Capital gains comeback raises stakes for 1031s

Friday, March 16, 2007 - 1:00am
Paul Cohen, CB Richard Ellis

With capital gains taxes set to rise, so does the need for real estate owners and investors to understand 1031 exchanges and the tax benefits they can provide.

In 2003, the U.S. Treasury trimmed the capital gains tax on real estate investments from 20% to 15% in order to boost investment activity and the overall economy. As many investors and non-investors alike are aware, the strategy has been successful and has contributed to an increase in property values.

In order to curb a period of possible over-activity and generate tax revenue, the Treasury has declared that the capital gains rate will revert back to 20% beginning Jan. 1, 2011. The increase in property values and the new higher tax rate will force owners and sellers to become better aware of how to protect their gains by utilizing tax laws like Internal Revenue Code 1031 aimed at benefiting real estate investors. But do owners, sellers, and investors currently know how to protect their pockets and profits from the increasing rate?

Internal Revenue Code Section 1031 has been in existence since 1928 and allows for capital gains from real estate sales used for business, trade, or investment to be transferred or deferred without taxation to another property as long as the property is also used for business, trade, or investment.

With the capital gains tax increase looming, it has become more important for sellers and owners to understand the benefits and investment power of 1031 exchanges. Are property owners and investors aware of the tax increase and 1031 laws?

According to a survey conducted by the Private Client Group of CB Richard Ellis in Miami, many owners are still in the dark. Of the property owners surveyed, 59% stated they would sell their asset before the capital gains increase, yet 74% expressed the need and desire to learn more about exchanges. Only 55% of the property owners claim that upon sale they will defer capital gains with a 1031 exchange.

Considering that many investors are not versed in 1031 exchanges, it is believed that less than 55% will exploit the exchange benefit and avoid capital gains taxes upon sale of their asset. Many sellers will be forced to pay taxes when they do not identify a property for purchase within the 1031 time constraints.

And because the values of properties have greatly increased in recent years, unaware owners will not know when to sell their asset and will incur opportunity costs associated with the missed opportunity to leverage tax-deferred gains into investments of greater value with bigger returns.

A simplified scenario illustrates this (see chart). Consider three investors all selling an asset and receiving the same before tax gains from the sale. The use of an exchange greatly affects the investor's returns on their next investment. Considering that most sophisticated investors re-invest gains as opposed to putting the money under their mattress, it becomes apparent that a 1031 exchange is a powerful strategy to employ. The chart does not take into consideration the ability to increase investment magnitude further through debt:

- Investor A sold property and chose not to re-invest the gains in the real estate market. They paid capital gains taxes (currently 15% soon to rise to 20%) and than invested the gains into another investment tool (in this case bonds yielding a 5% return). Investor A's annual cash flow is almost half as much as investor C's. Additionally, when investor A receives their initial investment from sale or maturity of the bond, they will again be forced to be pay taxes on their capital gains.

- Investor B also yielded proceeds of $1,000,000 from the sale of their property, but investor B did not find an exchange property or allowed time restrictions to lapse. Investor B paid the 15% capital gains taxes. Investor B months later found a new investment property to buy, but their buying power was reduced by 15% and, therefore, the value of the investment and annual cash flows were reduced.

- Investor C planned an exit strategy and found a replacement property for the exchange. Upon selling their initial property, the investor realized the same sale proceeds as investors A and B. Investor C was not taxed on the capital gains but was allowed to defer or exchange the proceeds into the new investment. With full-value buying power, Investor C maximized the investment value and income stream.

So what should investors and owners do in order to insure maximizing their profits and avoid paying rising capital gains taxes?

- Seek expertise in order to fully understand depreciation on property and when to dispose of the property and seek another with tax shelters.

- Capitalize on increased equity from appreciation and mortgage principal reduction and consider transferring a current investment into a greater one.

- Seek qualified broker representation that understands 1031 exchanges and can advise on the disposition of a current property and acquisition of another.

In an industry that has become highly competitive and sophisticated, it is important that investors arm themselves with all of the knowledge available in order to maximize returns and property values.

Paul Cohen is director of the CB Richard Ellis Private Client Group in Miami.

chart

Sample Scenario A- No Exchange B- Non-Exchange RE Investment C- 1031 Exchange

Before Tax Gains From Sale $1,000,000 $1,000,000 $1,000,000

Capital Gains Tax ($150,000) ($150,000) -

Net Proceeds $850,000 $850,000 $1,000,000

Re-Investment Tool Bond Property Property

Re-Investment Amount $850,000 $850,000 $1,000,000

Interest/Return 5% 8% 8%

Annual $/Return $42,500 $68,000 $80,000

Annual NOI Increases - 3% 3%

Initial Potential Investment (Before CG Taxation) $1,000,000 $1,000,000 $1,000,000

Sale In Yr 5 @ 8% Cap Rate $850,000 $956,682 $1,125,509

IRR 1.33% 6.40% 10.50%

Breaking News
In Florida Commercial Real Estate

PWC report: CRE to face long grind to...
Miami-Dade maintains retail recovery path
Plastics manufacturer to occupy 500,000sf
Marcus & Millichap closes $10M condo sale
CB Richard Ellis marks Town Plaze sale
NAI Tampa Bay sells 161 acres
Foram Group picks JLL to lease 600 Brickell
Continental buys 30,500sf shopping center