

# Does your investment property still measure up?

BY TOM LUNDSTEDT

**T**HE 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:

- 1. CASH FLOW:** After you pay all expenses and loan payments, cash flow is the money left over.
- 2. PRINCIPAL REDUCTION:** The loan is paid down with money collected from tenants.

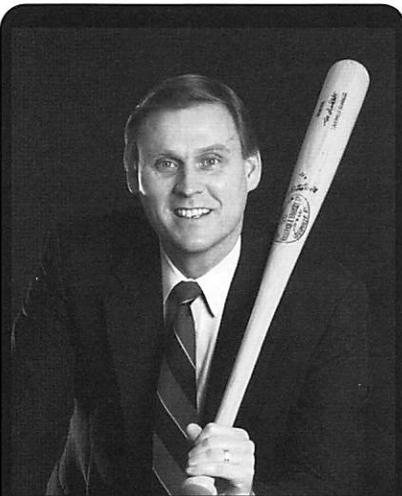
- 3. INCOME TAX SAVINGS:** IRS rules allow property owners to take depreciation deductions, which shelter the cash flow and principal reduction. Any leftover depreciation creates a paper loss, which, in many cases, can be used to shelter other income — such as salary from your job.

- 4. 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.



Tom Lundstedt, is known as the funniest investment and tax guy in America! His programs for residential and investment real estate have entertained and enlightened more than 2,500 audiences from sea to shining sea.

He's a former Major League baseball player whose striking combination of humor and real-world examples makes his subjects spring to life.

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His series of audio cds, workbooks and worksheets have helped thousands to laugh and learn. If you're interested in learning more about Tom's seminars and audio cds, he can be contacted at (920) 854-7046 or on the Internet at [www.tomlundstedt.com](http://www.tomlundstedt.com).

## Does your investment property still measure up?

### **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 look 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

**Your goal should be to maintain the highest possible rate of return**

## RETURN ON EQUITY WORKSHEET

	EXAMPLE	YOUR PROPERTY
<b>I. NET EQUITY</b>		
<i>Current Market Value</i> (after selling expenses)	\$ <b>120,000</b>	\$ _____
– <i>Loan Balance(s)</i>	– <b>40,000</b>	– _____
= <i>Net Equity</i>	\$ <b>80,000</b>	\$ _____
<b>II. CURRENT ANNUAL BENEFITS</b>		
<i>Cash Flow before Tax</i>	<u><b>5,000</b></u>	_____
+ <i>Principal Reduction</i>	+ <u><b>2,000</b></u>	+ _____
+ <i>Tax Saved</i> <small>or</small>	+ _____	+ _____
– <i>Tax Paid</i>	– <u><b>1,400</b></u>	– _____
= <i>Total Annual Benefits</i> (before appreciation)	<u><b>5,600</b></u>	\$ _____
<b>III. CURRENT ANNUAL RATE OF RETURN</b>		
<i>Total Annual Benefits</i>	= <u><b>5,600</b></u>	_____
<i>Net Equity</i>	= <u><b>80,000</b></u>	_____
Divide Total Annual Benefits by Net Equity		
= <i>Rate of Return on Equity</i> (before appreciation)	<u><b>7%</b></u>	_____ %

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.

Just for fun, take out your calculator and figure

how much money you'd have in 15 years if you leave the \$80,000 invested at 7 percent. Then calculate what \$80,000 invested at 18 percent grows to in 15 years. I could give you the answer but you might not believe me — check for yourself...it's gigantic!

### ***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 three common ways to move equity:

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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.

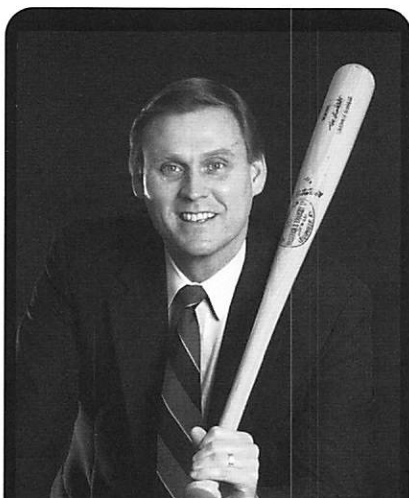
3. **EXCHANGE:** The third, and best, way to move your equity is to exchange. Exchanging allows you to move your entire \$80,000 net

equity to another property without paying tax. It's wealth building's most powerful tool.

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.

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## Use Your IRA to Invest in Real Estate



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BY TOM LUNDSTEDT [REDACTED]

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A SHORT, MIDDLE-AGED WOMAN wearing red glasses came up to me after one of my real estate seminars. She seemed shy and hesitant, but she'd listened intently and taken lots of notes during the class. She told me her name was Norma and proceeded to ask me several good questions about real estate investing. She happened to mention she had \$200,000 in her retirement account. When I congratulated her, she said, "Don't be impressed. I had \$300,000 a few years ago!"

Her retirement account, like many others, had suffered as a result of investment choices. Norma went on to tell me she wished she had bought real estate instead of "investing in an IRA." She was amazed when I told her she could have her cake and eat it too — or rather, have her IRA and real estate too! Let me explain.

First and foremost: A retirement account (traditional IRA, Roth IRA, SIMPLE IRA, SEP, Keogh, 401k, etc.)

is **not an investment!** It's simply a special account that **holds** your investments. It can hold many types of investments, such as mutual funds, stocks, bonds, and...drum roll, please: real estate!

Picture a truck with the words "MY RETIREMENT ACCOUNT" painted on the doors. In the back of the truck, you load whichever allowable investments you choose. As you picture this, ask yourself, "Is my retirement truck on the way to becoming a big, heavy-duty monster truck, or will I end up with a little, wimpy mini pickup?"

When I told Norma her retirement account *could* own real estate she said, "But I asked the company that administers my account if my IRA could own real estate, and they said 'no.'"

Whoa! Instead of merely saying "no," the person with whom she talked should have added three important words: "not with us."

## Use Your IRA to Invest in Real Estate

The problem is that most companies that hold retirement accounts aren't geared up to handle real estate. Therefore, they have no incentive to inform their customers that real estate is an alternative investment choice. That's the main reason for the misconception that real estate can't be held in a retirement account.

Let's get this straight: **Retirement accounts can own real estate.**

In a minute, we'll get to the basic ins and outs of real estate IRAs. But first some advice: This article is designed to be a launching pad for readers to begin their exploration of real estate IRAs. It's a complicated subject and everyone's situation is unique, so be sure to talk with your competent advisors before you take any action. OK, here we go.

First, establish a self-directed retirement account with a company/custodian that specializes in real estate IRAs. This is a relatively easy process and can be done by either establishing a new account or rolling over the assets of an existing account. (Be sure there are no surrender charges for rolling over an existing account.)

Once you're the proud owner of a self-directed IRA with a custodian that can handle real estate, what's next? There are specific rules as to what you can and cannot do with your real estate IRA.

### *Some Things You Can Do*

1. Your real estate IRA can buy and sell many types of real estate including raw land, rental properties, condos, fixer-uppers, commercial properties, lakeshore, etc.

Keep in mind it's the self-directed real estate IRA that buys, owns and sells the property. Not you personally. You don't withdraw the money from the IRA to buy the property — the custodian buys the property in the name of your self-

directed real estate IRA.

2. The property can be rented but the rental income is paid into your IRA, not to you.

3. All the expenses of renting and operating the property must flow in and out of your self-directed real estate IRA.

Be sure your self-directed real estate IRA has enough liquid reserve funds to cover operating expenses, improvements, etc.

4. It is possible to finance a property that is owned by your IRA. But the financing must be "non-recourse." That means the property, not the IRA account, is the sole security for the loan. Most traditional lenders won't provide non-recourse financing. However, seller financing or private loans are possibilities. Let me emphasize again: Get good professional advice before taking any action.

5. Your real estate IRA can buy a partial interest in a property. This is useful if your IRA doesn't have enough money to buy 100 percent of the property. It could be a partner and own a fractional interest.

### *Some Things You Cannot Do*

1. Your real estate IRA cannot buy a property that you, your spouse or certain family members already own. Likewise, your real estate IRA cannot sell a property it owns to you, your spouse or certain family members.

2. You, your spouse or certain family members cannot have any personal use of the property owned by your real estate IRA.

3. Your IRA cannot lease the property to your business. Your business cannot use or occupy any part of the property.

**Let's  
get this  
straight:  
retirement  
accounts  
can own  
real estate**

## ***Is a Real Estate IRA Right for You?***

So, now you know you *can* use your retirement account to buy real estate. But the bigger issue is *should* you use your retirement account to buy real estate? The answer is, it depends on the type of real estate and your unique situation.

You already know your real estate IRA cannot own property that is used by you, certain family members or your business. Therefore, primary residences, second homes and vacation homes are not candidates.

In addition, a rental property that produces tax shelter from depreciation deductions would probably not be a good fit because the tax shelter would go to waste in your retirement account.

Other types of real estate, such as raw land, fixer-uppers, and non-leveraged rental properties, are perfect candidates. The profit from these investments would be taxed if you owned the property personally. However, if your real estate IRA buys, owns and sells the property, the profit would compound in your IRA tax-deferred (or tax-free if it's a Roth IRA)!

Keep in mind, there is a limit on how much you can contribute each year to your retirement account. But there's no limit on how much the account can earn! Hubba hubba!

### ***Last But Not Least***

1. Before your IRA buys any property, you've got to understand how real estate works. There's a lot to it. Make a commitment to learn how to analyze a property before you buy it, including operating expenses and management considerations. Study the financial benefits such as cash flow, depreciation and appreciation. Learn how to determine cap rates, cash on cash and other

rates of return. And so on. The more you know, the better your chance of success.

2. Remember that real estate IRAs are a specialty and not every retirement account administrator/custodian is geared up to handle them. In the "Further Resources" box I've included several real estate IRA custodians (as well as some other resources) to get you started. Bear in mind, there are other custodians and you need to find one that's right for you. Check out their web sites or call them.

3. If you're in the real estate profession, I hope you can see the huge potential of real estate IRAs. Think of the millions of dollars that are sitting in the retirement accounts of your potential clients. Get out there and help them take advantage of a great opportunity!

*continued*

### **Further Resources**

<b>Entrust</b>	1-800-392-9653 www.entrustadmin.com
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<b>Lincoln Trust</b>	1-800-825-2501 www.lincolntrust.com
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<b>Sterling Trust</b>	1-800-955-3434 www.sterling-trust.com
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On the Internet, enter "*real estate IRA*" on a search engine such as Google

Another good resource is the book, **IRA Wealth**, by Patrick W. Rice with Jennifer Dirks

For more information on buying, owning and selling investment real estate, visit the "Products" section at [www.tomlundstedt.com](http://www.tomlundstedt.com)

## Use Your IRA to Invest in Real Estate

Finally, if the choices you've made so far for your retirement account aren't taking you where you want to go, find a new vehicle. Real estate opportunities are everywhere for those savvy enough to recognize them and motivated enough to take action.

### *Whatever Happened to Norma?*

Sometimes I wonder if anyone ever acts on the information they receive in my seminars. I can only hope. But if I let my imagination

run wild... It's 20 years from now and I'm driving down the interstate when a huge, shining, beautiful 18-wheeler semi truck pulls along side me. The driver gives a friendly toot on the air horn, waves and smiles. I can't believe my eyes — it's a little old lady wearing bright red glasses and as the truck passes I see huge lettering running from front to back: "NORMA'S REAL ESTATE IRA!"

What a country!

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