Unconventional Income from Real Estate

By Dolf de Roos

Most people, when contemplating a property investment, think in terms of using a little cash as a deposit or down payment, borrowing some money from the bank in the form of a mortgage, collecting rent to cover expenses such as the mortgage interest, maintenance, and insurance, and (hopefully) having some money left over as profit.

There is nothing wrong with such a simplified concept of real estate investing. Countless investors are doing it all the time with portfolios ranging from a single property to many hundreds of properties.

However, it is very limiting to consider only that one source of income, namely the rental income from the tenants. There are many other sources of income from property that can significantly augment the rental income, or even be the basis of your real estate income without you having to be in a position to collect rent at all.

One such extra income stream is almost invisible, but at the same time automatic. If you own any kind of business, and your net pre-tax profit (after deducting all actual expenses) is, say $100,000, then you can fairly expect to pay tax on that profit. This is like stating the obvious. However, if you own property, and your net pre-tax profit (after deducting all actual expenses) is $100,000, then it is not a forgone conclusion that you will have to pay tax on the $100,000.

The reason for the difference is that with property, you can deduct depreciation. This is a legitimate, legal expense that you can claim, even though it costs you nothing. In other words, you have not spent the money on this expense. To that extent, it is what we call a phantom deduction. In this manner, you may earn $100,000 pre-tax, but only have to pay tax on $40,000.

What makes depreciation even more attractive is that you need not even have paid for the property in the first place. You may be depreciating a million dollar property, but you may have only put up $80,000 in cash. Contrast this with the depreciation on say a car. If you buy a car for $20,000, and you depreciate it, then you can claim a portion of what you paid for it back each year. Even if you bought it on hire purchase or other terms, you will still eventually have to pay the entire purchase price. With real estate, you may never pay for the property, and yet you can still claim the depreciation on the full transaction value.

Many people use this extra revenue stream from the government (the depreciation write-off) as an excuse to buy negatively geared property. This is property where the income does not cover the outgoings, and therefore the property is running at a cash-flow loss. These investors relish the idea that the government is subsidizing their investment, even though they are losing money. Each to his own, but I would rather make a profit and pay tax, than make a loss and have the government absorb some of that loss. Apart from that, however, it is possible to be positively geared before tax, and yet when depreciation is taken into account, the government considers that you are running at a loss, and therefore gives you more money, with their approval. Now there’s an interesting stream of income from a property! (By the way, I know of no other business where you can make a profit, but the government considers that you are running at a loss and then subsidizes that loss).

Another source of income occurs when you split a property into the land component and the building component, and then lease out each one separately. You would effectively be creating leasehold property, and the quality of the lease on the building would determine the value of the lease on the land.

A slightly more familiar concept is to lease (or sell) the air-rights to a building. This gives the lessee the right to build or use the airspace above a building. Typically the owner of air-rights will build extra storeys onto an existing building.

Everyone has heard of property management. Most property investors have at some stage considered the pros and cons of having a property managed for them (less work at the price of the management fee). However, there is nothing to stop you as the owner of a property from signing up a management contract on the property that survives changes in ownership. If you do sell, your company can do the management, or even subcontract it out. The same would apply to cleaning contracts.

In a similar vein, you could lease the naming rights to a building on a long-term basis, or the right to hang or paint huge advertisements on the side of a building, or the rights to place an electronic billboard somewhere.

As with most aspects of real estate, you are limited only by your imagination. Investors in just about any other commodity, product, service, market or sector work hard to do all their homework, make a decision, (usually) put up all of the purchase price in cash, and then hope like crazy that their punt will have worked. Property investors can do so many creative things to an investment, that I firmly believe that while any fool can make a lucrative property lose money, so can anyone with a modicum of creativity turn even a bad property into a money-making investment.

My final example of an unconventional source of income from real estate is to on-sell a piece of land, but to retain the oil-rights to that land. A good friend of mine in Texas is doing just that: selling land, but retaining an interest in any oil recovered from the ground. He only gets 3% of the oil revenue, but some wells are currently pumping out $6,000 per day, so his 3% cash flow from property he no longer owns has him smiling broader than ever. He asked me in disbelief the other day: "Dolf, why aren’t more people doing this?"

Is it time to stretch your thinking?

Successful investing!