

Something To Think About

Over twenty years ago, the US experienced a capital gains situation similar to the one anticipated to occur two years from now, in 2011. In 1986, the long-term capital gains tax rate was increased from 20% to 28%, an increase of 40%. Investors, anticipating this occurrence, reacted in 1985 by selling off properties. The result was an approximate 80% increase in capital gains tax revenue that year. Due to the abundance of supply over demand, prices for commercial real estate were driven lower. It is our opinion that if capital gains tax rates increase in 2011, history may once again repeat itself in 2009-2010.

Some Recent History

Recent history provides some perspective of where we are and where we may soon be heading. In order to stimulate the economy, the trend over the past ten years has been to decrease long-term capital gains rates for individuals. Bill Clinton decreased it from 28% to 20%, and George Bush, as part of his overall tax cuts, decreased it again in 2003 to its lowest level in recent times of 15% for individuals. Capital gains tax rates for corporate and other non-pass-through entities remained at 35%. This 15% tax rate was intended to be short-term, extending only until 2008, but again, keeping with the trend to keep taxes low, the Republican majority congress and President Bush extended the expiration date to 2010. This trend, however, may now be shifting.

Why are Capital Gains Rates Likely to Rise?

In March 2008, the newly Democratic majority Congress rejected an extension of the Bush tax cuts past 2010. After 2010, the tax cut will expire, and beginning in 2011, the tax will increase to a minimum of 20%, and perhaps higher. Barack Obama has indicated, that if elected President, he will consider raising the tax to 28%. The effects of such an increase will likely be significant.

To begin with, it is certain that sales of commercial properties, absent legitimate tax deferral strategies, will result in lower actual after-tax proceeds, which will significantly reduce the overall internal rate of return (IRR).

As a point of illustration, the following chart depicts the results of a property acquired for \$10.0 million, which returns an annual 8% return on investment, with 3% annual growth. If held over a ten-year period, an increase in the capital gains tax rate to 28% will result in a leveraged IRR reduction of 95 basis points, or 7.6%. When comparing the results over a five-year period, the reduction balloons to 132 basis points, or 10.0%. Certainly not an insignificant number.

LEVERAGED AFTER-TAX IRR COMPARISON				
Acquisition @ \$10,000,000 3% Annual Growth and 8% Annual ROI				
	Capital Gains Rate		Variance	
Hold Period	15.00%	28.00%	Return	%
Five Years	14.52%	13.20%	-1.32%	-10.01%
Ten Years	13.40%	12.45%	-0.95%	-7.63%

These projections may encourage investors to react in ways not necessarily beneficial to maintaining real estate values. Possible reactions may be:

- A major sell-off of properties, as realized in the year prior to the 1986 tax increase, thereby impacting values to all, including those not selling. Remember, in 1986 it was a 40% increase; in 2011, especially given the historically low interest rate environment, the increase could be larger.
- A stagnant period in which transactions are limited due to tax consequences.
- An increase in 1031 exchanges. The exchange buyer is an eager seller's dream. In an effort to avoid taxes and often faced with pending timing constraints, the exchange buyer often overpays for properties. Loss of sound real estate judgment may ultimately result in a larger loss than if the buyer had paid taxes on the original gain.
- A search for other tax deferral techniques such as: UPREIT Contribution, Deferred Sales Trust (a highly controversial approach), Structured Sale Annuity (Insured Installment Sale), Charitable Trust, Installment Sale, or Self-Directed Installment Sale. Although we will examine each of these in later articles, obviously none replace lower capital gains tax rates.

Some More To Think About

Given the stated facts and circumstances, as an investor, the questions are obvious:

- Should I sell now and avoid the higher capital gains tax and potential downward pressure on values if there is a significant sell-off?
- Regardless of the potential sell-off, should I now take advantage of the lower tax rate, especially if I do not want to take advantage of a 1031 exchange and simply want to reduce my real estate holdings?
- Should I hold? After all, commercial real estate values have leveled off, and in certain areas of the country values have decreased. Even with the higher capital gains tax, some investors may hope that values will increase, offsetting the future higher tax.

It is clear that we are witnessing a spread between Class A properties that are well located, properly designed and well tenanted, and Class B properties where perhaps the credit, location or functional features are at issue. Risk is being priced back into the market. In our recent real estate boom cycle it was a rising ship for all types of properties. Real estate was considered a Mecca with little, if any, risk premiums priced into properties lacking sound fundamentals. It is anticipated that a new scrutiny of property characteristics, combined with pending tax rate increases, will certainly push the price of Class B and C properties lower. So if you are a buyer, opportunities will continue to rise. However, if you are a seller, timing is more important than ever.

In Summary

History indicates that prices fall in response to the increased supply when an unusual number of owners put their properties on the market when taxes are expected to increase. The effect on prices after the tax rate increase is unclear, but the costs of selling are certainly higher. Investors may want to consider their options – before prices are potentially eroded or taxes dramatically increase.

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