
Mark Sampson

This Article

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Banking on real estate to fuel your retirement

Be smart about where and how you invest

BY BERNICE ROSS


House as piggy bank image via Shutterstock.

If you are searching for a way to build a nest egg for your retirement or to put aside enough money to send your kids to college, one of your best possible strategies is to invest in real estate and to hold that property for an extended period of time.

I once remember reading that 90 percent of the fortunes made in this country were based upon owning real estate. Given the market downturn over the last few years, many people took serious losses in the value of their real estate holdings. Nevertheless, real estate investment is still one of the soundest financial moves that you can make, provided you are smart about where and how you invest.

This is especially true now due to the low prices and the low interest rates. Moreover, property values generally keep pace with inflation. This also means that you are paying off today's purchase with tomorrow's inflated dollar.

The people who build major fortunes in real estate tend to be contrarians. They buy when others are selling and sell when others are buying. They also avoid flipping, because, as one investor put it, "Flipping is nothing more than a Ponzi scheme." Instead, they consistently build their real estate portfolio by buying and holding their investment properties.

While the value of your property may go up and down, very few properties ever go to zero value. This means that if you pay off your property in 15 years, you will have an asset that has cash value that also functions much like an annuity. Here's a real-life scenario to illustrate this point:

A buyer who wanted to establish additional cash flow for retirement purchased a duplex for $245,000. The buyer put 20 percent down. The property required minor repairs and ran about $700 per month negative. (Under normal circumstances, this property would have been about $100 per month negative if the client could have taken the depreciation and other allowable deductions. He was unable to do so due to the alternative minimum tax requirements.) The client elected a 15-year loan to pay off the property as quickly as possible. That was 16 years ago. Here is where he is today:

1. Despite the real estate downturn, the property is currently worth $550,000 (i.e., it has more than doubled in value over the last 15 years). Even though the property was under rent control, the owner was able to increase the rents sufficiently to break even after five years.

2. Current operating expenses are about $12,000 per year (this includes reserves for repairs, taxes, vacancies and other operating expenses).

3. Gross income (the amount earned prior to expenses) is currently $36,000 per year with net income at $24,000 per year.

4. To sum up, the property is now free and clear. The buyer has recuperated all of his down payment and has an asset worth $550,000 that spins off $24,000 per year in net income.

Compared to other investments, a CD at 2 percent would require an investment of $1.2 million to generate an income of $24,000 per year. A stock investment that yielded a 6 percent return of $24,000 per year would have required a $400,000 investment. In this case, the buyer's initial investment was only $49,000 plus closing costs.

The buyer is approaching retirement age and would like to maximize the cash he has tied up in his real estate investment. He could sell the property and pay the capital gains tax. A different alternative is to do a 1031 exchange for a single-family residence that he rents out for the first 12-24 months he owns the property. He can then move into the property and live in it as his primary residence. When he sells, he and his wife could take $500,000 of the money from the sale and pay capital gains only on the amount above $500,000.

What are the downsides? Tenants can be a nightmare, and a vacant or damaged property can quickly eat up cash reserves. Furthermore, like any other investment, real estate investments can go down in value. It is also unclear what the current tax consequences will be in terms of capital gains, dividends and alternative minimum tax requirements.

In spite of these issues, the 1031 exchange provisions are an important plus. Because owners can exchange up (i.e., buy a more expensive property), they can continue to grow their wealth more quickly because they are able to defer their taxes until they cash out. As a result, real estate may become an even more attractive vehicle for increasing wealth in the future as well as providing a powerful hedge against inflation.

The question is how can one find, buy and rent an investment property? See Part 2 of this series to learn more about the secrets of "Hold."

Editor's note*: This is the first of a two-part series.*

Bernice Ross, CEO of ***RealEstateCoach.com****, is a national speaker, trainer and author of the National Association of Realtors' No. 1 best-seller, "Real Estate Dough: Your Recipe for Real Estate Success." Hear Bernice's five-minute daily real estate show, just named "new and notable" by iTunes, at* ***www.RealEstateCoachRadio.com****. You can contact her at* ***Bernice@RealEstateCoach.com*** *or* ***@BRoss*** *on Twitter.*