRS if structured properly.

Multi-Property and Multi-Party Exchanges

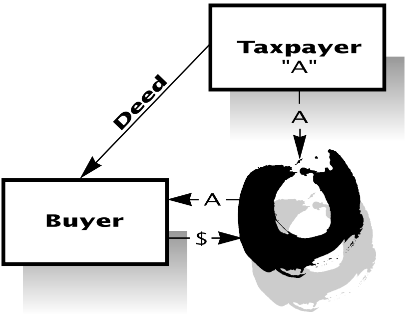
An investor can trade out of one property into several, or consolidate from smaller properties into one larger property. Two or more investors owning a property together can trade into separate properties.

The Delayed Exchange

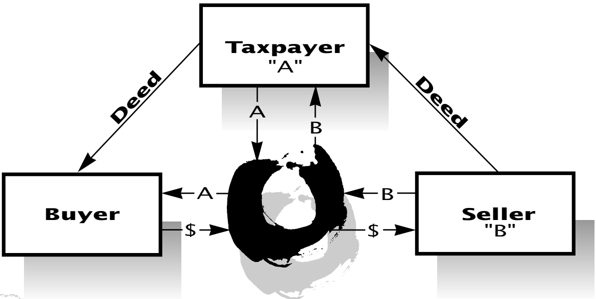
In a delayed exchange, the replacement property must be identified in writing within 45 days of closing the relinquished property and close within a total of 180 days.



PHASE I begins when the "Exchange Agreement" is signed and the relinquished property is transferred to Starker Services, through an Assignment Agreement. The property is then sold to the buyer and the cash proceeds are deposited into an exchange account.



PHASE II begins once a purchase contract is signed with a seller. Starker Services is assigned the contract and purchases the replacement property with funds held from the sale of the relinquished property. The exchange is completed when the replacement property is transferred back to the taxpayer pursuant to the "Exchange Agreement".



What is the difference between a sale and an exchange?

A sale is an exchange of real property for cash. A sale and repurchase of like-kind property following the Internal Revenue Service guidelines is an exchange; a "non-taxable" sale.

What provisions are required in a Purchase and Sale Agreement to enter into an exchange?

A Purchase and Sale Agreement should contain language establishing the exchangor's intent and notifying the buyer of the exchange. Examples are:

When Selling:

"It is the intent of the Seller to perform an IRC Section 1031 tax deferred exchange by trading the property herein with Starker Services, Inc. Buyer agrees to execute an Assignment Agreement at the request of Seller at no additional cost or liability to Buyer."

When Buying

"It is the intent of the Buyer to perform an IRC Section 1031 tax deferred exchange by trading the property herein with Starker Services, Inc. Seller agrees to execute an Assignment Agreement at the request of Buyer at no additional cost or liability to Seller."

Can an investor trade from several small properties into one large one?

Yes. An investor can also trade out of one large property into several smaller ones. When selecting more than one replacement property, investors must adhere to the Treasury guidelines regarding property identification.

How are the exchange funds protected?

Starker Services, Inc. has a variety of bonded exchange accounts including semi-fettered accounts, letters of credit, Treasury-backed and FDIC insured accounts.

Can an investor take some of the cash and exchange the remainder?

Yes. Any cash received will be subject to capital gains tax. If done properly, this won't affect partial deferment.

Can an investor receive cash from refinancing their property?

Refinancing is a non-taxable event if done correctly. Please call for details.

Can an investor carry back a note on their property?

Yes. There are several different ways to handle a note in an exchange. Tax or legal counsel should always be consulted whenever an investor carries a note.

Can a partnership, L.L.C., corporation or trust perform an exchange?

Yes. These entities can all exchange property they own for different property.

Can an investor trade out of a partnership?

Partnership *interests* generally are considered personal property and therefore do not qualify as "like-kind." If one partner wants to exchange separately they should consult their counsel to avoid triggering a taxable event. Starker Services, Inc. can provide more details.

Can assets other than real estate be exchanged?

Yes. Taxes can be deferred using IRC Section1031 on most personal property including, but not limited to, businesses, planes, boats, trucks and equipment. Call for a free booklet.

Can an investor cancel the exchange whenever they want?

The Exchange Agreement allows cancellation under certain circumstances, however, limits must be set. Having the right to cancel without restriction would be construed as control of cash which would disallow the exchange.

Can an investor build or improve a replacement property?

Yes. The Regulations describe this as a construction or improvement exchange. The Intermediary will keep the investor within the safe harbor guidelines.

Does an investor need to hire an attorney?

Starker's documents have been reviewed and approved by some of the most highly respected attorneys in the country. However, it is always advisable to have your counsel review any contracts signed.

Why use Starker Services?

We are the oldest, independent Qualified Intermediary in the Nation. We represent your interests while working with your closer or counsel. Exchanges are our only business - we have to be good.

SO EASY

Starting an exchange is a simple procedure.

The exchangor simply enters into the Purchase and Sale Agreement for the relinquished property. There is little difference between the familiar sale transaction and an exchange performed by SSI.

Starker Services, Inc., prepares documents and instructions needed, while overseeing the entire process. Each party to the transaction receives copies of all documents for review. If necessary Starker can prepare documents within one hour.

Step #1 Relinquished Property

1. Contact Starker Services, Inc. immediately upon deciding to perform an exchange. SSI works closely with all parties, including the real estate agent, attorney, and accountant.

2. SSI will ask for the name and address of the exchangor, the real estate agent, and the escrow holder/closing attorney. This is all Starker Services needs to prepare the documentation. Upon closing, ownership of the exchange property will transfer to Starker Services, Inc., and then to the buyer. This is done through direct deeding.

SSI will be available to assist everyone involved with answers to any questions that may arise.

The first phase of the exchange is complete.

Step #2 Identification

Replacement property must be identified within 45 days from closing the relinquished property. SSI provides the necessary documentation to comply with the Treasury guidelines regarding proper identification.

Step # 3 Replacement Property

The acquisition of the replacement property must be completed within 180 days of closing the relinquished property. After locating suitable replacement property, the exchangor should enter into an agreement to purchase and immediately notify SSI. Once again, Starker Services will request the names and addresses of all parties to the transaction.

Instructions to complete the exchange will be delivered to the closing officer and all parties involved for review and signature. The exchange is completed when the property is purchased by Starker Services and then transferred to the exchangor through direct deeding.

"Taxes are paid on capital gain, not equity or profit."

It is possible to have little or no equity and still owe tax. Capital gain is arrived at by subtracting the adjusted basis from the net sale price. The net sale price is the gross sale price minus standard transaction costs. To arrive at the adjusted basis, first establish cost basis (usually the original purchase price). Next, add to this figure all improvements made to the property which were not expensed. Then, subtract all depreciation taken over the period of ownership.

To determine the estimated capital gain, subtract the adjusted basis from the sale price. Next, subtract the transaction costs (commissions, fees, etc.) to determine the capital gain. Finally, multiply the capital gain by your combined tax rate (Federal and State) to determine your estimated tax. Remember, there are two different rates (see page two).

Original Purchase Price		____________________
Plus Capital Improvements	+	____________________
Minus Depreciation Taken		(________________) [D]
Equals **Adjusted Basis**	=	____________________
Current Sales Price		____________________
Minus Adjusted Basis		(____________________)
Minus Transaction Costs		(____________________)
Equals Capital Gain*	=	________________ [CG]
[CG-D] Times Capital Gain tax rate (15%)	=	____________________
[D] Times Tax Rate (25%) for depreciation	+	____________________
Add state taxes	+	____________________
Equals **Capital Gains Tax****	=	____________________

* *This is the amount of gain deferred if you exchange.*

** *This is the amount you save if you exchange.*

STARKER SERVICES, INC.

(800) 332-1031

- Free Consultation and Review
- Toll-Free Exchange Hotline
- Immediate Document Preparation
- Separate Insured Bank Accounts
- Bonded
- Available 7 days a week
- Presentations and Seminars
- National Newsletter, "*The Interchange*"
- National Presence
- Reverse & Construction Exchange
- Informative Website

This material is provided for informational purposes only and is not to be construed as tax or legal advice. The reader is strongly urged to speak with a tax or legal consultant before employing any of the concepts stated herein.

Please call or write for more information on exchanging and the use of our Qualified Intermediary services. Starker Services, Inc., a California corporation, has served the real estate investment public for over a decade. SSI does not provide tax or legal advice, or brokerage assistance.

07/04

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