



Putting Off Tax Bills to Build Wealth

How Tax Laws give the Edge to Real Estate

By Ray Meadows CPA, CFA, President of Berkeley Investment Advisors

One of the key advantages of a real estate investment in building wealth for retirement is the opportunity to defer taxes on income indefinitely. U.S. taxpayers with 401K plans can also defer taxes on investments in stocks and bonds but the deferral only applies to the assets you are allowed to contribute to the plan and you pay tax at ordinary tax rates once you start withdrawing income to live on. In this article I will show you why deferring taxes is important to your wealth and how U.S. real estate tax laws make indefinite deferral possible. First let's compare taxation of a stock portfolio to a real estate portfolio to see how taxation differences can effect retirement wealth.

As an illustration let's assume that real estate (equity) and stocks will return 14% every year for the next 10 years. Cash payments (dividends) are 2% and appreciation accounts for the other 12%. As I will explain in detail later, thanks to a (non-cash) deduction called depreciation, real estate cash payments are not taxable. Stock dividends are taxed as ordinary income while appreciation is taxed at the capital gains rate when recognized in accordance with the rules of the tax code. Outside of a tax favored savings vehicle, stock appreciation is *recognized* for tax purposes (and thus taxed) when a gain is *realized* by selling the stock. Thus the timing of tax payments depends on when the taxpayer sells positions to realize gains. The average actively managed mutual fund sells 85% of its positions each year. Let's assume individual investors only sell half their positions each year, so that, on average, they hold each stock for 2 years before selling it and reinvesting the proceeds. Since tax rules allow us to avoid recognizing real estate appreciation by reinvesting realized gains we can manage real estate investments so as to never recognize gains. With a few other

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assumptions about cash management for the real estate investment¹ we can compare the wealth buildup in the two asset classes.

What we find is that the real estate investment grows to be 25% larger than the stock portfolio by the end of year 10. Three-fourths of this difference is directly attributable to the lower taxes paid on the real estate investment and the rest represents the compounded returns on the tax money that was saved and reinvested. At retirement the real estate assets will generate after-tax income at least *25% higher* than the hypothetical stock portfolio. Clearly you want to defer taxes to build wealth. Next we'll look at the mechanics of tax law to understand how we can legally defer taxes on real estate income.

Real estate investments and their taxation are rather complex but we can look at a simplified example to get a feel for how the numbers work. This example may seem complex but it is, in fact, a simplification because we will ignore a bunch of details such as how the property is held², capital improvements, loan fees, transaction costs, cash management, etc. My example is for an apartment building we purchase for \$1,000,000 that generates net operating income of \$60,000 in the 1st year after purchase. Net operating income (NOI) is the operating cash income of the property before taking into account financing costs. We assume that both NOI and property value increase at the inflation rate, 3% per year. Based on this NOI we can finance 75% of the purchase price with a 30-year, fully amortizing mortgage, at a fixed interest rate of 6.5%. (Thus we must invest \$250,000 to buy the property). For tax purposes the cost of the building is deductible over 27.5 years as depreciation. The portion of cost attributable to land is not deductible. We would like to allocate as much of the purchase price as possible to the building. Without being too aggressive we can say the land is worth \$200,000 and the building is worth \$800,000. This gives us an annual depreciation tax deduction of \$29,091 (= 800,000/27.5).³

That's all we need to calculate our simplified taxable income & economic returns:

¹ 7% of the original investment is in the form of cash reserves that earn 6% interest and cash payments are accumulated 7 years before reinvesting in additional real estate assets.

² The example is written from the perspective of real estate directly held. The same results can be achieved holding the real estate in an Limited Liability Company (LLC) so long as cash distributed in excess of tax basis is treated as a loan to the owner of the LLC.

³ Note that Japanese tax law also allows depreciation deductions. For wooden structures (which all apartments in California are) the deductions allowed by the law are even higher than under U.S. law.

Berkeley Investment Advisors
Putting Off Tax Bills to Build Wealth

All amounts in \$1,000's (rounded)

Year:	1	2	3	4	5	6	7	Total to date
Net Operating Income	60	62	64	66	68	70	72	460
Less:								
Tax Depreciation	29	29	29	29	29	29	29	204
Interest Expense	49	48	47	47	46	45	45	326
= Taxable Income	(18)	(15)	(13)	(10)	(8)	(5)	(2)	(70)
Add:								
Tax Depreciation	29	29	29	29	29	29	29	204
Appreciation	30	31	32	33	34	35	36	230
= Economic Income	41	45	48	52	55	59	63	363

Here are the results for the first 7 years assuming we just hold passively during this time. We could also calculate operating cash flows by subtracting appreciation and mortgage principal payments from Economic Income. The total is \$62,000 over the 7 years. These cash flows are tax-free to the investor. Notice that Taxable Income is slowly heading towards positive territory as NOI increases and interest on the mortgage balance declines. In certain specific situations these losses can offset other taxable income. If they do not, then they are carried forward and can be used to offset taxable income on the property in later years.

Although we deduct depreciation on the building, this is not a true economic cost. In fact the property is appreciating at the inflation rate. Thus we add back depreciation and appreciation to taxable income to calculate our true economic returns on the property. Notice that Economic Income is much higher than Taxable Income. This is the beauty of real estate investing: untaxed returns that accumulate and earn additional returns.

My example stops at year 7 here because after that taxable income would turn positive and the investor may wish to take action to avoid generating taxable income on the property in year 8. In most cases the tax losses (\$70,000 here) will be carried forward because the investor cannot use them against other income. If we have such a carry-over tax loss we can allow the property to generate positive taxable income for a few years without paying tax because our prior losses would offset this income. For my example I will assume that we want to avoid generating taxable income on the property after year 7. In order to understand what is possible at the

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 Putting Off Tax Bills to Build Wealth

end of year 7 and the effects of different choices we need to look at our balance sheet.

	<u>\$1,000's</u>
Property Value	\$1,230
Less: Mortgage Balance	<u>678</u>
= Investor's Equity	<u>\$ 552</u>

Thanks to inflation, property value has grown \$230,000. This, combined with \$72,000 in principal repayments on the mortgage, boosts our equity in the property to \$552,000.⁴ At this point the loan balance is only 55% of the property's value and we are under-leveraged. If we refinanced the property to bring the mortgage back up to 75% of property value, the new mortgage would be \$922,000. After paying off the old loan we would end up with \$244,000 in cash. Ignoring the "do nothing" option, we have 3 great choices:

1. Refinance and pull money out to fund our lavish lifestyle,
2. Refinance and use the funds as a down payment on another property purchase, or
3. Sell the property and buy a more expensive one while structuring the transactions as an exchange for tax purposes.

What are the tax effects and economic results under each of these choices? Here's how things look under option 1.

All amounts in \$1,000's (rounded)

Year:	7	8	9	10	11	12	Total to date
Net Operating Income	72	74	76	78	81	83	852
Less:							
Tax Depreciation	29	29	29	29	29	29	349
Interest Expense	45	60	59	58	57	57	617
= Taxable Income	(2)	(15)	(12)	(9)	(6)	(3)	(115)
Add:							
Tax Depreciation	29	29	29	29	29	29	349
Appreciation	36	37	38	39	40	42	426
= Economic Income	63	51	55	59	64	68	660

⁴ Notice that equity has increased by \$302,000 (552,000 – 250,000). Adding this to the \$62,000 in cumulative operating cash flows gives us our (rounded) 7-year economic return of \$363,000.

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Putting Off Tax Bills to Build Wealth

In this scenario the investor increases borrowings against the property by \$244,000 and takes out the cash tax-free. Interest expense increases by \$15,000 in year 8 compared to year 7. The increase in interest deductions is enough to eliminate taxable income for another 5 years. Note that Option 1 reduces the economic income on the property going forward since the property now bears a heavier interest burden. Still, at the end of 12 years the investor will have earned \$660,000 on the \$250,000 original investment. The investor will have \$562,000 equity in the property and will have received \$104,000 in operating cash flows, plus the \$244,000 refinancing cash flow, all without any tax liability.

If we choose option 2 and reinvest the refinancing cash flow, the results are as follows.

All amounts in \$1,000's (rounded)

Year:	7	8	9	10	11	12	Total to date
Net Operating Income	72	132	136	140	145	149	1,163
Less:							
Tax Depreciation	29	58	58	58	58	58	491
Interest Expense	45	107	106	104	103	102	848
= Taxable Income	(2)	(32)	(27)	(22)	(16)	(10)	(177)
Add:							
Tax Depreciation	29	58	58	58	58	58	491
Appreciation	36	66	68	70	72	75	581
= Economic Income	63	92	99	106	114	122	896

As with Option 1, this increases interest deductions by \$15,000 on the original property, but in addition, we reinvest the borrowings in a new property that generates another \$17,000 in tax losses (as the 1st property did in its early years). Comparing years 8-12 with Option 1 we see that the 2nd property almost doubles the investor's economic income so that returns total \$896,000 over the full 12 years. Of this amount \$137,000 is operating cash flow that the investor receives free of taxes. At the end of year 12 the equity in the properties is \$1,009,000 and the investor could refinance to pull out another \$369,000 tax-free.

With Option 3 there are some rules to be observed such as the limit on the amount of time between the sales date and designation of the replacement property (45 days). This choice is similar to Option 2 in that we are reinvesting while we boost leverage back to 75%, but in this case we end

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 Putting Off Tax Bills to Build Wealth

up with one large property instead of 2 smaller ones. The results are as follows.

All amounts in \$1,000's (rounded)

Year:	7	8	9	10	11	12	Total to date
Net Operating Income	72	132	136	140	144	149	1,161
Less:							
Tax Depreciation	29	51	51	51	51	51	461
Interest Expense	45	107	105	104	103	101	846
= Taxable Income	(2)	(26)	(21)	(15)	(10)	(4)	(146)
Add:							
Tax Depreciation	29	51	51	51	51	51	461
Appreciation	36	66	68	70	72	74	580
= Economic Income	63	91	99	106	114	122	895

Depreciation deductions will be lower than under Option 2 because of how the depreciable basis for the new property is calculated. Otherwise, the results are virtually identical to Option 2. In addition to the lower depreciation deductions, this option would incur substantial transaction costs. This option may, however, still be preferable because of factors unrelated to taxation such as economies of scale or expected future economic returns.

The tax analysis presented above relates to U.S. tax law. Residents of foreign tax jurisdictions may incur tax liabilities in those jurisdictions depending on local tax laws and their implementation. In particular, because of the wide discretion granted to tax authorities in Japan, investors subject to Japanese tax can incur liabilities for tax even when Japanese tax law says there should be no tax.

The purpose here is illustrative. Reality will be more complex and will require detailed analysis. Berkeley Investment Advisors can do the calculations for your specific situation and investment. We help you proactively manage your investments to defer taxes and make the money work for you – not the government.

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