Investments:

Do ALL The Math Before You Make a Real Estate Decision

Happy New Year! To start the year off on the right foot, this month we'll talk about the importance of doing ALL the math before making a real estate decision.

A Gain Through Foreclosure?

I'll start this off with an example. A friend of our family bought a condo in 2004, and was married in 2009. She and her new husband wanted to buy a home together, and had the option to then become real estate investors by renting her condo to tenants – who would then pay her mortgage for her. She took a different route, however, and simply surrendered the condo to the bank in a foreclosure. To her, the math was easy: She owed $225,000 on a condo that was worth, (in the midst of the Great Recession), $175,000. She thought that math was easy – she'd save $50,000 of principal, and more in interest, by just walking away from the property. Since her down payment was minimal, (remember the "easy loans" available then?), she saw this not as a loss – but a gain, and a wise financial decision. She thought that, however, because she didn't do "all the math."

Maybe Not

The key calculations that were missing from our friend's analysis are: "What would it cost me to replace this asset today?" and "How much will I need to spend on this asset, and what could I expect to receive in the future from it?"

The logic behind "what's my replacement cost?" question is as follows: She bought this asset originally with a "zero down" loan. These loans, however, were no longer available by 2009. So; in order to buy the $175,000 condo next door, she would need to come up with a 20% (at the time) down payment of $35,000. After transaction costs, therefore, she would probably lose money if she gave the condo back to the bank, then bought the one next door. Does an investment really have a negative value if it would cost a substantial amount of money to replace it?

The next question will explore an interesting feature of real estate: It may, currently, have negative value but could be worth holding onto for future profits. Let's say that our friend has a monthly mortgage payment of $1,200, and that a suitable tenant could be found to pay $1,500 per month as rent. After property taxes, HOA fees, insurance and maintenance, our friend would be losing $500

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Christopher Miller is a Managing Director with Specialized Wealth Management in Tustin, California and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator, and as an advisor helping clients through over two hundred 1031 exchanges. Chris has been featured as an expert in several industry publications, and on television, and earned an MBA emphasizing Real Estate Finance from the University of Southern California. Call him toll-free at (877) 313 – 1868.

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per month. Her "incomplete math" had her "saving" $50,000 immediately vs. a $500 monthly cash shortfall. (She has a good career, and that extra $500 per month expense would not have been a problem.) The "complete math" however, looks at what it could be worth in the future. Today, that condo would sell for about $450,000. After 8 years of her tenants helping with the mortgage payment, the new loan balance is $169,000. By renting the condo for almost 10 years, she could have had $281,000 of equity in that condo that was once "underwater." Would you invest $500 per month for 10 years to get $281,000 in the future?

The Forgone 1031 Exchange

Some of my readers may have learned this lesson the hard way at one point, so it is a big reason that they are enthusiasts of the 1031 exchange. Let's say that, a few decades ago, an investor bought some apartment units for $250,000. He lists the property for $1 million and decides "I'm just going to take the cash and buy that boat I've always dreamed about." There's no harm in that, but let's do all the math. I'm also going to throw in a new wrinkle: 5 years ago, he took out a $600,000 mortgage on the units to buy another investment property.

Our example sells at full listing price, pays off that (now) $540,000 loan balance, and has $460,000 to go boat shopping with, right? Well, not so fast: His CPA does that math, (see "taxes math" in next paragraph), and says he will need to hold onto $312,500 of that to pay his taxes next year. So now he has $460,000 - $312,500 = $147,500 in the "boat fund." That sure doesn't buy a lot of boat these days. A "$750,000 profit" can really have a way of shrinking by the time it gets to your pocket.

"Taxes Math:" Accumulated Depreciation tax, 75% of $250,000 purchase price is $187,500. The IRS' 25% of this is $46,875. California's 9.3% of this is $17,437. Capital Gains Tax, $1 million - $250,000 is $750,000. The IRS's 20% of this is $150,000. California's 9.3% is $69,750. The 3.8% "Obamacare tax" is $28,500. $46,875 + $17,437 + $150,000 + $69,750 + $28,500 = $312,562, which I've rounded down.

Doing All the Math Could Save You Some Money and Find Some Opportunities

As these brief examples illustrate – sometimes we, as real estate investors, can fall into expensive traps if we don't look at all of numbers associated with our investments. My office phone number is (877) 313-1868.

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