Should I Buy a Rental Property?

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While many believe adding a rental property to your portfolio is a savvy way to access the real estate market, there's a catch: you're not just buying property, you're accepting the part-time job of being a landlord. It's easy to get lost in the allure of potential earnings and completely overlook the commitment that comes with owning and maintaining a rental property.

Financial Considerations

The profit is all yours: Owning a rental property comes with a major perk: you're the one who gets to pocket the earnings. In contrast to many other real estate investments, you don't have to share your profits with anyone else.

Rental properties offer two kinds of financial benefits: rent paid by tenants and the potential increase in the property's value over time. If the property's value goes up, it's reflected in your net worth and will result in an increased return should you decide to sell.

Rental properties aren't cost-free: Remember, rental properties aren't just about the money you can make. They come with a substantial down payment, mortgage, property taxes, insurance, and maintenance costs. When each tenant moves out, you're investing either time, money, or sometimes both, to prepare for the next resident.

Location can make or break the investment: Research how the properties in that location have done historically and if the value of homes in the area is expected to increase. Will you be renting the property somewhere that is showing continuous growth or somewhere that is losing population fast? Your financial success hinges on finding tenants for the rental. If you don't find any or have difficult tenants that can't make their bills, you're losing out on rental income while still responsible for the fixed costs.

Once you buy, you're committed: A rental property is illiquid, meaning it can't be easily converted into cash. Unlike an investment account you can swiftly withdraw from, selling property takes time and effort. While you are able to borrow against your equity, it may take time to establish the loan and it'll come with an interest rate.

Tax Considerations

While rental properties require a significant financial commitment, they also offer valuable tax benefits.

Rental Property Expense Deduction: Rental income will be taxed at ordinary income rates. However, you're allowed to deduct property expenses to reduce your taxable income. These expenses include mortgage interest, property taxes, operating expenses, repairs, and more. This means that you don't have to pay taxes on the entire amount of rent you've collected; instead, you're only taxed on the net amount after deducting eligible expenses.

For instance, let's say you earned $20,000 in rental income over the year, but you had $8,000 in expenses related to the property. By deducting these expenses, your taxable rental income becomes $12,000 ($20,000 - $8,000), which means you'll only pay tax on this reduced amount.

Property Depreciation: The IRS understands that assets like real estate tend to lose value when someone else is using your investment. In response to this, you can claim a portion of the property's value as a depreciation expense each year. This deduction will reduce your taxable rental income even further.

For example, if your property's value is determined to be $200,000, and the IRS allows you to depreciate it over 27 ½ years, you could deduct approximately $7,273 ($200,000 / 27 ½) as a depreciation expense each year.

However, this tax benefit isn't permanent. When the 27 ½ years are over, the depreciation deduction disappears. If you decide to sell the property, the sale will be taxed at capital gain rates, and the IRS will levy a depreciation recapture tax. This depreciation recapture tax helps the government recover some of the money they initially let you deduct. If you're looking to defer both capital gains and the depreciation recapture tax, you might want to consider a 1031 exchange instead of a traditional sale.

Personal Considerations

Having the financial means to purchase a rental property doesn't automatically make it a good investment for you. As with all investments, proper due diligence should be made. In the case of rental properties, individuals often underestimate the time and dollar costs associated with becoming a landlord and end up tying themselves up in an illiquid property that doesn't make sense for their portfolio — all for the promise of "passive income."

This is not a set-it-and-forget-it investment: Being a landlord comes with legal obligations to your tenants, and you'll be responsible for the property's maintenance and upkeep. If a pipe bursts on a Saturday night – legally, it's your responsibility to sort it out. While you can consider outsourcing maintenance or hiring a management team, remember that this will chip away at your overall returns.

You must be willing to take on risk: Owning a rental property introduces a completely different level of risk compared to conventional stocks and bonds. If a tenant decides not to pay rent or causes significant damage to the property, you not only face the loss of rental income but also the responsibility of covering repair costs. In certain instances, you might even find it necessary to seek legal assistance. As a result, many individuals may find this investment to be more trouble than it's worth.

This doesn’t mean real estate isn’t a good asset class for all portfolios. It's an asset that reacts differently to market fluctuations and has little correlation to stocks and bonds. However, there are many ways to access real estate in your portfolio. If a rental property is your only exposure to real estate, and something happens to the property, you could be facing a serious financial hit.

The Bottom Line

The decision to buy a rental property relies on how much time and dedication you have toward the investment. If you can manage being a landlord and understand the financial commitment it takes, then buying a rental property may help diversify your portfolio. As with all investments, suitability should be determined by looking at your whole portfolio and financial plan. Buying a rental property isn't as simple as purchasing a stock or bond; there’s far greater commitment once you sign the deed.