MULTIFAMILY ADVISORY GROUP

COLDWELL BANKER COMMERCIAL

Have You Owned Your Investment Property Too Long?

TEST YOUR INVESTMENT IQ

THE PURPOSE OF THIS ARTICLE is to give a friendly whack upside the head to people who own rental property. You probably made a good investment when you first bought the property. But have you owned it too long?

Depending on how long you've held your property, it might not be a good investment anymore. I didn't say not a good ***property;*** I said not a good *investment.* Read on to find a simple way to determine if your property is still measuring up. You may be in for a surprise!

First, let's quickly review the four financial benefits of owning investment real estate:

- ✓ **CASH FLOW:** After you pay all expenses and loan payments, cash flow is the money left over.
- ✓ **PRINCIPAL REDUCTION:** The loan is paid down with money collected from tenants.
- ✓ **INCOME TAX SAVINGS:** IRS rules allow property owners to take depreciation deductions, which shelter the cash flow and principal reduction. Any leftover depreciation creates a paper loss, which, in many cases, can be used to shelter other income, such as salary from your job.
- ✓ **APPRECIATION:** Over time, the property increases in value.

These four benefits are powerful! You earn tax-sheltered cash flow, your tenants buy you the building, you get to tell the IRS you're losing money, and all-the-while, the property goes up in value. ***What a country!***

So, why am I challenging you to reconsider whether your property is still a good investment? Simple! Your "return on equity" is probably low and getting lower by the year!

Let me show you an example. Don't get all tangled up in the numbers. Just concentrate on the big picture and how it applies to you.

Return on Equity Drops from 18 to 7 Percent

Assume you bought a rental house 16 years ago for $70,000. You invested $10,000 and borrowed the rest. Your goal is to retire in another 15 years and use the rental house to provide retirement income. (A great plan!)

So, how good was your investment 16 years ago? Let's total your benefits. Assume the cash flow, principal reduction and tax savings added up to $1,800 that first year. You were earning 18 percent ($1,800 divided by $10,000) on your investment. Not bad. Plus, the rental house was appreciating. You're an investment genius!

Fast-forward 16 years to the present. Let's assume the following:

Your yearly cash flow has increased to $5,000 and the principal reduction is $2,000; a total of $7,000, just from the first two benefits! In addition, let's assume the net value of your rental house has appreciated over the years so it's now worth $120,000 and your loan has been paid down to $40,000.

However, because you've owned the property so long, the depreciation deductions (assume they're $3,000) are no longer enough to shelter the $7,000 of cash flow and principal reduction. That leaves $4,000 of unsheltered (taxable) income. Instead of *saving* tax, you have to *pay* tax. If you're in a 35-percent bracket, (combined federal and state), you *pay* $1,400 tax.

So, your benefits from the rental house now looks like this:
$5,000 cash flow, plus $2,000 principal reduction, ***minus*** $1,400 tax paid. A total of $5,600.

This is all summarized on the "Return on Equity Worksheet" on the next page. (The blanks in the right column are for you to use on your own property.)

It's no wonder you consider yourself an investment genius if you measure the $5,600 against your original $10,000 investment: that's a 56 percent return. But that's where most people go wrong!

Your Original Investment Has Nothing to Do with Today's Rate of Return!

Your investment is *not* the amount you originally invested years ago. You've got way more than $10,000 "tied up" today! Your investment is the amount you could get out of the property if you sold it today. That's called your "net equity."

Over the past 16 years, your property has increased in value and your mortgage has been paid down. The current difference between the property's net value (after selling expenses) and your mortgage balance is $80,000. In other words, if you sold the property today, you could walk away with $80,000.

However, if you keep the property, in effect you're re-investing the $80,000 into the property. Now, how does your investment look?

Not so good. You're earning $5,600 in benefits on an $80,000 investment, that's only 7 percent! What if a REALTOR® called you up and said, "I've got a great real estate investment for you. You'll earn a measly 7 percent." You'd hang up on them! Well, you already own it!

If you wouldn't buy a property like that, why would you continue to own it?

What if you did this instead? Use your $80,000 equity as the down payment on a different property one that produces 18 percent again? With that down payment you could probably afford a $400,000 rental property. Once you've owned that property for a few years, your equity will have grown again. (and your rate of return fallen), so you repeat the process. The goal is to maintain the highest possible rate of return, which will make a huge difference in your future wealth.

You'll maximize your wealth by wisely moving your equity from your current property to another as soon as your rate of return would be greater in the next property.

Three Ways to Move *Your Equity*

Here's a key point. If you decide it's time to "move your equity," be sure to explore all your options. There are four common ways to move equity:

1.SELL: You could sell your current property and buy another. The problem with selling is you have to pay capital gains tax.

2.REFINANCE: You could refinance your current property and use the loan proceeds to buy another property. The problem with refinancing is you're probably not able to borrow the entire $80,000 equity.

3.EXCHANGE: The third way to move your equity is to exchange. Exchanging allows you to move your entire $80,000 net equity to another property without paying tax. It's wealth building's most powerful tool.

Bonus* Invest in Qualified Opportunity Zone/Fund: A Qualified Opportunity Fund is an investment vehicle that is set up as either a partnership or corporation for investing in eligible property that is located in a Qualified Opportunity Zone.

So, what does this all mean? Well, if you own rental property, congratulations. Your investment brilliance shines brightly. However, the longer you own that property your glow begins to fade. The wise thing to do is re-evaluate your property every year. In essence, make the decision to "re- buy" the property. As soon as the rate of return on your equity could be higher in another property, it's time to take action.

Contact me today to discuss your options!

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RETURN ON EQUITY WORKSHEET

I. NET EQUITY	*EXAMPLE*	*YOUR PROPERTY*
Current Market Value (after selling expenses)	**$120.,000**	$_____
- Loan Balance(s)	_ **40.,000**	_____
= Net Equity	$ **80.,000**	$.====

II. CURRENT ANNUAL BENEFITS		
Cash Flow before Tax	**5.,000**	_____
+ Principal Reduction	**+2.,000**	+_____
+ Tax Saved	+	+_____
or		
- Tax Paid	*1,400*	
= Total Annual Benefits (before appreciation)	**5.,600**	$ _____

III. CURRENT ANNUAL RATE OF RETURN		
Total Annual Benefits	= **5.,600**	_____
Net Equity	= **80.,000**	_____
Divide Total Annual Benefits by Net Equity		
= Rate of Return on Equity (before appreciation)	***7%***	====%

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