10 Tips for Buying Rental Property

Before purchasing investment property to rent, understand how financing works, the best way to manage tenants and the legalities behind the commitment.

If you've been watching reruns of HGTV's "Income Property" and wondering if it's time to buy an investment property and become a landlord, you're not alone.

Between a jump in inflation and the mood of millennials to rent instead of own, buying rental property has been on an uptick in recent years.

Should you take the plunge on a rental property? Experts offer a qualified yes, provided you do your homework first.

Here are 10 things to consider before diving into an investment property:

1) Determine if buying an investment rental property is right for you.

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 DG Design Group, a construction firm in Northern California.

So before you leap in, you’ll want to consider whether you have the time, willingness and skill to put into managing a rental. While rental property is considered a passive investment, that doesn’t mean you’re fully passive in managing it. You’ll need to be someone who’s willing to do the dirty work, fix things up, negotiate with tenants and run a business. Plus, you’ll need a significant amount of money to get started. Not everyone is cut out for it.

If managing an investment property sounds like too much, but you’re still interested in real estate, you might consider owning a real estate investment trust (REIT). REITs are publicly traded securities that invest in real estate and typically pay a large percentage of their earnings back to investors in the form of dividends. This may be a way to get exposure to real estate investing without the hassle of property management.

2) Buy or finance?

While some financial pundits insist you should never buy a rental unless you can pay cash for it, Jeremy Kisner, a senior wealth adviser at Surevest Wealth Management in Phoenix, begs to differ.

"Leverage (that is, a mortgage) typically magnifies returns, on both the upside and downside," says Kisner, who owns two rental properties in Las Vegas.

For example, imagine a rental property purchased for $100,000 in cash. The house yields a rent of $12,000 annually after all expenses, such as maintenance and insurance, and is taxed at $1,000. With a depreciation schedule of 27.5 years and an income tax rate of 20%, an investor would earn just over $9,500 in cash annually. So the investor's annual cash return is about 9.5%. Not bad.

Here's how the investor using leverage performed, assuming the same house. This investor has a mortgage for 80% of the house, which compounds at 4%. After subtracting the operating expenses as well as additional interest expenses, this investor earns almost $5,580 in cash annually. With $20,000 invested, the investor's annual cash return is about 27.9%.

In fact, the situation for the leveraged owner is actually a little bit better than these numbers suggest. That's because part of the rent goes to pay down the mortgage's principal. So, while the investor couldn't pocket the cash flow because it was used to pay the loan, the investor still profited (and paid tax) on that money.

That’s the power of leverage to swing an investor’s return.

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

If you do decide to finance the purchase, keep in mind that you’ll need to come up with a larger down payment than what is typically required for a residential mortgage. Most lenders require a down payment of at least 15% for an investment property. You’ll also need to have enough cash to cover closing costs, homeowners insurance, property taxes and maintenance issues that come up at the property.

Those who want more safety and are satisfied with lower returns can purchase for cash. Those with less cash or who want higher returns can use financing to boost their return, albeit with higher risk.

3) Find the right location

That old real estate 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? Investors can earn a return in two ways: cash flow and appreciation. In some areas, investors may want higher cash flow in order to compensate them for slower appreciation. But if investors expect an area to appreciate substantially, they may be willing to forgo some of the cash flow in order to enjoy that appreciation. The result: House appreciation outstrips the growth in rents, and houses appreciate while yielding relatively low cash flow.

"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 (age) 60 when they’re paid off, even after property taxes and insurance, I’ll double my Social Security income," he says.

4) Run the numbers on any potential purchase

If you’re looking to rent out your property, you’ll want to have a good idea of how much you could earn. It’s vital to do some research to figure out what comparable properties are going for.

If you’re involved with residential rentals, for example, you can easily scan Zillow and similar rental sites to see what other landlords are asking for their homes. You can compare the price per square foot and get a rough idea from the pictures of the quality of the property, and you can also judge the desirability of the location. That can offer you a gauge of what you could charge.

With an idea of how much revenue you could generate, then you can work down your list of expenses to see what you may have left as profit. You'll need to consider taxes, insurance and mortgage payments. But you'll also want to build in some buffer for the unexpected, especially significant repairs such as replacing an HVAC. It makes a lot of sense to factor in these costs even if you're not paying them every year, so you can get a conservative estimate of what you could earn on average each year.

The better your estimates, the more likely your property will meet your required rate of return. It's important to be realistic, or you could quickly wind up with a money pit.

5) Make sure you're landlord material

If you purchase a rental property, should you be your own landlord or fork over 6%-10% 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."

Kathy Hertzog, former president of Erie, Pennsylvania-based LandlordAssociation. org, says that there's a potentially steep 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."

On top of this issue, are you comfortable making the executive decisions that must be made in managing a property? Will you repair or end up replacing that failing air conditioner or leaky dishwasher? You'll need to make the call as to what is the best course of action. These are key things to consider when deciding whether to manage the property yourself.

6) 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% to 30% of your rental income for upkeep, maintenance and emergencies," says Hertzog.

"You want to make sure you're not just living off that," she says, "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 the failure to renew tenant leases in a timely manner and letting them slide to a month-to-month lease, according to 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," says George. "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, county and city where the property is located, landlords can give notice of eviction for a specified period. In California, where George is based, the state requires landlords to give 60 days’ notice for tenants who have lived in the property for more than a year (or 30 days for less than a year), though the situation may be different in rent-controlled cities. The landlord also might offer a new lease contract at the same time.

8) 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, typically caps the rent for low-income Americans who qualify at 30% of their adjusted monthly income. 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.

One downside to Section 8 renters is that it may be more difficult to increase rents over time, which could impact your ability to offset rising costs with higher rental income.

9) 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.

It's that powerful combination of tax benefits and investing returns that helps keep investors interested in rental properties.

10) Understand how rental law works

State and local landlord-tenant laws can act like an open manhole cover for rental owners who ignore them, according to Hertzog.

Case in point is tenant security deposits. It's not as simple as collecting and holding the money.

"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.

Of course, this is only one aspect of the laws surrounding rental property, and there are many others that landlords must know in order to avoid running afoul of them. You'll want to be familiar with rules around eviction, fair housing and other regulatory requirements.

Bottom line

Rental property can be an excellent investment if you approach it in a businesslike way. But you'll want to understand (as much as possible) what you're getting into before you lay down your money. While the appeal of generating a passive monthly income with real estate is high, it's important to remember that it often requires a lot of work to keep that income flowing.

Rental real estate can be an attractive long-term investment, but you need the right skills and temperament to be successful.