EPISODE 1281

[INTRODUCTION]

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Whitney Sewell (WS): This is your Daily Real Estate Syndication Show and I'm your host, Whitney Sewell. Today is a Highlights show that's packed with value from different guests around a specific topic.

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[INTERVIEW 1]

0:00:24
WS: Our guest is Noah Rosenfarb, thanks for being on the show Noah.

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Noah Rosenfarb (NR): Yeah, of course.

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WS: You know, let's move into just some general taxation stuff and you know, taking most advantage as possible for the passive investor and I think you can speak a lot to that as well.

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NR: I think one of the predispositions I had — because I was a practicing accountant. I come on the third generation CPA as you mentioned, my father had an accounting firm that I was a partner in for a decade. My father-in-law is a practicing tax accountant. This is the type of dinner table conversation we had around the tax code. That's somewhat unusual.

One of the things I learned early on is that the uniqueness of our tax system is that it's self-reporting. Although a lot of people report to the government through different forms like, you know, our K1 that we receive in an investment. It's provided directly to the IRS by the company that we invested in but then we take that cable and we have to report it on our form 1040. People sometimes issue a form, 1099, if we collected interest. They're reporting that to the government and then we report it on our 1040.

A lot of the things that we do as individuals and as owners of enterprises are not reported directly to the government and the government relies on us to self-report. Because we're self-reporting, we get to make our own judgment as to what is it that we're going to report as

income, what is it that we're going to report as an expense, and how we classify that. And the way that our system responds to that is by — if they have a question, the IRS will write you a letter and say, dear taxpayer, you know, you took this deduction or you — we believe you have this income, can you please verify by providing us with your evidence.

Because of the nature of the way that we report, it gives us as taxpayers a lot more freedom than other tax jurisdictions, where the government tells you exactly how much you owe. They complete the forms for you because everything's being reported on your behalf.

We want to use that flexibility to our advantage. We want to come up with ways that we could consider expenses to be business expenses or ways that we could consider our activities to qualify us as real estate professionals. For individuals that are investing, either as an LP or maybe sometimes they have a few units that they own directly and then they're making LP investments with other sponsors — if you can become a real estate professional, which doesn't require you to have a real estate brokerage license, but it does have other certain requirements. Then the government allows you to deduct all of the depreciation from all of your assets against any other ordinary income you have.

That's a massive advantage and so if you're listening and you've been actively engaged in the investment and real estate but you're not currently a real estate professional, maybe you're still at a job that you get paid every two weeks and you receive a W2 at the end of the year, that doesn't preclude you from being a real estate professional.

You want to be sure you're talking about that with your accountant and figuring out if there's some way that you or your spouse could qualify as a real estate professional.

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WS: I'm glad you just mentioned, you or your spouse. It's a potential that if you don't qualify, maybe your spouse does.

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NR: Yeah, we see that a lot of times, you know, you've got maybe a doctor or a lawyer and their wife is predominantly a homemaker. But if we can get them to classify as a real estate professional, it might be able to save them 50,000, 100,000, and 150,000 a year. So if we can keep a journal of the wife's activity looking for property every week, if we could keep a journal of the wife's activity, interacting with tenants or discussing investment properties with their spouse or with their financial advisor, with their accountant, then we could start to build up their resume as a real estate professional.

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WS: What about thinking outside the box a little more there, ways that you've seen for people to be able to find expenses that they can count as business expenses that we may not typically think of.

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NR: You know, I think there's a lot of things that we miss when it comes to the tax code and it's not really the fault of our accountants. The accounting profession in general has been taught how to look very clearly through the rearview mirror and make out all of the details of what's happened in the past but we're not taught to look out of the windshield and see what's coming.

As a profession, we're not incentivized to help taxpayers think about "How do we avoid future taxes." We are only paid for the return preparation in almost all cases. And I just had someone that had approached me about doing some tax planning and I told them to go back to their CPA firm to do a tax projection. And they were so miserably upset because the accountant just took their five months' worth of numbers, multiplied it by 12-fifths, and said, "Here's your year."

And you know it's like well there was no thoughtfulness. There was no advice, there was no counsel and I think that happens all too often in this industry. So be sure that if you are not getting tax advice from your current tax preparer, you have someone else in your life that is helping you focus on "How do we avoid future taxes, not just present-day taxes."

0:05:37
WS: That was going to be something I wanted to ask you. You triggered in my mind there, even just, you know, hiring a tax strategist versus hiring our CPA or an accountant. Somebody that we are speaking with — often about what's happening in our finances and our taxes. But, you know, should we hire somebody that is an actual tax strategist and then also, does that person then say do our taxes or they're just more of an adviser that will help us work with our current CPA.

0:06:05
NR: Yeah, I found that in most instances, really good tax strategists make a lot of money. And because they make so much money, they're not good people to do tax compliance because tax compliance is in some sense a commodity. Recording history is not very valuable. So most tax strategists, either don't do the preparation themselves or they don't even do it inside their firm. So you may work with a tax lawyer, you may work with a wealth manager.

You may work with an estate planning attorney, someone that is maybe a little bit more sophisticated just on taxes but not handling the preparation of your Form 1040 for your personal return. Or not handling your business partnership returns. We want to let somebody in a low-cost do that type of work. And when it comes to the real creativity critical thinking that's

the stuff that maybe we're paying $1,000 an hour or $2,000 an hour to someone who is incredibly brilliant. And we are not paying them for the hour that we are spending with them. We are paying them for the 20 years that they have spent learning exactly what to do with that hour.

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WS: Very well said. That's with a lot of professions, right? When you are hiring somebody that's a professional adviser, it seems like a lot per hour but it is well worth it because of their experience. So you know I hear about this, you know you are getting the 4% tax rate on your income and I would love for you to elaborate on how you've structured this to accomplish that. So you know maybe we could think the same way.

0:07:29
NR: Yeah, so bear with me because I am a bit of an egghead in some sense, that I love exploring the tax code and I love finding ways to beat the system. It is the game that gives me a lot of pleasure, it allows, it enables me to take the capital that I am creating and use it in a way that justifies what I am working for. And that does include causes that I care about and contributing to things that I want to make a difference but I don't enjoy funding our government.

So I came up with a strategy that is quite unique. Puerto Rico came out with tax incentives a few years ago. The island of Puerto Rico had really great incentives for pharmaceutical companies to come and manufacture their drugs there and they stated that in the 1980s and they built dozens and thousands of jobs in the pharmaceutical space, in pharmaceutical manufacturing. And then they took away those incentives and what — low and behold, all of those companies left the island.

And so they looked around and said, "Oh I guess that wasn't a good idea. Well what can we do now?" and they said, "Let's try and invite entrepreneurs to set up their business here and for retirees to come live on our island to enjoy their retirement." And they came out with two significant tax codes which were formerly called Act 20 and Act 22, now commonly called Act 60. And what they did for businesses is they said, "If you come and open your business in Puerto Rico, we'll agree for 20 years, we'll only charge you a 4% corporate tax rate."

So think about that, right now the IRS is currently at a historic low corporate tax rate of 21%. Certain states apply an additional tax rate on top of that but Puerto Rico is saying 4% that's all in. You don't pay IRS federal taxes when you're a Puerto Rico-based business, you don't pay any state income taxes when you are based in Puerto Rico. So I like that. I thought that was a unique incentive and so I went and set up a company in Puerto Rico with this 4% tax rate.

But I did one extra thing. Because a corporation, when it issues a dividend to a shareholder, that shareholder has to pay dividend income tax. And if you live in Puerto Rico and you receive a dividend from your Puerto Rican company, you don't pay any tax. Puerto Rico exempts it. So my brother, who operates our business there, is a Puerto Rico resident. He operates a Puerto Rico business that he owns. He receives a dividend, it's tax-free. So he has a 4% effective tax rate on his earnings from our company.

Me, on the other hand, I live in South Florida. I am bedded in our community, I've got young children. I really like raising them here in our suburban environment and I didn't want to move. That wasn't appealing to me. So what I did is I set up the ownership of my company inside of a Roth 401(k) plan. Now the benefit of a Roth plan, for the listeners that don't know, is that we pay tax on the money going in and we never pay tax on that money again.

So when I set up that company, it didn't cost me very much to set up. I made a small deposit into my 401(k) account. I paid some tax by converting it into a Roth and that company now owns the majority of my Puerto Rico business. So when we have let's just say a $1 million of income, we pay $40,000 of taxes, and 960,000 goes out as a dividend distribution. I pay no tax on that dividend, it goes into my Roth 401(k). I can invest that in real estate, I can invest that in the stock market. I can make private loans, all of the interest dividend and capital gains on those investments are tax-free and when I turn 59 and a half, I can take as much or as little of that money out as I want, also tax-free.

[INTERVIEW 2]

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WS: Our guest is Mark Pierce. Thanks for being on the show, Mark.

0:11:09
Mark Pierce (MP): Well, you're welcome, Whitney. I'm glad to be here.

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WS: Mark is an attorney, an accountant, and the owner of Cloud Peak Law. With over three decades of experience, Pierce has truly seen it all, at least from a legal perspective. This is apparent from the diversity of fields in which he assists clients all over the years. Those fields range from bankruptcy and real estate planning to oil and gas and security.

Mark, I'm grateful to have you on the show. Why don't you give the listeners a little more about who you are and what you do a little bit? Maybe where you're located, and let's dive into some of these issues that I know other operators are having and I know I've received some questions lately that you and I discussed briefly before we started recording that I want to get into today

that I know is going to help the listener. Give us a little more about who you are and your business.

0:11:56
MP: I'd be glad to. Cloud Peak Law is located in Sheridan, Wyoming. Wyoming is an isolated state, to say the least, the least populated state in the United States. We have in terms of social distancing 4.8 people per square mile, so I'm not sure what they mean by the social distancing for us anyway. It is the premier LLC jurisdiction of the United States, the first state to recognize and flush out what a limited liability company is. It also has become one of the premier trust jurisdictions in the United States as well. That is by design, the large financial industries within the state have pushed that to a conclusion.

I came back to Wyoming in 2012, eight years ago, for the purpose of providing commoditized legal services to people in a very specific area, those being LLCs and trusts. Over the last eight years, we've put together a trust and LLC formation, and operation administrating entity that allows people to get good, quick information regarding LLCs and trusts online, and to book online consultations with attorneys as well, who are schooled almost solely in trust and LLC administration. That's just begun to take off within the last couple of years, and I hope that you will visit our website and take a look through those through that information because there's a great deal of information that you can go over there that relates directly to the real estate industry.

As a result of that, I brought my son in. We've got three or four programmers working for us now, several attorneys, administrative assistants, and all of that.

0:13:29
WS: Well, Mark, again, I'm grateful to have you on the show. Just so the listeners know, I've had numerous questions recently about – once somebody gets into this business, which it is not an easy feat, but you get going. You get your business operating. But then you start – you have other growing pains, right? One of those is then you have – People start thinking about, "Well, how do I structure these things on the personal side?" As an operator, well then we start owning parts of different deals. Maybe we're investing passively as well. We're thinking about our family and our kids, and all these things start happening that maybe didn't happen before. I know it happened to me, and I started doing a lot of research and consulting people like yourself.

But I thought maybe you could help us talk through that a little bit, and even then maybe get into why the Wyoming entity or LLC is so popular, because I know that came up as well during many of these conversations. So, just on the personal side for an operator, just thinking

through the structure of our entities, whether we should have a corporation, and what falls under those.

Maybe you have some suggestions or ways that we can think through those things?

0:14:35

MP: Well, I have a different prejudice towards limited liability companies, just because I've been involved with them for the last 40 years in and out of the state. I practiced in Florida, I practiced in Colorado, California, Arizona, and it seems to me that the limited liability company gives you at least as much if not more protection in terms of a liability than a corporation does, but it also allows you the flexibility of being taxed in the way that you want to be taxed. An LLC can be taxed as a passive entity, like a sole proprietorship, as a partnership, as an S corporation or as a C Corporation.

From the standpoint of tax flexibility, you get a lot more with that LLC than you would with a corporation, but you also get to pick and choose which aspects of the LLC code you want to apply to you, and then you can modify a great number of those applications. For instance, Wyoming has what they call a close limited liability supplement so that you don't have to go through the regular corporate formalities and pretend that you've had a meeting every year, for example. You also don't have to have special meetings to adopt certain matters such as liquidations or asset acquisitions and dispositions. It gives you a lot more flexibility in the standpoint of running a small business, which most of us have.

When you get into real estate syndication by way of example, you're looking at getting a property, and then you get proper, and you begin running that property and going through all of those issues. Then you get a second property, and then you get a third. Then it just becomes inevitable that you end up with more and more properties. The problem is you don't keep up on the corporate side with what it is that you're doing. You wake up one day and say, "My goodness!" Somebody points out and said, "Everything is at risk for everything else's liability." So you begin segregating them out into operating entities. Well, that's fine, but each one of those operating entities should probably be located in the state where that real estate is, because it's not going to make any difference if you have a Wyoming company in Missouri. Missouri is probably going to apply Missouri law. Even though they shouldn't, that's what they're going to do.

You realized, "I need to put each one of the operating entities into a separate LLC. What I do with my passive interest because I've run into some things with that as well?" You put together a collective holding company at the top that holds each one of those operating subsidiaries. Now, the holding company could also be an LLC because an LLC can hold other LLC interests. Then off to the side, you put a management company because then you get more deductibility

on your expenses. You get a broader definition of what an expense is, so it lowers your tax implications. Plus, if a management company is running those operating subsidiaries, you can commingle all the funds, which you cannot do if you're operating those subsidiaries individually. So the management company takes all the money into a single pot, provides all the insurance that goes on, provides all the operating expenses that go on, and then makes an accounting to each one of those entities at the end of every year, including a fee for running the management company.

That ultimately is where any real estate syndication company is going to come into play.

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WS: Nice, okay. That's a lot to think through right there. I know you laid it out very quickly, and so it makes this seem so easy.

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MP: We've drawn pictures on the website for you. I know that I'm very visual, and it helps me to look at these things from the standpoint of where are your squares, where are your triangles, and where are your circles? And then to see the cash flows back and forth and begin to understand what it is that I'm talking about, and that's your legal structure.

0:18:07
WS: Nice. I look forward to looking at these diagrams myself because I'm also very visual. I'd love to see that and be able to draw on it and think about where that money flows. It took me a while to figure those things out. I mean, wait a minute. How is this entity related to this entity, and are they related, and can they be, or should they not be? And money flowing from one to the other.

Is that like a top entity? Is that holding these other entities? Is it owning those entities? Is money going to the first entity and then distributed to the others? Can you walk through a little bit of that?

0:18:40
MP: Yeah, I'd be glad to and I think that's one of the best questions you get because, even with a close limited liability supplement applicable to your LLC, you have to watch the money flow because that's what's always going to trip you up. If you have a subsidiary that's generating money, it wouldn't take that excess money and just invest it in another subsidiary directly. You'd want to strip that money up to the holding company. It's called equity stripping. You maintain enough equity in that operating subsidiary to provide for its day-to-day operations, typically two to three months with no revenues. Anything over that is stripped up to the holding company.

The holding company then makes additional investments into operating subsidiaries that need working capital but it does it in the form of debt. That way, it becomes a preferred creditor and not an equity holder or a combination of an equity holder for its initial investment. But a creditor adds to any additional cash infusions going in, invests that in with a promissory note, secures it either with real estate or personal property or both. Then it strips that money away over time in the form of distributions going back to repay the loan that's been made, which is a huge differential on your accounting because now it's a repayment of a loan, not a repayment of capital. So if you start stripping money back up to that LLC and the taxes haven't been paid, then the LLC ends up paying the taxes first on income before it gets a return of its equity. Whereas if you distribute the debt repayment backup, you don't have that worry. That's a huge impact on a small business owner over time in terms of his cash flow.

You put the equity stripping in place, and then the holding company ends up with the money, and then the holding company can invest in new subsidiaries or make capital infusions into older subsidiaries or keep that money and distribute it out to the limited liability company holders, the members, which is key because that gives you a double envelope of protection. That way, each one of those LLCs at the bottom, the operating subsidiaries, are not liable for one another's debts, and the holding company isn't liable for debts. You as an owner behind the holding company have double envelope protection as to those debts within those LLCs.

That's something that's been put into place in Standard Oil of Ohio in the 1880s, so it's not as if we've come up with it as a new idea.

[END OF INTERVIEW]

[OUTRO]

0:20:53
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