The Business Library — **Resource Report #40**

How to Evaluate Real Property Investments

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Before You Invest in Real Estate

You can lose considerable money in real estate if you aren't knowledgeable about the market, financially able to wait out the slumps, and prepared to be patient until the property's potential is reached. Consider the following advisories:

- Invest only the amount of money you can afford to tie up in an illiquid investment and not so much that your net worth and access to capital for other purposes are seriously affected.

- Diversify the geographic location of your real estate investments and research each area where you're thinking of buying in terms of its tax base, industries, transportation systems, and zoning regulations.

- Evaluate properties in terms of their annual cash flow and potential for long-term increase in value.

- Investigate beforehand the IRS rules on deductions, losses and profits of real estate investments, but do not rely solely on the current tax results as financial justification for the investment. Tax laws do change. The property should be a good investment *without* the tax advantages.

- Thoroughly check out all potential and existing tenants, insist on sizeable security deposits, and stick to standard lease agreements.

- Be equipped to properly manage the property, either with sufficient personal time if you're doing it yourself or with extra cash to hire a reputable management company.

- Solicit — and listen to — the advice of experts in choosing properties, arranging financing, and selling them off.

This **Resource Report** will help you address all of the above concerns. Read it carefully before you invest in real estate.

Special Option for Business Owners — On page 8 of this Report, we explain and illustrate why you and your family should own your company's facilities and how to do it. Now to the Report on how to evaluate real property investments.

Thomas J. Martin, Publisher

How to Evaluate Real Property Investments

The appeal of real estate as an investment is considerable. Underlying that appeal:

- The price tags on many desirable properties are relatively low.
- Alternative option to diversify your investment portfolio.
- Low mortgage interest rates mean more of the buyer's monthly payment goes toward principal repayment and the property's equity value builds up faster.
- Real estate carries valuable deductions, especially mortgage interest and property taxes.
- A portion of the annual income and cash flow can be sheltered from taxation by depreciation of the property.
- The proceeds from future refinancings of the property often can be received tax-free.
- On the eventual sale of the property, much of the profit is taxed at a maximum capital gain rate of 15%, rather than at ordinary income rates of up to 35%. The spread — tax savings — is 20 percentage points (35% vs. 15%). Every $100,000 in profit on a real estate investment leaves $20,000 more cash in your pocket than the same amount of additional compensation.

But be forewarned: Real estate, because it is so illiquid and can't be sold readily like stocks and bonds, is not an investment to be made lightly; that's been proven many times. Timing, location, and the preparation of realistic cash flow projections are the keys to making good real estate investments.

Here are many ideas to use in evaluating real estate investments.

#1. What to Look For

Keep to the fundamentals: Look for property that is undervalued or can be easily upgraded in value. *Examples:* A structurally sound building that needs only surface work such as painting and nominal repairs to fetch a higher price or an apartment building in an area getting an influx of new industry.

Be realistic: Be certain your projected increase in value is realistic. Don't depend on zoning changes or other planned government actions to increase the value of the property. The changes may take years to come about or they may never happen. You're better off relying on normal market forces. Also, do not rely solely on the tax economics of a real estate investment. Tax laws *do* change. Your cash flow and future increase in value should justify the investment *without* anticipated tax savings.

Do your homework: Investigate the property you want to buy. *The usual:* electrical, plumbing, structure, environmental, termites, sewage, etc. Consider hiring a professional engineer to thoroughly inspect the property *before* putting down a deposit to buy it or make the Purchase and Sale Contract contingent on a satisfactory report from the engineer.

#2. Where to Get Information

Develop contacts with the local real estate community, e.g., members of the local zoning board, contractors, industry planners, redevelopment authorities, real estate firms, etc. Real estate market information is readily available to potential investors, but it's largely a matter of being the first to hear of new developments, industry expansion plans, low-vacancy apartments, etc.

Basic rule: The success of a real estate venture is directly related to the buyer's knowledge of the property being acquired and the geographic area where the property is located.

#3. How to Limit Risk

Don't tie up a lot of your cash. Because of the illiquid nature of real estate, some of the investment should be financed with a loan in an amount you know you can repay. When you sell that property to buy another property, the new downpayment can come from the profit on the original property, not from additional cash that you have to lay out.

Basic protection: Be sure any potential capital loss on the property, including the cash needed to reach cash flow breakeven (i.e., rental income equals all cash outflow), will not substantially affect your net worth and that the property is more than adequately insured. You don't want to lose your entire investment because of a fire or natural disaster. You also don't want to buy real estate if there's a risk that you may have to sell off the investment suddenly — at distressed prices — because you need the money elsewhere.

Rental rule of thumb: Monthly rental income should be about 0.8% of the property's purchase price — 9.6% on an annual basis. One-half of 1% is dangerous. If you can get 1% of the purchase price (12% annually), your odds of success are greatly increased. *Note:* These percentages may change depending on location and the capital appreciation you stand to realize on the property down the road.

Cash flow rule of thumb: With real estate, you need extra cash to ride out *both* cash flow deficits and six to 12 months of zero rental income. The cash cushion should be even greater if you are borrowing mortgage money to finance most of the investment, say, more than 70%. Foreclosure is very expensive and the cost of the legal proceedings can amount to *more than* the capital you have invested in the property.

#4. Where to Buy

The suburbs of major metropolitan areas, or fringe areas of cities with good transportation systems, can be a better investment than center cities or high-tax areas. Also, if you're in the market for properties that require a great deal of personal management (e.g., rental apartments), you may be better off looking in your own geographic area unless you know someone who could manage the properties for you.

Furthermore, if you're buying several of the same type of property (e.g., three single-family homes or two office buildings), you would be well-advised to choose properties in different geographic areas so a decline of property values in one area can be cushioned by greater stability or increased values in another area.

#5. What Kind of Real Estate to Buy

Undeveloped land, because of its speculative nature, lack of annual cash flow, and possible zoning problems, is generally not a good idea for your first venture. Residential property (family homes, multi-unit apartments) can be good if the demand for rentals in the area is strong and *cash flow is predictable.*

With larger multi-unit dwellings, pick the community carefully and diversify among buildings in several communities to further lessen the risk that the whole investment will be restricted by regulation.

Commercial property can be profitable but it has some unique problems: It usually requires more management and can be vacant longer between occupancies so you may need extra cash to ride out any problem periods.

#6. Can You Afford It?

You need access to adequate capital to make real estate investments. Don’t consider buying the property *unless:*

- You can afford to tie up the cash; as indicated, real estate is a notoriously illiquid investment.
- You can handle the mortgage payments for one year or more *without* depending on the rental income from tenants.
- You are willing to pay a professional company to manage the property or you will invest the time and effort in managing the property yourself. Remember, you have maintenance and collection hassles you don't have with stock and bond investments.
- You're not likely to have to borrow money for more pressing needs in the next few years (a real estate mortgage can diminish the credit available to you for other purposes). This is a particularly important consideration if the investment does not have a current positive cash flow or if your children are nearing college age or you need capital for other business or personal purposes.
- You have done the necessary homework to assure that the property has a better-than-average (not just average) chance of increasing in value in the future. You should look for a compounded annual return in the area of 15% on your invested capital. Don't forget; you're tying up cash and giving up liquidity.

Cash flow caution: Project your annual cash flow from the property for at least five years; it's just as important as long-term profits. But, again, keep in mind that it is not uncommon for an investor in real estate to have to dip into his or her own pockets for cash to make ends meet during the time he owns the property. A real estate investor should be willing to make those additional current monthly outlays in exchange for the opportunity of eventually selling the property at a significant profit.

#7. When to Sell

Don't fall in love with a property and don’t hold onto it any longer than it takes to realize its potential. Once the value is achieved, sell it off and buy something else with new potential or invest the proceeds in more liquid assets such as bonds, stocks, or certificates of deposit.

#8. You and Your Tenants

Even the best real estate potential can be undermined by irresponsible tenants. Efforts spent checking out candidates' prior rent histories, their financial position and credit rating, and the stability of their reported income is cheap insurance against a tenant wiping out your profits and cash flow. Remember, you're giving a substantial amount of credit; at $1,000 a month, a three-year lease is worth $36,000 of credit.

Security deposits: Requesting two or even three months' rent as a security deposit reduces your risks and encourages the tenants to stick around for the term of the lease. Also, it shows financial substance on the part of the lessee.

Lease agreement: Always get a signed lease and use a standard lease form. Its clauses have been tested in the courts. Then add to or delete from it with caution and only after consulting with a lawyer who is experienced in real estate rentals. Your lease agreement should do more than spell out how much rent is due. It should detail the procedure by which you can evict destructive or delinquent tenants. It also should specify repairs and maintenance for which you're responsible and those that the tenants are expected to take care of themselves. Also, a statement of who the occupants are and the total number permitted in the dwelling helps forestall potential problems.

Finally, keep all tenant meetings and agreements at arm's length, purely business. Don't rent to friends, relatives, or business associates. Inevitably, you will make concessions in signing a lease, obtaining an adequate security deposit, rental payments, etc.

Existing tenants: If the building you are buying has in-place tenants, review their leases carefully. Look also at the expiration dates. *Reason:* In a soft market, to keep a tenant at the end of his or her lease or to attract a new one, many real estate investors have had to make such concessions as lowering the monthly rent and/or making improvements to the property at the tenant's request. That's especially true if the building is near a newer and/or largely vacant building.

To a novice landlord, many items that could go into a lease may seem unduly restrictive, but experience is a harsh teacher. As one real estate investor, who has been through three tenants in five years, notes, "With each tenant, the number of

clauses in the lease gets greater."

An Option Just for Business Owners

If your company needs a new office building or manufacturing facilities, it almost always makes sense to buy the property *personally* through a partnership or sole proprietorship, rather than through your company. That way you build equity outside your business with property you can sell separately or continue to own after you sell the business.

Personal ownership also avoids double taxation when the property is sold. If the corporation owned and sold the property, it would be taxed on the capital gain at the corporate level (up to 35%) and then the stockholders would pay another tax on any distributions of the proceeds (up to 35% or 15% if it's a dividend).

Equally important, personal ownership means the proceeds from subsequent refinancings of the property go into your pocket and usually can be received on a tax-free basis.

Example of Tax-Free Refinancing

Let's assume you purchase an office building for $250,000 and in five years it's worth $400,000 If the original mortgage was $187,500 (say 75% of $250,000), a refinancing would **generate $112,500** new money (75% of $400,000 less $187,500 initial mortgage). Any money already repaid on the initial mortgage also can be added to the amount you walk away with from the refinancing.

What about the increase in the mortgage payment? This can be provided for in the lease agreement with your business by increasing the annual rental amount at the end of five years.

Another idea: You may even want to purchase the property in your spouse's or children's names, which is a very effective form of estate planning.

Protect Yourself

If you're going to pursue this ownership strategy, consider the following advisories with your accountant and corporate lawyer:

- Obtain board of director approval on the lease arrangement and, if possible, try to abstain from voting on the lease as a board member.

- Obtain an appraisal of the property and be sure the rental amount between you and the company is comparable to other rentals in the same area the property is located.

- If you have minority stockholders, obtain their written approval before closing the transaction.

- Use standard lease forms. Don't make the lease agreement too different.

- If your family is involved in owning the property, check out the estate and gift tax effects before making them part owners.

- Try to avoid having your company guarantee the mortgage note. If it does, the arm's-length nature of the transaction may be questioned by the IRS.

- Because of your position (owner, employee, board member), get sound legal, tax, and accounting advice. Be careful of conflicts of interest and effect all family/business transactions on an arm's-length basis, i.e., as if you were doing business with an outsider.

- Do not use your company's counsel; use your own lawyer. This further shows that the transaction is an arm's-length one.

Before structuring the terms of the purchase and lease contract, consult with your accountant and lawyer. There are other considerations, including the tax treatment of rental income, depreciation, passive losses, the alternative minimum tax, at-risk rules, and the tax deduction of interest expense.

Finally, before you make the decision to own the company's facilities, compare the company's and your personal tax rates. If the company's tax rate is consistently lower than your personal rate *or* it has a net operating loss carryforward, the deductions from the rentals paid to you are not as valuable to the company since it is in a low or zero tax bracket. Thus, there may not be a tax advantage to you owning the property and leasing it to the company since the arrangement would give you taxable rental income and the business would have little use for the rental deductions.

* * *

In considering any real estate investment, use, in addition to your accountant and other advisers, a lawyer experienced in the purchase and rental of real estate

properties. This is particularly important if your family will be involved in the ownership. Be sure he or she is fully informed of both your personal and business tax situation, as well as your family's total financial profile, i.e., your trusts, wills, gifts to children, and overall estate plan.

Last, as indicated, projected net cash flow is the name of the game. If the investment won't show a *positive* cash flow initially, be sure your projection of the potential capital appreciation in the property more than makes up for those early cash flow deficits.

References:

For a review of the tax laws on real estate investments, please see *Exhibit 1* on the next page.

For suggestions on protecting your real estate investment in your home, see *Exhibit 2* on page 14.

For a summary of the rules and pitfalls before you invest in real estate properties, see *Exhibit 3* on page 17. ☐

Don't fall in love with a property. Once its potential is reached, sell it off and use the profits to make another investment.

Exhibit 1

Tax Facts and Cautions On Real Estate Investments

Over the years, the tax laws have made changes that affect your tax writeoffs but the basic economics of real estate investments and the equity build-up and tax-free refinancing potential still hold true. However, you must act prudently in making real estate investments. Knowing the rules and cautions will help you lower taxes, increase your deductions, and build greater equity. Consider these advisories with your accountant and other advisers.

☐ *Double taxation:* Try to own the property *personally* or through a partnership, S corporation, or limited liability company. When a regular (C) corporation owns the property, there's a potential double tax to pay when the property is sold: once at the corporate level (up to 35% tax rate) and then on any distribution of the proceeds to the company's stockholders (up to 35% tax rate).

☐ *Family ownership:* If your children are going to be part owners of the property, be aware that all income in excess of $1,700 for children under age 18 is taxed at the parents' marginal tax rate.

☐ *Related parties:* Be careful of the rules involving transactions between related parties, e.g., between you, your family, and/or the business. *Example:* If the rental income paid to you by a business you own is *more than* the current market rate, the difference may be labeled a dividend by the IRS, which is taxable income to you but not tax deductible by the corporation. Similarly, if the corporation owns and sells the property to you for *less than* its fair market value, the difference also may be declared a taxable dividend.

☐ *Passive losses:* Losses from real estate rentals are restricted since they are considered passive losses. A maximum of $25,000 in losses can be deducted each year. The $25,000 allowance is phased out when your adjusted gross income is

between $100,000 and $150,000. The IRS also may question your deductions if the real estate investment creates too much passive income, especially if you use that passive income to offset other tax shelter (passive) losses. If you have no passive losses, this should not be a concern.

Furthermore, if you don't *actively* manage the property, your passive losses from the real estate investment can be used *only* to offset passive income. Without passive income, the losses may have zero tax value until you sell the property.

☐ *Refinancings:* There are situations where interest on a *refinanced* mortgage may *not* be deductible. And, in some cases, you might have to recapture (report as income) losses taken in the past. Even with those problems, refinancing still can make economic sense since the proceeds from a refinancing are usually received tax-free by the owner. *Best advice:* Check with your accountant and tax adviser before refinancing any mortgages.

☐ *At-risk rules:* Be careful of the "at-risk" rules which restrict your losses to the amount you have at risk in the property. Talk with your advisers about the special at-risk rules that apply to real estate investments.

Tax Rules on Real Property

☐ *Depreciation period:* Real property is depreciated over 27.5 years for residential property and over 39 years for commercial and other properties.

☐ *Depreciation recapture:* Your cost basis when you sell the property is reduced by any depreciation taken on prior tax returns. The tax rate for depreciation recapture is 25%.

☐ *Interest deductions:* As indicated, under the IRS' investment interest and passive loss rules, your tax deductions can be limited, particularly on interest deductions of refinanced mortgages. Since these rules are critical to the utilization of tax losses, tax planning and working through the tax and cash flow economics of owning the property are essential.

☐ *Capital gain taxation:* Your profit on the sale of the property is taxed at the 15% capital gain rate if held for more than one year. If the property is sold

within one year after purchase, it's taxed as a short-term capital gain at income tax rates up to 35%.

☐ *Alternative minimum tax:* The income from real estate investments may produce a preference item on your personal tax return which could result in the payment of minimum taxes of 26% or 28%. ☐

Exhibit 2

Your Investment in Your Home

Your first and probably largest real estate investment is your home. Even if you don't own or plan to own other property as an investment, you need to familiarize yourself with the rules, restrictions, and options on home ownership to maximize your deductions and protect your equity.

There are three areas in which a homeowner is most likely to make expensive mistakes: selling the home, establishing the cost basis, and insuring the home. Here are advisories on each area.

Selling Your Home

When you sell your home, your total cost basis is the original purchase price of your home *plus* closing costs *plus* the cost of any capital improvements since you purchased your home. This total cost basis, after adding commissions and other closing costs associated with the sale, is then subtracted from your selling price to come up with your taxable gain. *Other facts:*

- Single homeowners can exclude up to $250,000 of profit on the sale of a home. Married taxpayers filing jointly can exclude up to $500,000.

- The capital gain exclusion is available *only* if the home was the taxpayer's principal residence for at least two of the five years preceding the sale. (There are exceptions, principally for job relocation and health reasons.)

- The capital gain exclusion applies to all taxpayers, irrespective of age, and for *each* sale or exchange of a principal residence, but generally can't be used more than once every two years.

- The exclusion also can apply to condominiums, co-ops, mobile homes, and houseboats, but only if that is your principal residence. If you sell your second or vacation home and it doesn't qualify for the exclusion, e.g., you don't meet the two-year principal residence test, you will owe tax on the gain.

Tax-saving strategy: If you own a second home and want to avoid paying taxes on the capital gain, plan ahead. Try to make it your principal residence for two of the five years preceding its sale. Be sure to keep a log of the time spent at each

home and formally change your legal address, e.g., where your monthly bills are sent and your address on tax filings.

Despite the capital gain exclusion, you still need to keep records on your home expenditures and expenses, especially if your home state does not recognize the federal exclusion and assesses its own capital gain taxes on home sales.

Establishing Cost Basis

- Set up a home improvement file and every year put into it your invoices and cancelled checks for any work completed that year. That way, when you sell your home, you will be able to document its cost basis for tax purposes. This information is also useful in supporting a fair market value figure when you're selling or refinancing your home.

- There is a major tax difference between *capital* improvements and *maintenance.* Only capital improvements are added to the cost basis of the property. Capital improvements include such items as air conditioning, fences, fireplaces, decks, carpeting, paneling, skylights, awnings, built-in dishwasher, garbage disposal system, etc.

- Keep all supporting documents, e.g., work contracts, building plans, surveys, legal fees, closing costs, etc. Again, you will need these receipts to document your cost basis in the property, whether personal or business. Be sure the vendor's invoice includes the date, cost, and a description of the work.

Insuring Your Home

- *Casualty and theft losses.* In planning your insurance coverage, keep in mind that you cannot deduct the first $100 of *each* casualty and theft loss. In addition, casualty losses equal to the first 10% of your adjusted gross income (AGI) are not tax deductible. For example, if you have a $10,000 casualty loss and your adjusted gross income is $70,000, you can deduct *only* $2,900; $7,100 is *not* tax deductible ($70,000 x 10% = $7,000 plus $100 deductible equals $7,100). If you have multiple losses in any one year, the $100 applies to *each* loss, but the losses can be combined for the 10% of AGI test.

- *Coinsurance clause.* Some homeowner contracts today have coinsurance requirements that provide full loss protection only if the policyholder increases his coverage as the value of the insured property increases.

An example: Let's assume you have a policy with an 80% coinsurance clause, a house that would cost $100,000 to replace (not including land and foundation), and an $80,000 policy covering your home. Note that the policy covers 80% of the replacement value — meeting the minimum coinsurance requirement of 80%. Now,

in the event of a partial loss, say $40,000, the insurance company will pay the full loss of $40,000 because you maintained a policy for at least 80% of your home's replacement value.

Why it's important: Assume the cost to replace your home goes to $150,000, but you fail to increase the amount of your policy coverage to $120,000 (80% of the current value). You still have an $80,000 policy with an 80% coinsurance clause. Now if you have a claim for $40,000, the insurer will send you a check for only $26,667, which represents 67% of the total claim. **You lose $13,333** since you insured only 67% of the minimum requirement ($80,000 divided by $120,000 equals 67%).

What to do: Many companies offer a guaranteed (extended) replacement cost endorsement. This modification of the policy not only eliminates the coinsurance provision, but also guarantees that, even if the cost to rebuild the property is more than your policy limit, the higher amount, usually up to a maximum of 125% of the policy's limit, will be paid. Talk to your agent about adding this provision to your policy and the additional cost. Without this provision, your insurance payment to replace your home is limited by the policy's dollar limit. Any excess replacement cost over that policy limit is your responsibility.

- *Other protection:* Check and update *contents insurance* for the replacement value of your home furnishings, collectibles, and personal belongings and *umbrella insurance* to protect you against personal lawsuits and judgments in excess of your existing property and casualty policies. ☐

Summary of Rules Before You Invest in Real Estate — see next page

Exhibit 3

Summary of Rules and Pitfalls Before You Invest in Real Estate

☐ Learn about the real estate market. Develop contacts among local real estate information sources (e.g., members of the zoning board, contractors, industry planning specialists, and real estate management firms, etc.). The success of a real estate venture is directly related to the buyer's knowledge of the type of property being acquired, as well as the geographic area in which the property is located.

☐ Be aware that a real estate investment is an illiquid investment; unlike stocks or bonds, it cannot be readily converted to cash. That's why you don't want to invest in real estate if there's a chance that you may have to sell off the investment suddenly — at distressed prices — because you need the money elsewhere.

☐ Diversify the location of your investments. That way, a decline of property values in one area can be cushioned by increased values in another area.

☐ Do not rely on the tax economics of a real estate investment. Tax laws *do* change. Your cash flow and return should justify the investment *without* anticipated tax savings.

☐ Project your annual cash flow from the property for at least five years; it's just as important as long-term profits. And be conservative when projecting the increase in the property's value. Don't depend on zoning changes or other planned government actions to increase the value. You're better off relying on normal market forces.

☐ If you're a novice in the real estate investment area, start by buying publicly owned real estate ventures or joining forces with an established real estate professional in your area.

☐ Properties that offer good upside potential for appreciation are in areas with stable industries and good transportation systems. *Location* is still one of the most important factors in real estate investments; know all about the area in which a property is located.

☐ Be sure the investment cannot substantially affect your net worth. With real estate, you need extra cash to ride out *both* cash flow deficits *and* six months to one year without any rental income.

☐ Be very cautious when buying *undeveloped* land; it lacks cash inflow and thus a current annual return on your investment. Zoning restrictions on its use and development may also affect its value and salability. Current zoning laws should be investigated carefully on any property purchase, whether developed *or* undeveloped. It could affect the property's value and salability.

☐ Thoroughly check out potential tenants. Irresponsible tenants have destroyed the projected cash flows of many real estate investors. Don't rent to friends, relatives, or business associates. Always get security deposits, preferably two or three months' worth. Keep tenant contacts and agreements at arm's length.

☐ Understand the IRS rules pertaining to real estate investments, particularly the write off of interest and the passive loss rules. These rules can affect your tax deductions and thus your net cash flow.

☐ Before financing the property, check with your accountant on the IRS' *at-risk rules.* Your losses and deductions can be limited by the amount of money you have at risk in the property.

☐ If you're not prepared to manage the property, select a management company which has an established track record. Provide for this fee in your cash flow and income projections.

☐ Don't fall in love with the property. Once its potential is reached, sell it off. Holding property that won't increase further in value makes no economic sense.

☐ Use your advisers — *all of them.* Discuss your proposed investment with

your accountant, lawyer, investment broker, insurance broker, and every real estate person you know. □

Project your annual cash flow for at least five years. It's just as important as your eventual profit when you sell the property.

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The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

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