WTP EXCHANGE
1031 Exchange Excellence

The Million Dollar Mistake

Since their elementary school days together, Bob and Joe had dreamed of building a real estate empire in the hopes of becoming the next Donald Bren.

After graduating from college and working a couple years, they each saved up enough cash to buy an investment property. Bob bought a duplex for $175,000, and Joe acquired a 5-bedroom house near the university for approximately the same amount. Soon after closing on their first investment properties, they both found tenants and began receiving rental income.

After owning and managing their respective investment properties for five years, Bob and Joe each decided that the time was right to sell their current properties and use the proceeds to acquire more investment property. After meeting with his RE/MAX agent, Bob immediately called Joe on the phone.

"My realtor told me that I might be able to save a lot of money in taxes by taking advantage of a tax strategy known as a 1031 exchange," said Bob.

"Sounds complex, and I don't understand the tax laws … I'm going to focus on what I do best – investing in real estate," replied Joe.

A few weeks after their phone discussion, Bob and Joe both closed on the sale of their properties. Bob engaged the services of a 1031 exchange service provider (often referred to as a "Qualified Intermediary"), but Joe did not. Both of them used the after-tax proceeds from the sale of their properties to soon thereafter acquire more investment property.

Over the course of the next 20 years, the two friends continued to buy and sell real estate. Although their lives were changing as they were getting older, the one constant was each man's drive to build his own real estate empire. And they were very good at it – both Joe's and Bob's investment properties averaged 6% annual appreciation.

One day, after Bob and Joe had each bought his fifth investment property, they started talking about their real estate successes over a baseball game. Joe started to brag that he had built up over $1.7 million of equity in his investment properties.

"Not bad," Bob responded, "but I think I'm up to almost $6 million of equity."

Joe's jaw dropped. "How did you accumulate $4 million more than me? I thought our properties were appreciating at a similar rate," he asked, astounded at his friend's success.

"Do you remember when I called you to tell you about my realtor's idea of taking advantage of a 1031 exchange? Every time I sold a property, I followed his advice and never paid a dime of tax. It was the best real estate advice I ever received."

"I can't believe that failing to take advantage of that tax strategy has cost me $4 million of net worth," said Joe. "But since it's a tax-deferral strategy, I guess you have to pay the tax eventually … don't you?"

Bob didn't have the heart to tell him that as long as he continued to take advantage of 1031 exchanges until the time of death, the tax would be permanently wiped out when the properties transferred to his kids.

About the author: Ron Hodgeman is a tax attorney and the leader of the 1031 exchange practice at WTP Exchange. Ron has dedicated his entire career to helping individuals and companies to minimize their tax liability when selling business or investment property. Ron can be reached at 513-721-6333 or ron.hodgeman@wtpexchange.com.