Four Ways Residential Real Estate Investors Build Wealth

Investing in real estate is not for everyone. But if you're looking for a way to increase your personal wealth, purchasing a rental property may be for you — especially in today's real estate market.

We're not talking sky-high appreciation rates — like in the late 1970s or mid-1980s — which virtually guaranteed a solid return for many real estate investors regardless of what they purchased. What we are talking about is a residential market in which a well-chosen, well-managed rental property of one to four units can be the "shining star" in an investor's portfolio.

What's happened? Today's availability of fairly priced — and even some undervalued-homes — combined with outstanding low-payment interest rates and a solid rental market have boosted sales. Once again, opportunity-driven investors are finding a great value, financing the purchase and keeping it rented much easier than in recent years.

Keep in mind, any opportunity has a downside risk. Real estate is complex, and each property is different. But right now experience shows rental property investors can benefit from informed real estate professionals who can find the right property in the right location with the right financing. The key to success today is doing your homework and making sure the numbers work.

If you've bought your own home, you already know many of the financial advantages of real estate ownership. Here's a brief overview of the many ways you can profit from owning rental real estate today.

1. Lower Your Taxes

Investor tax incentives can be substantial. Some investors can use deductions from rental property to offset some of their wage income. Other investors, while not eligible for the offset, can avoid owing taxes on their rental income by showing adequate expenses and deductions. Even if rental payments do not cover the investor's expenses, tax breaks may actually make up the difference — or more.

As an investor, you can claim deductions for actual costs you incur for financing, managing and operating the rental property. That means mortgage interest payments, real estate taxes, insurance, maintenance, repairs, property management fees (if any), travel, advertising, and utilities (if the tenant doesn't pay them) may be subtracted from your adjusted gross income when figuring your personal income taxes up to the amount of real estate income you receive.

Also, don't forget deductions for depreciation. The tax code assumes buildings and improvements "wear out" over time. These "losses" are deductible from income, regardless of the property's actual market value. Depreciation is a "non-cash" expense; that is, no actual payment needs to be made out of pocket. Although the government collects deferred taxes on the income sheltered by depreciation when you eventually sell, you've gotten "free" use of the money in the meantime. And if you do a tax-deferred exchange by purchasing a replacement property, you can defer taxes on the depreciation and on any profit. (Ask your tax advisor about Section 1031 of the U.S. Tax Code.)

2. Have A Positive Cash Flow

A positive cash flow results when the rent you receive exceeds the total you pay for the mortgage, taxes, insurance, maintenance and other carrying costs.

That's not as hard as it sounds. First, decide whether you need a positive cash flow before or after taxes. A pre-tax positive cash flow translates into current income, a goal of many retired investors and others with current expenses. Properties yielding a pre-tax positive cash flow are harder — but certainly not impossible — to find.

If this is your goal, you need to buy wisely. Not all properties will yield high enough rental income to cover expenses. Make sure you know how much rent to expect by finding out about rents for similar units nearby, the property's current rental fee, and date of last rent increase.

Keep in mind, you may need to purchase with a large down payment so your mortgage payments are smaller.

A positive after-tax cash flow can come from a negative pre-tax cash flow. Generally, the depreciation deduction makes the difference. If you meet the eligibility test, you'll be able to use the depreciation to shelter some of your taxable income and reduce your tax bill.

Second, you'll want to ensure your tenants make timely rental payments and take care of the property. Of course, a positive cash flow is impossible without rental income. A thorough credit, employment, and landlord check on applicants will help you find good renters, and a strong lease combined with a required security deposit will help put you ahead.

3. Use Leverage

As an investor, you magnify the return on your investment by borrowing a large part of the purchase price. That