

# **What You Had Better Know If You Have, or Plan To, Purchase Real Estate for Investment**

## **Using the Investment Analysis:**

Welcome to your best opportunity to take into account all the factors that make real estate such an attractive investment. Plug your numbers into my formula, and receive a comprehensive, detailed performance report. The report will shed light (or shadow) on the merits of your investment. It may not be absolute, but it is the single greatest guide to real estate investing I have seen. I think that you will find it simple, enlightening and helpful.

## **Two Approaches:**

### **You are contemplating the purchase of property and want to see how it will perform.**

This form is designed to return a report without any special considerations. Just fill out the information and we can complete your report straight away.

### **You own a property and want to see how it is performing (should you hold or sell?).**

There are two ways we can compile this report: How has the property performed to date, and what do we expect it to do in the future.

- Past performance is most accurate, as we can look at the purchase cost, today's value, and calculate the exact appreciation rate. We will also have accurate information on rental income, and expenses from which to work.
- Looking at a current investment for future performance, is fairly straight forward. The only exception is the loan, which will be amortized "mid-stream". In this case, we will need the current loan balance, the payment amount (principle and interest), and the remaining term of the loan. If this information is not readily available, don't worry, we can make some fairly accurate guesses with what you provide.

## **Terminology and Explanations:**

### **Land Allocation**

There are two parts of a property that have value: the land and the improvements (structure). In general, values of improvements tend to diminish over time as they are used, and or, become dated. As for real estate investors, they can claim this loss of value to the improvements as "depreciation". Currently, investors may depreciate a building to \$0 over the term of 27.5 years. For example, if you purchased a rental home for \$500,000 and determined that 20% of its value (\$100,000) was land, the remaining \$400,000 would represent the value of the improvements. The owner could take depreciation of \$14,545 per year ( $\$400,000/27.5=\$14,545$ ). If the owner occupies the 28% tax bracket, the "paper loss" depreciation of \$14,545 would save him or her \$4,072 each year in taxes.

### **Loan Information**

Interest paid on investment properties is tax deductible. Because this amount changes through the term of the loan(s), we need to know the date the loan(s) originated, the interest rate, and term (in

years). We will also use this information to determine the loan balance at the completion of your ownership, as you retire this debt. If you own the property free and clear, your loan balance is \$0.

## **Rental Income**

How much are you collecting, or do you anticipate collecting, in rent?

## **Annual Vacancy Allowance**

There may be times between tenants where no rent is being collected. This may be 2 - 3% if you cater to long term tenants in a stable market, to 50% or more for those who rent short-term, nightly, or weekly. The goal here is to come up with a factor to make certain our adjusted rental income is accurate.

## **Annual Operating Expenses**

If you own a rental property you may incur additional expenses that we need to account for to determine net rental income. Many, if not all, expenses are deductible. For example, consider property management fees, property taxes, utilities, trash, water/sewer, association dues, maintenance, lawn service, snow removal, etc...

## **Holding Period**

How long do you intend to hold the property? This represents the completion of the investment when you "cash out". We can also use multiple holding period terms to see where you will be in 5, 8 or 10 years, for example.

## **Annual Property Appreciation Rate**

Here is an area where you need to consult your crystal ball. This will be your best guess as to whether property values will rise or fall, and at what rate. Historic values are a good base to anticipate the future. However, this is a good conversation to have with your real estate agent.

## **Cost of Sale**

When you are done with your investment, you will need to sell it before you can "cash out". You may have real estate brokerage fees, title insurance costs and a few other items. A good rule of thumb is 7% unless you know otherwise.

## **Before Tax Investment**

If you were not invested in real estate, where would your money be invested? In a money market account at 5.5% or a CD at 7.25%, stocks, bonds, or ? We will use this percentage to calculate the cost of having your funds tied up in real estate and also use it as a baseline comparison.

## **Cost Recovery or Depreciation Term**

We discussed this earlier under land/improvements allocation. Current tax law allows for 27.5 years. You need to modify this only if your property is under a different set of depreciation rules. If you own vacant land, depreciation does not apply, as it is for structures only.

## **Capital Gain Rate**

Tax laws can change. The capital gain rate was recently lowered. There are a few tiers in the capital gain rate, but they seldom apply, and as such the 20% rate will be applied in almost all circumstances. So unless you know otherwise, use 20%.

## **Your Tax Rate, Federal and State**

Claiming expenses on a real estate investment may lower your tax liability, which is the same as creating income. We will want to look at these benefits, and how they affect your investment