

Orange County Business Journal

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Gaining Capital

By - 1/28/2008

Orange County Business Journal Staff

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A capital gains tax increase may drive commercial real estate prices higher.

Seems counter-intuitive, right?

Federal capital gains taxes have been held at a reduced rate of 15% since 2003 for taxpayers above the 15% income tax bracket. The party is likely over.

On Jan. 1, 2011, the capital gains tax rate is scheduled to revert back to its pre-2003 level of 20%. The capital gains tax cut was passed and extended during a period when Republicans controlled the White House and both houses of Congress.

A common criticism of the capital gains tax cut among Democrats is that a disproportionate benefit is realized by the wealthy. Given the current democratic control of Congress and the impending presidential election—which could also result in a democratic White House—a return to the 20% capital gains rate in 2011 seems inevitable.

So why will this capital gains tax rate increase potentially drive commercial real estate prices higher?

At first blush, it seems logical that the increase in the capital gains rate will result in fewer sales. Commercial property owners may be less apt to sell their buildings and pay higher taxes, and potential buyers might be reluctant to buy property knowing this tax rate is higher.

This effect may be dwarfed, however, by a new wave of investors attracted by the unique nature of the 1031 exchange. The ability to avoid taxes via the 1031 exchange in income-producing real estate is not found in other major capital assets.

You sell a stock, you pay capital gains taxes.

You sell a bond, you pay capital gains taxes.

You sell income-producing property, and you can exchange into another (often larger) income-producing property without paying taxes.

As an example of how frequently the 1031 exchange is utilized, let's look at some OC investment sales in 2007. Of the 14 office buildings that the Economos Group of NAI Capital sold as investments last year, exactly half were purchased by a buyer using funds from a 1031 exchange. The largest exchange purchase was a \$27.4 million three-building office portfolio in South Orange County.

As capital gains taxes increase, stocks and bonds become less attractive compared to commercial real estate. It is logical to assume that if the capital gains tax rate does increase as scheduled in 2011, there will likely be a flight from securities and bond markets into commercial real estate. These increased investment dollars could exert significant upward pressure on commercial real estate prices.

The anticipation of the capital gains tax rate increase in 2011 is likely to cause traditional securities and bond investors to start thinking more about buying commercial property very soon.

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