Compound Logic

The wealth-building power of 1031 exchanges just makes sense.

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In today's highly competitive market, commercial real estate professionals continually look for ways to enhance their value to clients. Fortunately one of the best tools for accomplishing this value-add status may be the well-known Section 1031 tax-deferred exchange.

Almost all industry pros are familiar with the most commonly recognized benefit of a 1031 exchange: The tax that otherwise would be due is deferred. Yet many people are starting to realize that exchanging is a powerful tool that can accomplish a variety of investment goals beyond lowering the immediate tax bill.

A particularly intriguing aspect of implementing an exchange strategy is its wealth-building capacity. Qualified property for this type of transaction is "property held for use in a trade or business or for investment," according to Internal Revenue Service guidelines. Although qualified properties include depreciable business property such as aircraft and collectibles, investment real estate is the focus of this discussion, which highlights one of the most advantageous aspects of 1031 transactions.

The Compounding Effect

When Albert Einstein was asked, "What is the most powerful force in the universe?" His reply was, "Compound interest." People in the financial services industry understand the effects of compounding: For example, whether an investor starts funding an individual retirement account at age 20 or 40 results in a dramatically different retirement balance at age 59½. The simplest of illustrations — the "double the penny" example — further highlights the sometimes surprising benefits of compounding: A penny doubled every day for a month is worth only two cents on day two, but on day 31 it is worth $64 million. Compounding plus time can indeed produce impressive investment growth.

Potentially the most powerful benefit of a 1031 exchange, the compounding effect also is the most overlooked. The key to getting the highest compounding result is keeping all of the money working for the investor — not only now but also into the future. In an exchange, the amount of tax that otherwise would be paid is reinvested. The projected future value of the compounded yield on the deferred tax becomes very substantial over time.

Many real estate investors also add leverage, which significantly amplifies the compounding effect. For example, in 1988, an investor who possessed strong management skills sold a $1 million property that had a $200,000 basis. Without utilizing an exchange, the gain on the sale would have been $800,000 with approximately $200,000 in taxes due. After paying the taxes, there would have been approximately $800,000 after-tax cash to reinvest.

But the investor exchanged the property and bought a $1 million income-producing replacement property that was 85 percent occupied. He put $200,000 down — exactly the same amount he otherwise would not have had without the exchange. Two years later, after making necessary management adjustments, he increased the property's occupancy to 94 percent and sold it for $1.4 million. The $200,000 that he put down on the property (money that would have been used to pay the recognized gain in 1988) added to the $400,000 he just made equals $600,000.

The investor did another exchange and put the $600,000 in proceeds down on a $2 million income property that had been under-managed and was at 83 percent occupancy. Three years later, after achieving 92 percent occupancy in the property, the investor sold it for $2.6 million. With the $600,000 he had put down plus the $600,000 he made on the sale, after only five years the $200,000 tax that was deferred had grown to $1.2 million. Alternatively, without the exchange strategy the investor would have had no compounding benefit from his investments because the initial $200,000 would have been paid to cover the tax obligation.

Compounding combined with leverage can build wealth very quickly. Over a 12-year period, this investor did five exchanges and turned the money that he otherwise would not have had ($200,000) into $4.8 million.

Many investors have developed exchange strategies that have enabled them to go from a modest net worth to a very high net worth in a 10- to 20-year time frame. Clearly, these real-life examples are achieved more easily when real estate is in an up cycle, but this does not negate the potential benefits of employing a 1031 exchange strategy and holding real estate through the down cycles. Over time, the investors still come out far ahead of where they otherwise would have been if they had sold, paid the tax, and gone into an alternative investment.

Since there are no restrictions on the number of exchanges a taxpayer can complete, this strategy can be used during the taxpayer's entire lifetime. Although some investors eventually sell property that is acquired via an exchange and pay the tax, it is very common to never cash out and carry investments into the taxpayer's estate. At that point, the estate receives a stepped-up basis and the tax consequence disappears.

Other Exchange Benefits

Of course there are other investment objectives that can be accomplished by using the 1031 tax-deferral tool. Some of the most desirable include the ability to relocate an investment or sell property in one location and purchase another property in a more desirable location. Another advantage is the ability to convert non-cash-flow property into income-producing property by selling undeveloped land and buying income-producing property. Lastly, many taxpayers are looking to simplify their investments by eliminating management headaches. For instance, an investor can sell an apartment complex and buy an office building with a single tenant that occupies the space on a triple-net lease basis.

While these other investment strategies are important to specific investment goals, the one goal of the 1031 exchange that applies to all clients is the compounding effect of the deferred tax. If commercial real estate professionals can prompt clients to look beyond the immediate tax deferral and educate them on the wealth-building capacity of a long-term 1031 exchange strategy, they could actively help their clients benefit from the compounding effect. Understanding the full benefit of this tool can give commercial real estate professionals a strategy they can use in any market — up or down.