Dollars & $ense

IS OWNING RENTAL PROPERTY RIGHT FOR YOU?

If the word "investments" just means stocks and bonds to you, you are overlooking a potentially lucrative source of income: rental property. Rental property can provide a steady stream of cash, and you may realize a hefty profit when you sell the property. There also are certain tax deductions you can take as the owner of rental property. Of course, as with any investment, there are risks, too.

WHAT TO OWN

Rental property comes in various guises: apartment buildings, condos, single-family houses, duplexes, commercial property and so forth. If you want to invest in commercial property or major apartment complexes, a real estate investment trust (REIT) might be right for you. You trade shares in a REIT through a stockbroker. An equity REIT owns and rents properties; a mortgage REIT makes loans to others for the purchase of property. Although you should access a REIT's potential for long-term growth, many people invest in REITs for the dividends they provide.

Other investors, however, prefer direct investment in rental property. They buy a single family home or a condo unit, for example, and rent it to someone else. If this appeals to you, you should consider the following when buying rental property.

LOCATION, LOCATION, LOCATION

Is the property in a neighborhood that appeals to renters? For example, property near colleges or military bases attracts people who prefer to rent rather than own. Are schools, shopping facilities and parks in the area? Is it in a low crime area? Furthermore, is the property close to where you live or is it some distance away? Many owners want rental property to be nearby so they can easily check on the property and tenants.

CONDITION OF THE PROPERTY

Is it well maintained or will you have to do major repairs before you rent it? Major repairs shouldn't necessarily discourage you from investing in the property. Many investors specifically look for properties that need improvements because they can buy them cheaper than well-maintained properties. They then either make the repairs themselves or hire out the work.

COSTS INVOLVED

Most likely you will have to make a down payment of at least 20 percent of the selling price, and your mortgage rate probably will be slightly higher than if you had bought the property as your own home. Other costs you will have are property taxes, utilities, maintenance (including landscaping), advertising and insurance. If someone manages the property for you, you will have to pay him or her. Fortunately, many of your costs are deductible (see below).

FINDING TENANTS

Getting and keeping tenants, of course, is critical to making your property a successful investment. You can advertise or work through a real estate office. If the property is in a college community, you could post notices on campus bulletin boards. Ideally, you'll want tenants who are dependable with rent payments and who will do little damage to the property. Before you rent to anyone, you should do a background check that includes contacting the potential renter's previous landlord(s), getting a credit bureau report, verifying employment and making sure that he or she has no criminal record.

WHAT TO CHARGE

You can charge rent that is equivalent to your monthly costs (including anticipated maintenance), less than your monthly costs, or more than your monthly costs. Checking local classified advertisements should give you a good idea of what equivalent properties rent for. You likely will not want to charge much higher than that or else you will have greater difficulty finding tenants. Some owners charge less than the going rate—even if it is less than their actual costs—to ensure that they'll attract tenants. Most property owners also require a security deposit.

Once you have a tenant, you may want to increase the rent periodically—usually on the anniversary of the tenant's signing of the lease. (Your costs, including maintenance and taxes, increase yearly, so raising the rent helps you keep up.) Normally, you must give a renter at least 30 days written notice of a rent increase, although some areas require longer notice times. If your property is subject to rent control laws, check with the appropriate government

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office in your community to find out how they will affect your rental property.

LEASE AGREEMENT

You should ask your tenant to sign a lease agreement, which is a legal contract. Office supply stores sell standard lease agreements. You may, however, want an attorney to draw up a contract that incorporates terms and restrictions not found in standard agreements.

TAX IMPLICATIONS

You, of course, will pay property taxes on your rental units, and you will have to declare the rental income you receive on your federal and state income tax returns. On the other hand, you can deduct your expenses. These deductions include property taxes, advertising, insurance and the cost of repairs and improvements.

You also can depreciate the value of the property as well as capital improvements and furnishings that you provide. When you sell the property, you must recapture the depreciation. If you actually live on part of the property but rent out the rest of it, you must separate your rental expenses for tax purposes. IRS Publication 946, How to Depreciate Property, discusses depreciation, and Publication 527, Residential Rental Property, explains deductions.

LEGAL AND INSURANCE CONSIDERATIONS

As a landlord, you must follow state law and local ordinances, including zoning restrictions, applicable to your rental property. You also must abide by anti-discrimination laws. In case of an accident on your property, you'll need property owner's insurance, which also covers structure replacement. A personal liability umbrella policy, which provides additional coverage at relatively inexpensive rates, also is recommended. Some advisers suggest holding property in a limited liability company, which protects your personal assets should someone be seriously injured on your property and sues.

ASSESS THE RISKS

Short of your property being destroyed or your being sued, the greatest risk is not having tenants. Without a tenant, you don't have an income to cover expenses. That's why many property owners like to keep rents under the going rate to ensure that they keep good tenants and have minimal problems finding new ones when the property is vacated. And if you are looking at the property as a long-term investment and one for which you hope to reap a handsome profit when sold, the housing market could go bust.

Nevertheless, owning rental property is a good way to divest and spread your investment risk. It does require more work than investing in stocks and bonds, but the financial rewards can be much greater.