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Why Invest in Real Estate (Part 2 of 3)
Investment Returns

Last month we began a series on investing in real estate by looking at some of the primary "financial" reasons that people invest in real estate. This month we will look at the four primary types of Investment returns that real estate can provide. The four basic types of investment returns for real estate are: Cash Flow, Appreciation, Loan Amortization, and Tax Shelter. Lets take a look at each of these one at a time.

CASH FLOW

Cash flow is all the money in and out. Positive cash flow is what you are looking for and is generally defined as the amount of money you have after all expenses have been paid. Specifically, it is your Gross Potential Rent, minus any vacancy or rent loss, plus any other income like parking or laundry income, minus your monthly expenses including your loan payment.

APPRECIATION

Appreciation is generally thought of as how much the value of a property increases over time. This is indirectly related to the strength of the overall market and directly related to improvements completed on the property that result in better overall performance, such as lower vacancy, higher rental rates and reduced expenses, etc.… In real terms "Appreciation" sometimes referred to as "Value Enhancement" can be thought of as the Future Resale Price minus the Original Purchase Price.

LOAN AMORTIZATION

Loan amortization refers to your monthly mortgage payment. Unless you have an interest-only loan, your payment has two parts. Both parts relate to the fact that the tenants are essentially paying off your mortgage. These two parts break down as follows: the first part of your mortgage contains a principal portion, which goes toward reducing the balance of your loan. The second part relates to the interest portion of your loan that is being paid each month and is an expense that you get to write off come tax time. The principal amount paid each month goes toward "killing off" the loan (amortize is Latin for "to kill"). The second part, which is the interest portion, is actually part of the Tax Shelter portion of how you make money in real estate. We will look at that next.

The four basic types of investment returns for real estate are: Cash Flow, Appreciation, Loan Amortization, and Tax Shelter.

TAX SHELTER

This last one is well known by investors but generally not so well understood. Generally, when you receive money, it is taxed. For instance, if you get a paycheck, you look at the Gross amount that you earned, then you see the taxes taken out resulting in your Net amount – the amount left after taxes. Some less savvy real estate investors might think that their "Cash Flow" from their investment property is the amount on which they will be taxed. This is, of course, not true and yet another part of the beauty of real estate as an investment vehicle. There are two "hidden" tax deductions sometimes referred to as "phantom cash flow." These work together to produce what investors refer to as a Tax Shelter. The first deduction is for mortgage interest as mentioned previously. The second deduction or "tax shelter" is what is known as the depreciation deduction. The IRS refers to this in the tax code as "cost recovery." Essentially, the tax code allows you to take your NOI (Net Operating Income), which is your income after expenses, but before loan payments. Then, you are able to deduct your loan interest AND depreciation. Depreciation can get a little technical but basically is the value of your building, not including your land, broken down over 27.5 years for residential property or 39 years for commercial property. For simplicity sake I am leaving out a few finer details, but when you crunch the numbers, you will see in many instances that your taxable income on your investment real estate is actually lower than the cash you put in your pocket – hence the term "Tax Shelter"– truly amazing!!!

Next month we will wrap up by looking at some of the common ways to evaluate a real estate deal by "crunching the numbers".

Happy Investing!!!