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## **Memorandum**

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**DATE:** March 10, 2000  
**TO:** John Sample  
**FROM:** Professional Staff Member  
**RE:** Rental Property Issues

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Following the investment allocation strategy we discussed in January, a portion of your total investment assets should eventually be allocated to investment real estate. Part of your real estate holdings could be allocated to a rental property, as you suggested. Purchasing a rental property using a mortgage results in a leveraged real estate investment, and is generally a more risky exposure than the real estate investments we typically recommend. However, in a market where the rental property could provide stable rents, a leveraged approach also has the potential to generate superior investment returns.

A rental property will also be depreciated, so that when this non-cash expense is combined with your cash expenses (including mortgage), the property may operate at a loss for tax purposes. Rental activities are treated differently from other business activities that result in losses. Referred to as "passive activity losses" in the tax code, these losses are deductible only to the extent of other passive income; simply stated, losses from rental activities can only offset income from rental or other passive activities. If the rent from your property does not cover all of the expenses including depreciation, any losses are likely to be carried forward until they can be unlocked by passive income generated by some other activity, or by your sale of the rental property.

Even though the losses are not deductible, the property may still generate positive cash flows, since depreciation is a non-cash expense. The result is a rental property that generates a positive tax-free cash flow at levels sufficient to attract your attention as an investor, even though you are not getting the full tax benefit of the loss. If we can allocate some other investment to a passive activity that generates enough passive activity income to offset any losses from your rental property, then the full benefit of your rental property investment can be realized.

The specifics of any rental property investment can be evaluated as the opportunities become available.