10 things to weigh before diving into income property

By Jay MacDonald • Bankrate.com

You've been watching HGTV's "Income Property" and wondering: Is it time for me to buy a rental and become a landlord?

You're not alone. Between our "Friends"-like economy ("seems like you're always stuck in second gear"), historically low interest rates, flat-line wages and the mood of millennials to rent instead of own, income property has been on an uptick since the Great Recession.

In fact, for the first time in five years, more Americans are putting their money into investment properties than vacation homes, according to the National Association of Realtors.

Should you? Experts offer a qualified yes, provided you do your homework first.

Here are 10 things to consider before diving into income property.

**It's not as easy as it looks**

Forget the TV sitcom stereotypes of clueless landlords. To make the most of income property requires an accountant's eye for detail, a lawyer's grasp of landlord-tenant laws, a fortune teller's foresight and, should you choose to manage your rental property yourself, a landlord's firm-but-friendly disposition.

"Where people who want to become landlords fall short is, they don't realize how much work goes into it," says Diana George, founder of Vault Realty Group and president of 946 Bay Capital, a real estate investment firm based in Oakland, California.

**2. Success requires a long-term outlook**

Jeremy Kisner, a senior wealth adviser at Surevest Wealth Management in Phoenix, owns two Las Vegas rentals. The unit he's had for 13 years has had two tenants and low maintenance; the other has had three tenants in four years, the last one a costly eviction.

He's taking the same advice he gives his clients.

"The way that people get in trouble with almost all investments is, they just don't hold onto things long enough," he says. "With rentals, if you break even on a cash-flow basis, that's actually not too bad because you're paying down the principal and building equity that way. Then, you hopefully also see some appreciation."

**3. It's easy (and costly) to break the law**

State landlord-tenant laws can act like an open manhole cover for rental owners who ignore them, according to Kathy Hertzog, owner of the Erie, Pennsylvania-based Landlord Association.

Case in point: tenant security deposits.

"There is definitely bookkeeping involved. You need to have that account for each tenant and keep that money in that account and save it," Hertzog says. "Security deposit laws govern how much time you have to return a security deposit when tenancy ends, less any expenses for cleaning and repair, all of which have to be itemized.

"In some states, if you don't turn that in, the tenant can go after the landlord for double their security deposit for failing to return it within the specified time period," she says.

**4. Are you landlord material?**

If you purchase a rental property, should you be your own landlord or fork over 6 percent to 10 percent of your rental income to a management service? While there's no right answer for everyone, George and Kisner prefer to subcontract the work.

"They do the background check on your tenant, make sure they sign the lease and pay their rent on time," George says. "That frees you up to manage your money, not your property and tenants."

Hertzog says that there's a potentially steeping downside to being your own landlord.

"If you get too close to your tenants and the tenants have financial problems, you can find yourself stuck because you don't want to evict them," she says. "You have to be very professional about it, because if somebody doesn't pay their rent, they're stealing from you."

**5 . Should you buy your rental or finance it?**

While some financial pundits insist you should never buy a rental unless you can pay cash for it, Surevest Wealth's Kisner begs to differ.

"Leverage (i.e., a mortgage) typically magnifies returns, on both the upside and downside," he says.

Kisner gives this example: A property purchased for $380,000 should be worth $486,432, assuming 2.5 percent annual appreciation, after 10 years, leaving a loan balance of $244,781.

However, the annualized rate of return for the 10-year holding period increases from 8.09 percent to 8.84 percent in the scenario where he had a mortgage. The cash buyer has a lower rate of return because there is no leverage to magnify gains.

George concurs: "I definitely agree with going conventional (mortgage). It's a really good way to maximize your dollars."

**6. Be sure to budget for the unexpected**

Failure to plan for the myriad expenses of owning a rental can become a fast track to disaster.

"As a landlord, you want to save about 20 percent to 30 percent of your rental income for upkeep, maintenance and emergencies," says Hertzog of the Landlord Association. "You want to make sure you're not just living off that, because then when something big happens, you won't have any money to fix it, and now you're stuck because you're a landlord with a property that needs to be repaired quickly, and you don't have that money."

Kisner couldn't agree more: "It's been my experience that you always underestimate all the different expenses that have a way of coming up and always overestimate just how positive the cash flow is going to be," he says.

**7. Remember to renew your leases**

If mom-and-pop landlords have one glaring blind spot, it's failure to renew tenant leases in a timely manner, according to Vault Realty's George.

"You'd be surprised how many landlords don't renew their leases every year, so they're letting their tenants go on month-to-month leases," she says. "What's wrong with that? What's wrong is, their whole thinking is that now, if I want to get my tenant out, I can't because now they're not strapped to a lease.

"Also, they can't raise rent. The only way you can change rent is if you have them sign a form changing the lease every year. That's how you keep your tenants in check. When you let it slide like that, it can be really difficult to get your tenants back on track," George says.

Depending on the state, landlords can give notice of eviction for a specified period. In California, where George is based, the state allows landlords to give 60-days' notice. The landlord also might offer a new lease contract at the same time.

**8. It's all about location, location, location ... sort of**

That old Realtor mantra about the importance of location takes an interesting turn when applied to income property.

"The best locations with the most appreciation are where you'll potentially have the worst cash flow with a rental," Kisner says.

Why? Because the better the neighborhood, the more investors will expect in appreciation. And as the neighborhood appreciates, rents go up accordingly.

"As a result, the property has to appreciate more in order to compete as an investment with properties in less desirable areas," Kisner says.

His solution: Err on the side of appreciation. That's what he's doing with his two rentals, which, in a good month, barely break even. "But if I hold them until I turn 60 when they're paid off, even after property taxes and insurance, I'll double my Social Security income," he says.

9**. Want long-term tenants? Consider Section 8**

Sudden tenant vacancy is the bane of every rental owner.

"Each month that a rental stands vacant, you're having to pay mortgage, utilities and maintenance out of your pocket, so turnaround is one of the things you need to address really quickly," Hertzog says.

One popular solution? Give Section 8 renters a try.

Section 8, aka the Department of Housing and Urban Development's Housing Choice Voucher Program, pays 33 percent to 75 percent of the rent for low-income Americans who qualify.

While some landlords are skeptical of the paperwork and potential upkeep problems presented by some Section 8 renters, Hertzog views Section 8 tenants favorably.

"Older populations and persons with disabilities are usually excellent tenants. They take excellent care of the property because this is their home. This is where they want to be. Plus, if they don't pay their rent or ruin your home, they risk losing their Section 8 voucher," she says.

**10.** **Don't forget rental property at tax time**

There's a singular ray of sunshine that beams down upon income property owners each spring as they hunker down with their accountant to prepare their federal income tax return.

"When you have your own home, you can write off the interest and that's about it," George says. "But when you own an investment property, your Schedule E tax form enables you to write off nearly everything under the sun, from painting the home to changing the light bulbs.

"So, even though you have rental income to report, you can show less income than you're actually collecting and write off your mortgage payment and interest while building equity at the same time," George says.