EPISODE 1134

[INTRODUCTION]

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ANNOUNCER: Welcome to the Real Estate Syndication Show. Whether you are a seasoned investor or building a new real estate business, this is the show for you. Whitney Sewell talks to top experts in the business. Our goal is to help you master real estate syndication.

And now your host, Whitney Sewell.

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Whitney Sewell (WS): This is your daily Real Estate Syndication Show. I'm your host, Whitney Sewell. We are introducing a new segment called The Real Estate Syndication Show Highlights, where we're bringing you a look back at episodes focused on a specific topic that we believe added a lot of value to you in your syndication journey.

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[INTERVIEW 1]

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Whitney Sewell (WS): Our guest is Tom Wheelwright. Thanks for being on the show, Tom.

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Tom Wheelwright (WS): Hey, thanks for having me, Whitney. It's great to be here.

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WS: We'll go right into the syndication business and the tax stuff that people need to know about syndication.

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TW: I think a lot of people have heard about this carried interest rule, where it's no longer when you're holding period for your carried interest to be long-term capital gain, but it is a three-year

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holding period. Yeah, there's been some discussion, is it? Is it not? I will tell you, it is. Okay, it is a three-year holding period.

So, what do you do if you've got somebody who comes to you two years into the project, which we have a lot of that going on right now, and they say “We're gonna pay ridiculously low cap rate for this property and how do you not sell it?” Well, you don't wanna pay twice the capital gains tax when you sell that property. So, that's where, again, you meet with your tax advisor and figure out a way how that carried interest, turn that into a 1031 exchange.

So I've actually done that with a number of syndicators where the limited partners don't do that kind of exchange and the general partners, the developers, the syndicators do the exchange. It's not an easy thing to do. There's a lot of eyes for that and pieces to cross to do it. But when you're talking about millions and millions in dollars of capital gain, and you're talking about the dirt between a 20% rate and a 40% tax rate, maybe it's time to actually spend a little effort, trying to figure out how to avoid that tax.

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WS: We're gonna have to make sure we have a very good tax strategist on our team to be able to figure that one out. So you mentioned capital gains, what about the difference between long-term versus short-term capital gains? I often hear people mention that. Could you explain that a little bit?

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TW: Well, that's what I'm talking about with carried interest. So, normally, if you're under a year, that's a short-term capital gain, which is tax at ordinary income rates, upwards of 40%. If you are over a year, then it's tax long-term car gains rates somewhere between zero and 20%. If you have a carried interest though, which is how most syndicators make their money, is with a carried interest, that's a three-year term in order to be long-term capital gain. And that's my point, is that if you're in that two to three-year period, and you're thinking, “Well, this is long-term capital gains,” it may be for your investors, not for you. So, that's where you sit it down with your tax divider say, “Okay, the investors are fine with their long-term capital gain, I'm not gonna be still fine because mine's a short-term capital gain tax to 40%.” So, that's where you really have to pay attention.

Now, we look at 1031 exchanges, and by the way, you only have to do a 1031 exchange or you're carried interest long enough to get the three-year rule. If you're on autonomy, you need to hold that new property for another year, and then you can sell it, and then now you're long-term capital gains, and if you don't want to reinvest in another property. So, that's another thing to look at is shorter-term versus long-term. That's a big, big difference.

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WS: So on the passive investor side, now, I'd like for you to elaborate maybe the benefits of investing passively in the tax benefits as an LP, but then what else do they need to know on the tax side? What do they need to make sure their accountant is aware of before they go and invest in this syndication?

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TW: Well, the first thing that you look at is, what's their tax rate? Right, if they're in a high tax bracket, then they wanna be sure to use those losses as fast as possible. The challenge is they're probably going to be if they're passive investors, they're probably gonna be passive losses. Now, the passive losses can only offset passive income. But that means if you don't have any other income, but say your salary, then your passive losses are gonna sit there.

Now, you don't lose them, they just carry forward to the next year and they carry forward indefinitely. So, you don't have to worry about losing those passive losses, and by the way, when the property is sold those past losses are all for you. So, at the worst, you're going to get them in the year that you sell the property. And when you consider and you say, “Well, that’s just watching,” but it isn't, because you're gain, may be long-term capital gain, but your loss is ordinary. So, you may be taxed at 20% on your gain, but yet, the loss is offsetting your wages that are tasked to 40%. So, that's still a really good deal for the investor.

The other thing is that I can't believe I'm saying this, but there are some investors that actually should be investing through their solo 401(k). Okay, you don't wanna do it through an IRA, because if you do it through an IRA, you'll be subject to the unrelated business income tax because of the debt finance income presuming that you're not paying cash for this property. So, even IRAs can be taxed.

So, you have to be a little careful about investing through an IRA, but a 401(k) is subject to unrelated business income tax. And, here's kind of a fun thing, you can roll your IRA into a solo 401(k) and avoid that income tax on the debt finance come. So, that's actually a really big deal. If you've got an IRA and you could have a solo 401(k), 'cause you're in business for yourself, you really ought to be looking at creating that solo 401(k), make that investment.

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WS: And as we're on that topic, I did have a listener question that's related, and as far as related to the IRA and the Solo 401(k) investors, and they were talking about the unrelated business income tax and unrelated debt financing tax on the syndication side, is there a top of syndication structure that would help eliminate those taxes?

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TW: The way you eliminate it is to not have IRAs investing. That's really the way to do that. Obviously, if you've not leveraged, that's another way to do it seriously. Those are the two ways. Right, either don't leverage or you've leveraged, but make sure that people roll their IRAs into the 401(k). 401(k)s aren't subject to it so you don't have to worry about it.

[INTERVIEW 2]

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Whitney Sewell (WS): Our guest is Ted Lanzaro. Thanks for being on the show. Ted.

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Ted Lanzaro (TL): Thank you, Whitney. Thank you for having me.

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WS: I have investors that contact me and say, "Do you have somebody that can help me with this?" Like they have a CPA, maybe they've used for years and years and years, but they really need a tax strategist, somebody that's going to just really dive into their specific scenario and how do we find somebody like that like yourself, is maybe some questions that we should ask that CPA when we're developing that relationship, to find out if they're really going to just sit down with us like you are, have that call to really figure out our specific scenario, what's best as opposed to just really filling our taxes for us?

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TL: There's a lot of fantastic CPAs out there. A lot of them specialize in different things. I'm a real estate CPA. I'm a real estate CPA because I'm a real estate investor, also. So, I have come naturally. I started out 29 years ago, we started working with real estate investors and saw what was going on and said, "Hey, you know, I could do some of this myself."

I started my investing career just by buying single-family and multifamily properties down in the Southeast Florida area. And as I started investing, I also started going to real estate investment club meetings and met other investors, and they found out I was a CPA and they asked me to start doing tax presentations for these clubs. And I started going around and speaking, and the more I did that, the more clients I got.

I think the biggest question that you can ask is, are you also a real estate investor because that's why my clients hire me because I speak their language, I can go and walk through a building and tell you within 5% how much repairs are gonna be needed. And I can write a school of work to build out of a building or something. So, it's those kinds of specialized skills that my clients like about working with me.

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WS: I like that a lot, finding that CPA that's in this business as well. Obviously, they're gonna have a different take on the business if they're in it as well and investing in the day-to-day.

But you mentioned earlier the real estate professional status, and could you elaborate on what that is for maybe the listener that hasn't heard of that, but maybe some of them has, but it's not clear what that actually means?

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TL: So, there are three types of real estate investors, essentially from a tax point. You have your passive investors, those who are gonna be your limited partners in your syndication. So they're not part of the decision-making, they're just putting their money in, and for a return on their investment, right.

The second time would be an active investor. So, if you're an active investor, you might be somebody who's managing your own properties or the guy who's putting the tenant in, calling the plumber when the toilet clogs, those kinds of things. As long as you put in the hours, you are allowed to deduct $25,000 a year against your ordinary income, assuming that your ordinary income doesn’t exceed $150,000 a year. Once your adjusted ordinary income exceeds $150,000 a year, then you're basically phased out and your losses to real estate are carried over. But if you're a real estate professional, that's somebody who works full-time in the real estate business, either as a developer, broker indicator, real estate agents can qualify also, so people that are doing that and are documenting at least 750 hours a year, and it's more than half of what their total work activity is, and if you do that, have the ability to take on unlimited losses against your ordinary income. So a real estate broker who has a $40,000 loss on a rental property, could allocate that $40,000 loss against his $200,000 of real estate broker income during the year, assuming that he keeps track of the hours in order to qualify as a professional.

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WS: Great, I appreciate you laying that out. And so obviously it's going to benefit those that can do it full-time, they are able to be a real estate professional, should we all pursue to be a real estate professional if we're doing this full-time?

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TL: If all you're doing is working in the real estate business, and there are a few tricks because you're working the real estate business could be simultaneous as a landlord, a broker, as a syndicator, you could be doing multiple things. So, there are some tricks, you have to make an election to aggregate their activities in order to be considered a professional, because what the IRS says, it's not just 750 hours, it's 750 hours per property unless you would like to do that aggregation that I was just talking about. So, there's a trap built into the rules.

And what I tell people is one, it's just a two-sentence election on your tax income, for me it's making sure I check the right box on my software when I'm doing your return. I have a checklist to make sure to do that every year right. But also in your head, it would be making sure that you have a log or are using some sort of app that tracks your work time so that you can prove that you have 750 hours of time in per year, and also that it's more math than to do it.

So, I had a client who has a full-time job, and she said to me, "I'm a real estate professional," and I said, "I don't think you are qualified, you have a full-time job as an IT person." And she said, "No, but I also work 2,000 hours at least in my real estate business, and I can prove that I work more than half my time in real estate." And I said "You work 2,000 hours as an IT person, 2,001 hours as a real estate professional. When do you sleep? So I don't think you qualify and you don't have a log." So, she says, "Well, you're fired, I'm gonna do my taxes myself and I'm gonna take real estate professional stuff." So I said, "Okay, well, that's okay. Do what you wanna do." So two years later, the phone rings, I think of a fortnight, she says, "I just called up to the IRS's office and they are questioning my real estate professional status. Can you help me?" And I said, "No, I told you, you were wrong. I can't help you. You don't need me now, you don't need a CPA, you need a lawyer or a magician. There's nothing I can do about it. You have to pay the extra taxes because you don't qualify. And I don't do that."

So it's one of those things where if you're legitimately in the business, it's an excellent opportunity to be able to deduct the rental losses that most of the time is gonna come from depreciation. Because we're not buying as a real estate investor, we're not buying in real estate to lose money, we're buying real estate to make money and have that money sheltered by the depreciation of the property.

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WS: Now, that was gonna be a question about too, as far as the people who are working, who have a W2 job, could they still claim this? I've heard similar stories where people are trying to be, a lot of their time, they work just as many hours in real estate, is there ever a time where that would work where I have a W2 job or position, but I can still claim? I just have to make sure I'm working more hours in the real estate and I'm logging that time up to 750 hours or more? Or is it just like that's a major red flag, I just shouldn't even pursue that?

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TL: It would be a red flag when you have a W2 income from somewhere else. But that's where the record-keeping comes in. Let's say you have a W2 job that was only 1,000 hours a year. It's a part-time job. Some people could do that. And let's say that then you spend the other half of your time working as a real estate broker or a syndicator or a developer, and in those scenarios, you put in that 1,100 hours. So, now you've got over 750 hours and you're more

than half because you've got 1,100 real estate hours compared to your 1,000 W2 hours. In that scenario, as long as you track that, then you don't have a problem. You may have a larger risk of an audit. But, when you do get called into the IRS's office when they sent you a letter and question your log, you have it already. "Here you go, here's my log. End of the story now." Now, it's all good as long as you have that record-keeping in place. And that's why every speaking engagement that I do starts with a lecture about record-keeping. For the people, record-keeping is the foundation of literally every strategy that I use with my clients,

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WS: I'd love to hear that lecture for myself and for listeners as well. But, do you have a best practice or a way to log those hours if we are a real estate professional, we're claiming that? Do you have some best practices for logging that time?

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TL: I always tell people, whatever is most comfortable for you, what you're gonna use. Because I can give you an app, say for example, and you might hate it and you're not gonna use it. It could be anything as simple as a pad of paper that I write to my car right in, bringing it down my hours every day. It could be an Excel spreadsheet. It could be some sort of app that I'm using.

I would rather have a good piece of paper than an app you don't use, I'd rather have a good spreadsheet. And, the same thing goes with record-keeping. I can tell you what the best thing for you to use would be, but if you don't wanna use it or you're like, "this is too hard or whatever," I rather have it written down on a piece of paper.

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WS: I agree completely. Done is better than perfect. They're done is better than not done. So, Ted, why don't you share a little bit of that with us as far as the record-keeping, obviously it's so important, or else you wouldn't share it every time, right? Maybe you can share a little bit of that and a lot with us on some record-keeping tips.

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TL: Record-keeping is the foundation of all of the tax strategies that we use. And there's a lot of opportunities, I bet the IRS, especially with the new 2017 Tax Cuts and Jobs Act. There's a lot of opportunities for real estate investors to take advantage of the tax laws. There's also the thing that Congress put in there was a record-keeping requirement. So if you're going to take real estate professional status that you want a lot, if you wanna deduct in your miles, you wanna file a lot, if you're gonna take the home office deduction, you better have a good

spreadsheet that shows all of your housing expenses. If you're gonna take to a qualified business income deduction, you are able to show that you qualify.

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