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Using Real Estate in Retirement Planning

REAL ESTATE INVESTMENTS CAN BE A KEY SOURCE OF INCOME AND HELP PROTECT A RETIREMENT PORTFOLIO FROM THE UPS AND DOWNS OF THE STOCK MARKET.

Adding real estate to a retirement portfolio can help diversify investments beyond stocks and bonds. This can protect a portfolio from market drops and has the potential to provide cash flow and growth to support a client through his or her retirement years. Investing in real estate can be done in two ways: directly, or through a real estate investment trust (REIT). Choosing a strategy will depend largely on the goals, needs and interests of your client.

DIRECT REAL ESTATE INVESTMENTS

“Successful retirement planning creates enough cash flow to support an investor’s lifestyle, and real estate that leads to a cash conversion may be the right solution for an interested client,” says Irving Diaz, managing director and licensed real estate broker with Irving J. Diaz & Associates, LLC, in Miami. Investing in commercial real estate, such as multiple-family properties, office buildings, retail shopping centers and industrial warehouses, can provide the following advantages:

- **Cash flow:** Offers a continuous stream of income. Keep in mind, however, that property management costs can impact profits.
- **Equity gain:** By refinancing, cashing out or obtaining a line of credit against the equity, the investor can make improvements to existing properties. This can increase the value of the real estate or allow for higher rents. An investor can also use the equity as down payments to acquire additional investment properties, increasing his or

her portfolio’s value and creating additional cash flow.

- **Tax shelter:** By writing off allowable operational expenses, an investor can enjoy more of the cash flow generated by the property. Additionally, by exercising a 1031 Exchange, the investor can trade like-kind properties while deferring capital gains taxes.
- **Value appreciation:** An increased market value can create additional cash for an investor when the property is sold.

“Investment real estate is a long-term wealth creation vehicle,” says Diaz. “As a result, most acquisitions should be held between three and five years, minimum.” Having a liquidation plan rather than selling quickly can help an investor realize the full appreciation value of the property.

PURCHASING PROPERTY

Deciding whether to purchase real estate outright or obtain a mortgage depends on the investor’s financial and tax circumstances. “Even investors who can afford to purchase property with cash should choose to leverage other people’s money,” recommends Diaz. “This strategy reduces your risk and can increase your investment opportunities.” There are two ways to leverage money: equity leverage—bringing in a cash partner—and debt leverage—meaning a mortgage.

For example, an investor may be able to acquire a \$1 million office building through a cash purchase. If the annual net operating income (NOI) is \$100,000, the return on investment (ROI) is

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Irving Diaz, managing director and licensed real estate broker with Irving J. Diaz & Associates, LLC, in Miami.

determined by dividing the NOI by the purchase price (\$100,000/\$1 million); in this case, the ROI is 10 percent. “Keep in mind that a real estate investment with an annual return of 10 percent will result in a higher actual rate of return due to the added value of property appreciation,” says Diaz.

An investor may also choose to acquire the property by allocating \$250,000 as a cash down payment and obtaining a \$750,000 mortgage for the remainder. If total annual

expenses are \$75,000, including the mortgage debt, the ROI would then be \$25,000 from the same NOI of \$100,000 annually (\$100,000 – \$75,000). Although the investor’s ROI remains at 10 percent (\$25,000/\$250,000), he or she can purchase three additional properties in the same manner, spreading risk across four investments.

REAL ESTATE INVESTMENT TRUSTS (REITS)

A REIT is a tax structure for a corporation that invests in real estate, most commonly commercial properties. Investors may purchase shares of public REITs and earn profits based on the overall performance of the properties. The IRS requires REITs to distribute at least 90 percent of their net income, exempting them from taxes, as taxation responsibilities are passed to the investors.

“If an investor does not have the experience or interest in property acquisition, management and taxation, then a REIT may be the best real estate investment option,” explains David Donnelly, CPA, a partner in the Houston-based accounting firm Gainer, Donnelly & Desroches, LLP. “REITs are providing about a 7 percent return on investment right now and offer a partial tax credit for property depreciation. In addition, REITs may be able to take advantage of trends in the subprime

mortgage industry to purchase prime properties below market value.”

Other reasons to consider REIT investments:

- They support investment in properties an investor could not afford alone.
- They provide diversification through multiple properties in many locations.
- Global REITs allow international diversification.

“Real estate investments can be a key source of income, protected from the ups and downs of the stock market, that can help high-net-worth clients sustain their lifestyle throughout retirement,” says Donnelly. Choosing the right options and structuring them for a client’s portfolio requires collaboration between a team of experts, including the client’s financial advisor, real estate investment broker, tax advisor and attorney. ■

The information presented is not intended to be investment advice. It is important to seek the assistance of qualified experts to determine how owning real estate fits within a high-net-worth portfolio and financial strategy.

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