



## Headlines

Archive

CoStar Advisor Newsletter

Most Viewed

News Feeds

Events

Add an Event

## Speculation Rising Over Impact of Expiring Capital Gains Tax Cuts on CRE Sales

Opinions Vary On Whether Investors Will Sell This Year to Avoid Higher Capital Gains Taxes, Some Wonder If Capital Gains Hike Will Last Long In Face of Choppy Economy

By **Randy Drummer**  
August 25, 2010

14 retweet

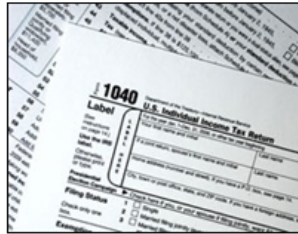
Like

LinkedIn

Print

Email

The debate over tax cuts enacted in 2001 is expected to heat up when the U.S. Senate reconvenes in September after its summer recess. The maximum tax rate on capital gains and dividends will revert from the current 15%, a 70-year low, back to 20% on Jan. 1, 2011, and commercial real estate experts are beginning to speculate on the impact that reverting back to the higher rates will have on the still-fragile economic recovery.



The likelihood of higher marginal and capital gains and dividend taxes, along with the impacts of health-care reform, financial regulatory reform and proposed changes in the way investment and leasing income are accounted for, has been a major preoccupation of the real estate industry in 2010. As the stretch run for the mid-term election campaigns unfolds, however, with the national unemployment rate stalled at around 9.5%, many Republicans and U.S. businesses are wasting no time in calling on President Obama and the Democrat-controlled Congress to extend the capital gains tax cuts for all income brackets, including families earning at least \$250,000 a year.

Marcus & Millichap recently posted a research note speculating on how CRE investors will react to the reversion of the capital gains tax rate to 2003 levels. Its conclusions: investment transaction volume could ramp up at the end of the year as long-term owners attempt to reap profits before taxes rise in gains from transfers of real property. Also, Marcus & Millichap believes the increase in capital gains taxes will spur interests in the long-dormant 1031 tax exchange market after years of inactivity, as investors seek shelter by indefinitely deferring capital gains and associated taxes through tax-deferred exchanges.

The research note authored by Marcus & Millichap Managing Director of Research Services Hessam Nadji observes that when the major tax code revision took effect in 1986 under President Reagan -- including a capital gains increase from 20% to 28% -- investors scrambled to liquidate, nearly doubling the total realized capital gains from the previous year.

"Despite the decline in investment values over the last two years, many investors will likely follow this liquidation strategy, locking in their profits rather than waiting for investments to appreciate sufficiently to offset the [capital gains] tax hike," Nadji said.

Tax cuts under the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 are scheduled to expire Dec. 31. Democrats are proposing extending the cuts only for households making less than \$200,000 a year. Income earned in the current 10% tax bracket will be taxed at a rate of 15%, while the overall federal tax rate for the two highest earning brackets would rise from the current 33% and 35% to 36% and 39.6%.

Dividends will no longer have a special low rate but will be taxed at regular tax rates -- a maximum of 39.6% for the wealthiest Americans. All told, the expiration of all tax provisions will increase tax revenue -- and correspondingly, drain disposable personal income -- by about \$300 billion, or 2.7%, in 2011, according to an analysis by the Congressional Budget Office (CBO).

Long-term capital gains taxes have averaged 26% over the last 50 years, hitting a high of 49% in 1970 during the Ford administration. In addition, the historic high 28% rate

of 40% in 1976 during the Ford administration. In Nadji's view, the risk is high of future tax rate increases once the economy stabilizes. Though investors often choose to hold their assets in the year following a tax rate hike, perceived risks may encourage them to continue selling assets in 2011.

While apartment owners will likely see notable recovery in occupancy and rents in over the next year, offsetting some of the capital gains increases, demand for retail and office space remains tepid, preventing owners of assets -- especially those outside major markets -- from regaining much control over rents and sale prices, Marcus & Millichap said.

"For investors holding these assets, future capital gains tax increases could overshadow appreciation substantially, extending the hold period to break even against current net profits for several years," Nadji said in the note. "Investors who purchased these assets more than six years ago likely have profits to protect and may consider liquidating late this year."

Accordingly, the ability to defer capital gains through 1031 tax exchanges will become even more attractive when capital gains taxes rise, Nadji and other analysts said. Since 2002, the year before the capital gains rate was reduced to a more-than 70-year low of 15%, the number of 1031 exchanges has fallen by nearly half, M&M said, citing data from the Treasury Department and Tax Foundation. With sellers discouraged from taking investment profits after capital gains taxes revert to 20%, the number of deals involving exchanges will rise substantially, Nadji said.

Massey Knakal Realty Services Chairman Robert Knakal told Fox Business late last month that in addition to the heightened number of distressed sellers in the current marketplace, recently, "we've seen a large increase in the number of discretionary sellers that are putting properties on the market, and the number one reason they're doing that is because they're afraid of the capital gains tax increases." In addition to the rise in the federal tax rate from 15% to 20%, investors are concerned that cash-strapped states and municipalities will also raise taxes to help balance their deficits, Knakal said.

While real estate economists queried by CoStar agree that tax increases are a front and center concern for investors, not everyone is convinced that the capital gain hike will cause a rush to sell assets over the next year -- or even whether the increase in capital gains will last for very long in the current economic climate before being cut again.

"This is a time when it is less painful to increase capital gains tax rates, since few owners have significant capital gains. Thus, I don't see a flurry of sales to beat the change," said Norm Miller, vice president of analytics for CoStar Group. "I expect that we will see more 1031 exchanges down the road, but not so much in the immediate future."

Richard Green, real estate economist and director of the USC Lusk Center for Real Estate, adds that although tax exchanges are dormant, "a return to 2000 tax law would almost certainly bring back the 1031 market."

Steve Cauley, director of research at the Ziman Center for Real Estate at the UCLA Anderson School of Management, said he'd be "very surprised" if there's a large bump in sales transaction, either now or next year, due to anticipation of the capital gains increase. Cauley pointed out that in 1986, property owners had already seen a large run up in values before the tax changes took effect and were ready to take profits. Plus, the prevailing view, or fear, at the time was that the tax code changes would be long term or even permanent, he said.

"It isn't clear to me that the capital gains portion of this tax increase is going to be long-lived this time around," Cauley said. Clearly, Congress won't abolish the tax increases for high-income people. But given the possible changes of the balance of power in Congress in November and the continuing soft economy, "it's hard to imagine we'll have a long-lived increase in capital gains taxes," he said.

"There's a clearer understanding now that long-term increases in capital gains taxes will retard economic growth. With real estate prices down so much, I would be really surprised to see a selloff, by the end of this year or next year, unless prices continue to decline and people try to get off the sinking ship."

For those investors who are selling now, some believe it may not turn out to be the best decision. "I think the sell-off will be much less pronounced than in 1986," Cauley said.

14 retweet

Like

LinkedIn

Print

Email

#### More US National Commercial Real Estate News Stories:

- [Cornerstone, Kettler Sell Pentagon City Multifamily for \\$125M](#)
- [STG Leases 111,900 SF at Reston Town Center](#)
- [Eight Takeaways on the Current State of Distress Opportunities](#)
- [Abercrombie & Fitch Shuttering 110 Stores, GM Shrinks Real Estate Holdings, More Retailer Right-Sizings](#)
- [Survey: Recession Weakens 'NIMBY' Resistance to New Development Projects](#)
- [This Week in Retail: NFL's Ray Lewis Looks To Be 'All Business' Off the Field Too](#)
- [Bank Watch: Regulators Close Seven Banks with \\$4.4 Bil. in Assets](#)
- [InComm Expands to 186,000 SF in Downtown Atlanta](#)

- [Boston Properties to Acquire 510 Madison](#)
- [In The Pipeline: CoStar Development and Construction News for Aug. 22 - 28](#)

[Jobs](#) | [Buy Now](#) | [Schedule a Demo](#) | [Newsletter Sign Up](#) | [Anti-Piracy](#) | [Terms of Use](#) | [Site Map](#) | [888-226-7404](#)

© 1997-2010 CoStar Realty Information, Inc. All rights reserved. Portions of service protected by U.S. Patent Nos. 6,871,140, 7,076,452, 7,174,300