chapter 22 Real Estate Principles

terms to know:

real property
personal property
fixture
lot and block
metes and bounds
eminent domain
police power
fee simple
encumbrances
easement
lien
multiple listing service
offer
earnest money
deed
proration
time sharing
appreciation
depreciation

objectives:

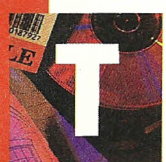
After reading and studying this chapter you will be able to:

22-1 Define real estate terminology, including legal descriptions of property, rights and interests in property, and ownership of property.

22-2 Describe the step-by-step process of buying a home.

22-3 List and explain real estate investment options, including single-family houses, duplexes, multiplexes, apartment buildings, and land.

22-4 Explain the benefits and risks of real estate investments.



The biggest and best investment you will ever make is the purchase of your own home. Owning real estate is a financial goal of many people. Having a place to call your own is a primary motive of many home buyers. While personal preferences and tastes are the foundation of many home buying decisions, financial factors may modify your final choice.

In the previous chapter, you learned some of the advantages and disadvantages of owning your own home. In this chapter, you will continue to study home ownership as you learn about the process of buying your own home. You will then explore real estate investments—the purchasing and holding of rental properties as short-term and long-term investments, including houses, duplexes, multiplexes, apartment buildings, land, REITs, and other choices. You will also discover the many rewards and risks involved in home ownership and real estate investments.

Real estate ownership

Real property is land and anything permanently attached to it, such as buildings, fences, and sidewalks. Real property within a county and state is a matter of public record. By visiting your county courthouse, you can select a piece of property and find out where it is located, who owns it, its legal description, and other public information. **Personal property** refers to items that are not permanently attached to real property but are removed when the property is sold, such as cars, lawn mowers, and furniture. When an item of personal property is permanently affixed to real property, it is called a **fixture.** A fixture becomes a part of real property when removing it would cause substantial damage to the building or land. For example, if you attach a bookshelf to the wall of a room using fourteen molly bolts, the removal of the bookshelf would do considerable harm to the wall. Therefore, the bookshelf is considered a permanent feature, or fixture, of the home.

Legal Descriptions

Land is measured by federal and state governments using base lines and prime meridians. From the intersection of these points, surveys are made into townships, square miles, or sections. Local areas are also divided into townships, sections, and acres, then into subdivisions and lots for resale to individual buyers. There are five common ways to describe real property: informal reference, lot and block, metes and bounds, government survey, and assessor parcel number.

Informal Reference

A street address is one way to describe land with a building on it. For example, a property could be described informally as, “the house at 235 Sycamore Street, Dallas Texas,” or “the ranch known as the Lazy M Ranch located 15 miles south of Alturas, California.”

Lot and Block

Using the **lot and block** method of describing real estate, a house located at 1400 Elm Street would be identified as follows:

> Lot 3, Block 6, of the Sunshine Addition to the City of Portland, Multnomah County, Oregon.

This description identifies the property by its lot number and block number within a subdivision. Both the lot number and the block number of individual pieces of real property are shown on a map of subdivisions on file in the county recorder's office called the *recorded plat*.

Metes and Bounds

Another type of legal description is **metes and bounds,** which is a detailed method of identifying a parcel of property by specifying its shape and its boundaries. Such a description would read like this:

> Commencing at the permanent reference mark which designates the Sunshine Addition to the City of Portland, thence north 80 degrees 0 minutes 0 seconds east, 152.0 feet to the point of beginning; thence south 80 degrees 0 minutes 0 seconds east, 180 feet; thence south 15 degrees 0 minutes 0 seconds west, 160 feet; thence south 85 degrees 0 minutes 0 seconds west, 151 feet; thence north 4 degrees 11 minutes 18 seconds east, 199.5 feet back to the point of beginning.

A map based on the foregoing metes (distance) and bounds (direction) would look like Figure 22-1. Metes and bounds are based on benchmarks, which are used as permanent reference marks, and degrees in a circle, which move in a clockwise direction from the point of beginning.

Government Survey

The rectangular survey system was authorized by Congress in May 1785 as a fast and simple method of surveying property. Rather than using existing monuments, it was based on imaginary lines that circle

The rectangular survey system was authorized by Congress in May of 1785.

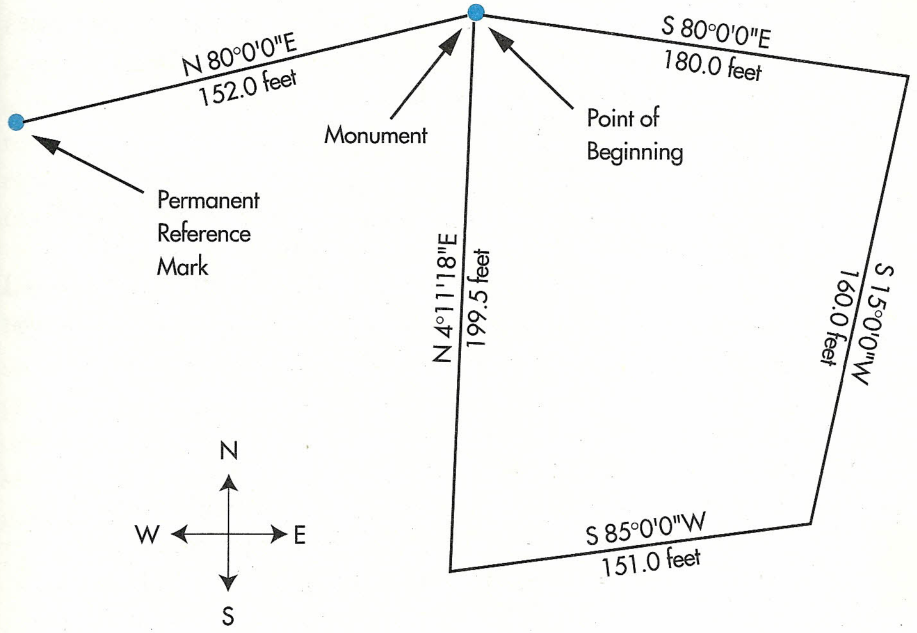


Fig. 22-1

Metes and Bounds Diagram

the earth. These lines are east-west (latitude) and north-south (longitude). Certain longitude lines were selected as prime meridians; for each of these meridians, an intercepting latitude line was selected as the baseline. Every twenty-four miles north and south of a baseline, correction lines were established (because the earth is a sphere rather than a flat surface). Ranges are marked every six miles east and west of prime meridians; townships intersect range lines every six miles north and south. With this type of legal description, a piece of property would be described as follows:

> The northwest quarter of the southwest quarter of Section 32, Township 2 North, Range 3 East of the Sixth Prime Meridian.

Assessor's Parcel Numbers

In most counties, the tax assessor assigns a parcel number to each parcel of land in the county. A parcel could be assigned a number like 15-8-44, which would mean Book 15, page 8, Parcel 44.

Rights of Government

Owners of real estate are free to do whatever they please with the property they possess, subject to several government-imposed restraints. As an owner of real property, you have the right to build or tear down your building within the government's building codes. Some of these rights are limited by law and by building codes, or by zoning laws of cities and/or counties. *Zoning laws* restrict how property in an area can be used. These laws are imposed to control lands and subdivisions to assure the highest and best use of the lands.

Property Taxes

Government has the right to impose taxes on real property. Property taxes are called *ad valorem* (imposed at a rate percent of value) taxes because they are based on value. Real estate taxes are an important source of money for cities, counties, and states. In many states, schools, fire and police, parks, and libraries also depend on property taxes to operate.

Eminent Domain

The right of the government to take away privately held real property regardless of the owner's wishes is called **eminent domain**. Land is usually taken for the public good for such things as schools, freeways, streets, parks, urban renewal, garbage disposal site, or public parking. The legal proceeding is called *condemnation;* the property owner must be paid the fair market value of the property taken.

Police Power

The right of the government to enact laws and enforce them for the public health, safety, morals and general welfare is called **police power.** Examples of police power include zoning laws, building codes, health and fire regulations, and rent control. Police power does not take away property (like eminent domain), but it does restrict how an owner may use the property.

Rights of Owners

Real estate ownership is a right in the United States. Each citizen has the power to own real property. If you own property, you have the right to determine its use and its management; therefore, you are called the *owner*. Ownership is a bundle of rights. If you own all the rights to property, you own it in **fee simple.** After the rights of government are held in reserve (property taxes, eminent domain, and police power), the remaining fee simple interest can be held by a person and his or her heirs forever.

Limitations of property rights are called **encumbrances** and are grouped into public rights such as the right to tax, the right to acquire property (eminent domain), and police power for the general welfare. Private rights are incidental to ownership. Easements and liens are examples of private rights.

Easements

An **easement** is the right or privilege one party has to use the land of another person for some special purpose. For example, an easement for telephone or electricity enables the telephone or power company to erect poles or bury cables on and across the property. Easements also may be given for people to walk or drive across the land.

Liens

Because of the permanence (immovability) of real estate, it is good security for a loan, debt, or judgment. A **lien** is a hold or claim that one person has on the property of another person to secure payment of a debt. In addition to property tax liens (by government), there are several other types of liens placed against real property, such as mortgage liens, judgment liens, and mechanic's liens.

1. A *mortgage lien* is a pledge of property by its owner to secure repayment of a debt. In contrast to a property tax lien imposed by law, a mortgage lien is created by the property owner. If the mortgage is not repaid, the creditor can foreclose and sell the pledged property.
2. A *judgment lien* arises from a lawsuit for which money damages are awarded by the judge or jury. The law permits a hold against property of the debtor until the judgment is paid. The judgment remains attached to the property until the debt is paid, and the creditor can force the sale of the property to pay the debt.
3. A *mechanic's lien* gives anyone who has furnished labor or materials for the improvement of property the right to place a lien against that property; a sale of the property can be forced to recover the money owed. To be entitled to a mechanic's lien, the work or materials must have been provided under a contract with the property owner. The legal theory behind mechanic's lien rights is that labor and materials enhance the value of the property, and the property should be security for payment. The mechanic's lien must be filed within a set period of time (60 to 120 days after work completion) and expires in a year or two (depending on state law). Unfortunately, if the property owner pays the contractor, but the contractor fails to pay a subcontractor for labor or materials, the mechanic's lien can force double payment by the owner.

When a person owns a property "free and clear," it does not mean that the property has no other interests against it. Public rights always remain; easements and other private rights may also apply. Free and clear means that no mortgages or other types of liens are placed against the property. When a debt is secured by a *mortgage*, the borrower signs a document that gives the lender a lien on the property.

The process of buying a home

In buying real estate either for a residence or for investment, you should consider the location, accessibility, climate, nearness to employment, type and quality of construction, cost and effort of maintenance, and numerous other factors. If you are uncertain or inexperienced as to how to go about gathering and assessing such facts, you can always obtain information and advice from a real estate agent. Banks, savings and loan companies, builders, and appraisers are also good sources of real estate information.

After you carefully consider all the factors involved in a real estate purchase, you can begin the process of purchasing real property. This process can take many weeks or even months. Generally, the procedure can be summarized as in the following paragraphs.

A real estate salesperson can be helpful to you in your search for the right home.

Finding and Selecting Property

In order to find the property you want to buy, you will need to see many houses. You can look by yourself or work with a real estate salesperson, who is trained to know the market, help you find the right home, and assist you with the purchase, financing, and closing. There is no charge to you, the purchaser, for these services. Either way, you will visit many homes listed with the real estate agency, advertised for sale in the newspaper, or that you just drive past and want to see. In the newspaper classified ads, homes are listed by area of town or geographic location. Some are for sale by the owner; others are listed with real estate agencies.

Real estate agencies that belong to a **multiple listing service** offer a valuable service to homeowners: wide exposure to people in the business of selling homes. Most metropolitan, urban, and suburban areas have many real estate sales offices located within their boundaries. When these real estate agencies form the multiple listing service organization, all listings from each office are combined into one book. All salespeople within that geographic area have access to all real estate listings and can sell any of the properties listed to a buyer. Thus, when you list your house for sale with one real estate salesperson, you really have all the salespeople in the area working for you. The person who lists your house receives half of the sales commission; the person who sells your house receives the other half. The cost to you is the same, yet your exposure to the sales market is much greater.

A multiple listing service gives persons seeking to buy a home in a specific area greater exposure to available homes. They can see many listings in all parts of the city. The cost to the buyer is the same; real estate commissions are included in the sale price of a home. Most multiple listing books come out twice a month. Homes are listed according to location and value. The less expensive homes are listed first in each section.

After you have viewed many homes in the area you prefer, you may decide you want to buy one of them. Before you can take possession of the property, however, you must complete the formal buying process, which may take several weeks or months.

Making an Offer

To let the seller (owner) know you want to buy his or her home, you sign an agreement called an **offer.** This formal document explains the terms of the purchase—the down payment; the mortgage you will assume or acquire on your own; and the dates when you will pay what is due, close the deal, and take possession. This agreement is also known as an "earnest money offer." **Earnest money** is a portion of the purchase price that the buyer deposits as evidence of good faith to show that the purchase offer is serious. This money is held in a trust account until the transaction is closed.

If you fail to meet the terms of the agreement, you will have damaged the seller. The house may have been held off the market for awhile and therefore could not be sold to anyone else. You may forfeit your earnest money to the seller if you do not buy the home according to the terms of the agreement. One way to avoid losing your money is to make your offer contingent on obtaining financing and the property passing an inspection.

When the seller accepts your offer exactly as it is stated, you have what is called an *acceptance*. You may withdraw your offer at any time until the seller accepts it. If any conditions of the offer are changed, the seller makes what is known as a *counteroffer*. You have the choice of accepting or rejecting the counteroffer. For example, the seller may want a different date of possession or a larger cash down payment.

Obtaining Financing

After you have come to an agreement with the seller, you will probably borrow to buy the property. To finance your property purchase, you will need to obtain funds for a down payment, meet certain requirements of your lending institution, and assess different types of mortgages.

Down Payment Sources

The most common source of down payment money is from parents or relatives. Most lending institutions will not allow mortgage applicants to also borrow their down payment. In other words, there cannot be another lien against the property other than the mortgage at the time the sale is closed. Because the down payment can be $5,000 to $10,000 or more, many first-time home buyers have difficulty saving the money and must "borrow" it from parents.

Qualifying for a Mortgage

To qualify for a mortgage loan, borrowers must complete extensive loan applications. Credit history will be checked, along with banking and other references. The borrower must prove to the lender that he, she, or they are capable of meeting the monthly payment. Lenders will look for evidence that the borrower is able to meet current bills, type and amount of debt already incurred, amount and source of income, and the borrower's creditworthiness. Generally, lenders will expect that the monthly mortgage payment will not exceed 30 percent of the borrower's take-home pay. The purpose of loan qualifying is to assure the lender that the borrower can and will meet the debt obligation.

Types of Mortgages

There are two basic types of mortgages: *fixed-rate mortgages* and *adjustable-rate mortgages* (ARMs). With a fixed-rate mortgage, the interest rate is set and does not change during the term of the mortgage, which is usually fifteen to thirty years. With an adjustable-rate mortgage, the interest rate is usually lower than the fixed rate to begin with, but the interest rate changes as economic conditions vary. For example, a fixed rate of 8 percent would remain unchanged for thirty years. An adjustable rate of 5 percent may escalate to 10 or 12 percent as interest rates go up in the economy. Most adjustable-rate mortgages specify maximum rate increases (such as 2 or 3 percent a year) and ceilings (such as a top of 12 percent) to which the interest rate can rise.

Taking Title to Property

After both parties have reached an agreement, and financing has been obtained, title to the property must be transferred. A title simply means the right to ownership of property. The **deed** is the document that transfers title of real property from one party to another. The form of ownership of property should be reviewed and proper advice sought before deciding upon taking title to property under a deed. The following are different ways of taking title to property: joint tenancy, tenants in common, partnership, and corporate.

The two basic types of mortgages are fixed rate and adjustable rate.

Typical property buying transactions involve a number of procedures that can limit the buyer's chances of getting a defective title. A buyer should order a *title search*, which lists all the facts about the property being purchased: name(s) of owner(s), liens against the property, easements and assessments (such as sidewalk or street lighting), property taxes, and so forth. A *title insurance company* will issue a preliminary title report (and eventually the title insurance policy). This report gives the buyer detailed information about the property: mortgages and other liens, the owners, legal descriptions, map, and any restrictions on the property. Title insurance provides the buyer with insurance for any claims arising from a defective title. Most lenders require that the borrower buy title insurance.

As part of the closing process, loan papers are ordered from lending institutions, and all necessary papers are prepared. If any problems arise, the buyer and seller are notified. For example, some deeds may carry restrictions that limit the kind of building that can be erected and the use of the property. Inspections, such as termite examinations, are carried out. A credit report is issued. Proper prorations are computed, and the closing documents are prepared. A **proration** is a divided cost or expense. For example, if property taxes are paid for a year at a time, and the buyer takes possession half way through the year, the buyer's "proration" is one-half of the prepaid taxes. In other words, the buyer must reimburse the seller for half of the taxes that were prepaid.

When all these procedures are completed, the seller and buyer are notified of a closing date. The *closing* involves a meeting of the buyer, seller, and lender of funds, or representatives of each party, to complete the transaction. In some parts of the country, the closing is known as settlement, or close of escrow. First the buyer, then the seller, signs the necessary documents. A hodgepodge of local customs dictates how a closing is handled. Your local real estate agent, lender, or attorney can brief you on the procedures in your area. At closing, the buyer takes possession of the property. On closing day, the buyer will pay a variety of fees and charges. The *closing costs*, also referred to as settlement costs, are paid when a real estate transaction is completed. Figure 22-2 is a list of typical closing costs for a real estate transaction.

Real estate investments

Real estate is a very popular investment for many Americans as you learned in Chapter 14. After making substantial investments in real estate, a person may quit his or her job to work full time managing

Fig. 22-2

Typical Closing Costs

TYPICAL REAL ESTATE CLOSING COSTS

Type of Cost	Typical Amount	Who Pays
Credit report (on buyer)	$50	Buyer
Property appraisal fee	$150-$500	Buyer
Pest and damage inspection	$50	Buyer
Mortgage loan origination fee	varies	Buyer
Mortgage loan assumption fee	varies	Buyer
Document preparation (deeds, closing costs, etc.)	$50-$100	Buyer and Seller
Notary fees and filing fees	$10-$50	Buyer and Seller
Title search; title insurance	$100-$750	Seller
Survey	$150-$500	Seller
Attorney's fees	$500-$1,000	Buyer and Seller
Escrow fees	$50-$500	Buyer and Seller
Escrow payments	varies	Buyer and Seller
Transfer taxes and fees	varies	Seller

investment properties. Most people begin with an initial purchase of a single-family house or small apartment building. Then they may purchase an inexpensive run-down property (but in a good neighborhood), make a low down payment, and refurbish the property. After it is refurbished, this property may be sold (to obtain more cash for subsequent purchases), or it can be rented to bring in monthly income to pay off the underlying mortgage.

The excess of rental income over underlying mortgage payment plus repair and maintenance expenses is *positive cash flow.* If the owner of real estate does not receive enough money from rent to pay the underlying mortgage and other expenses, the result is *negative cash flow.*

Figure 22-3 is a cash flow statement prepared for the owner of a triplex. Examine this statement carefully.

You may notice no entry for cleaning deposits or for last month's rent. These payments by tenants are probably being held in trust on their behalf. Since deposits and last month's rent are not earned income to the landlord, the amounts are not listed as revenue. These deposits will show as income when used by the landlord to pay for cleaning or to cover the last month's rent. A cleaning deposit is used to offset the expense involved in cleaning rental property after a tenant vacates the premises. Property owners cannot keep monies deposited with them unless there is damage or cleaning expenses incurred.

Another factor to consider that affects cash flow is *vacancy.* When a rental unit is not being rented, no income is received to offset the

Fig. 22-3

Cash Flow Statement

CASH FLOW STATEMENT
For Property at 875 Sycamore Street
For the Year Ended December 31, 19--

Rental Income Received:			
Unit 1	($800/month x 12 months)		$ 9,600
Unit 2	($700/month x 11 months)		7,700
Unit 3	($500/month x 5 months and		2,500
	$550/month x 6 months)		3,300
Total Income			$23,100
Expenses:			
Unit 1	New bathroom heater	$350	
	New paint	175	
	Repair screen door	75	
	Repair stove	50	$ 650
Unit 2	Repair leaking roof	$400	
	Repair bathtub	250	
	Replace locks	75	725
Unit 3	Repair counter	$300	
	Clean carpet	100	
	New paint	175	
	Replace wiring	300	875
Mortgage payment, First Bank ($1,100 x 12)			13,320
Property taxes			2,850
*Property management fee (10%)			2,310
Total Expenses			$20,730
Net Cash Flow (income minus expenses)			$ 2,370

*Note: The management fee is 10% of rental income.

mortgage payment and other expenses. Vacancies occur from time to time as tenants come and go. If a long time is taken to get a unit rerented, the owner may experience a negative cash flow as a result.

Single-Family Houses

A small house is often the best way to get started as an investor. In determining which property to buy, the most important factor to consider is the future resale value. Location is the key to good resale value. More popular and well-maintained neighborhoods always hold value.

Houses on quiet streets, next to more expensive properties, and consistent with other houses in the neighborhood will best hold their value. Most experts advise you to buy the smallest or least expensive house in the neighborhood. In this way, the higher-valued homes around you will bring up the value of your property.

Duplexes and Multiplexes

A *duplex*, or building with two living units, is usually located in a residential neighborhood, often at a corner location. A *triplex* or *quad* is also likely to be tucked within a neighborhood setting. These types of units are rented to families and others who are attracted to a residential neighborhood, or a less traveled street. Duplexes and multiplexes generally do not rent for as much money as single-family houses, but offer many of the same advantages.

Apartment Buildings

To invest in an apartment building, you may need to form a partnership or joint venture with several other investors in order to have enough cash to make the down payment. For example, you may pool your resources with three others, each contributing $100,000. You might assume an underlying or existing mortgage, or you might apply for a new loan. You would have to contribute your share toward the expenses not covered by rental income.

Investors in apartment buildings often form a partnership or joint venture to pool their resources.

Land

Most people who buy a tract of land assume that the value will increase in the future. Because land is considered speculative, most banks will not grant a mortgage; therefore, you must purchase land for cash. Nevertheless, land located in the right location can sell for many times its original value if property values are rising. For example, a vacant lot purchased 20 years ago for $15,000 could be worth several hundred thousand dollars today if it were in a commercial (business) area.

REITs

For those who do not want to invest directly in real estate, that is, who do not want to purchase and own specific property, there is an option called REIT (Real Estate Investment Trust). REITs were explained on pages 326–327 of Chapter 14.

A Real Estate Investment Trust trades like a stock and works like a mutual fund. Your investment is pooled with other people's money, and the trust invests the money in real estate. For many people, REITs are attractive because the trust makes the investment decisions, shares are easily traded, and the current yields are fairly high. Share prices of REITs fluctuate in response to economic conditions, the size of the dividend paid by the trust, and the changes in real estate values. Long-term gains depend on the underlying values of the real properties held by the trust and the quality of the trust's management. You will find REITs listed in the funds section of *The Wall Street Journal*.

Other Choices

Other real estate investment choices include condominiums, cooperatives, PUDs, and time shares. These choices are often considered quite risky. Owners may have trouble reselling these kinds of property without careful planning and considerable luck.

Condominiums

A condominium owner has partial responsibility for land and building maintenance and management as well as some other ownership costs. In addition to the mortgage, the owner must pay a monthly or yearly fee to cover these costs. Often, existing apartment complexes are converted to condominiums. (Condominiums were also discussed in Chapters 14 and 21.)

Cooperatives

A cooperative is similar to a condominium. You would sign a *proprietary lease*, which is an owner's agreement to meet the conditions of the owners' association. A proprietary lease entitles you to own an apartment in a building with numerous other similar units, subject to rules established for the benefit of all owners. But rather than have your own mortgage for a unit within the building, as is the case with a condominium, there is one big mortgage on the entire building. A group of people called *cooperators* go in together and contribute equal shares to make the large mortgage payment. For example, a cooperative building may contain ten apartments. The underlying mortgage of $500,000 may involve a monthly payment of $5,000. Each cooperative owner would have to pay 1/10, or $500 per month for the mortgage payment. In addition, each owner would pay a share of the utilities bill, the property taxes, the insurance, and so on. Like condominiums, cooperatives are organized under a management agreement. A monthly fee is charged for maintaining the building and grounds.

PUDs

A PUD is a planned unit development. PUDs have features common to both condominium and cooperative ownership. You buy a house and the lot as separate property. You also must pay a monthly fee to a community association that owns the common areas. Common areas are open green spaces and may include parks, pools, clubhouse facilities, jogging trails, boat docks, and so on. These areas are not maintained by the city; the owners all contribute to the maintenance.

Time-shares

Time-sharing is a method of selling living units within a vacation facility to many owners. Each owner has a fractional ownership interest in a unit. Units are typically sold for one week a year. However, a buyer can usually purchase an additional week (or weeks) if he or she so desires.

The idea began in Europe in the 1960s when groups of individuals would jointly purchase units at ski resort lodges and summer vacation villas. Each owner would take a week or two of vacation each year. In 1969, the first time-share opened in the United States. Since then, hotels, motels, condominiums, townhouses, lodges, villas, recreational vehicle parks, campgrounds, and even cruise ships have been time-shared.

For a purchase price ($5,000 to $15,000), you get the right to vacation at a location (from Hawaii to Mexico to the Caribbean) for one or more weeks a year. When you own a time-share, the dates you can stay at the vacation location are guaranteed each year. You must pay a monthly or yearly fee to help cover the maintenance costs of the property. When the owners are not vacationing, their units are often rented to the public.

Generally, time-shares are good for only a set number of years: 10, 20, 25, or 40. At the end of that time, your interest expires. During the term of the time-share you can sell your interest, but finding buyers can be difficult. You may not get back your original investment or make a profit. Nevertheless, this type of vacation alternative is attractive to some people, such as ski enthusiasts who like to spend two weeks every year at a certain ski lodge.

The financial benefits of real estate

A potential benefit is increases in the value of property. **Appreciation** is the increase in property value while a person owns the property. For example, if you buy a piece of real estate for $50,000 and a year later it can be sold for $60,000, the appreciation is $10,000. Appreciation is not taxable until property is sold, and the cash is actually received.

As an owner of real estate, you can deduct from your adjusted gross income on your tax return the property taxes you pay to the local government. You can also deduct the interest you pay on a mortgage loan. Real estate is a *tax shelter* because the owner is able to take advantage of these income tax deductions.

For the owner of rental property, in addition to normal operating expenses, interest on a mortgage, and property tax payments, you are permitted to deduct a *depreciation allowance* based upon the expected life of the property. **Depreciation** is the using up of property value. Most rental properties are depreciated over twenty-five to thirty years. For example, if an apartment building is purchased for $200,000, with an estimated value of $20,000 on the land (land is not depreciable) and an estimated life of twenty years, the annual depreciation expense (tax write-off) would be $9,000 ($200,000 − 20,000 ÷ 20).

If you use *leverage* (that is, you borrow money to pay for your investment) you can make a healthy return investing only a limited amount of your own money. It enables you to acquire more expensive property than you could buy on your own. This is an advantage when property values are rising. Unfortunately, when you use leverage (other people's money), you can still lose money (your initial investment) if real estate prices go down.

Assume that you buy a $100,000 property with no loan and then sell it for $120,000. The $20,000 gain represents a 20 percent return on your $100,000 investment. Then assume that you invest only $10,000 of your own money and borrow the other $90,000 (90 percent financing). Now you have made $20,000 on your $10,000 investment, or a 200 percent return.

personal perspective

Who Needs a Real Estate Professional to Sell Property?

In order to sell real estate for others, you must have a real estate license in the state in which you do business. Anyone assisting buyers or sellers and receiving any type of fee, such as a commission or a referral fee, must have a license. Real estate law protects prospective buyers and sellers from receiving advice and help from people who do not have the appropriate education and experience to provide assistance.

If you are buying and selling real estate for yourself, you do not need to have a real estate license. Many real estate investors hold a real estate license, even though it is not necessary. However, if you are employing a licensed real estate professional, make sure he or she declares in all purchase offers, listing agreements, newspaper advertisements, and other documents that he or she is a licensed real estate professional.

When selling real estate, contact several agents for a listing presentation in your home or property. What you want to learn from each agent is pertinent information about the agent and the company, the terms of the listing, a price estimate for your property, and the marketing steps the agent will take.

Past performance is a pretty good indicator of future success. Find out how many homes your prospective agent and firm have listed and sold recently and how many times she or he was responsible for finding the buyer.

Reject any agent whose company is not a member of the local Multiple Listing Service. The MLS provides a master list of all the properties for sale in a community through its member real estate companies. MLS is perhaps the only benefit a real estate agent can provide that you couldn't get on your own.

critical thinking

1. Provide a list of questions you might ask an agent before signing a contract to have the agent sell your home.
2. Talk to several real estate professionals (realtors, brokers, loan officers, appraisers), and ask them to explain their responsibilities to buyers and sellers in a real estate transaction.

The risks of owning real estate

There are considerable risks along with potential rewards with real estate ownership. For example, a rental property purchased right before an economy goes into a recession is likely to have a negative cash flow. When people cannot afford to pay a high rent, landlords are forced to lower rents or offer special incentives ("first month's rent free," for example) to attract tenants. On the other hand, when rental housing is scarce and the location is desirable, owners of real estate can raise rents and still keep the property fully occupied.

Real estate wears out. The roof will need replacing every fifteen or so years; pipes break and must be replaced; painting, inside and out, must be done every few years. If renovation does not occur, the property loses real value over the years. Remodeling may be needed to stay competitive and to attract high-quality tenants.

One risk of owning real estate is that it is fairly illiquid.

Unfortunately, real estate is prone to uncontrollable factors as well. If the surrounding neighborhood is changing adversely, the property will lose value. Population shifts into or out of any area can affect rental income. A community depending on servicemen to fill the supply of rental units would be severely hurt by a military base closing, for example.

Real estate offers many opportunities to investors, but real estate is also fairly *illiquid*. Property cannot always be sold quickly; in fact, it may take several months or even longer to sell a rental property. Many people consider real estate a long-term investment—one that builds up equity over the years until the underlying mortgage is paid in full.

Summary

Real estate investing is challenging and fun, but also requires considerable thought and preparation. It isn't as easy as it seems. You can own real property (land and anything permanently attached) and personal property. Real property is described by informal reference, by lot and block, by metes and bounds, by government survey, or by an assessor's map number. The rights of government in real property include property taxes, eminent domain, and police power. Ownership rights are what's left after the above interests.

To buy a home, you first begin the long and careful selection process. Cautiously consider the location and desirability of the property. An offer expresses your interest in purchasing property and includes a deposit of several thousand dollars (earnest money). If you arbitrarily change your mind, you can lose this deposit. Closing is the process of preparing papers and gathering evidence so that the property can be transferred from the current owner to the new owner.

Financing a new home involves a significant down payment ($5,000 or more) that is often borrowed from parents or saved by the borrowers. To qualify for a mortgage, borrowers must have a good credit history, a good source of income, and enough money left over to make a house payment after other debts are paid. Fixed-rate mortgages have a specified set interest rate for the length of the loan. Adjustable-rate mortgages (ARMs) have an interest rate that varies according to economic conditions. While the initial interest rate is usually lower with an ARM, it is likely to increase over the length of the loan.

Real estate is a good way to diversify an investment portfolio. Examples of these investments include single-family homes, duplexes and multiplexes, apartment buildings, land, REITs, and other choices. A real estate investment should be considered a long-term investment.

Benefits of investing include appreciation in value, tax savings, positive cash flow, and leverage. Disadvantages include weak economic conditions, repairs and maintenance, renovations to keep the value of property increasing, and illiquidity.

22

end-of-chapter activities

Vocabulary terms

Directions: Can you find the definition for each of the following terms used in Chapter 22?

appreciation
deed
depreciation
earnest money
easement
eminent domain
encumbrance
fee simple
fixture
lien
lot and block
metes and bounds
multiple listing service
offer
personal property
police power
proration
real property
time sharing

1. The increase in property value while a person owns the property.
2. A property owner's interest in real property after legal limitations, zoning laws, easements, and the like that could interfere with your use of the property.
3. A claim, right, lien, or other liability limiting title to real property.
4. The right of the government to take away privately held real property.
5. An organization that combines real estate listings for a number of real estate offices to facilitate buying and selling.
6. The using up, or wearing away, of real property value.
7. Items that are not permanently attached to real property, such as cars and furniture.
8. An item of personal property that is permanently affixed to real property.
9. A formal, written proposal to buy a home or other piece of real property.
10. A legal description of a parcel of property by its shape and its boundaries.
11. The right of the government to enact laws and enforce them for the public health, safety, morals, and general welfare.
12. Land and anything that is permanently attached.
13. A description of property by its lot number and block number within a subdivision.
14. The right or privilege one person has to use the land of another person for some special purpose.

15. A hold or claim that one person has on the property of another person to secure payment of a debt.
16. A portion of the purchase price that the buyer deposits as evidence of good faith to show that a purchase offer is serious.
17. A document that transfers title of real property from one party to another.
18. Dividing costs or expenses, a process done at closing.
19. A method of selling living units within a vacation facility.

Facts and ideas in review

1. List the five common ways of describing real property.
2. List the three encumbrances described and briefly explain each.
3. Explain these three types of liens: mortgage liens, judgment liens, and mechanic's liens.
4. Summarize the four steps in the process of buying a home.
5. What is a multiple listing service? Can you name this service in your local area? (Hint: Look in the Sunday newspaper in the classified section or an advertisement of realtors belonging to this service.)
6. What is an earnest money offer?
7. What is the purpose of a title search and title insurance?
8. How do most people get started investing in real estate?
9. Distinguish between positive cash flow and negative cash flow.
10. Briefly describe the different investment options for the purchase of real estate.
11. What are the financial benefits that are derived from owning real estate?
12. What are some of the risks associated with owning real estate?

Applications for decision making

1. Make a visit to your county courthouse. In the assessor's office or records division, look up the property where you live. To start, all you need is your street address. Locate and write down your lot and block, metes and bounds, government survey, and assessor's