FINANCIAL ADVISORY

What is Your Return on Taxes?

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We real estate investors are naturally tax averse. Even though we dislike taxes very much – taxes are probably even worse than you think? This month, we'll talk about that.

WHAT IS YOUR RETURN ON THE TAXES YOU PAY?

What return do you earn on the taxes you pay? The common answer I receive is "Zero." This answer is wrong – and it's wrong by a mile! If we review our financial calculations, we'll recall that a "zero percent return" means that we made a $100,000 investment and sold for $100,000 sometime in the future. A zero percent return means that we got our money back. How much of your tax money do you get back? The common answer to this question is the correct one – "Zero." Therefore, paying taxes and getting zero of it back equals a 100% loss!

TAXES GET IN THE WAY OF COMPOUNDING INTEREST

All investors can benefit from the concept of Compounding Interest. Our real estate may be appreciating by a certain number every year – let's estimate it at 5%. Through compounding interest, the number that we are multiplying by 5% every year is constantly increasing, therefore compounding our interest. This is one of the reasons that rent control can be so destructive to property values: $100,000 of rent today can be $240,000 in 2040 if we can raise rents 5% per year. A cap of 3% per year, however, gives us a maximum rent of $170,000 in that same year – A staggering $70,000 less. And that's only from a difference of 2% per year. Imagine the negative impact that taxes can have on your returns!

AN ILLUSTRATION OF DAMAGE TAXES CAN DO

Sometimes stockbrokers, when they learn a client will be selling real estate, like to give this advice: "Just pay the taxes, and I'll earn it back for you." To evaluate this option, I'll walk investors through the numbers. I have covered the taxes involved with selling real estate in several past (and will in future) articles, so no need to go into details here. Let's just say my client will receive sales proceeds of $1 million, and that he'll owe $300,000 in taxes if he does not complete a 1031 Exchange.

By paying taxes to invest in stocks, the investor has experienced a 100% loss on 30% of his gain, and is left with $700,000. Let's say that this amount grows at the same rate that the S&P 500 did for the past 5 years, (during a fantastic bull market), at 12.5% annually. If we can achieve this rate of growth over the next 5 years, our investment will grow to $1,261,422.

If we did a 1031 Exchange into real estate, on the other hand, we could have been earning income and experiencing growth from our full $1 million investment – with zero dilution from taxes. To "beat" the stock market scenario above, we only need to earn $261,422 of income and growth from our real estate over the next 5 years. My calculations say this would be a 5% annualized return.

Is it easier to earn a 5% annualized return than it is to earn a 12.5% one? Can I expect to do better than 5% annually through growth and appreciation on my real estate? Can I expect the stock market's record bull run to last another 5 years?

TAXES MAY BE EVEN WORSE THAN YOU THINK

As I said earlier, my investors tend to be naturally tax averse. Surprisingly, taxes are even worse on their returns that most of them even imagine. Are you taking any unnecessary 100% losses on your taxes? My toll free number is (877) 313-1868.