

# When Should Real Estate Be Sold?

by Jack P. Friedman

Determining the best holding period for income-producing real estate is a major concern of realty owners, property managers, investment counselors, and mortgage lenders. Owners want high yields, yet many of them dispose of real estate so quickly that, after they settle with their broker and Uncle Sam, their yields are negative. Property managers and investment counselors, in advising on matters pertaining to the resale of real estate, sometimes find themselves relying on rules of thumb. Mortgage lenders are also concerned with the resale of real estate, chiefly because they need to be able to estimate when loans will be repaid, and frequently a sale dictates property refinancing.

Numerous events can affect financial results from real estate ownership by causing property appreciation, an economic decline in value, or changes in operating income. The proportions of certain variables can be expected to affect after-tax equity yield rates. Such variables include the improvement ratio and the ever-changing loan-to-value ratio. And, since each parcel of realty is unique and so is its owner, generalizations about income-producing realty can be quite misleading.

Still, recognized authorities have written that it is best to sell income-producing real estate after ten years of ownership, partially because of income tax considerations.<sup>1</sup> Since the analysis used by many of them is based on before-tax equity yield rates, their conclusions are unsupported by their methodology.

The main purpose of this paper is to describe some of the findings of a study of certain variables that affect after-tax yields and holding periods for income-producing real estate. In addition, applicable current tax law and some of its evolution are described.

## TAX LAW CHANGES

In July 1969, permissible depreciation methods for all income-producing real estate except new residential property were changed to the methods shown

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1. James E. Gibbons, "Ellwood Capitalization Concept in Appraisal of Investment Property," *Appraisal Journal*, vol. 32 (July 1964), pp. 358-62; Robert C. Cox, "Mortgage Equity Capitalization: A Leader's Look," *The Real Estate Appraiser*, vol. 39 (March-April 1973), pp. 41-48.

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in *Table 1*. Section 1250 of the *Internal Revenue Code* (a section presumably intended to affect the holding of real estate) was also modified.

The purpose of Section 1250 is to prevent realty owners from enjoying capital gains rates of taxation on the profit from a quick turnover of realty that has been depreciated using a rapid method. This section was introduced in 1963 to prevent the conversion of ordinary deductions (depreciation) into capital gains. The section prescribes what is commonly called "depreciation recapture." It requires the recapture, as ordinary income, of excess accelerated depreciation. Excess accelerated depreciation is the difference between the depreciation claimed by using an accelerated method and the amount that straight-line depreciation would have been on the same asset, with the same salvage value and useful life (see *Figure 1*). Before Section 1250 was added, all depreciation claimed on real estate held over six months was taxed at capital gains rates. When Section 1250 was introduced, capital gains rates could still be achieved in time: ten years became the minimum holding period required to avoid all recapture.

In 1969, Section 1250 was modified to extend the holding period necessary to avoid recapture of post-1969 accelerated depreciation. The 1976 Tax Reform Act tightened Section 1250 even more. *Table 2* summarizes depreciation recapture periods.

From 1963 through 1969, holding depreciable real estate for ten years was significant in that it assured all capital gains tax rates upon a sale. Presently, the figure of ten years is not nearly so significant. It is now a factor only for property that is still under the same ownership as before 1970 and on which accelerated depreciation was claimed before 1970. The law that applied to 1963-69 depreciation now has a diminishing overall impact; so ten years has lost much of its significance as a suggested holding period, at least from an income tax standpoint.

## VARIABLES LIKELY TO AFFECT FINANCIAL RESULTS

Some important variables that are likely to affect the financial results from income-producing real estate include the following:

- 1) The overall rate of return at the time of purchase and resale. This is the ratio of net operating income to the sales price.
- 2) The loan-to-value ratio. This ratio will change over time.
- 3) The interest rate of the mortgage(s).
- 4) The amortization term of the mortgage(s).
- 5) The owner's marginal income tax bracket.
- 6) The minimum tax on preference income.
- 7) The improvement ratio and costs of various assets.
- 8) The depreciation method used.
- 9) The depreciable life (or lives) claimed for income tax purposes.
- 10) Forecast changes in net operating income.
- 11) Forecast changes in property value.

When the values of these variables are known, it is possible to forecast the amounts of before-and after-tax cash flow which the property can be expected to generate and the proceeds from a resale. These 11 variables, since they may

vary independently of one another for any given project, could result in an astronomical number of possible combinations. In view of all the possible variations, it is obviously dangerous to apply a general rule in suggesting a holding period for all income-producing real estate.

## **SCOPE OF THE STUDY**

The study focused on holding periods of from one to 30 years for hypothetical improved income-producing real estate. A single self-amortizing conventional level-monthly-payment mortgage loan encumbered the hypothetical properties. Physically, the hypothetical properties were composed of one depreciable asset (improvement) and one non-depreciable asset (land).

The number of possible combinations was reduced to 27 likely possibilities for each of three "types" of income-producing property (see *Table 3*) under three different depreciable lives and three alternative mortgage loan amortization periods. Other variables were changing or constant as indicated in *Tables 4* and *5*.

The variables used were judiciously selected for various reasons, including tax law, lending institution policy, market data, and purposes of sensitivity analysis. Each of five variables was allowed to take on three values for the three types of property (*Table 3*), which resulted in 729 possible outcomes ( $3^5 \cdot 3$ ). Each outcome was simulated for 30 years by using a computer.

## **FINDINGS OF THE STUDY**

The performance of the property, in terms of changes in net operating income or value, had a profound effect on the internal rate of return and the year that this measure peaked.

### **Income and Value Increasing**

When net operating income and the fair market value of the property were both increasing, a short optimal holding period resulted, and after-tax internal rates of return were high. Under such conditions, the average suggested holding period was 8.3 years, with the range from 6 to 14 years for the 81 trials under these simulated conditions.

The early year of sale was suggested by the decreasing financial leverage. With property appreciation, the loan-to-value ratio was declining rapidly. In order to maintain the high leverage ratio required to sustain such high yields, the property must be sold in favor of more levered property or refinanced.

### **Income and Value Decreasing**

When net operating income and the fair market value of the property were both decreasing, an average suggested holding period of over 28 years was recorded. In most cases, the related after-tax rates of return had been slowly rising from the start and had not reached their crest by the thirtieth year, when rates below 7% were being attained. This indicated that the property owner should have acquired other investments (such as municipal bonds or other investments in the same risk category that offer competitive after-tax

rates). However, once the hypothetical subject property was acquired, capital losses and operating income declines were sustained immediately. When combined with the potential selling costs (stipulated to be 3% of the gross sales price), the early losses depleted purchase capital to the extent that there was no reason to sell. Investment inflows from the property, no matter how small, were handsome compared to the remaining amount of equity. In such cases, a long holding period is suggested.

### **Shortest and Longest Holding Periods**

The shortest average suggested holding period was recorded in the category where operating income was increasing and property value declining. Such a situation may occur, for example, when the only hotel in a town reaches old age. The value declines for various reasons, including anticipated modern competition, but, because of the present local monopoly, operating income remains high. Such a building should be sold before the declining value severely depletes the equity.

When value was increasing but operating income declining, the longest suggested holding period was recorded. An example would be an older office building or theater in a key location on land that is steadily appreciating in value. The owner could hold out for further property value increases for an indefinite time but, whenever an offer is tendered, he should review alternative investment opportunities and consider a sale.

### **OTHER VARIABLES**

The depreciation method, depreciable life, and mortgage amortization term each had a surprisingly slight effect on the suggested holding period.

#### **Depreciation Method**

The use of the sum of the years' digits method of depreciation (with 1969-75 recapture rules applied for conventionally financed residential property) extended the suggested holding periods slightly, as compared to other methods of depreciation. Despite the full depreciation recapture provision that was applied when the 150% declining balance depreciation method was used, the suggested holding periods under that method of depreciation were slightly shorter than when either of the other depreciation methods was used.

Ranges of suggested holding periods under the three methods of depreciation were very narrow and indicated that the method of depreciation has only a minor effect on the suggested holding period for income-producing real estate. This also implies that a property owner need not be particularly concerned with Section 1250 in determining whether to hold or sell income-producing property. It also implies that the best year of sale should be sought on an individual case basis, considering known amounts and rates, expected or forecast occurrences, and the individual situation of the owner.

#### **Depreciable Life**

The use of a 25 year depreciable life (rather than one of 35 or 45 years) tends to decrease the suggested holding period, but only slightly. Within any of the

three depreciation methods considered, a 20 year change in the depreciable life (25 years versus 45 years) did not affect the average suggested holding period by more than one year. The widest range (based on averages of results from nine combinations of net operating income and value change) was 5.6 years. The range of years in that case was from a low of 14.8 years to a high of 20.4 years.

### **Mortgage Amortization Term**

The findings of this study indicate that, as the mortgage amortization term increases, so does the suggested holding period. This is because the longer mortgages provide a greater degree of leverage over an extended time period, allow more tax deductions per dollar of debt service paid, and provide more cash flow, though at the sacrifice of proceeds from a sale. Typically, however, a five-year increase in the mortgage term led to only a one-year increase in the suggested holding period, which might be considered a minor effect.

### **Effect of Income Tax Brackets**

Those in the highest tax bracket considered (50%)<sup>2</sup> have shorter suggested holding periods, especially when both mortgage terms and depreciable lives used are short. This shows that a high-tax-bracket income-property owner who uses a short depreciable life and mortgage term reaps after-tax benefits early and should consider a relatively early disposition; otherwise the tax-shelter situation will be reversed. Should either the mortgage term or the depreciable life be extended, benefits will accrue over an extended period. In that case, the high-tax-bracket owner should retain the property to claim more depreciation and interest deductions while postponing capital gains taxes. Longer depreciable lives tended to increase the suggested holding period for tax-paying property owners. Results for those in lower tax brackets were shown to be less sensitive to changes in variables which affect taxable income. The minimum tax was not considered because the amount of tax due (if any) depends upon the personal situation of the individual investor.

### **The Interaction of Mortgage Principal Payments with Depreciation Charges**

Depreciation charges and mortgage principal payments have opposite effects on cash flow and project taxable income. Depreciation charges are permitted as income tax deductions, whereas loan repayment is not a tax-deductible item. Cash payments are needed to reduce the principal balance of a loan. In contrast, depreciation claimed for income tax purposes requires only a bookkeeping entry that involves no transfer of funds. Therefore, tax-paying property owners who are interested in retaining cash would prefer to claim tax-deductible depreciation expense rather than pay non-deductible cash to reduce a mortgage loan.

As stated above, mortgage principal payments and depreciation charges have

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2. Tax brackets above 50% were not considered. The minimum tax on preference income was not considered because the amount of tax due (if any) depends upon the particular situation of the individual taxpayer.

opposite effects on cash flow and the taxable income that is generated by the property. As long as the depreciation claimed for the year is greater than the mortgage principal payment for that year, before-tax cash flow will exceed the amount of property-generated cash flow that is subject to income taxes. In those years when the reverse holds true (that is, when mortgage principal payments exceed depreciation charges), the taxable income generated by the property will exceed before-tax cash flow. This will occur with time, as depreciation declines under accelerated methods and the mortgage principal increases. When accelerated depreciation is claimed and the property owner is in a high tax bracket, income taxes attributable to ownership of the property may exceed the cash flow generated by the property. In other words, after-tax cash flow may become negative.

## **TWO TURNING POINTS**

The effects of depreciation charges and mortgage principal payments combine to create two turning points in the ownership of income-producing property. One of these is the point at which principal payments for a given year exceed depreciation for the year. The other is reached when after-tax cash flow becomes negative. These two points and their implications are discussed below.

### **First Turning Point**

Test results showed that property should normally be held at least until the time when principal payments exceed depreciation charges. Before that time, the amount of taxable income will be less than the amount of cash flow, and at least some of the annual cash flow will be tax-free.

### **Second Turning Point**

Test results also showed that income-producing property should be sold before the time when after-tax cash flow becomes negative. Although this point did not occur in all of the trials, when it does occur the owner must pay cash to retain the property. If the property is held beyond this point, greater after-tax proceeds of sale can be realized but the trade-off (cash outflows first, additional proceeds later) is not normally worthwhile because of the time value of money.<sup>3</sup>

## **A GOOD POLICY**

An important financial reason for the sale of income-producing property (other than in distress situations or to settle estates, etc.) involves the principal of substitution. It is a good policy to be continually evaluating alternative investments, particularly those considered to be in the same category of risk as the subject investment. The "pull factor"<sup>4</sup> shows the after-tax rate of return needed by competing alternative investments to match forecast financial results for the next year of the subject property. It is computed

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3. This depends upon the personal situation of the property owner. Some owners may prefer to postpone a sale until retirement or other circumstances may cause the gain on a sale to be taxed at a low rate.

4. See "The IRR Plus the Pull Factor," *The Real Estate Appraiser* (March-April 1976).

for any given year by dividing the sum of forecast after-tax cash flow and the forecast change in after-tax reversion for any year by the ending equity of the preceding year.

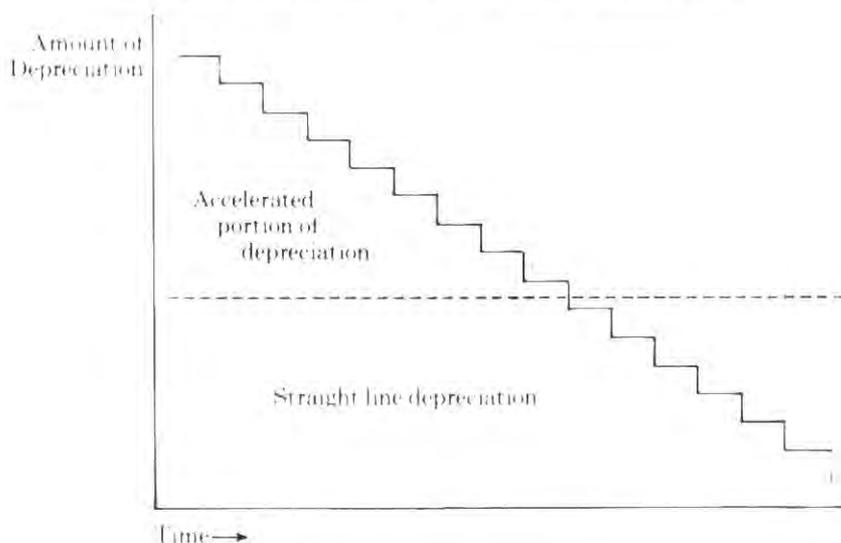
Any subject property considered may have "peaked out" or just begun to gain momentum in terms of the financial benefits provided. Still, the decision to hold or sell should rest on the anticipated future project income compared to alternative investment opportunities. Past performance does not give this information: it is the expected future income that is important.

## CONCLUSION

Rapid depreciation methods, longer asset depreciable lives and longer mortgage amortization periods tend to lengthen suggested holding periods for income-producing real estate. Property performance in terms of value and operating income changes have a significant effect on holding periods. Under conditions of property appreciation and operating income increase, shorter holding periods were shown to be preferable since the use of favorable financial leverage diminished rapidly. Longer holding periods were suggested under other conditions, especially when large unrealized capital losses were incurred shortly after property acquisition. Favorable mortgage refinancing tends to extend the suggested holding period.

There are many variables which have an effect on income-property holding periods. Some variables arise from within the property, others are external. Some are uncontrollable whereas at least some control may be exercised over variables. Since determining the best year of sale is a complex matter, that determination is better performed on a case-by-case basis, considering all relevant factors including the personal situation of the individual property owner.

**FIGURE 1**  
**EXCESS ACCELERATED DEPRECIATION**



**TABLE 1**  
**DEPRECIATION METHODS ALLOWED**  
**FOR REAL ESTATE ACQUIRED**  
**AFTER JULY 1969**

<u>Type of Property</u>	<u>New</u>	<u>Used</u>
	(The original use begins with the taxpayer.)	(Acquired with a tenant physically occupying.)
Apartments (at least 80% of income is derived from dwelling units)	Sum of the years' digits Double declining balance 150% declining balance Straight line	125% declining balance (if remaining life is at least 20 years) Straight line
Other (office buildings, shopping centers)	150% declining balance Straight line	Straight line

**TABLE 2**  
**HOLDING PERIODS NECESSARY TO AVOID**  
**DEPRECIATION RECAPTURE**

	<u>When Depreciation Claimed</u>		
	<u>1964-69</u>	<u>1970-75</u>	<u>After 1975</u>
Commercial property	120 months	Always ordinary income	
Residential property	120 months	200 months	Always ordinary income
Low-income residential	120 months	120 months	200 months
Five-year rehabilitation	N/A	200 months	200 months

Notes: 1) All depreciation (both excess accelerated and straight line) is recaptured as ordinary income for property sold within 12 months of acquisition. 2) For each month short of the required number of months, 1% of the excess accelerated depreciation would be recaptured as ordinary income to the extent of the gain recognized upon a sale.

**TABLE 3**  
**TYPES OF INCOME-PRODUCING**  
**PROPERTY CONSIDERED**

<u>Type of Property</u>	<u>Method of Depreciation Accounting</u>
New residential	Sum of the years' digits
New non-residential	150% declining balance
Used property	Straight-line

**TABLE 4**  
**VARIABLES THAT CHANGED**  
**WITHIN THE STUDY**

Depreciable lives considered for tax purposes	25, 35, and 45 years
Mortgage loan full amortization periods considered	20, 25, and 30 years
Income tax brackets (Capital gains rates at one-half of each of these)	0%, 25%, 50%
Net operating income; compound annual change	-2%, 0%, 2%
Total property value; compound annual change	-2%, 0%, 2%

**TABLE 5**  
**VARIABLES HELD CONSTANT**  
**THROUGHOUT THE STUDY**

Loan to value ratio	75%
Mortgage interest rate	9%
Overall rate of return on total property	10%
Ratio of improvements to total property	80%