# TIC TIC BOOM

**Even in the midst of the current 1031/TIC boom, paying capital gains tax when selling an asset remains a viable option.**

Robert Miller

When investing in real estate, the primary objectives are to defer a pending capital gain tax, create positive cash flow, obtain appreciation benefits and/or obtain tax depreciation. The question is: what is a 1031 tax-deferred exchange investor going to do in 24 to 48 months when it realizes that the 4 to 6 percent cash-on-cash return that it has been earning on the net-leased passive real estate investment it recently purchased has lost 10 to 15 percent of its value on an income approach-to-value analysis? Do investors realize that the reason they are selling their respective property for more money then they ever anticipated is the same reason they are paying more money for a replacement property on a return basis? Perhaps the current capital gain tax of approximately 15 to 17.5 percent may be the lowest it will ever be. If that is the case, investors may be better off not selling that property. Completing a 1031 exchange to defer paying taxes is often a secure investment, but presently, selling an asset and paying the capital gains tax may be a viable option, allowing for liquidity and freedom to seek out a new investment that will offer the potential for greater returns.

Beginning in second quarter 2004, the net-lease marketplace began to grow at an exponential pace. According to data from the retail properties division of Northbrook, Illinois-based The Boulder Group, in that quarter, there was a 79.8 percent increase in the number of available net-lease properties, bringing the number of available properties to more than 6,300 as compared to the previous quarter total of 3,510. This growth was sustained through the second quarter of 2005, when the number of available properties reached its high mark of 9,234. The number of properties sold has correspondingly climbed since second quarter 2004, reaching an all-time high in the second quarter of this year, when 3,800 transactions were documented. By the third quarter of this year, a decrease in available net-lease properties was documented at 6,898, a number close to the second quarter 2004 available inventory levels.

A large portion of all of these aforementioned transactions are completed by tax-deferred exchange investors motivated to consummate a transaction in order to save or delay the payment of a capital gain tax. During the last 3 to 4 years, interest rates in the financial markets have steadily decreased. As money becomes more or less expensive to borrow, the values of real estate on an income approach-to-value basis will also increase and decrease along with the interest rates. As interest rates decreased and values of property increased, the use of the 1031 exchange investment tool gathered steam.

However, since second quarter 2004, when short-term interest rates began increasing, the marketplace has seen cap rates decrease or remain the same. This trend has continued through the third quarter of 2005. This adjustment can be solely attributed to the diminishing supply and increased demand of available net-lease product.

As in any valuation, the greater the supply, the lesser the demand and vice versa. The current economic environment has allowed purchasers to borrow debt at historically low interest rates that subsequently enable a purchaser to afford a more expensive property. The continued low interest rate environment, which has lasted in excess of 24 months, has created sales values at unprecedented highs. This investment cycle will slow as interest rates increase, but as long as the market lacks a consistent supply of product, the demand will continue to bring about record-breaking prices.

Examples of passive real estate investments available in today's marketplace that best meet this description would be drug stores, banks and corporate-guaranteed restaurant properties. An investor that purchases a Walgreens property at a 6.25 percent capitalization rate may see the value of this investment decrease on an income approach-to-value basis to a 7.25 percent to 7.5 percent capitalization rate over the next 24 to 48 months. This represents a 13 to 16 percent decrease in value. Why is the property value decreasing? Because when that investor purchased the property, the 10-year yield was between 3.9 and 4.5 percent. In the event interest rates increase and money becomes more expensive to borrow, the values of real estate will most likely decrease. This holds true for most real estate, both commercial and residential. If the income does not increase at a rate that exceeds the rising interest rate environment, then the investment will decrease in value. The cash-on-cash return that may be realized over a 5- to 10-year period may not equal the amount that the replacement property has lost in value over that same length of time.

One issue occurring in today's real estate marketplace is concern that, as the supply and demand ratios of investment real estate become thinner and thinner, investors will compromise the essential components that justify the value of replacement properties in order to complete a transaction. An investor seeking a replacement property to satisfy a tax-deferred exchange requirement and whose objective is to purchase a passive non-management investment would most likely be searching for a well-located property that was occupied by a reliable credit tenant signed to a long lease term and paying a reasonable rental rate that is not above market value.

Depending on the geographical location of the real estate, this investment will trade between a 5.25 and 6.25 percent capitalization rate. An investor looking for a better return will need to compromise the reliability of the tenant, length of lease term, rent per square foot and/or location of real estate. The problem is that the spreads in compromising these components do not necessarily equate to realizing a better return. Restaurant properties that are guaranteed by restaurant franchisees that do not hold significant guaranties have been trading at capitalization rates between 6.25 and 7.5 percent. Unless these acquisitions are completed on an all cash basis, the investor will likely obtain a mortgage personally guaranteed at debt rates based on indicators used to price the debt at a spread (175 – 275 basis points) greater than the 5-year Treasury yield (4.67 percent as of November 4, 2005) or the prime rate which recently was increased to 7.05 percent. In the event that the income stream does not increase at a rate equal to or greater than the rate at which debt rates increase, when the loan is due and the investor refinances, it may be looking at paying a high annual principal and interest payment during the latter year of the lease term and receiving a lesser cash flow than it collected during the initial years of the investment.

Investors are being advised not to pay what may be the lowest capital gain tax rate in history and instead acquire an asset that may devalue in the next 24 to 48 months. Instead of purchasing a replacement property, an investor may be better off not selling the original asset, or paying the capital gains tax and waiting for another opportunity. It is possible that the liquidity gained from paying the capital gain tax or not selling the initial property will be more valuable in the next 24 to 48 months than any replacement property that the investor is considering purchasing.

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