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APR/MAY/JUNE 2008

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CAPITAL GAINS TAX AND PRIVATE BUSINESS OWNERS

by John E. Barry

As the United States heads toward the November presidential election, the impact of a slowing economy, changes in the mergers and acquisitions markets and changes in tax rates are all important factors for investors and business owners to consider.

Taxes should rarely drive investment decisions, but a possible upcoming change could impact how you factor taxes into your investment strategy. For five years, the tax on capital gains has been the lowest in history. There's a good chance, though, that capital gains taxes will increase under either a Democratic or Republican presidency.



With the current capital gains tax level scheduled by law to increase to 20% in 2011 from today's rate of 15%, the critical question is whether incremental changes will be enacted by the next president or will a more drastic increase occur. The likelihood of a larger move higher has increased since the credit crisis began last summer, the stock market is off, the dollar is sharply lower, and the economy appears headed for an official recession if we are not already in one now.

John F. Kennedy searched for an answer to the benefit of a higher capital gains tax and found none. He stated "the tax on capital gains directly affects investment decisions, the mobility and flow of risk capital... the difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy."

While some tax professionals believe that tax changes could become effective in 2009-10, most believe such changes are likely to occur as currently contemplated in 2011 as Bush's tax cuts expire. Thus, there will remain about a 2-year window to continue to take advantage of capital gains rates at 40-year lows.

For owners considering selling their business within the next several years, the after tax impact on their bottom line is that it may behoove them to consider such an event sooner rather than later. Assume your self storage facility has a net operating income before interest expense, depreciation, and amortization of \$350,000. At an 8% cap rate, the value is \$4,375,000. After tax, assuming 15% and 28% capital gains tax rates, the net proceeds of the business would be \$3.72 million and \$3.15 million respectively. The reduction is significant to the owner equating to more than 15% reduction in net proceeds or \$570,000. When taking into account the loss associated with the time value of money differential between selling now and in two years, or when the capital gains rate is increased, the total loss in value grows to nearly 26%.

The good news is self storage facility values are still very near the top of the market, and the continuing reductions in interest rates only enables buyer financing. At the same time the slowing economy and budget deficits will call for long-term tax hikes, including the capital gains rate. Owners should expect an increase in the capital gains rate at the earliest in 2009 and at the latest in 2011 and make their business decisions accordingly.

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