Real Estate vs. the Stock Market

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Investors have many choices in today's market as to where to place their investment dollars. Many choose the stock market, in part because it is the easiest place to get started as an investor. However, those wanting to build significant wealth over the long term should consider real estate. Aside from the fact that over time, as populations tend to increase, land values should naturally increase, investing in real estate has many strategic advantages not available with other investments. Some of those strategic advantages include:

Income and Appreciation

It is very possible in today's market to find properties that will be cash flow positive. This means that the rents collected from the tenants will more than cover the costs (expenses and financing) associated with owning the property. Few stocks in today's market pay significant dividends, most are held for future appreciation. Those stocks or bonds that are acquired for cash flow tend not to appreciate well. With real estate, investors can have the best of both worlds: income and appreciation.

Leveraged Appreciation

The basic idea of leverage is that an investor can acquire a very high valued asset for a much lower investment amount. This works in the investors favor in an appreciating market, magnifying the returns on investment. For example, an investor may purchase a million dollar property with 30% down. If that property appreciates 10%, the return on investment is 33%. In the same example, with 10% down, the investor can achieve a 100% return on investment.

Although not impossible, it can be difficult to use leverage when investing in the stock market. Using leverage to acquire stocks is referred to as "buying on margin" and at best investors may only borrow 50% of the purchase price of the stock. Investors who choose to buy on margin are also subject to margin calls (adding more funds to the brokerage account) should the value of the stock decline significantly. The Federal Reserve Board also regulates which stocks are marginable, so options may be limited.

Tax Advantages

Although Wall Street can offer investors tax advantaged vehicles like the tax free municipal bond or the ability to buy and sell stocks through an IRA or 401K, the tax advantages Wall Street can offer pale in comparison to what is available with real estate. With real estate, there are tax advantages available while both <u>owning</u> and <u>selling</u> real estate. Let's first discuss the advantages available during the course of real estate ownership:

> <u>Mortgage Interest Expense</u>
> The government allows all of the interest associated with the financing of the property to be written off as an expense of owning the property. For many real estate investors, especially those with interest only loans, this expense deduction can be substantial.
>
> <u>Depreciation</u>
> Depreciation is a method for matching the costs of acquiring property over the properties estimated economic life. The IRS now requires that most properties be depreciated using the straight-line method of depreciation (27.5

years for residential properties, 39 years for commercial properties). Depreciation will act as an intangible expense and will shelter income from taxes.

Expense Deductions
Many of the costs associated with owning and managing a real estate investment, such as management fees and insurance premiums, are deductible. One deductible expense worthy of note is the travel expense. Many real estate investors acquire real estate in places they like to (or have to) visit, and each time they travel to the property, the travel costs are a deductible expense. Not a bad deal if the property happens to be in Maui, or around the corner from a relative.

Passive Losses
Due to depreciation and expense deductions, it is possible to own a property that is producing positive cash flow, but for tax purposes showing a loss. These "passive losses" are subject to certain restrictions, but in many circumstances can be used to offset passive income from another investment.

There are also specific tax breaks available when selling real estate. The tax breaks available depend on the type of real estate sold. If a primary residence is sold, Section 121 of the Internal Revenue Code allows the seller to avoid paying capital gains taxes. If an investment property is sold, Section 1031 of the Internal Revenue Code allows the seller to defer the payment of capital gains taxes. Both sections of the tax code merit further discussion:

Section 121
Upon the sale of a primary residence a taxpayer can avoid paying capital gains taxes on the first $250K of gain if single, or the first $500K of gain if married. The seller(s) must have owned and lived in the home as their primary residence for two out of the past five years.

Section 1031
Upon the sale of an investment property a taxpayer can defer the payment of capital gains taxes. In order for the entire tax liability to be deferred, the taxpayer will need to reinvest all of the sale proceeds and purchase a property of equal or greater value. The new property must be acquired within 180 days.

Many investors can use both Section 121 and Section 1031 together for maximum tax advantage. An example would be an investor who conducts a 1031 Exchange into a rental home. After establishing the property as a rental for two years, the investor moves into the property. Once the property is established as a primary residence, taxes can be avoided on the sale via Section 121.

Obviously investors have many choices available to them on Wall Street. With a little education however, many investors might find that investing in Main Street, or Elm Street, might be a better long term decision.