

# Building Wealth With Real Estate

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# Goal of My Presentation- Understand These Topics

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- How To Build Wealth And Retire Sooner
- Types of Income
- Income Tax Rates
- Cash Flow
- Depreciation
- Leverage
- New 2018 Tax changes



# Wealthy People Pay Less Taxes

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- Most wealthy people don't earn their wealth from a salary
- Most wealthy people don't work for money
- Most wealthy people earn wealth as business owners or landlords
  - As business owner, we pay taxes after our expenses
  - As business owner, income can be produced without owner working
- Wealthy people earn income from investments and real estate
  - Long term capital gain rate is 15%
  - Rental income can be one of the lowest taxed income after depreciation
- Most wealthy people don't pay high income tax rates, because their income is not subject to ordinary income tax brackets



# How Much Do You Need To Retire?

(assuming a 4% withdrawal amount)

- To make \$50,000 per year, you need \$1,250,000
- To make \$75,000 per year, you need \$1,875,000
- To make \$100,000 per year you need \$2,500,000



# Retirement Account Savings- Limits

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<u>Account</u>	<u>Contribution Limit</u>	<u>Additional Catchup-Age 50 and older</u>
401(k) and 403(b)	\$18,000	\$6,000
Simple IRA	\$12,500	\$3,000
SEP - IRA	25% of compensation up to \$54,000	None
Traditional & Roth IRA***	\$5,500	\$1,000



\*\*\*Traditional IRA and Roth IRA subject to AGI income limits



# What is an Asset- definition

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- a. items of ownership convertible into cash; total resources of a person or business, as cash, notes and accounts receivable, securities, inventories, goodwill, fixtures, machinery, or real estate (opposed to LIABILITIES).
- b. Accounting. the items detailed on a balance sheet, esp. in relation to liabilities and capital.



# What is a Liability- definition

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- a. moneys owed, debts or pecuniary obligations (opposed to ASSETS).
- b. Accounting, liabilities as detailed on a balance sheet, esp. in relation to assets and capital.



# My Definition

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Asset- something of value owned that puts money in my pocket

Liability- something of value owned that takes money out of my pocket





# Three Types of Income

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**1. Earned Income**

**2. Investment Income** (dividends, capital gains, interest)

**3. Real Estate Income**



# IRS Income Reporting

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Type of Income	Reported on IRS Form
W2 Wages and Salaries	1040
Business Income	Schedule C
Capital Gains	Schedule D
Interest and Dividends	Schedule B
Real Estate Income (rental)	Schedule E
IRS/Social Security Benefits	1040

Which of the above incomes are subject to FICA and/or self employment taxes?



# What is AGI (Adjustable Gross Income)

Form 1040 U.S. Individual Income Tax Return 2015

For the year Jan. 1-Dec. 31, 2015, or other tax year beginning . . . 2015, ending . . . 2015

OMB No. 1545-0074

IRS Use Only—Do not write or staple in this space.

Your first name and initial . . . Last name . . . Your social security number . . .

If a joint return, spouse's first name and initial . . . Last name . . . Spouse's social security number . . .

Home address (number and street). If you have a P.O. box, see instructions. . . Apt. no. . .

City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).

Foreign country name . . . Foreign province/state/country . . . Foreign postal code . . .

Filing Status 1 ☐ Single 4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ 5 ☐ Qualifying widow(er) with dependent child

Check only one box. 2 ☐ Married filing jointly (even if only one had income) 3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶

Exemptions 6a ☐ Yourself. If someone can claim you as a dependent, do not check box 6a. 6b ☐ Spouse

Dependents: (1) First name . . . Last name . . . (2) Dependent's social security number . . . (3) Dependent's relationship to you . . . (4) ☐ If child under age 17 qualifying for child tax credit (see instructions)

If more than four dependents, see instructions and check here ☐ . . .

d Total number of exemptions claimed . . .

Income 7 Wages, salaries, tips, etc. Attach Form(s) W-2 8a Taxable interest. Attach Schedule B if required. Do not include on line 8a tax-exempt interest. 9a Ordinary dividends. Attach Schedule B if required. 9b Qualified dividends 10 Taxable refunds, credits, or offsets of state and local income taxes 11 Alimony received 12 Business income or (loss). Attach Schedule C or C-EZ 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐ 14 Other gains or (losses). Attach Form 4797 15a IRA distributions 15b Taxable amount 16a Pensions and annuities 16b Taxable amount 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 18 Farm income or (loss). Attach Schedule F 19 Unemployment compensation 20a Social security benefits 20b Taxable amount 21 Other income. List type and amount 22 Combine the amounts in the far right column for lines 7 through 21. This is your total income ▶

Adjusted Gross Income 23 Educator expenses 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 25 Health savings account deduction. Attach Form 8889 26 Moving expenses. Attach Form 3903 27 Deductible part of self-employment tax. Attach Schedule SE 28 Self-employed SEP, SIMPLE, and qualified plans 29 Self-employed health insurance deduction 30 Penalty on early withdrawal of savings 31a Alimony paid b Recipient's SSN ▶ 32 IRA deduction 33 Student loan interest deduction 34 Tuition and fees. Attach Form 8917 35 Domestic production activities deduction. Attach Form 8903 36 Add lines 23 through 35 37 Subtract line 36 from line 22. This is your adjusted gross income ▶

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form 1040 (2015)

## Adjusted Gross Income

- 23 Educator expenses . . . . .
- 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ
- 25 Health savings account deduction. Attach Form 8889
- 26 Moving expenses. Attach Form 3903 . . . . .
- 27 Deductible part of self-employment tax. Attach Schedule SE
- 28 Self-employed SEP, SIMPLE, and qualified plans . . . . .
- 29 Self-employed health insurance deduction . . . . .
- 30 Penalty on early withdrawal of savings . . . . .
- 31a Alimony paid b Recipient's SSN ▶
- 32 IRA deduction . . . . .
- 33 Student loan interest deduction . . . . .
- 34 Tuition and fees. Attach Form 8917 . . . . .
- 35 Domestic production activities deduction. Attach Form 8903
- 36 Add lines 23 through 35 . . . . .
- 37 Subtract line 36 from line 22. This is your adjusted gross income ▶

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Form 1040 (2015)

AGI

AGI is the sum of wages, taxable interest, dividends, IRA distributions, capital gains, rental, and SS benefits

Bottom line of 1040 page 1 of tax return



# Adjusted Gross Income (AGI)

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## Income Item

- + W2 Wages and Salary, unemployment benefits
- + Dividends (schedule B)
- + Capital Gains (schedule D)
- + Taxable Interest
- + IRA/Pension/Annuity/Social Security income
- + Business Income (schedule C)
- + Rental Income (schedule E)
- Exemptions and Schedule A deductions do not reduce AGI
- Student loan interest, health savings accounts, moving expenses, 401K/IRA can reduce AGI

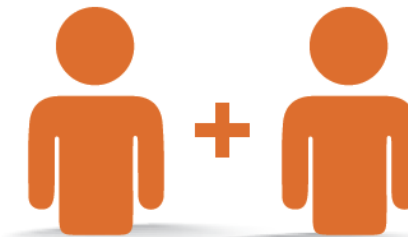




# Tax Rates- Married/Filing Jointly- 2017

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<u>Tax Bracket</u>	<u>Income</u>
10%	0 - \$18,550
15%	\$18,551 - \$75,300
25%	\$75,301 - \$151,900
28%	\$151,901 - \$231,450
33%	\$231,451 - \$413,350
35%	\$413,351 - \$466,950
39.6%	Over \$466,950



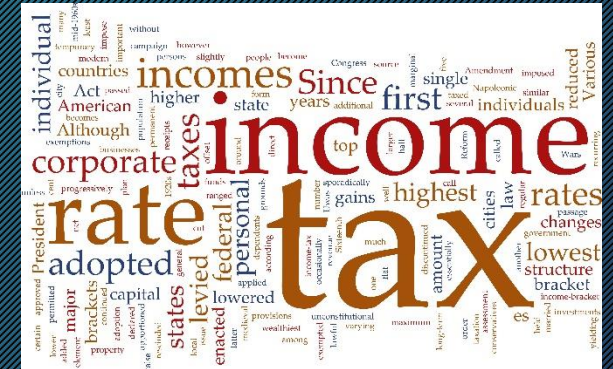
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# Income Tax Rates

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	<u>Tax</u>	<u>Percent</u>
Earned	W2/Wage Earners/Business Income/LLC	Up to 39.6%
	Fica & Self-Employment (before \$127,200 cap)	7.625% & 15.3%
Investment	Long Term Capital Gain & Qualified Dividends (most taxpayers)	15%
	Maximum Long Term Capital Gain/Dividends (taxpayers in the top income bracket)	20%
	Net Investment Income Tax (AGI above \$250K, married filing jointly- dividends, rents, capital gains, interest)	3.8%
	Depreciation Recapture	25%
Real Estate	Real Estate Profit After Depreciation	Can be as low as Zero
	Estate/Gift Tax (exemption \$5.45 million)	40%





# Other Income/Tax Items- IRS 2017

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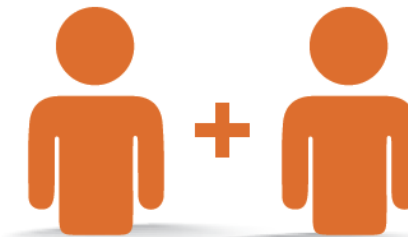
- Can gift \$14,000 per person per year (\$28,000 for spouses splitting gifts)
- Schedule A Deduction Phase Out- when AGI exceeds \$313,800 (married/filing jointly)
- Medicare withholding income cap- \$127,200 (6.2% employee, 12.4% self-employed)
- No income cap on Medicaid withholding (1.45% employee, 2.90% self-employed)



# Tax Rates- Married/Filing Jointly- 2018

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<u>Tax Bracket</u>	<u>Income</u>
10%	0 - \$19,050
12%	\$19,050 - \$77,400
22%	\$77,400 - \$165,000
24%	\$165,000 - \$315,000
32%	\$315,000 - \$400,000
35%	\$400,000 - \$600,000
37%	Over \$600,000



**MARRIED  
FILING JOINTLY**



# 2018 Tax Changes

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- Personal exemptions eliminated
- Standard deduction - \$12,000 single
- Standard deduction - \$24,000 married
- Property and state income taxes capped at \$10,000 (medical and student loan interest still deductible if taxpayer itemizes)
- Homes priced over \$400K with 2.5% tax rate will exceed \$10K cap
- Most taxpayers will not itemize (interest/property taxes/charity <\$24K)



# 2018 Tax Changes- cont'd

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- Reduces the limit on deductible mortgage debt to \$750,000  
(current loans up to \$1 million are grandfathered and not subject to new cap)
- Repeals moving expense deduction (except military)
- Child care tax credit doubles to \$2,000  
(phase out starts at \$400K married, \$200K single.... phase out started at \$110K and \$75K in 2017)
- Repeals moving expense deduction (except military)
- Child care tax credit doubles to \$2,000  
(phase out starts at \$400K married, \$200K single.... phase out started at \$110K and \$75K in 2017)



# Advantages of Real Estate Investing

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- Leverage
- Cash Flow
- Depreciation
- OPM
- 1031 Exchange- defer taxes
- Deduct losses against ordinary income
- Leave to heirs (fair market value is cost basis at time of death)
- Instant equity when property is purchased below market
- Can convert rental property to primary residence and avoid capital gains (live in home two of the last five years)
- Can take tax free cash flows to pay Schedule A deductions (free double dipping)
- Can use IRA to purchase rental property



# Real Estate Deductions

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<u>Item</u>	<u>Homestead</u>	<u>Investment Property</u>
Interest	X	X
Property Taxes	X	X
Hazard Insurance		X
Mortgage Insurance	X	X
Depreciation		X
Repairs		X
Improvements (depreciate)		X
Loss From Sale		X
Principal	NA	NA



# Your Children's College Education- paid by tenant

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- Purchase one property for each child (when they are young)
- Should have over 60%-70% equity when children are college age
- Pay off home 10 years early and use cash flow for tuition
- Cash out refi and pull equity out to pay for college tuition in lump sum
- Mortgage interest is tax deductible
- Loan proceeds are tax free (it is a loan)
- Tenant pays the mortgage
- If the property is negative cash flow, can write off loss (subject to AGI rules)
- Children inherit home and any remaining debt (still have equity)
- Children can sell home after they inherit from parents and pay no capital gains or depreciation recapture (cost basis is fair market value of property at time of death)



# Real Estate Capital Gain/Loss Analysis

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- Can deduct up to \$25,000 in yearly losses against ordinary income (passive loss)
- Passive loss is reduced by 50% of the amount by which your adjusted gross income exceeds \$100,000
  - Deduction completely phased out when AGI > \$150K
  - Unrealized passive loss can be rolled over each year
- Rental income profits not subject to self employment taxes
- Can defer capital gains and depreciation by taking advantage of 1031 exchange
- Must pay long term capital gains plus taxes on depreciation if property is sold and proceeds not reinvested



# Return On Investment - Leverage with Real Estate

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- Principal Reduction
- Cash Flow
- Appreciation
- Depreciation tax savings
- 1031 capital gains savings
- Rent increases
- Gradual increase in principal payment over amortization schedule
- Instant equity when property purchased below market



# Mortgage Qualifications- Investment Real Estate

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- Must put minimum 20% down (80LTV) for SFR (single family residence)
- Multi-family properties require 25% down (75LTV)
- SFR mortgage rates are lower for 75LTV
- Must have six months reserves (PITI) for subject rental property after closing costs, down payment, and prepaid expenses
- On number 5 -10 mortgage- must have six months (PITI) per rental property
- Fannie Mae allows a maximum of ten mortgages
- Full Doc loan on Fannie Mae mortgages
- Have to qualify using personal income
- Unless subject property has current tenant and lease agreement, lender will not count rental income (exception- investor has two years experience as landlord)
- Debt to income ratios including mortgage on subject rental property should be below 45% of gross income



# Depreciation - sample calculation

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Purchase Price	\$169,000
Land Value	-\$42,500
Improvement	\$126,500
Depreciation Term (SFR)	27.5 years
Yearly Depreciation	\$4,600
Monthly Depreciation***	\$383.33



\*\*\*Depreciation is a non cash expense



# Sample Investor Transaction

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Property- 1367 Sqft home in Leander, Block House Creek

Closing Date- 8/6/2016

Purchase Price- \$169,000

Loan Amount- \$126,750

Interest Rate- 3.75%

Current Rent- \$1,375/mo

Property in our portfolio, sold to new investor with existing tenant below market, tenant occupying home





# Cash Flow/Profit/Loss Analysis- rent \$1375/mo

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<u>Item</u>	<u>Monthly</u>	<u>Yearly</u>
Interest Expense	\$392.78	\$4,713.36
Principal Payment	\$193.92	\$2,327.04
Property Taxes	\$409.12	\$4,909.44
Hazard Insurance	\$50.25	\$603.00
PITI	<hr/> \$1,046.07	<hr/> \$12,552.84
 Cash Flow = Rent - PITI (\$1,375 - \$1,046.07)	 \$328.93	 \$3,947.16
Gain = cash flow plus principal payment (\$522.85 + \$193.92)	\$522.85	\$6,274.20
Deduct Depreciation	(\$383.33)	(\$4,600.00)
Taxable Gain	\$139.52	\$1,674.20



# Return On Investment - Sample 12 month Calculation

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Cash to Close	\$44,409.95
Yearly Profit	\$6,274.20
Equity from purchase of home (purchased below market)	\$10,000.00
Appreciation- 3%	\$5,007.00
Depreciation Tax Savings (25%)	\$1,150.00
Deduct 5% for repairs	(\$825.00)
Total ROI	\$21,606.20

ROI- (does not include management fees/vacancy) 49%



# Extra Benefits to Realtors & Property Managers

- Tenants can become clients and purchase homes
- Tenants can refer business (rental and sales)
- Rent your property to a client while they build a home (if you do sales)
- Report depreciation on Schedule C instead of Schedule E and get around the \$100K AGI limitation (property will show profit on Schedule E, loss taken on Schedule C)
- Purchase properties with tenants below market from your investors (have to disclose FMV)
- Purchase properties from move-up clients and get a commission to offset your capital costs
- Purchase your office and sublease space to attorney, loan officer, insurance agent, etc.



# SFR- Advantages

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- Easiest property to lease
- Can purchase as owner occupant and convert to investment property in future
- Most desirable property for prospective tenants
- Attracts most stable tenant- tenants may stay longer in SFR
- Higher rents attract better quality tenants
- Easiest property to sell- have larger pool of buyers
- Recession proof- can always lease and sell SFR home regardless of market
- Opportunities to purchase foreclosures or distressed properties below market



# SFR- Disadvantages

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- Less profitable- more difficult to cash flow in down market
- More expensive cost per door
- 100% vacancy if property has no tenant
- Requires tenant to provide yard maintenance



# Duplexes- Advantages

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- Can be highly profitable in good rental market
- Can purchase as owner occupant and have tenant cover part of mortgage
- 50% vacancy may cover majority of your mortgage payment
- Make sure property has garage and fenced yard
- Buy in best neighborhood you can afford
- Attractive to fixed income tenants (smaller units)





# Duplexes- Disadvantages

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- Compete with apartments
- Smaller pool of buyers than SFR- many buyers are investors
- Many properties have been neglected by previous owners/landlords
- Repairs can be high if property has been neglected
- Attractive to lower income applicants who may not take care of property
- Higher turnover rate





# 4Plexes- Advantages

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- Can be very profitable in good market
- Highly attractive to professional investors
- Lowest cost per door
- Can purchase as owner occupant
- Most likely will cover most of mortgage if purchased as owner occupant
- Great tax deduction due to higher sales price- larger depreciation amount





# 4Plexes- Disadvantages

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- Much harder to rent than duplexes and SFR
- Compete with apartments
- Attractive to lower income tenants
- Many properties have been neglected by previous owners/landlords
- Limited inventory of properties for sale
- Repairs can be high if property has been neglected
- Most don't have garages or yards





# Investment Terms/Metrics

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Net Operating Income = Gross Operating Income - Operating Expenses  
(debt service not included in this calculation)

Cash Flow Before Taxes = Net Operating Income - Debt Service

Cap Rate = Sales Price / Yearly Net Operating Income

Cash on Cash = Total Acquisition Costs / Yearly Cash flow before taxes  
(considers operating expenses, vacancies, repairs)

Gross Rent Multiplier = Sales Price / Monthly Gross Income  
(does not include operating expenses)



# What is the Definition of Wealth?

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- How many days, months, or years you can survive without working?



# How To Build Wealth?

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- Reduce personal debt
- Lower your overhead
- Stay in your primary residence (minimize move up)
- Build a portfolio of income producing assets
- Understand the difference between an asset and a liability
- Invest in 401K (employer match), SEP, IRA
- Transition income from W2 to lower tax bracket income (capital gains, dividends, rental property)
- Don't buy big liability assets (expensive homes, cars)



# Summary

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- Cash Flow
- Depreciation
- Leverage
- Can double dip by using profitable cash flows to pay personal interest/taxes/mortgage on primary residence and reduce ordinary earned income
- Your tenant experience will mirror the quality of the subject property you are leasing
- Use real estate to pay for your child's college education
- Guaranteed retirement income after asset is paid off
- It is almost impossible to save enough money to be wealthy



# Questions & Answers

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