Have you considered investing in real estate?

Do you realize that real estate investments have characteristics which are unique from traditional asset classes? Do you know how to invest in real estate individually or participate in real estate investment opportunities? Would you think of private real estate investments as part of your investment portfolio?

At Abundance, we believe that privately held real estate investments deserve a place in many client portfolios, in spite of the differences from traditional asset classes, which are traded on the open market and provide accurate, real-time valuations. We understand how to incorporate real estate into your portfolio, to work alongside your traditional investments, providing substantial cash flow, significant tax optimal gains, or a combination of the two. You might consider investing in real estate for the following reasons:

- **Real Estate is a hard asset**
- **Real Estate provides significant tax advantages**
- **Equity builds in the property over time**
- **Real Estate provides diversity to investment portfolios**

Unlike bonds and equities, real estate is a hard asset. While the value of real estate fluctuates, those fluctuations aren't evident on a daily, monthly, or annual basis. The true market value of real estate is only determined when it is sold. Additionally, Income producing real estate will generally have long-term leases in place which can smooth out the fluctuations of the underlying asset, thereby making the volatility less apparent. This helps to prevent irrational decision making on the part of the investor, which leads most investors to sell when the market is low and buy when it is high.

Real estate offers significant tax advantages

Because real estate is tangible, it has historically appreciated over time. It is truly a limited resource, no more will be discovered, and with limited exceptions, it cannot be created or destroyed. As more land is used, supply is reduced, and in general, price will go up. Certain areas can change in character over time, i.e. Brooklyn, NY and Detroit, MI which is one area for significant risk and reward. At Abundance, we look for opportunities that appear to be in a stable area and are not focused solely on the value of the underlying property.

Depreciation can defer tax on profit distributions

Privately held real estate investments also provide significant tax advantages. Operating expenses, interest expense, and depreciation can all be deducted against cash flow from the investment, and losses can be carried forward. In many cases, an investor will see positive cash flow, some of which will be tax-sheltered due to deductions based on expenses related to the property. Those losses are passed through to all owners in proportion to their ownership.

Depreciation is an interesting concept because it is a theoretical expense, which may or may not actually be incurred in that tax year. Depreciation is based on the concept that physical improvements to land will deteriorate over time, and all business assets have a useful life. The useful life is determined by the IRS in what is called a depreciation schedule. The entire cost of the property, minus the value attributed to the land can be depreciated over the useful life of the asset. That "expense" is passed along to the investors and is used to offset income derived from the property, therefore, providing a portion of that return which is tax-sheltered. It must be noted however, that depreciation is recaptured upon the sale of the real estate at the ordinary income rate of the taxpayer, while any gain on the property held for over a year will be taxed at a reduced, long-term capital gain rate. Depreciation is recaptured and capital gain taxes are only paid upon the sale of the property. Therefore, the property could be refinanced at a higher value, with money from the refinancing distributed to investors in a tax deferred manner, and the property may be depreciated in total down to a $0 basis. Additionally, paying tax on the property can be avoided if instead of selling the property it is exchanged with property of a similar character in a 1031 like-kind exchange. In a 1031 exchange, the current basis of the property being disposed is carried over to the new property, and no tax is paid on the exchange.

While a real estate investment may be cash flow positive, it could still experience a theoretical loss for the year due to depreciation expenses. Passive loss rules don't allow for that loss to offset income from activities in which the investor is actively engaged, however, it may be used to offset gains from other passive investment activity, such as gains in the stock or bond market. By having a separate asset class in an investment portfolio, an investor can achieve better overall tax minimization, even if all assets are rising or producing income in certain cases.

Another attractive reason to participate in private real estate investments is that the tenants pay rent, which is used to pay down the note and build equity in the property on behalf of the investor. By leveraging the cost of the property, the owners or equity partners, will only pay the initial amount put down on the property, but after the loan is paid off using money obtained from rent, the owners will own the entire property at a fraction of the total cost, while having the ability to depreciate the entire amount of the property allocated towards improvements.

Distributions from refinancing real estate are tax-deferred

Private real estate investments also behave differently than equities and bonds, and can reduce correlation in portfolios, thereby lowering your overall. Taking a simplistic view, stocks act opposite of bonds. When the stock market declines, there is a flight to safety with money moving into bonds. When the market is performing well, money moves out of bonds and into stocks. Holding private real estate investments helps to provide an asset class that performs differently than both stocks and bonds. Stocks tend to have higher amounts of volatility, where bonds tend to be very stable investments with lower volatility. From a risk standpoint, the right real estate investment should be similar in volatility to bonds in a lot of cases, but have returns close to or exceeding those of the historic overall stock market. As a third asset class in portfolios, privately held cash producing real estate investments should act to flatten out spikes that result from money moving between equities and bonds, while providing significant cash flow in the form of dividends, and as a long-term purchase, should increase in value over time.

Another positive attribute of Real estate is that it acts as a hedge against inflation due to it being a hard asset. As the value of currency falls, real estate should rise in value while avoiding supply risk associated with commodities. By owning the actual property, and not a real estate stock, investors should directly benefit as a result of inflation, thereby reducing the negative effects of reduced buying power.

Private Real Estate Investment

It is necessary to distinguish private real estate investments from Real Estate Investment Trusts (REITs). A share of a REIT is really preferred stock which pays out dividends to investors. Shares of REITs perform more like equities and fluctuate in value on a daily basis. REITs also do not provide the same tax benefits of private investments, and tend to be ownership in the holding company, not the properties themselves. Public REITs do offer an advantage over private real estate investments in that they are generally liquid and investors can usually sell out of their positions with ease.

We invite you to discuss this with us if you have any questions about the concepts discussed in this paper or if you are interested in learning more about incorporating private real estate investments into your total wealth strategy.

John Schaffer joined Abundance in 2013 and oversees the firm's compliance program and advises clients on matters of personal wealth. His prior experience ranges from real estate and construction to criminal and civil law. John attended The Pennsylvania State University, where he majored in Marketing, and later returned to complete a joint degree in Law and a Masters of Business Administration. His graduate education focused on business, tax, and estate law. John is an active member of the Pennsylvania Bar.