FINANCIAL ADVISORY

Buying Properties with Leverage or ALL - CASH: Which Way is Right for You?

BY CHRISTOPHER MILLER, MBA
SPECIALIZED WEALTH MANAGEMENT

HAPPY NEW YEAR! As many of my readers know, I specialize in the partial-interest real estate market. My deals are available turn-key: That is; all the inspections, repairs, negotiations, price reductions and loan closings have already happened. When one of my clients fills out paperwork for the property, I have helped him select, he knows that his closing can occur as soon as a few days later.

There is no such thing as a "one size fits all" approach concerning investment real estate. For this reason, I offer a variety of properties and work closely with each investor to help choose the properties that are right for their unique situation.

This month, we'll be talking about leverage (loans) on the properties I offer. Some properties have a loan in place, while others are available ALL-CASH – with no loan. Which type is right for you? That depends on what your unique needs are. Let's discuss:

RISKS OR DOWNSIDES OF LEVERAGED PROPERTIES

Whenever one buys real estate with a loan, his #1 risk is that something will happen where he can't make his monthly mortgage payment to the bank. The bank then takes his property from him, and he loses everything. When using leverage on properties, we try to lessen this risk by using moderate leverage – but the risk still exists.

RISKS OR DOWNSIDES OF NON-LEVERAGED PROPERTIES

As I have discussed in the past, a completely tax-deferred 1031 exchange requires you to replace all of the equity that you receive AND all of the debt that was paid off as a result of your property sale. So - if you sold 8 units for $1 million and paid off a $500,000 loan, you'll need to buy a property with a loan of at least $500,000 and spend all of your $500,000 equity on a new property in order to complete a fully tax-deferred exchange. Any "unreplaced debt" will be considered boot by the IRS – and will be taxable. If you need to replace leverage as part of your 1031 exchange; a downside of an all-cash offering is that it may come with an expensive tax bill.

Non-leveraged properties tend to offer lower cash on cash return than higher leveraged ones: due to the effect of positive leverage. With our larger, institutional-grade assets; our properties have access to loans with low fixed-interest rates. Our current offerings have loans at fixed rates

Please turn to page 20

Christopher Miller is a Managing Director with Specialized Wealth Management 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 three hundred 1031 Exchanges. Chris has been featured as an expert in several industry publications and on television and earned an undergraduate business degree and an MBA emphasizing Real Estate Finance from the University of Southern California. Chris began his real estate career in 1998. Call him toll-free at (877) 313 – 1868.

Continued from page 18

in the 3.9% range. If we're buying a $1,000,000 property at a 6% CAP, that means our Net Operating Income (NOI) is $60,000, and our cash-on-cash return (or return on equity) is 6% annually. (5% X 1,000,000.) Let's say we buy it with $500,000 down and a $500,000 10-year, interest-only loan at 4%. That will give us a $1,667 monthly payment for $20,000 of annual debt service and leaving us with an NOI of $40,000. Our cash-on-cash return, or return on our equity, is now $40,000 / $500,000 (our equity invested) = 8%. I have spoken with many an investor who was surprised to learn that he could make a greater return on his investment <u>with</u> a mortgage payment than without one.

Investors who have owned property long enough to have paid their loans off – have often exhausted the deprecation on their properties. Since their building is fully depreciated, they no longer enjoy any tax deferral of their income from it. If they sell their million-dollar property and replace it with another $1 million all-cash offering, their basis moves forward to the new property, and is still zero. All their income is still fully taxable.

BENEFITS OF LEVERAGED PROPERTIES

The first benefit of leverage that I'll address deals with that last paragraph. If, rather than an all-cash property, I exchange my $1,000,000 of equity into a property that is leveraged at 50%, I buy $2 million worth of real estate. The IRS would call that additional $1 million acquired through leverage "new basis" that I can then start depreciating. If I purchase a residential property depreciable over 27.5 years and use a ratio of 80% improvements to 20% land, (only improvements can be depreciated), that gives me an annual depreciation deduction of $29,090 – not too bad. ((1,000,000 / 27.5) X 85% = $29,090.) A new annual tax deduction of $29,090 is a significant improvement upon a Zero deduction.

We investors build wealth in real estate through the use of leverage. I know of a local apartment property that was purchased for $785,000 back in 2012, and recently sold for $1,250,000. An all-cash investor would have earned a profit of $465,000 – fantastic for such a short time period, and probably not a return we can expect every time. That property was bought in 2012 with a loan, however. Let's say that the owner used a 25% down payment of $200,000 and borrowed the balance of $585,000 at 5.5% fixed for 30 years. Loans don't amortize (pay down) very fast during their initial years, but by today that balance would be around $525,000. After the $1,250,000 sale and $525,000 loan payoff, our investor is left with a profit of $525,000. His profit is higher than if had bought for all cash because he gets to keep the bank's share of the profits. (The bank puts up most of equity but keeps none of the appreciation.) That is how real wealth is built in real estate! (and we're not even counting the income he earned over those years.)

BENEFITS OF NON-LEVERAGED PROPERTIES

With a non-leveraged, or all-cash, purchase; your risk of loss due to a bank foreclosure is eliminated. Note that all of the risks associated with owning rental real estate still exist: Income from the property could decline or disappear altogether, and you could be stuck with a property that isn't making any money, but still needs taxes, insurance and maintenance costs paid. When reviewing these properties, we'll always want to be comfortable with the financial health of our tenant and in the property's re-leasing prospects if that tenant were to go out of business. While we may not be able to eliminate risks, we can still manage them a bit.

WHICH STYLE IS FOR YOU?

I have clients who consider themselves risk-averse; but are choosing leveraged properties over all-cash ones for the additional depreciation benefits they can receive – benefits that we estimate will defer 40% of their income from taxes. I have other clients who prefer to buy all-cash properties to minimize foreclosure risk. Still others will mix an all-cash offering with a leveraged one so they can meet a 1031 exchange's minimum debt requirement – without adding any more liabilities.

As with many questions, the short answer to "which style is for me?" is "Well; that depends." The longer answer can be given after a detailed discussion. This month, due to space constraints, I was not able to elaborate on some complicated real estate concepts as much as I like to. If you'd like more clarification, or if you would like to have a "which style is for me?" discussion, please call my office toll-free at (877) 313-1868.

Continued from page 20

Securities offered through Emerson Equity LLC, member FINRA/SIPC. Emerson Equity LLC and Specialized Wealth Management are not affiliated. All investing involves risk. Always discuss potential investments with your tax and/or investment professional prior to investing.

1031 Risk Disclosure:

- *There is no guarantee that any strategy will be successful or achieve investment objectives;*
- *Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;*
- *Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;*
- *Potential for foreclosure – All financed real estate investments have potential for foreclosure;*
- *Illiquidity – Because 1031 Exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.*
- *Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions;*
- *Impact of fees/expenses – Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits*