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Voiceover: Welcome to the REI Diamonds Show with Dan Breslin, your source for real estate investment, jewels of wisdom.

Dan Breslin: Welcome to the REI Diamond Show. I'm your host, Dan Breslin, and this is episode 210 on 1031 Exchange Real Estate Investing to Avoid Taxes with Dave Foster. If you're in building wealth through real estate investing, you are in the right place. My goal is to identify high-caliber real estate investors, and other industry service providers. Invite them on the show and then draw out the jewels of wisdom.

Those tactics, mindsets, and methods are used to create millions of dollars and more in the business of the real estate. Dave Foster is an expert in 1031 exchanges. Real estate investors who have mastered the use of 1031 exchanges avoid their investment gains from being taxed heavily at each transaction. The 1031 exchange allows investors to postpone paying income taxes on large real estate profits. This keeps your gains compounding over time, leading to more substantial wealth over time. Think Warren Buffet, who has been a master at Tax Advantage Investing. Shall we begin? All right, welcome to the REI Diamond Show Dave, how are you doing?

Dave: Hey, I'm doing awesome Dan. It's great to meet you and to be with you. you and I were talking before, I love that real estate sign behind you. That's the kind of thing every realtor should have.

Dan: I know, right?

Dave: Antique, it's awesome.

Dan: I will for the listeners, because I don't think I've ever discussed it, but that's from my grandfather, and the signs probably from the 1950s and he was a broker for the Catholic church in Philadelphia. He was like a Property Manager and that was kind of his shtick. and we were joking about being third me, third generation. My dad flipped or like had two or 3 rentals that he did a renovation on and like gave them to his partners and that was the extent of his second generation, and Ed Kelly was my mom's side, and so he was the grandfather who passed when I was like 8 years old maybe, so it's a stretch for me to kind of say I'm 3rd generation, but it helped me have the confidence to get started back in 2006 and do those first couple deals when I had $0, 0 experience and 0 connection, so

Dave: That's awesome. We all start somewhere man. That's for sure.

Dan: Yeah man, so for us to get a start, Dave, whereabouts are you physically located and and recording from today?

Dave: Actually I'm in sunny St. Petersburg, Florida.

Dan: Sweet.

Dave: Where winter came, it was 54 degrees. We're in the height of our big winter, so don't cry for me, we're okay.

Dan: Wow. Did you guys fare okay with a hurricane that came through a few weeks ago?

Dave: Yeah. Actually, yeah. For everybody who kind of watches those sorts of things, it looked like we were in the crosshairs, so everybody started bugging out, most of my family we take what we call harrications, where you just grab a copy of your insurance, pack the dogs up and go visit friends, but then it took that turn and ended up going south of us and messed up Fort Myers, Lien Collier County pretty bad, but we just got not much at all, so we're fortunate. Others not so much.

Dan: Yeah, I was surprised as the hurricane was coming toward your area, how many friends and people who literally like work as service providers within our organization, graphic designers, the mail house, the print shop, and I'm like, "Oh my gosh, I have like, I don't know, 5 or ten pallets worth of like printed material that are now in jeopardy." That's like not any small, let alone all the friends, family, lives and all that, so we feel like we as a company really dodged a bullet probably the same way that you do, but prayers for the families of everybody who did not dodge the...

I did notice last night I saw a video and I see that in Naples there is this influx of listings now for vacant lots that just hit the market, so people are like refusing to rebuild time to get out. What interesting insight or observation have you might maybe seen a little closer, to the ground there in Florida with what just occurred with the hurricane?

Dave: Well, yeah, I think the model is out there just it, it's who we are. People love, especially in that area, they love to buy their dream retirement home and many times that's a lot to be built on, or it's a home and you go through something like this, and it's like waking up and starting to question your own mortality again. It's like, "Wait a minute, do I really want to live through this?" The reality is they always rebuild. I think perhaps what I was discussing with some other colleagues, this is really a microcosm identical scenario, is what we had in 2014 with the fires in Pigeon Valley or Pigeon Forge, Tennessee and Gatlinburg, that destroyed 80% of the rental stock of properties.

Dan: Wow.

Dave: As you can imagine, at that same time, the exact same thing happened. Everybody that could not stomach the risk, or could not rebuild sold the lots, and then those started getting bought up rebuilt, and now if you just just say, Pigeon Forge Gatlinburg, those are hot topics on everybody's radar for the massive amounts of vacation rental South Florida anywhere or Northern California in the wildfires, any 1 of those places are going to experience the same kind of researching.

They always come back because there's always people who are optimistic and who see the 10 years of benefit, but the problem is if you're one of the people that have to live through the 1 year, that can sometimes cloud the other 10, so it'll take some time.

Dan: Fair enough.
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Dave: They're going come back stronger. Absolutely, and don't believe everything you see on the media, some sensational pictures, but if you notice most of those pictures are stick-built construction trailer homes, older types of buildings. You don't have to go very far inland at all and see that most of the properties built in the last 15 to 20 years did just fine.

Dan: Okay. All right. Yeah, I wonder what the pricing is on those lots. I imagine that there must be some market force at work with supply and demand and those same lots even 3 months ago, before the hurricane must have sold for some percentage more, than they're going to get now, right?

Dave: It could be or strangely enough, in many cases I actually bought a lot like this where I had my choice between a lot and a lot with a house on it, and I chose the lot because I was going to have to tear down my house, so if the hurricane took care of that, now might be the time to put a premium on a raw lot that already has plumbing to it. Who knows.

Dan: Yeah, true enough, so I think we're going to get into the 1031 exchange here in a few moments Dave, but do you want to share your kind of background in real estate as a framework I guess, and then maybe how that progressed into doing the 1031 exchanges as a business model?

Dave: That's actually a very fun story to tell because it just, I mean it feeds exactly right into it. The 1031 exchange we're going to kind of be dancing around today, is a process that lets real estate investors sell investment real estate that they hold for productive use, and then go and buy new investment real estate, and if they use the 1031 process, they get to indefinitely defer paying tax on the profit, and depreciation recapture, which just basically means the IRS lets you keep the tax and use it for your own benefit.

When you stop and think about that, if you've got a hundred thousand dollars tax and you get to use that for yourself, say you put it into a stock if you were going to put it into a stock, or if you put it into a real estate that makes 10% investment, that's $10,000 a year, and I don't know about you, but that's real money to me, so the 1031 exchange is huge. The way that I found it was by learning a lesson in the school of hard knox.

We wanted to find a way to create financial freedom that would give us time to enjoy our family, because time's the greatest commodity we have, and like a whole lot of people over the last few years we said, "Hey, let's do real estate. It's got to be easy, anybody can do it. Let's go." So 23, 24 years ago I bought a duplex in Denver, Colorado, fixed it up and sold it. Life was awesome until I went to my accountant and he said, "Dave, didn't you know you have a silent partner?" I said, "What do you mean?" He goes, "Uncle Sam and Uncle Sam's about to make more on this property than you are."

Well, that just didn't sit well, not to mention the fact that it put my plans many years down the road and behind. It was right at that moment in 1997 that there was a huge court case settled between the IRS and a guy named Starker and the IRS lost, so this whole new way of doing 1031 exchanges was going to be available for everyday investors, and when we started to look at what the impact on that would've been, I said, "Oh my gosh, we would've totally jumpstarted our own career." And I had friends, saying "Dave, we want to do this for others, do you want in?" And I said, absolutely.

From that moment I've embarked on a 23 plus year career of doing 1031 exchanges for others, and using it in our portfolio and business practice, we managed to transition to 3 different geographic markets and end up with a portfolio strangely enough in Cape Coral, Florida, back in the day, where we were able to buy a fifty three foot sailboat and live on it for 12 years while raising our family, and paying for that with income from our rental properties. All without paying a penny in capital gains tax, so when that happens to you, you get pretty excited about it, and I love doing that for others and that's what got us into it.

Dan: Nice. Still got the boat?

Dave: We sold the boat when the kids started talking about college, because that's where all my money goes these days.

[laughter].

Dan: Fair enough. Fair enough. My daughter's got 2 more years of the college payments there. Cool, so let's dive into it. You kind of described what the 1031 is. I think people who get in real estate hear about it and for me it, it felt like a very far off distant kind of thing when I first thought of doing, "Oh how do I get the property, the first property that's going to actually appreciate and give me a gain." And then the 1 1031 exchange I did do, it was a 2 flat 2 unit here in Chicago.

I bought it, renovated it, had it a year, year and a half, something like that, sold it versus keeping it and made like $25 or something like that, and I did a 1031 exchange just for the sake of doing it. I didn't need the $25,000 and I was like "Well, we'll do the exchange." And I, I had a eight unit building lined up so I put some more cash with the 1031 money to get into the much larger deal, and I still have that 8 unit now it's a ten unit and it's 1 of the better deals in my portfolio they'll hang onto.

Now that I've gotten that thing kind of stable and and brought up to speed. Looking back Dave, it felt like it was almost too small of a deal for the 1031 for me it was like, "Ah, it was all that even weren't it?" I mean I saved like nine, $10,000 in tax and that's 9, $10,000 in tax, so it was worth it. I had the experience and I have the new building, which I may not have even stepped up to and bought that 8 unit. It may have never been a motivation for me if it wasn't for wanting to do the 1031 exchange, but I'm curious with 23 years worth of investment deal, 1031 transacting for clients, what is the optimal deal size that you've seen take place, or maybe the most common deal size where the 1031 is like worth, it really moves to needle. Maybe there's an example of a deal there too that you would share.

Dave: Yeah, I think it's really important to remember that just like you treated it, the 1031 is a tool, now it's a tool that you can use strategically, but it's a tool that like any other tool can have many different uses, depending on what the person wielding it knows, or what they're trying to do. Like I can make a hammer work for all kinds of electrical problems, I just have to use it right, but that being said, I think when I think of over the years, it really depends on where you're trying to get to. 1 of my favorite clients of all time was like in 2004 there was a lady that sold a lot, and she literally made $10,000 on a lot.

Now as a resident of the state of Florida, she was looking at $1,500 in tax, by the time she paid for her exchange and everything, she was literally only going to save like 5 or 600 bucks, and I asked her about that. I said, "Are you sure you want to do this, it's just not that much whatever." She goes, "Hey, that $500 is mine and you bet I want to." So see there's a lot of just personal philosophy about how you feel about paying taxes, but what's important is to see what she did, that $500 became part of a down payment on a larger property, and just like when you got started, that first amount of gain wasn't that much, but it gave you extra boost on a down payment for a larger property.

That starts to roll forward. It's basically a form of compound interest. It's just compounding, and I wish that we had an ability for me to put some screens up here, but I've actually got some examples where we take the exact same investor and 1 of them does 1031s, 1 of them doesn't. That's the only difference, and they sell a piece of property first and then they take whatever is left. Now on the a hundred thousand dollars game for the investor doing the 1031, they've got $20,000 more to put in as a down payment on the next property.

The other investor doesn't, but we live... we do that in four steps and literally at the end of 4 steps, 20 years 4 transactions, 20 years, the investor that has deferred the tax has a down payment that allows them to control almost twelve million of real estate. Whereas the investor who does not do 1031 exchanges has the down payment in the cash, to control about three and a half million. That's how huge that difference is in using the tax for yourself ,versus paying for it now, and it's the same principle as your 401ks and IRAs. It's just the tool that exists outside of those retirement accounts to let you do the same thing. Grow tax deferred.

Dan: Yeah, and you touch on something that I think is an elusive topic and I learned it best reading the Snowball, which is the story about Warren Buffet that came out maybe 10 years ago, and he would talk about those same compounding gains and you see the chart twelve million for investor A who did the 1031 s and 3.5 for investor B and we're like, "Well yeah that's great. That makes sense." But like until you really, I don't know, realize the impact of compounding that tax portion of your investment, it took me a few years to really have the maturity and the patience to put the money down there, and set it to work right?

Because investor B was not going to have access really to that cash pile from the sales. I'm sorry, investor A who got to twelve million in the end, he's not going to get access to any of his cash whatsoever to like do other flexible stuff outside of real estate for that full 20 year period. He's not going to touch it, and I think that for me at least when I was a little younger, I liked the hit of flipping a house and there's a $30,000 profit flipping a house.

Dave: Absolutely. You are an adrenaline junkie, and I got a little bit of that I mean as well, and you're absolutely right. There are those people that gravitate to that. Number 1, they love the deal to get in to get out. They've created value, they love having that cash in hand, but there's so many things and this is not a knock on the model because I do it some too, but you have to just recognize there's opportunity cost for that, and opportunity cost number 1 is, you're going to pay a truckload more in tax every year. You have no preferential treatment.

Number 2, you don't get the tax right off of depreciation when all you're doing is buying and selling. You got to recapture all of that, number 3, as part of the calculation of the internal rate of return, 1 of the things that is huge that people forget is the amortization of the loan. If you borrow money to buy a property and then rent it to someone, the tenant is paying the mortgage payment, and part of that mortgage payment is a return of the capital that you borrowed.

Plus you get the tax right off on the interest there, so there's a whole number of different tax-related opportunities you don't get when you're fixing and flipping, but talk on it does feel good, it really does and there's a reason for doing that, but can I give you the answer because this is what so many of my investors do, and it is an awesome strategy to get the best of both worlds. Buy your properties, fix them, and rent them out. Now right there, you just opened up the door for a great internal rate of return. You're going to get depreciation, you're going to get rent tax, rent flow, you're going to get depreciation, you're going to get amortization of the loan, you're going to get the tax write-off on interest.

While you own that property and that tenant is paying all the bills, do a cash-out refinance, pull the cash-out refinance, and use that as a down payment to go buy your next project. Fix it up, put a renter in it as soon as that happens do another cash-out refinance, and the next thing you know you are juggling three or four what feels like fix-and-flip properties but they're fixed and flip properties on properties, but you're going to hold over a 1-year mark, and then when you sell them you're going to 1031, and here's where we throw gasoline on it.

When you sell that property in 1031, you're not going to buy 1. You're going to take the down payment, and you're going to use that to buy 2 cheaper properties if you want to grow that way, and all of a sudden you got more fix-up work than your crews can handle, and yet all of it is going as capital gains and all of it is 1031 eligible, and you're using that deferred tax but you're also still getting those refise out either to invest in something else or to buy braces or college, or whatever it is that you need.

I've got a couple of clients that least will do twenty to thirty exchanges a year. Every 1 of the properties they've owned for more than a year because that's just their model. They've got one year removed from the fix and flip but they still get their adrenaline fix but then they just hold the others long enough to do the 1031 out it. That can be a great way to get the best of both rules.

Dan: Yeah and you're describing a level of patience and that was not what I had and I was a liquidity junkie for lack of a better word. I just wanted to have access to it. It's why people buy into, I think some, at some level stocks, the stocks give you this allure because they're liquid. Bitcoin gives you this allure because it's liquid, I can get it back out. There's some security there and being able to like make the instant withdrawal, which is not there if my plan is to hold the property for a years or 20 years. I hear you mentioned the year deadline. Is that a minimum in order to be able to do the 1031 or is that arbitrary for the investors?

Dave: Let's see. It's fairly arbitrary. There's no statutory holding period. 1 year, anything more than 1 year is generally seen as totally safe, but the true standard is your intent. If you have a property that has been your intent to hold for productive use, then it qualifies for 1031 treatment. If you buy a property with the intent primarily of reselling it, it does not qualify. Now the things that a year does, and my industry's even guilty of this, we used to use a monitor called a year and a day, a year and a day, a year and a day doesn't do anything magical, but what it does do is this, any property you own more than a year generally gets afforded long term capital gains treatment.

That feels longer term than ordinary income. Secondly, any property you've owned for more than a year or a year and a day at least, is reported on two consecutive tax returns because you owned it in 2 consecutive years, and thirdly, there's several different case rulings out there where the IRS trying to get a handle on this, gave an idea of what three different appropriate holding periods would be, and they used the phrases 2 years, 2 tax shares and 2 calendar years, so it did not take the bright attorneys in America long to figure out. That if you want to take that at face value that's anything in between 2 days and seven hundred and thirty days.

To keep it simple but also to give them plenty of gray, the iris makes the standard intent, and intent is whatever you can demonstrate. 1 of my favorite exchangers from 2 years ago is actually up in Tennessee, which we were talking about earlier. He sold a cabin that he bought thirty days after he bought it and he wanted to do a 1031, and I said, "No dude, you cannot just buy and sell, that's not what 1031 is for." And he said, "But but Dave, I had to honor the long-term lease that was in the contract and it was actually part of the contract to buy. I had to honor this long-term lease because the tenant was a friend of the seller."

I said, "Well that's a nice try, but how come you're not honoring that lease?" He said, "Well because she broke it." I said, "Well okay, that's a little bit different but still what's your intent?" Well he said, "I think the problem is actually the bear." A bear had literally taken up residence at the trash cans for that house. The tenant felt unsafe so she broke the lease and this guy said, "I don't want to try to rent something with a bear." And he actually had ring photos to prove it. so his accountant was perfectly fine. Guess what? That's pretty easy to demonstrate his intent, wasn't it?

Dan: Yeah, I guess it is, right? I assume he made money thirty days later.

Dave: Well, Pigeon Porge 2017, '18. Yeah, he did okay.

Dan: Okay, nice. How about the deadline? So I believe that 8 unit I was referring to early in the episode, I think I had that lined up and was going to buy it anyway, like I was already under contract or something and then I think I had the other 1 sort of selling, so it wasn't like I set out and said, "Oh I'm going to 1031 this $27 into another building and then go find something." I was simultaneously had them working so the deadline wasn't an issue, but a lot of the other times I was going to consider the 1031, it was more of an issue of having something of high enough quality for me to 1031 into the next 1.

I'm going to be honest, I love selling properties to 1031 buyers, because they're typically motivated and they pay more than the average entrepreneurial investor buyer, so how does your client, or what is your suggestion to not get burned by being a motivated buyer, once you've put the 1031 in place?

Dave: Oh man, absolutely, you're speaking right to it, so the first thing that you got to just burn into your mind is that nobody, I mean nobody in history has ever gone broke by paying tax on profit. It may feel like it, but nobody has ever gone broke paying tax on profit. There is no transaction in the world that is worth it if you have to overpay, to a point where it is more than it would've cost you to not do it, so there's a real cost analysis that has to go in place, but it is very true that many times a 1031 investor will look at this and say, "Well this deal, I'm going to have to overpay something for it, but the tax I would've to pay if I don't do the 1031 is this, and it would take me 4 or 5 years to recoup all of that tax if I have to pay it right now as opposed to putting it in this which brings me maybe a little bit less, or cost me a little bit more."

You've got to really dive into those so that you can know and be sure, but there's no penalty for starting, and not completing an exchange, so the idea is if you've got a tax bill you want to defer start the exchange and look around. You've got forty five days to shop around, if you don't find something, let your exchange die. Exchanges are cheap for a card variety exchange, $1000, 900, something like that, and then that's a tax right off anyways, so it really is going to cost you maybe five or $600 to kick the can down the road and see if you can find something that you like.

Now what you did was a great strategy because you already had your acquisition target, and it was probably a seller's market, so you then looked at your portfolio and said, "Okay, I want to buy this. Do I have any properties that are ripe to sell that I could move into this that would then position me better, and so I'm going to sell those into a 1031." My gosh, you remember this, there was a period of time in particular in California where people would put things on the market and they would get 20% over list, day 1 cash offer, 5 day close.

Dan: Wow.

Dave: It was insane, so what we told people is take care of the hard job first. In that type of market, the hard job was finding your replacement, so go find your perfect replacement, get it under contract, then go sell your other property because it's going to take a week and that gives you plenty of time, but you don't have to worry about them finding a property. You don't have to worry about somebody like Dan holding you a hostage, because he knows you're a 1031 buyer, all those good things start to happen, and then I think also along with that though is don't forget that the second half of your 1031, is going to happen the same way your first half happens.

People who complain about having to overpay for a purchase, need to remember that the reason is that it's a seller's market, and they probably got overpaid when they sold. You got to take the market where it comes, and so then those are the the primary strategies that we would tell people that. Now we're in transitioning market where things are hanging on the list a little bit longer, so now might be a good time to wait, be patient, get a sale, but get an extended contractor for your sale and then go shopping, because every week you shop people are getting a little more anxious to sell, so I think this is absolutely great market to be a 1031 seller right now because you sold and you're going to buy into a depressing market. Not depressing, but that downward.

Dan: Opportunities exist.

Dan: There you go. That's exactly. Depressing sounds too much like 2008.

[laughter]

Dan: We'll be careful how we're talking about that here for the time being, and I think that's an interesting observation, so the California market was super hot and at the same time we here in Chicago, I'm 1 of the markets where we do business. There is the California buyer buying the four flat, 5 flat 8 flat, twenty two flat, they don't exactly know the nuance of the neighborhoods, so a lot of times California buyers going to buy in areas with more challenging tenant base, but higher cap rates.

I guess they keep getting the appreciation too, and enough people pay the rent, but all the locals will not touch a lot of those buildings for the headaches that come with them. In Philadelphia, we have the New York buyers who kind of operate and behave a lot like the California buyers. Atlanta, the entire country seems to be just buying into those single families. There's not a hell of a lot of apartment buildings there. Interesting observation there to hear the 5... get the 1031 s probably what they're doing is probably why they overpay a little for these places in these marginal areas, when we're looking at them.

Kind of explains the psychology going through the mind of that buyer there. I think too, I come back to the patience and the liquidity and what you described a minute ago, Dave and I wrote it down was, you're selling a property and I'm picturing myself, right? Maybe even a listener who's got something to flip. They're selling it and they can taste the liquidity and it's like, man, to have this, $50,000,$ 60,000, $80,000 hit my account is going to feel good, and instead taking a detour, committing a 5, 6, $700 fee if the exchange fails going into the 1031, and putting some forced patience against that liquidity and having a deadline for forty five days, to intentionally go out and select something that might be another level up as a property, right?

2 more of the property you just got rid of in slightly better locations than the one you got out of as far as like future appreciation. Otherwise, I don't really find myself digging through the real estate market and hunting for the 8 unit that I bought unless I kind of have the 1031 lined up, so I feel like it forces you to be a little more patient, put the liquidity off. You still might end up having to take the liquidity and pay a tax anyway, but at least you're forecasting a thirty to forty five day search period and you got the money in the bank and now your mind's thinking on levering up the investment, so now I'm more like investor a who ends up with the twelve million because he's being patient.

I don't want to like understate the amount of patience required and that's what I took from Warren Buffet's book, it's not run out and buy jets as soon as he could afford jets. There was this lifelong patience of compounding that took place, and I almost feel like from my own experience, that patience and being that long-term investor, it took me, I don't know, 8, 10, 12 years to see the value in. Now I was building a business that turned out to be very much thriving through that period of time, so I allocated my energy a certain way but cannot overstate the patience factor in participating in the compounding effect of real estate.

Whether that's just holding and managing right for the long term, whether that's 1031 exchanges like we're talking about today. Or maybe it's cost segregation kicking a can down the line in another format, or some other form of patience and hanging onto your investments long term. For me the patience is like coming now that I'm 41, 42 years old, I'm learning it and in my 30s I was not patient at all.

[laughter]

Not at all.

Dave: I have never actually phrased it this way, but I was listening to your talk and here's exactly what it is. Anybody can go go into real estate and create a job, you become a realtor, you buy and sell, you become a fixed and flipper. Anybody can do that as a job and during up times you'll do really, really well and you'll buy a lifestyle as a job. The 1031 portion of it is like taking the job and adding to that contributions to your retirement.

The patience that you have reaps rewards for you later, but like you said, you've got to be patient, but it's like giving you the opportunity to indulge in that adrenaline side, but at the same time start to prepare for the future, and build that nest egg and yeah, that's kind of the mentality, and we talk a lot about the life cycle of a real estate investor because your life, just like your life changes, your needs, your desires, your targets, your energies will change as you grow older, so early like you said, when you're young and impatient, you're buy buy buy buy buy.

Using the 1031 you can sell 1 and buy 2, you can start to branch out geographically, because the 1031 exchange will let you go anywhere in the country you want, and we've sort of hinted at this because it was with your 1031, but you can go from different classes, so you could sell a single family home and go buy an industrial building anywhere else in the country. Sell commercial, buy raw land. At some point in time you may get a builder itch, so you use the 1031 to go buy a chunk of raw land, create a land bank off of that and do some things with that.

As you start to get older, your energy wanes but your wisdom has increased. Now we start to 1031 into more passive opportunities because we have the ability to examine those, and do due diligence to buy triple net commercial properties, or 1031 compatible syndications, vacation rentals that we eventually convert into our primary residence. There's a ton different ways they just have to be appropriate for you where you're at right now.

Dan: Can you touch on that vacation rental thing that you just alluded to. Describe that.

Dave: That's my favorite thing of all, so here's the principle, the 1031 exchange is a sale of investment property, followed by a purchase of investment property, but you do not have to use it for investment forever, and the key is that you can... say you live in Cincinnati and you're getting ready to retire in a couple years, so you sell your Cincinnati rental and you go buy something on the beach in Sarasota, use it for investment for a couple years generating income, and then when you're ready to retire.

Dan: 2 years, 2 tax returns.

Dave: There's actually a safe harbor for the IRS. At 2 years, there's still a lot of people that say a year is okay and 1 of the quirks of that law is that you being in it does not count, as long as you are working on it, so I know I had some people in Fort Myers that would have to go down and and really watch the automatic sprinkler system for 5 or 6 months a year, because it was so prone to failure, so 2 years as a safe harbor, they're going to go from Cincinnati and retire where? In there former investment property that doesn't trigger a tax event.

Dan: Wow.

Dave: It gets even better. I feel like the roco[?] guy now, but wait, it's even better when they sell their primary residence in Ohio, if they've lived in it for 2 out of 5 years, they get to take the first 500,000 in profit tax free, so they sell Ohio, $500,000 is tax free. They move into a house with all the other money tax deferred. What a jumpstart on retirement that is. It gets even better.

[laughter]

I have a god constant beach that did 3, 1031s into 3. I mean literally on the same floor identical condo units on St. Pete Beach. He moved into the first 1 and converted it. That started his retirement.

Now he's going to live there as his wife says until it's time to redecorate, but they're going to stay there because as soon as he has owned that property for 5 years, as soon as he has lived in it for at least 2, then he can sell it and take a proration of all of that deferred 1031 gain tax-free.

Dan: Wow, so that would count like on the $500 gain, is that?

Dave: Up to $500. Correct, but you only get it prorated, so if he rented it for 2 years as he did and then he lives in it for 8, he will get 8 tenths of the gain to 3.

Dan: Wow.

Dave: Where's he going to move to? Next door, and he'll do it all over again. Now most of us who have been... who foolishly misspent our youth are going to have to be looking to deliver pizzas for Dominoes or bag groceries at Kroger's or something to supplement our social security, right? His supplement job is he lives in a beachfront condo and he'll sell 1 every once in a while and pay some tax, just like I'm going to have to pay tax on my pizza delivery earnings. Who would you rather be?

Dan: Yeah, right.

Dave: What an awesome strategy right? We did much the same thing in that we kept converting properties in each of our markets, and every time we sold 1 we took the tax free money and put that into our by the boat kitty, and so that was how the boat was purchased for cash with tax-free dollars, and then the rest of our holdings we simply generated income off of through productive use.

Dan: Okay, so was it rental income going for the cash kitty?

Dave: No, no, no, well for the boat kitty, it was the tax-free sales of our primary residences, and the properties we converted. To live on, we used revenue from our rental investments.

Dan: Nice.

Dave: Now that's my favorite way that the 1031 investor can actually get the money out, but again, like you keep saying Alta[?], this whole thing, patience is the key, but patience will reward you. You want to know my second favorite way is to enjoy it all?

Dan: Right.

Dave: You got to die.

Dan: Well I don't know if that's enjoyable.

[laughter]

Dave: Like I said, it's my second favorite and we're all heading there anyways, but here's what happens for the 1031 for anybody but for the 1031 investor especially. When you die holding real estate, that real estate is given what's called a step up in basis so that your heirs inherited as if they paid market value the day you died, so all of that profit over all of those years goes to your heirs tax free.

Dan: Then it starts the depreciation clock for them all over again?

Dave: All over again. I've got 1 family, we're in our third generation of from Connecticut and man they're awesome. We did exchanges for granddad who passed away many years ago. The portfolio went to his son who again was 1031, and until he passed away a few years ago and his children are now doing the same thing.

Dan: Wow.

Dave: Each time they inherited all of the tax disappeared.

Dan: How much jeopardy is this in from a political sense, right? They keep tossing a 1031 on the table for the tax code, they're going to pay for this and pay for that, take away the step up basis, right? What is your opinion or feel on the likelihood of the 1031, and the step up basis that we were just talking about existing for the next 10 to 20 years?

Dave: Yeah. Oh my gosh. I'm a firm believer it was either Will Rogers or Kitty and Tucker that said, no one's personal liberties or property are safe as long as Congress is in session, so you got to start from that point and never say never because lots of power concentrated in a few silly answers, but here's what's happened over recent years. First of all, in the 23 years I've been doing this, every president I've been under has talked about getting rid of 1031, because it's low hanging fruit right? "Oh, if we just eliminate that, think of all the extra tax revenue we'll get and we'll be able to make money."

The only president that did anything with it was Donald Trump, and all he did was eliminate the personal property exception, where you could 1031 things like his jet, heavy equipment for other heavy equipment or airplanes, that kind of thing, and what he replaced that with though was this bonus depreciation, so I think he was seeing a way that he could get some extra bonus depreciation off of his plane, rather than having to sell it, because that's what the impact was. Okay.

Not judging just saying, but every president has talked about it, none of them have done it, anything. Why? Because think about it. For every dollar that you get from a long-term capital gains, which is at 15%, you're going to slow down the real estate market because people will hold properties longer, it's just a given. When people hold properties longer, what's not going to happen? You'll have much fewer, you'll have 2 fewer real estate agent commissions, 2 fewer title company transactions, 2 fewer inspections, 2 fewer attorneys, 2 fewer painters.

All of these people that do ordinary income work, which is tax at much higher rates, and when you actually see the real numbers that have been produced, the cost to our economy is astronomical in the terms of billions of dollars that would be lost, if they tried to simply collect the long-term capital gains from 1031 transactions.

Dan: Wow.

Dave: To the point where when President Biden, I mean he was loud and proud about it. Was going to get rid of it, and that was right at the same time when you got my application for employment. Do you remember that? I sent that over to you.

Dan: Oh yeah.

Dave: Because I thought I was going to be out of job.

Dan: Got you.

Dave: Right at that time the Senate, now the Senate's 50/50 red and blue, right? The Senate actually took a unanimous voice vote specifically to say no change will be allowed to section 1031 text verdict exchanges. Which it was a resounding, it will not change. Now the same thing has basically happened with the step up and basis. Guess what? There's a whole ton of representatives, senators and people of influence that have property they'd love to be able to give to their kids, and not pay tax on. I'm really not concerned about that because ultimately we're all going to look out after our own self-interest, but 1031 looks very, very safe and it's been around since 1920.

Dan: Oh okay.

Dave: No, it's nice. It's 1 of the original parts of the code.

Dan: Yeah, and I mean when you look at it too from the code is there, to your point of kind of keeping the transactions flowing and I own a shopping center, I own couple self, like in a self-storage fund, I own apartment buildings. I wouldn't have bought any of that stuff if it wasn't for the 1031 exchange. I wouldn't have invested money in those things if it wasn't for the depreciation that I was going to get. I would've had to pay a big tax bill and I probably just would've needed to feel like I needed to hang on to whatever was left because I would've been wiped out.

Instead, the tax code incentivizes me to put my capital back in place for society's benefit, so the code is doing what it is, right. We talk about the tax benefit side for us as individuals, but for the impact that the recycling of capital has on society, I think it's a good thing and I hope even those in Congress and Senate, regardless of what their background is, probably would I hope continue to see that benefit for society.

Dave: Yeah, it's a really counterintuitive way of looking at the tax code, but if you don't view it as how the government gets your money and start thinking of it as how the government incentivizes your behavior, and in 1920 they wanted the small farmer to be able to sell their farms, and buy bigger farms, and they couldn't do that if they had to pay tax on the sale through farms. That's what started it, so the incentivization is that they really want a bustling, robust, strong real estate sales market, and the way to do that is to incentivize behavior where you do that, and they incentivize it by giving you the 1031 exchange.

Dan: Dave, I know we're getting close to the end here, but I do want to ask you your observation, let's say January 2022 through, we're at October 21st, 2022, and most of us listening who aren't listening years in the future, we've had interest rates go from 3% to 7% in that same time period, and we feel a slowdown collectively in the real estate market. Can you describe maybe your observation through the lens of transaction volume in 1031 exchanges, that you've been a part of during that time?

Dave: It's a little too soon for us to tell simply because there is a normal pause in real estate in the fall, it's just people start school we're gear towards the holidays. Builders all left their buildings under roof and weathered and so they now they're working inside, so there is typically a reduction in volume and we're seeing that. We're down about 20%, so it's little bit is some of that a factor of interest rates of a cooling market of longer days on market? Possibly, but it's really hard to speak to it. I don't think we're going to really know until next March or April for sure what's happening.

I do know this though. I am so old that I remember when 13% was not a bad interest rate on a commercial asset, so those who want to wine about 6 or 7 think again and take a history lesson. Yes it's high and we've got to make sure in our analysis for people that they are able to make cash flow work with what they're having to pay for the cost of money, but by the same token, someone said it great the other day, you marry property, you find the property you want to keep and you marry it, but you date the interest rate.

Because if it's a good property and you can make it work right now, even at a higher interest rate. If interest rates come down for you in 2 years, that's just an extra bonus on top of which is already a good return for you, so yeah, it's softening how much. Yeah. It doesn't feel urgent at all, but again keep my resume on top of your pile and next April or May we'll see what's happening.

Dan: Yeah, and I mean if we look into context, I felt this way this time last year and we didn't know if the rates were going to start climbing earlier than they did, but I could even see it in the comps. If I go in and pull single family comps. I pay a lot of attention to the month and the date that they wanted our contract when he settled, and we could see the cooling off in the transaction volume the markets we're in this time last year the same way, I recall it being that way in history too, right?But these are recent memory for context coming through 2006, 7, 8, 9, 10, 11, 12, those time periods were rough.

I believe 2009 was the lowest transaction volume at somewhere around four and a half million, if I'm not mistaken, and I think we had like six and a half million last year, so we're talking 20 or 30% more transaction volume in a country with 20% more population, through that same 10 year period, right? So we kind of had this increase in transaction volume from population, so even if it were as bad as the 2009 crash, which we're not seeing Goldman and big bang failures or anything catastrophic occurring yet.

I mean, who knows what the future brings, but even if we saw that same reduction in volume, I forget what it actually was the volume in '05 '06, it may have been five and a half million, I don't remember if it peaked at 6, but 10, 20% less transaction if we went down like 4, 4 and a half million transactions now that is still a lot of real estate transaction volume that's occurring even at the bottom of the market in the worst cycle for our... at least my memorable history, right?

I was too young during the '80, '89, '90, '92 and I wasn't around for the late '70s thing that kind of took place, so even if the market is down, houses still have value and they will still be transactioning. It's just a matter of buying the assets right, and being able to make the improvements and do the value add

Dave: People still have to have someplace to live, and we are seeing a nation where the percentage of renters is increasing dramatically, so yeah, again, I can speak directly to the 1031 and Dan 19... or I'm sorry, in 2005 there were about 570,000, 1031 exchanges done. 2008, that number had plummeted to 68,000, so in that crash we saw an almost 90% decrease, so that's why I sit here and go, yeah, 20% no big deal, that's a normal market.

Dan: Yep. Yep.

Dave: 2005, 2008, that was not normal, so I don't have to cuddle up in a fetal position and worry about that.

Dan: Yeah, and that's actually good to know because I sell a lot of houses to people who are going to live there, so my numbers of four and a half million were a whole lot of people who were taking advantage of the first time home buyer credit that came out during those years.

Dave: Absolutely.

Dan: Right. If it got that bad, there would be something of that nature for sure. With the way that they come.

Dave: Absolutely they will.

Dan: Yeah, so if we had a 20% drop off and we were doing mostly owner occupant transaction, which a lot of our flipper podcast audience is probably doing, again, it all comes down to buying right and making sure that you did a quality product and you can still get out of it, and I probably wouldn't build the deal on the highest watermark that exists in the marketplace today. Right?

[laughter]

Dave: That's exact. I had a ton of investors that lost 90% of their wealth in 2008. I mean 90% of their wealth, but it was all on paper, and those that did not have to sell just kept renting those properties, and now they're worth many multiples more than that.

Dan: Nice, so Dave, in closing the crown jewel of wisdom, if you were passing this on to, I don't know, 1 of your kids or maybe someone just getting started in real estate, what would you consider to be kind of the crown jewel of wisdom? What's your piece of sage advice that you would pass on to someone?

Dave: You've been stealing it from me this entire time?

Dan: All right.

Dave: There's 2 people in history, 2 groups that have always ruled the world. Banks and real estate owners become one of those, and if you're going to go the route of owning real estate, be patient, it's long-term that it will produce for you.

Dan: Well said. Dave, I appreciate you coming on the show. Thank you for giving me the time. I got a couple pages of notes here and I had a blast. Really appreciate it.

Dave: It was so good to be here and chapter[?] things. I actually feel better already, don't you?

Dan: Yeah. Yeah.

Dave: What a in a good spot.

[laughter]

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