Japanese Tax Benefits of Buying California Foreclosures

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In crisis comes opportunity. Investors with significant Japanese taxable income are likely to achieve **annual returns exceeding 25 %(!)** over the next five years when buying rental property in the San Francisco Bay Area. Two unusual circumstances lead to this niche opportunity. Japanese tax benefits alone (for rental properties more than 20 years old) generate returns of 11-14% on investment; the rest would come from cash flow and appreciation. For the first time in a generation small rental properties are available in the San Francisco Bay Area at prices that offer very attractive returns and low long term risks. This should enable overseas investors to obtain much better leverage than has historically been possible. This leverage in turn boosts Japanese tax benefits and returns.

A Japanese Tax Law Quirk

A fully deductible 5-year depreciation schedule combined with high tax rates provides annual tax savings in Japan equal to 11-14% of the amount invested.

Unlike the United States, the tax law in Japan does not limit passive loss deductions. This means that depreciation deductions for a rental property can be used to shelter other ordinary income in Japan. Since income tax rates quickly hit 33% and go as high as 40% in Japan, depreciation deductions produce large cash tax savings for investors. Another key difference is that the Japanese law allows a 5 year write off period for rental properties that were built using wood more than 20 years ago. The reason for this very generous schedule seems to lie in the nature of wooden Japanese buildings – they are typically torn down and rebuilt after 20 years. Although the law is written with Japanese property in mind, the same schedule would apply to any rental property built from wood. Before investing, investors should seek local tax advice in Japan to ensure that the local tax office will recognize the special depreciation schedule provided under the law.

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Current markets offer enough cash flow to support loans at 80% of value.

Why Now?

Although people have been aware of this Japanese tax break, until now it has been very difficult to find properties built of wood that were priced at a level that could support the necessary leverage to make the numbers work. Wooden apartment building construction occurs mostly in the western U.S. but these properties were always priced very high relative to rents – reducing the available leverage and returns. In states with good pricing (i.e. high property yields) the properties were not built of wood. The popping of the housing and credit market bubbles has wiped out most of the buyers who were willing to buy at extremely low rates of return (i.e. high prices). The only buyers left are the ones that require the property to support a reasonable amount of leverage. Since the banks are forcing sales, there are more sellers than buyers and bargains are available in certain areas. In fact, prices have overshot to the downside for the current mortgage rate environment. Either mortgage rates will increase or current prices will go up once the recession is over and more investors start paying attention to real estate prices.

Berkeley Investment Advisors Will Show You How

At Berkeley Investment Advisors, we love this kind of market. We specialize in analyzing the numbers and the market – not sentiment. We know the beaten down Bay Area markets well and we look forward to helping our clients navigate through this amazing period of bargain hunting. We will identify the major areas of opportunity and provide detailed financial and market analysis. We help serious investors with all aspects of finding and closing a deal. But it won't be easy.

The key is financing. The reason why so many bargains are available is that credit is much tighter than the past. Still, money is available for investors with substantial net worth and good credit. We expect that investors will have to pay significantly above the normal residential interest rates if they are overseas - but the deals will still look good. We help you find the best financing sources and get the approvals needed to finance your purchase.

Capitalization rates on properties under $400,000 in California are well above 6% - far too generous to last past the recession.

Examples

We searched the East Bay multiple listing system and found the best values in Contra Costa County – the north east bay. In Antioch we found a four unit building selling for $265,000 that could produce gross rents of $42,360 per year – and a capitalization rate of 9.3%. In Crocket we there is a fourplex for $390,000 that could be rented out for $47,160 per year – a 6.7% capitalization rate. These properties should produce returns in excess of 25% - including tax benefits. For further details see the summary of property analyses in Appendix A.

Risks

The main risk in pursuing this strategy is operating risk – the chance that renters cannot be found at the expected rent level or that operating costs exceed expectations. While we cannot know for certain what rents will be, we can determine what other similar properties in the area are renting for and allow for a discount to fill units quickly in assessing the downside risk.

On the cost side, many major costs are easy to predict:

- Property tax is set by law
- Insurance companies are very competitive - reducing the likelihood of surprise premium increases
- Management costs are a fixed percentage of gross income

Capital expenditures, repairs, maintenance, and turnover costs are the most variable costs. These costs constitute about 41% of operating costs and roughly 15% of expected gross income. We have two defenses – due diligence in assessing the property's condition and operating costs prior to purchase and cost conscious management. Even in a worst case scenario where these costs increase by a third, this will not be large enough to put the property in a negative cash flow situation. Thus there is little risk to the owner of not being able to manage out of the situation.

Conclusion

Because of the financial distress in California real estate, we are seeing an unprecedented opportunity to buy small rental properties with decent leverage and still achieve positive cash

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flows. This is a double bonanza for investors in Japan since the typical property in California was built of wood over 20 years ago and thus qualifies for accelerated tax deductions under the Japanese tax rules. Although it is challenging for overseas investors to purchase and manage property, Berkeley Investment Advisors provides the local expertise needed to successfully take advantage of current market conditions. Investors who can use the Japanese tax deductions should more than double their money over the next 5 years. If you have at least $90,000 to invest, now is the time to buy. We don't expect these market conditions to persist much longer.

Appendix A

Summary of Example Properties

Property Address	2216 Spanos St. Antioch	1211 Flora St. Crocket	379 Pinole Ave. Rodeo	940 Mariposa Ave. Rodeo
Price	$265,000	$390,000	$190,000	$98,000
Gross Income	42,360	47,160	22,800	13,200
Net Operating Inc.	24,773	26,316	12,422	7,320
Cap Rate	9.3%	6.7%	6.5%	7.5%
Investment Amount	87,100	127,000	63,000	33,500
Projected 1st Year:				
Cash Flow	9,963	4,520	1,803	1,843
Tax Benefits	9,538	17,558	8,664	4,161
Equity Increase	7,179	10,566	5,151	2,657
Total % Return	31%	26%	25%	26%

Notes:

Rents are based on market comparables.

Tax Benefits are based on depreciating 80% of costs over 5 years and a tax rate of 33%.

Investment Amount includes down payment, closing costs, and working capital.

All mortgages are assumed to be for 70% of value at 7% fixed for 30 years – fully amortizing.

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