Tax Increases Loom for Weary Investors

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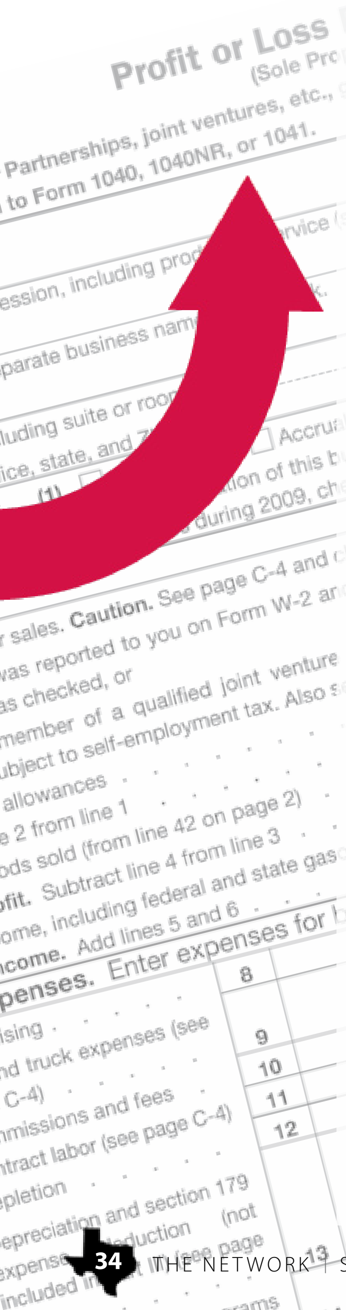

Tax increases scheduled for 2011 are the latest burden facing investors – particularly those in real property investing. In the media you hear this referred to as the expiration of the Bush tax cuts.

The 2001 Tax Relief Reconciliation Act reduced rates for long-term capital gains and qualified dividends to 15% for the lowest two income tax brackets. The lowered rate was set to expire in 2008, but was extended in 2006 under Bush's Tax Reconciliation Act. It is now scheduled to expire at the end of 2010, at which time the rate will increase to 20%, representing an effectively 33% higher tax rate.

INVESTORS' RESPONSE TO CAPITAL GAINS TAX RATES

Gains are a way in which earnings are paid to investors, and the realization of gains is very sensitive to capital gains tax rates. Because taxes are paid on realized, rather than accrued, capital gains, taxpayers have control over when they pay their capital gains taxes. By holding an asset, a taxpayer defers the tax. Real property investors have even more control because they can choose to defer their gains even longer with tax-deferred exchanges.

The incentive to do so—even when it might otherwise be financially desirable to sell an asset—is known as the "lock-in" effect. As a consequence of that incentive, the level of the tax rate can substantially influence when asset holders realize their gains, a phenomenon that is readily apparent when tax rates change. For example, the Tax Reform Act of 1986 increased capital gains tax rates effective at the beginning of 1987. Anticipating the increase, investors realized a greatly increased level of gains in 1986. Then, in 1987, realizations fell by almost as much, returning to a level comparable to that before the tax increase.

The current year has seen increased property sales activity, but not in large volume (partly as a result of the current administration's announced capital gains tax increase). The effect of the pending increases is likely muted by poor market conditions, as most property owners who do not have to sell in this market have chosen not to do so. Consider a hypothetical office building with an owner looking to liquidate the investment at the end of 2011. Under normal market conditions, the owner might anticipate a 5% tax increase and only a 3% return on the investment, in which case he would sell before the tax increase is implemented. With undervalued property in current conditions, however, the future anticipated return on investment might be 7%, when the market readjusts, in which case it might be advantageous to maintain the investment.

JUST WHAT THE DOCTOR DIDN'T ORDER

What about 2011 and beyond? If history is an accurate indicator, we could see a slight increase in property sales activity between now and year-end as the tax increase approaches. The increase in sales activity, unlike that in 1986, will be greatly tempered by the current unfavorable market conditions for sellers. The transaction volume should slow considerably in 2011 due to continued unfavorable market conditions for sellers and the resulting lock-in effect—not what the commercial property market, or the overall economy, needs.

The disincentive is not limited to capital gains; the increase in marginal tax rates is a disincentive to investment in general. In contrast to the current administration, the Reagan administration passed the Economic Recovery Tax Act of 1981. This act introduced an accelerated system of depreciation know as ACRS. ACRS depreciation is based on recovery periods instead of useful life, and cost recovery periods were significantly shortened. These shortened recovery periods resulted in greater annualized depreciation deductions and therefore greater cash flows. Consequently, there was an immediate increase in commercial property values as well as commercial property sales velocity.

As stated above, as tax rates increase, after-tax rates of return will be negatively impacted and consequently so will commercial property values. Most investors are more interested in the after-tax cash flow and yield projections than before tax projections. Plug any deal into your favorite analysis spreadsheet software and see what happens to the returns as you increase the assumed tax rate on the annualized cash flows as well as the capital gains rate on the realized portion of the reversionary sale proceeds.

There is political speculation that the complexion of Congress could change in November and with it the pending tax increases. Who knows? Maybe the tax gods will bring us a capital gains tax cut.

With a capital gains tax cut, stocks, real estate and other assets would most likely experience an immediate boost in value. This increase in value is known as "the capitalization effect." The capitalization effect explains how a capital gains tax cut would increase an owner's after-tax returns on assets leading to an almost immediate rise in asset values as investors capitalize the increased return.

WHAT SHOULD YOU DO?

Since capital gains increases affect investments that produce such returns, alternative investment analysis should be used to compare real estate investments to other competitive opportunities. Real estate should continue to perform well against alternative investments, but sentimentality is no excuse for chasing lower returns.

Also – remember, there is not a better place than Texas in which to weather this economic storm. ▪

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