Real Estate Investment Isn't Always a Good Deal

There are three basic investments that investors can generally make.

The first -- which I prefer because of the return on investment and the lack of time it takes for the investor with a good professional money manager -- is a well-diversified stock portfolio.

The second most common investment is bonds, which are considered very safe. Unfortunately, too many people don't understand the inverse correlation of interest rates to bond prices, and the effect they can have on investors' principal if they invest at the wrong time.

Last is real estate. Real estate can be invested through a broker and what is known as a real estate investment trust, which I have discussed before. Today I'm talking about investors actually buying rental properties as an investment.

Be careful of those who hype the benefits of real estate investing and tell you about all the money they made. What they do is tell you they bought a piece of property for $300,000 and sold it for $600,000 five years later. What they forget to tell you is about all the expenses -- insurance, taxes, maintenance and repairs.

They also neglect to tell you how much time they invested into that property -- looking for the property, spending time marketing and advertising for renters. If the property isn't local, they always tend to forget about their travel expenses. Remember, time is money.

If they were to run it as a business, they would realize that the return is not as great as they make it out to be.

I'm not down on real estate, but when it comes to investing in anything, I try to be real about the attributes of the investment. And when you rent out a piece of property, it is not as easy as it may seem. You must ask yourself if you're fit to be a landlord and whether you want to be a landlord.

One thing I joke about with clients is that that they will never get a call from the president of General Electric in the middle of the night saying a pipe has burst and there's water leaking all over the house. You must really think about that because a house will need repairs.

Also, how good are you at reading people? You will be interviewing potential renters, and if you're not good at reading people, you may end up with the renters who don't take care of your property or, worse, become deadbeats at paying rent.

Also, many states' laws definitely favor the renter, not the landlord. Be prepared to hire an attorney to help you through the legal ramifications that may come up.

You also need to be aware of discrimination laws; there are potholes there, as well, where you could be sued.

You may think it would be simple to just hire a property manager. You can do that, but your expenses will go up. When repairs are needed, the property manager may not try to find the least expensive professional to do the best job, but rather the quickest way to get it done so they don't spend much time on it.

Long story short: Your expenses could be higher than you think. Remember, this is a business and you want to keep your expenses low so your profits are higher.

Last, let's talk about taxes. Yes, there are tax benefits to owning rental properties: All the expenses are deductible and can offset the income that is received. However, some of the losses cannot be deducted until the property is sold.

I would recommend that before you invest in real estate, have a good conversation with your tax preparer about the tax ramifications.

Be prepared to pay your tax preparer more, maybe a lot more, for doing your taxes because there will be extra work. If you're a high-income earner -- a married couple earning $250,000 per year filing jointly or a single person earning $200,000 per year -- you will also need to discuss something called net investment income tax, also known as NIIT. You may be subject to an additional 3.8% tax, which many investors are unaware of until their taxes are prepared -- not a pleasant surprise.

Taxpayers can also deduct passive activity losses from other passive income, but they should be aware that those deductions begin to phase out if the taxpayer surpasses the MAGI threshold of $100,000. MAGI stands for "modified adjusted gross income." You will have to back out of certain deductions, such as IRA contributions, rental losses and one-half of self-employment tax, just to name a few.

Again, a good tax preparer will explain this to you, so you will understand completely how rental properties will affect your tax situation.

I, personally, own no rental properties because of the time and effort it takes for the return. I have found it is much easier to invest in stocks and get returns that are similar, if not better, without the headaches.

It is also amazing to me the people who want to buy rental property are not taking advantage of the best investment -- using their 401(k) at work or an IRA contribution. When you take that into account, stock investing wins hands down over the long term, compared with the return on real estate.