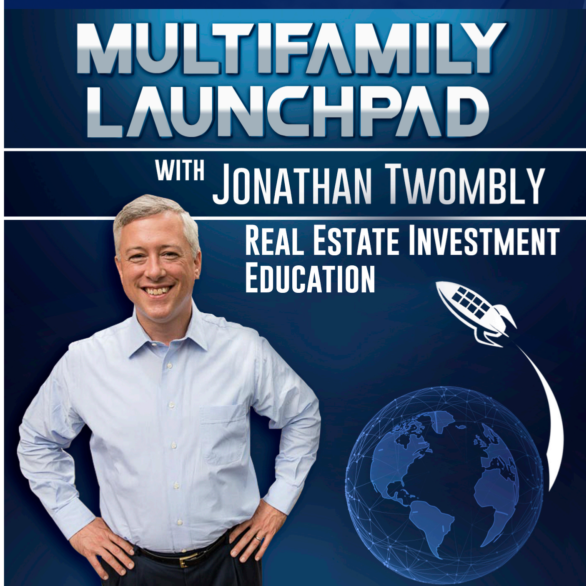

The Taxation Landscape for Real Estate Investors

Module 9 - Video 2

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Video Overview

What's covered:

- The overall taxation landscape for real estate investors

Disclaimer

Disclaimer

- I’m NOT a CPA
- I’m a lawyer, but I’m not a tax lawyer and I’m not YOUR lawyer
- This presentation is based on my layman’s working understanding of the tax laws as they affect my profession
- It’s very confusing, and I cannot even guarantee I’m getting it all right
- You MAY NOT rely on anything herein as tax or legal advice
- You MUST consult your CPA and tax lawyer before making any real estate investment decisions

The Tax Landscape

THE OVERALL TAX LANDSCAPE FOR INVESTORS

Real estate has numerous tax advantages for both active and passive investors, and you should be familiar enough to discuss with your investors:

- Deductibility of expenses & interest
- Normal depreciation, accelerated depreciation, and bonus depreciation
- Passive income tax treatment
- Long-term capital gains tax treatment
- Tax-free refinance
- Section 1031 like-kind exchanges
- Opportunity zones
- Death
- More detail on Section 1031 exchanges in a separate video
- Additional tax benefits just for syndicators in a separate video


Deductibility
of Expenses

Expense Deductibility

- All expenses for the operation of the property are deductible from taxable income:
  - ✓ Routine repairs and maintenance
  - ✓ Service contracts
  - ✓ Payroll expenses
  - ✓ Property taxes
  - ✓ Insurance
  - ✓ Marketing
  - ✓ Utilities
  - ✓ Property management fees
  - ✓ Administrative, legal, and accounting expenses
  - ✓ Mortgage interest (but not principal)

Expense Deductibility

- As a result, you only owe income taxes on the net profits from the property!
- However, mortgage principal paydown (amortization) is NOT deductible from income
- It's paid from after-tax profits
- So, if you have a mortgage on the property, your taxable net income will exceed your cash net income, resulting in "phantom" income
- Phantom income = taxable income your charged with even though you did not receive the associated cash
- This amount grows over time as the balance of repayment shifts from mortgage interest to principal repayment

Depreciation

Depreciation

- Thank goodness for depreciation, because it wipes out phantom income!
- Depreciation is a legal/tax recognition that things wear out over time. So you can deduct part each year to account for this wearing out.
- Land does not depreciate
- Buildings depreciate at different rates from other property
- Depreciation comes in three flavors:
  - ✓ Normal depreciation
  - ✓ Accelerated depreciation
  - ✓ Bonus depreciation

Normal Depreciation

- Normal depreciation for commercial properties is over 39 years
- But for residential properties – including multifamily! – it's over 27.5 years
- ***No matter how old the property actually is, depreciate resets for each new owner!***
- You can therefore deduct 1/27.5th of the value of your MF buildings each year
- Generally, land is assigned about 20% of the value of any real estate purchase (but this can differ from place to place)
- You cannot depreciate land, because it does not wear out
- So you take 80% of the purchase price, divide it by 27.5, and that gives you the amount you can deduct each year
- $5mm purchase minus 20% equals $4mm building value
- $4mm / 27.5 = $145,454 each year – knocking out most, if not all, of your net income on a property this size

ACCELERATED DEPRECIATION

- However, you can accelerate depreciation even faster if you do a "cost-segregation" study
- Cost-segregation study segregates out and assigns a value to everything on the property that's not considered "the building"
- The building depreciates at $1/27.5^{th}$ each year, but other things depreciate even faster, giving you even more of a tax advantage
  - Cabinets,
  - Carpets/flooring,
  - Appliances, etc.
- These can depreciate on a 15-, 7-, or even 5-year schedule

Accelerated Depreciation

- Thus, if you bought a $5,000,000 property, and 20% of the value was land, you would have $4,000,000 of depreciable property
- If you did cost-segregation and found that 25% of that was depreciable on a 5-year schedule, it would look like this:

Purchase:	$5,000,000
Land:	-$1,000,000
Depreciable:	$4,000,000

x25% = $1,000,000 @ 5 years

+ $3,000,000 @ 27.5 years

= $200,000 + $109,091 = $309,091 per year!

Bonus Depreciation

- Bonus depreciation is a new benefit for the real estate industry, to encourage investment in capital items
- Allows you to do a cost-segregation study and then depreciate 100% of all items on a depreciation schedule of under 20 years right away
- In other words, you could take 100% of the $1,000,000 in 5-year depreciation items in the first year!
- So, on our last example, you could take $1,109,091 in depreciation in year 1
- Full bonus depreciation is available only through 2022, and phases out 20% per year from 2023-2026.

Depreciation Recapture

- However, depreciation (in any form) is subject to ”recapture”
- Your current income may be tax-free up front
- But you get a tax hit when you sell
- Federal recapture rate is your current income tax rate, capped at 25%, plus the 3.8% net investment surtax
- Assume $5,000,000 property has NO gain over 10 years and you sell
- You took 10 years of simple depreciation at 1/27.5th per year on $4mm =$145,454 x 10 = $1,454,545 of deductions
- Even though you had ZERO gain on sale, you owe recapture tax of $1,454,545 @28.8% = $418,909 in tax obligations
- If you were in top 37% bracket, you saved $538,181-$418,909=**$119,273**
- If your bracket is 25% or less, you saved nothing, but deferred tax for 10 years

Pass-Through in Syndications

- Depreciation losses pass through to investors in syndications where the syndication is structured as an LLC
- Investors receive depreciation in proportion to their ownership of the asset
- However, you may also structure the deal so that you, as a syndicator are entitled to receive a portion of the depreciation, in which case your investors would get less than their full proportioned amount
- This is a matter of your operating agreement
- However, the general proposition is that your investors' income is offset by the depreciation corresponding to their ownership percentage


Passive
Income &
Capital Gains
Tax Treatment

Passive Income Tax Treatment

- Any income remaining after depreciation is subject to income tax
- Passive investors will be taxed at passive (unearned) income tax rates, which are generally lower than earned income tax rates
- Unless you qualify as a ”real estate professional,” your income from a real estate property is also taxed at passive income tax rates
- Passive investors with tax losses after depreciation may use them to offset passive income gains from other investments
- Real estate professionals with tax losses after depreciation may use them to offset regular earned income
- Will discuss how to qualify as a real estate professional in the separate video on special provisions for syndicators

Capital gains Tax Treatment

- Appreciation gains are taxed at federal capital gains tax rates, which are capped at 20% plus the 3.8% investment surcharge
- This is a benefit if you are in a tax bracket of 25% or more
- So, if the property appreciates by $1,000,000 at the time of sale, then federal capital gains tax would be $238,000
- At normal tax rates, the federal tax could be $250,000 to $370,000, so this is a big benefit
- Most states also impose capital gains taxes, but these are also lower than state regular income tax rates

Tax-Free Refinance

Tax-Free Refinance

- Tax-free refinance allows you to pull out equity tax-free
- Example: your $5,000,000 property appreciates to $6,000,000
- You refinance at 75% - $6,000,000 x .75 = $4,500,000
- You pay off your original $3,750,000 loan
- You pocket $750,000
- Not taxable, because loans are not considered income – you have to pay them back
- But the property is paying back the loan for you!
- (You still owe tax on the money used for principal repayment, unless knocked out by depreciation)

Section 1031 Exchange

SECTION 1031 LIKE-KIND EXCHANGE

- Section 1031 of the tax code allows you to defer depreciation recapture taxes and capital gains taxes under certain conditions
- You must purchase a more expensive property, with a larger equity down-payment, within a certain period of time
- Otherwise, you must pay the recapture and capital gains taxes
- You can do this an unlimited number of times, buying bigger and bigger properties and deferring the taxes indefinitely
- However, the taxes never go away, they are only *deferred*
- Section 1031 is NOT generally available for syndicated deals, because LPs in syndications technically own stock, not real estate
- Will go into more detail in a separate video just on this topic

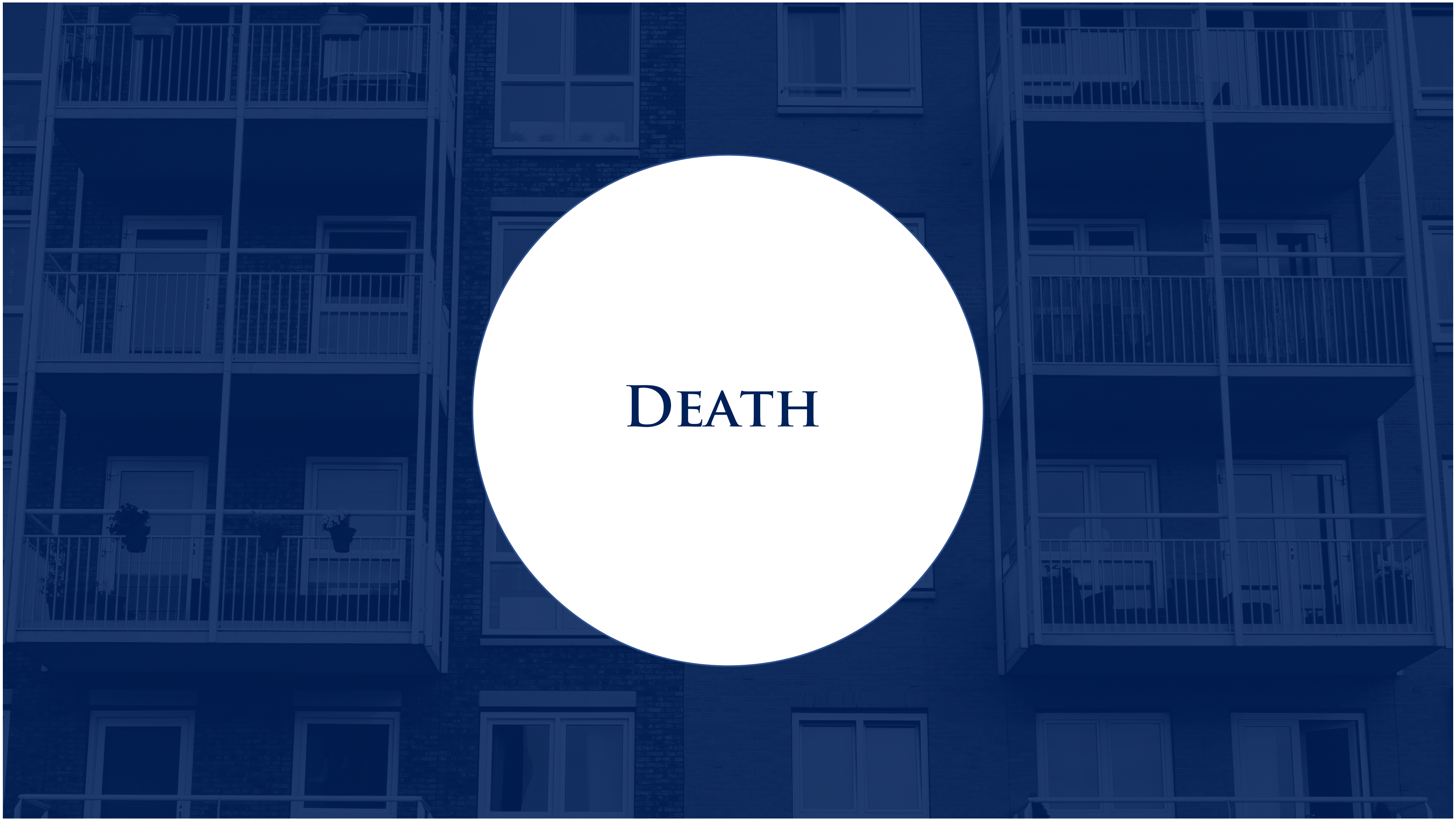

Opportunity
Zones

Opportunity Zones

- A new benefit in the recent tax reform intended to spur investment in underdeveloped areas
- If you sell a property and reinvest the proceeds in a qualified opportunity zone property, you can:

1. Defer the gain on the first property for up to 9 years
2. Eliminate 10% of the capital gains tax if the OZ investment is held for 5 years
3. Eliminate another 5% of the capital gains tax if the OZ investment is held for 7 years
4. Pay no capital gains tax on the investment in the OZ, if held for at least 10 years

- This area is still new and uncertain, with lots of rules, so speak to your CPA



Death

DEATH

- Dying’s not great for you, but it confers a great tax benefit on your heirs
- If your estate is under the threshold (currently $11mm), your estate pays no estate tax
- And, when you die, your heirs take your assets at their current market value
- All gains are effectively wiped out, and your heirs take at a the new basis
- For example, you purchased your property for $5,000,000 and it appreciates to $6,000,000 – you have a taxable capital gain of $1,000,000
- But if you pass to your heirs without selling, they take it at the $6,000,000 value, and only gains above that are taxed
- If they inherited today and sold the property tomorrow for $6,000,000, they would owe no capital gains tax
- Death allows you to eliminate the deferred taxes from repeated 1031 exchanges

Q&A in The Facebook Group

Next up:

Module 9 - Video 3
Section 1031 Like-Kind Exchanges