

Investment Property Financial Ownership Benefits

Whether you currently own an investment property or if you are considering purchasing an investment property, a few simple calculations of the property's financial ownership benefits can help you determine the kind of financial return that the property generates, i.e., its Return on Equity.

Financial returns on investment are expressed as a percentage and are based on the equity in the property, i.e., the difference between the property's market value (what it would sell for on the open market) and the property's outstanding loans (mortgages, equity loans, etc.). Before beginning, keep in mind that there are other factors, such as commissions on the property sale, any true losses suffered on the property prior to or during its sale, costs to prepare the property for sale or income taxes that you may owe from the sale, which may impact on your true equity and therefore on your true Return on Equity.

There are four types of financial ownership benefit calculations that are used to arrive at a Return on Equity; *Cash Flow*, *Property Appreciation*, *Debt Reduction*, *Tax Benefits*.

For the sake of simplicity in this Return on Equity calculation, we will define equity as the difference between the property's market value and the property's outstanding loans. For example, if the property's market value is \$300,000 and the property's total loans outstanding are \$200,000 then the equity or the owner's investment in the property is \$100,000.

Cash Flow: This is your total yearly rental income less all property expenses (loan payments, maintenance expenses, leasing fees, management fees, and taxes and insurance). This difference is your cash flow. If your management company handles payments of all your property expenses, including your mortgage payment, this number may be equal to your owner's check(s). For this example, we will assume a \$2,000 positive cash flow for the year. Dividing this \$2,000 cash flow number by your \$100,000 equity, your **return on cash flow is 2%**.

Property Appreciation: This is how much the market value of the property increased in one year. For example, the property was worth \$280,000 at the beginning of the year and increased by 7% or \$20,000 to \$300,000 at year end. If we divide the \$20,000 appreciation by the equity of \$100,000 it results in a **20% return on appreciation**. Appreciation may be affected by a number of economic and community factors. In fact, some properties may have negative appreciation. You may wish to contact a local appraiser for help with your property's annual appreciation percentage value in order to arrive at your return on appreciation. You may also use the following link to The Office of Federal Housing Oversight for property value and appreciation information on residential properties <http://www.ofheo.gov/HPI.asp>

Debt Reduction: This is how much your mortgage principal amount is reduced in one year. The longer your mortgage loan term; the less it reduces the yearly principal but conversely it provides you with a lower payment and therefore a higher cash flow. If we assume your loan principal was reduced by \$4,000 during the year, and we divide it by the \$100,000 equity, your **return on debt reduction is 4%**.

Tax Benefits: This is the Federal and State tax benefit achieved through writing off depreciation and business expenses of the rental property against ordinary income. Let's assume, for demonstration purposes, a Schedule E tax write off of \$50,000 after considering mortgage interest, depreciation and all other tax deductible expenses. Let's further assume that the owner is in the 35% tax bracket, which results in a tax savings of \$17,500. If we divide the \$17,500 tax savings by the \$100,000 equity, your **return on tax benefit is 17.5%**. Consult with your tax advisor for more specific details about your tax position.

To arrive at your total Return on Equity, we must add the above four types of financial ownership benefit calculation percentages. In our example that total is:

- ***Cash Flow - 2%***
- ***Property Appreciation - 20%***
- ***Debt Reduction - 4%***
- ***Tax Benefits - 17.5%***

Total Return on Equity - 43.5%

The above figures are used purely as examples to calculate and arrive at a presentation of total Return on Equity. The total Return on Equity percentage can vary by a wide range due to a host of local, general or your own economic factors that may affect each of the individual benefit percentages. Generally speaking, a 20% or greater total Return on Equity is acceptable but there may be local, general or your own economic factors, which might make a less than 20% return acceptable.