

Wealth Advisor

Real estate investing: → **Do your homework first**

We commonly hear, "Now is a good time to invest in real estate." The truth is now *may* be a good time to invest in commercial real estate. It may not be.

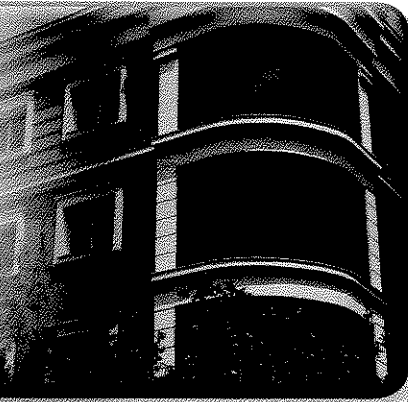
We don't know the future. When you consider investing in commercial real estate, be prepared to do your homework.

Recent trends in real estate

The following specific references and observations are from "The Economic Outlook: A Half-Speed Recovery," an April 2011 Standard & Poor's seminar presentation by Beth Ann Bovino, senior economist:

- ❖ "The recession ended in June 2009."
- ❖ "Housing now appears to be stabilizing."
- ❖ "Private nonresidential construction is still weak but improving."

Positive economic data in one area do not suggest positives for all areas.



- ❖ "The financial system appears to be stabilizing."
- ❖ "The recovery will remain slow and uneven."
- ❖ "Another dip into recession is possible if the financial markets lock up again, oil prices jump higher or consumers remain scared."

These statements suggest cautious optimism – real estate appears to have hit bottom and may be stabilizing.

Areas of concern

When considering an investment in real estate (finished structures/new construction), include the following areas of concern, and address them in your analysis. That analysis, along with a host of other factors, will determine whether the investment meets your needs.

- ❖ **Real estate values generally rise and fall with the availability of capital.** A study of the capital markets, including the availability of long-term debt and the secondary markets for the exchange of debt, is a key to determine the price stability of the investment.

See *Real estate investing* on page 6

Inside

Fall 2011

2

Should the kids help pay for their college education?

3

Caution: Investing in raw materials can be risky

7

Good credit report may mean dealing with the bureaus

Inside

A wealth management bulletin to clients from:



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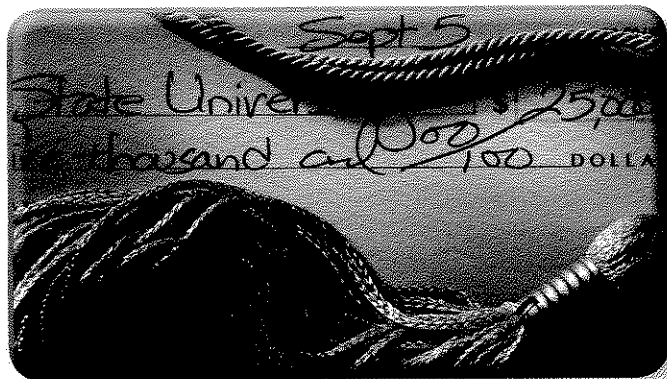
College expenses continue to rise, and paying for college presents challenges for most parents. The costs can be staggering.

Many parents start saving when their children are born, hoping to have enough to defray the cost by the time the children reach college age. Others, and likely most, start thinking about these expenses once the child starts looking at colleges.

For many years, parents have debated whether children should help pay for their college education. While there may not be clear right or wrong answers to this question, both options have points to consider.

Kids helping pay

The old adage of having “skin in the game” applies here. The general thought is that children who are helping to pay for college will be more aware of the costs involved and more likely to take education seriously. They might be more careful about the major and courses they choose rather than dabbling in various topics of interest without choosing a clear path.



Helping pay can also give students a great feeling of responsibility and maturity. After all, they are on the path to independence.

In fact, this point is seen as such a positive that many college graduates list on their resumes the percentage of college expenses they paid. It's a way for them to show potential employers that they are adults and are ready for the challenges of the real world because they have experienced the real world of paying for college.

Another point considers whether the parents have the means to fund the college education. Many parents, even those who have saved, have seen their incomes cut and their investments deteriorate. They may no longer be able to pay for the entire experience. If students want college degrees, they may need to participate financially.

Parents footing the bill

Many people say parents should pay the entire bill for college so that students can focus on studies and do their best with

Should the kids help

pay for their college education?



their academic endeavors. Carrying a full load of college classes is, in some ways, a full-time job in itself.

For every hour of classroom time, students may need to spend one to two hours outside of class. So a 15-hour class load could easily translate into 40 hours of class and study time.

Others note the stress students feel when they have to worry about finances at this point in their lives. They may be too distracted to do their best work, even if they have the time. They may also miss out on college activities, which some say is part of the maturation experience.

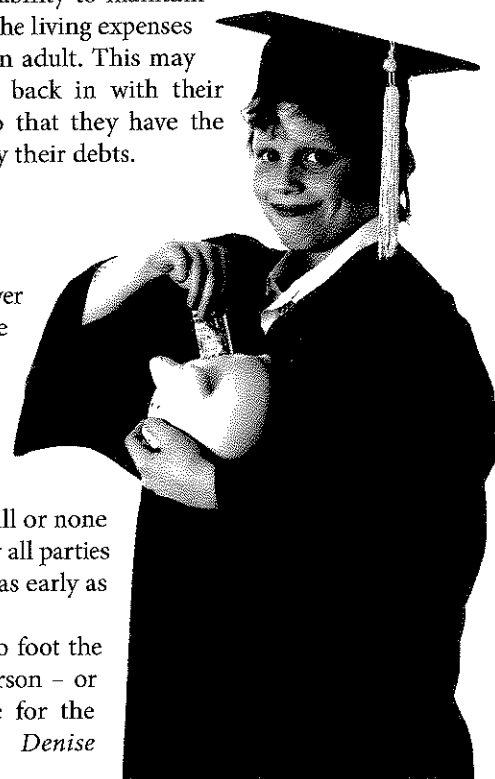
Another consideration is the parents' income and asset levels. Many financial aid applications require this information. Students may not be able to receive substantial aid because the parents are deemed to be in a position to contribute a large percentage of the costs.

Finally, students who pay for their own college experience will likely enter adulthood with a large amount of debt. They will have to pay back thousands of dollars over 15 to 20 years, possibly delaying their ability to maintain their homes and defray the living expenses that are part of being an adult. This may result in their moving back in with their parents after college so that they have the funds necessary to repay their debts.

Optimizing the equation

Perhaps the best answer is available only to those who start thinking about this issue very early in their children's lives. Whether the parents will pay the entire bill, part of the bill or none of the bill, it is helpful for all parties to understand the plan as early as possible.

Someone will have to foot the bill. The earlier that person – or persons – can prepare for the costs, the better. – Denise Altman, CPA



Caution:

Investing in raw materials can be risky

Many investors purchase commodities based on speculation about how prices will change. Prices can go through great swings, and investors can very quickly gain or lose large sums of money in volatile markets.

Commodities are raw materials, such as wheat, oil, precious metals and oranges, that can be bought and sold in bulk. Buying on margin and purchasing futures and options while betting on changes in the market make for great risk and, for some, great profit.

In addition to the possibility of making large profits, commodities are sometimes used as a hedge against inflation. Commodities are not closely coordinated with stocks and bonds. This means that if the market for stocks and bonds is down, investment in commodities may still generate profits.

Is it a good idea for the average investor to get into commodities? Those without the necessary expertise and the disposition and wherewithal to risk significant losses should be cautious about this investment. If you do invest in commodities, many financial advisors recommend that commodities not exceed 5 percent or 10 percent of your portfolio.

From a long-term perspective, investing in commodities may make sense because the demand for energy, food and precious metals from the developing economies, such as China, India and Brazil, is likely to increase over time. According to the International Monetary Fund, the economies of developing nations are expected to grow by 6.4 percent in 2011, compared with 2.2 percent for developed nations.

World population is expected to grow to 9 billion by 2050, which means the demand for food should increase – people have to eat.

However, for any given short period, prices can be affected by events that are not always foreseeable. Political upheaval in oil-producing nations and the drop in Japan's industrial production after the earthquake and tsunami are examples of unforeseeable events that can affect prices for commodities. While the demand for food may be more or less steady, perishable commodities are affected by weather, so there may be an oversupply or undersupply during any given year.

The average investor may not wish to risk significant sums that can be greatly affected by unforeseeable events and volatility driven by speculation about matters such as whether China's

economy will slow down or the "Arab Spring" will endanger oil supplies. The French investment bank Natixis predicts there will be even more volatility and perhaps bubbles in commodities in the near future because of excess liquidity in financial markets.

If you do want to invest in commodities, what are the ways in which you can do it? One way is to invest in futures and options associated with them. You can purchase on margin, which creates leverage that can lead to big profits.

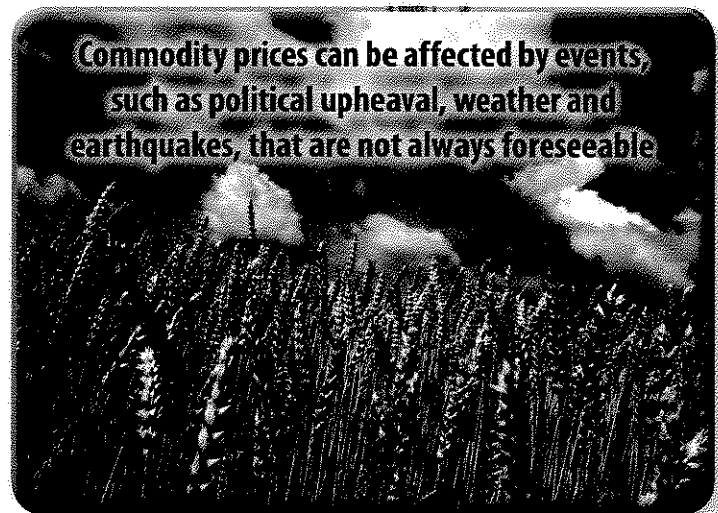
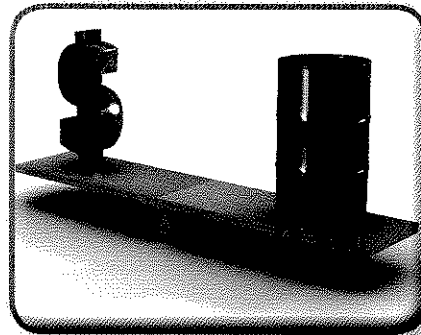
A downside is that leverage can also lead to big losses. If prices drop, you may be subject to margin calls.

The futures market can be very volatile, sometimes changing so fast that you lose your money before you have time to close out your position. The average investor should be cautious about getting involved in futures without expert knowledge or advice.

Investing in companies associated with commodities is another way to invest in commodities. Stock prices tend to be less volatile than the futures market.

However, these are not direct bets on commodities, and an individual company's share price may be affected by company-specific factors rather than just commodity prices. An investor should do appropriate research and get advice if considering investing in particular commodities-related companies.

Exchange-traded funds (ETFs) and exchange-traded notes (ETNs) are also ways to invest. Not all commodities have ETFs or ETNs. Commodity ETFs usually are tied to the price of commodities or a group of commodities that comprise an index. ETNs are unsecured debt that mimics the fluctuations in commodity prices and carries with it the credit risk of the issuer.



Commodities, as a small part of a balanced portfolio, may be a good idea. However, the average investor should proceed with caution. – Mike Wilson, J.D.

Real Estate Investments

Real estate investing

answers change almost daily

Ask any 100 financial experts whether now is the right time to buy an investment property, and you'll get a hundred different answers, ranging from "Heck, yeah!" to "Are you insane?"

The truth is, there is no right or wrong answer that will fit every situation in every market. That said, there are some indicators favoring the "Heck, yeah!" camp in the current market:

Housing prices have fallen. No one can dispute the decline in the housing market. All geographic areas have been impacted. In some markets (notably Southern California and Florida), housing prices are down by 30 percent to 40 percent from their peaks of 2006 and 2007.

But, say the "Are you insane?" camp, this may not be the bottom. Waiting a year or two may save another 5 percent or so.

But whether prices have fallen as low as they will go may not be the question – provided your intent is to hold onto your property long enough to see a housing recovery. The question may be, "At what interest rate will you be borrowing?"

Interest rates are down. Interest rates are hovering near the 5 percent mark for investment properties, with a required 20 to 25 percent down depending on the number of units (for two- to four-unit properties, the down payment is 25 percent; single-family homes, 20 percent).

No one expects interest rates to remain this low for long. So, the trade-off between a potential further housing decline and the more likely scenario of an interest rate uptick looks like this:

Assumptions:

- ❖ Current market value/sales price: \$300,000
- ❖ Current 30-year fixed investor interest rate: 5.25 percent (approximately 0.75 percent more than the prevailing owner-occupied rate)
- ❖ 20 percent down
- ❖ Holding period: Five years

Scenario 1: Investor buys a \$300,000 home at current market value, holds it and rents it for five years:

- ❖ 5.25% interest rate on loan
- ❖ \$300,000 sales price
- ❖ 20% down (financing \$240,000)
- ❖ \$1,325.29 monthly payment
- ❖ Total payments over 5 years ($60 \times \$1,325.29$) = \$79,517
- ❖ Carrying costs of \$79,517 = down payment of \$60,000 = \$139,517 investment

Scenario 2: Investor waits one year, house price declines 5 percent to \$285,000, and interest rates rise 2 percent:

- ❖ 7.25% interest rate
- ❖ \$285,000 sales price
- ❖ 20% down; (financing \$228,000)
- ❖ \$1,555.36 monthly payment
- ❖ Total payments over 5 years ($60 \times \$1,555.36$) = \$93,321.60
- ❖ Carrying costs of \$93,321.60 + down payment of \$57,000 = \$150,321.60 investment

So, if the market declined another 5 percent in value, but interest rates rose 2 percent, the investor who waited would be \$10,804.60 behind the investor who bought at a higher sales price but lower interest rate.

These are what-if scenarios, but most experts believe we are at – or even below – the bottom (some areas such as pockets of Southern California saw a 3 percent to 4 percent increase from last year, for instance). And most economists predict rising interest rates.

Rental rates are up. In both scenarios, the investors would hope for renters to carry their monthly mortgage payment, and chances are good they would find them. Nationwide, rental vacancies are low, hovering at around 9.7 percent, a decrease of 1 percent, according to the latest statistics by the U.S. Census Bureau.

Therefore, rental rates are up. Some areas, such as the South, still report relatively high rental vacancies (12 percent), but other areas, such as the Northeast and West, saw vacancies of only 7 percent. New York, Washington D.C., Boston and other metropolitan areas are seeing rental rate increases resulting from increased demand.

Given this financial trifecta – lower housing rates, lower interest rates and increased

Given this financial trifecta – lower housing rates, lower interest rates and increased rental rates, this is potentially a very good market in which to purchase an investment property.



See *Real estate answers* on page 5

The Debate Continues

How to **break even** → on rental property

With rental properties, unlike many investments, breaking even on a monthly basis is the immediate goal. As long as rental income covers outgo, most investors in these properties are happy.

Rental properties are long-term investments, and current income is rarely the goal. Instead, the goal is to find a renter – or renters, depending on the property – who will cover carrying costs while the investor takes advantage of tax breaks, write-offs and appreciation. Then, as mortgage rates stay steady and rental income increases, the investor will realize a positive cash flow.

But first things first. If a property doesn't break even from the start, you will have to cover the difference between rental income and carrying costs. The breakeven point means that the market rental rate covers the mortgage, interest and taxes, plus a 10 percent buffer for vacancies, repairs, maintenance and utility costs. You should verify that this will be a sufficient buffer for any given property.

To maximize the potential to break even, and to minimize vacancy rates, make certain you know market rates, vacancy rates and market demand in your area.

For instance, if most of your tenants will commute to work, is the property close to public transit? If it's a family

home, is it in a good school district? Then purchase the property at a price that will allow you to rent at or just below prevailing market rates.

One way to determine the breakeven price for a given property is the Duct Tape Formula, so named because it patches together several figures to come up with a workable number:

1. Take the prevailing monthly rental rate for the type of property you're considering (for example, \$1,500).
2. Take the current interest rate (for example, 5.25%).
3. Add a factor of one ($5.25 + 1 = 6.25$), and put two zeros in front of this number (.00625).
4. Divide the number into the prevailing rental rate ($\$1,500 / .00625 = \$240,000$).

Therefore, an investment property with a \$240,000 sales price should provide a breakeven situation.

Let's try it on a fictional property with a sales price of \$240,000. If you put 20 percent down, you are left with \$192,000 to finance:

\$192,000 at 5.25% =

\$1,060 + \$300 for taxes and insurance (Check local rates.) =

\$1,360 + 10% vacancy/repair buffer = \$1,490

Therefore, there would be a slight positive cash flow (\$10) for this property if rented at \$1,500.

Note: This formula relies on 20 percent down and works for owner-managed properties only. If you put more money down, you can break even on a higher-priced property. If you don't manage the property yourself, you will want to add 10 to 20 percent to your carrying costs for property management fees. – *Yvonne Aileen*

Real estate answers *continued from page 4*

rental rates, this is potentially a very good market in which to purchase an investment property. But before you call your Realtor, determine how your market area stacks up to nationwide figures.

If you believe housing prices in your area are at or near the bottom, decide on your investment goals:

- ❖ Equity growth or cash flow?
- ❖ How long do you plan to hold the property?
- ❖ Single-family home or apartment units?
- ❖ How does real estate compare to other forms of investment?
- ❖ Can you swing the down payment?
- ❖ Given an unplanned vacancy, could you carry the mortgage for up to six months?

- ❖ Will you manage the property yourself or hire a management company (10 percent to 20 percent in fees)?
- ❖ What are the tax implications of owning and selling in the time frame you have in mind?

If you are considering the purchase of an investment property, you'll want to answer these questions sooner rather than later because the window of opportunity may be closing.

Zillow, a real estate website, reported that the nationwide housing market is showing signs of leveling off. March/April 2011 figures show a 0.77 percent decline compared with a decline of 0.89 percent in November/December 2010.

And while that's still a decline, it may be a sign that the bottom – and the investment opportunity – is here. – *Yvonne Aileen*

Real estate investing *continued from page 1*

- ❖ **The economic recovery is described as uneven.** Real estate generally does not move. Positive economic data in one area do not suggest positives for all areas. Study the local demographics and economic conditions of the property. Take into account matters such as concentration vs. diversity.
- ❖ **Occupying part of the building might be wise.** Lenders generally consider owner-occupied properties a lower risk than tenant-occupied properties. When you think about it, the lender is partly underwriting the credit-worthiness of the tenant as well as the owner in a fully tenant-occupied building.

Understand the various real estate segments, including the current outlook for the segment of the investment under consideration. Many properties may “mix” segments or types.

There are several broad categories, as well as a diversity of investment vehicles that bundle investment types, spreading risk over several segments and geographic areas, according to Standard and Poor’s April 2011 Seminar, “CMBS Performance” by Gary Carrington, senior director and analytical manager – U.S. CMBS Surveillance.

Here are current outlook statements for some segments:

- ❖ **Office** – “Continued stress”; “Unemployment continues to affect vacancy rates, although rents are exhibiting some signs of improvement in certain sectors.”
- ❖ **Retail** – “While we expect continued macroeconomic stress, retail properties will benefit from growing disposable income and improving consumer sentiment over the long term.”
- ❖ **Multifamily** – “We believe multifamily demand is increasing due to rising household formations and a conscious decision to rent versus buy, reflecting ongoing concerns about the housing sector.”
- ❖ **Lodging** – “Performance in certain lodging sectors showed signs of recovery in 2010, and we expect further improvements in performance metrics going forward.”
- ❖ **Industrial** – “Recent economic data, including the resurgence in U.S. manufacturing, suggest improving conditions for industrial properties.”
- ❖ **REIT** – real estate investment trust – A REIT is an investment vehicle that generally invests in income-producing real property or finances real estate. It is required to distribute 90 percent of its income as dividends to investors. This investment can provide diversity with limited investment capital.

The right team of professionals

Make sure your professional advisors communicate. Do not focus solely on cost. Real estate failures often come at a high price.

You may need:

- ❖ **Real estate professionals** to assist in locating the real estate, including raw (properly zoned) land that makes sense for your business or investments
- ❖ **CPAs or other consultants well-versed in commercial real estate** to assist in the evaluation of the purchase or investment, including tax considerations

- ❖ **Architect and general contractor** if new construction is the best choice for you or your business
 - ❖ **Bankers or other lenders** to assist in financing the investment
 - ❖ **Insurance agents with experience in commercial real estate** to assist you in protecting the investment
- A great team of advisors is a key factor of success.

Business plan

A good last step in the decision-making process is to document the findings and insights of the prior work in the form of a business plan that includes an exit strategy, budget and cash flow.

A business plan for real estate investments should contain at least the following sections:

- ❖ Table of contents
- ❖ Executive summary (including an exit strategy)
- ❖ Investment/business description and vision
- ❖ Definition of the market
- ❖ Description of the real estate or investment portfolio
- ❖ Organization and management of the ownership or management group
- ❖ Marketing strategy, if applicable
- ❖ Financial management
- ❖ Appendices:
 - ◆ Budget – one-year minimum
 - ◆ Cash flow projection – one-year minimum

Your CPA or real estate consultant can assist in these areas. The Small Business Administration has an online tool to aid in the writing of a business plan, including helpful definitions of the segments. A business plan provides the structure to think about and present the findings of the analysis. It should be a cogent and compelling story.

Have your business advisors and even lenders proof the business plan. Welcome their comments. The more input, the better.

It is impossible to protect against all risks. However, you can execute the basic steps outlined here. While not a guarantee of success, following the process can weed out many failures.

Take advantage of prudent real estate investment opportunities. Evaluate each real estate investment opportunity in a well-scripted and well-executed process.

Choose your professional advisors well because you will require their expertise to evaluate many variables, such as soil conditions, EPA considerations, financing alternatives, obsolescence, repairs now and in the future, etc.

Produce a well-defined summation – business plan, budget and cash flow – that communicates the value of the investment as well as accumulates some of the items needed for financing.

Here are some helpful resources:

- ❖ <http://web.sba.gov/busplantemplate/BizPlanStart.cfm>
- ❖ www.standardandpoors.com/home/en/us

You can also look up local demographic data on the county website of the property’s location. – *Joe Harper, CPA*

Optional standard mileage rates have increased

On July 1, 2011, the optional standard mileage allowance for owned or leased automobiles increased from 51 cents to 55.5 cents per mile for business travel.

The new rate should better reflect the real cost of operating an auto as a result of higher gas prices. "Auto" for this purpose includes owned or leased vans, pickups and panel trucks, as well as cars.

In addition, employers can use the rate to provide tax-free reimbursements under an accountable plan to employees who supply their own autos for business use. The rate can also be used to value the personal use of certain low-cost, employer-provided vehicles.

The rate for using a car to obtain medical care or in connection with a move that qualifies for the moving expense deduction will increase from 19 cents to 23.5 cents per mile.

The IRS made these special adjustments for the final months of 2011. It normally updates the mileage rates once a year in the fall for the next calendar year.

"We are taking this step so the reimbursement rate will be fair to taxpayers," said IRS Commissioner Doug Shulman.

The mileage rate that applies to the deduction for charitable contributions did not increase and is set under the Internal Revenue Code at 14 cents per mile.

More information is available in IRS Information Release 2011-69 and Announcement 2011-40.



Wealth Advisor

The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation. Please be advised that, based on current IRS rules and standards, the information contained herein is not intended to be used, nor can it be used, for the avoidance of any tax penalty assessed by the IRS.

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