# Tax Benefits of Investing in Real Estate Syndicates

For Passive Investors and Limited Partners

THE REAL ESTATE CPA

# What We'll Cover

- Passive Activity Loss rules
- Cost Segregation Studies
- 100% Bonus Depreciation
- The 20% Passthrough Deduction
- Investing via Retirement Accounts

# Passive Activity Loss Rules

- A taxpayer may only offset passive losses from passive activity income (IRC Sec. 469)
- A passive activity is generally one that includes any trade or business where the taxpayer does not materially participate and any rental activities regardless of the participation level
- If you actively participate in your rental activities, and if you have rental losses, you can claim up to $25,000 of those losses as long as your MAGI is below $100,000
  - Phased out once MAGI hits $150,000
- Active participation means making management decisions or arranging for others to provide services

# What if My MAGI is Above $150,000?

# Suspended Passive Losses

- Rental losses incurred once your MAGI is above $150,000 will be suspended and carried forward to future years
- Suspended passive losses can be used to offset passive income and gain on sale of a rental
- When selling a rental, the suspended losses from all other rentals can be used to offset the gain on sale (it's not property specific)
- But you must dispose of substantially all of the rental activity; so be careful about grouping elections
- Provides flexibility: may not need to do a 1031 exchange

# Cost Segregation Studies

- The practice of allocating value to all property components to accelerate depreciation resulting in a significantly higher depreciation expense during the early years of ownership
- On a multi-family property, generally 20-30% of the purchase price will be allocated to 5-, 7-, and 15- year property (important for bonus depreciation)
- Costs can rage significantly, often approaching $7,000 for a 150 unit property
- Most syndicates perform a cost segregation study

# 100% Bonus Depreciation

- Allows for the immediate expensing of property components with a useful life of less than 20 years
- Increased from 50% to 100% thanks to the Tax Cuts and Jobs Act
- Often results in immediately writing off 20-30% of the property's purchase price in the first year of ownership
- As an example, a $10MM multi-family property that undergoes a cost segregation study could yield a $3MM first year depreciation expense thanks to 100% bonus depreciation

# Example of Tax Benefits from 100% Bonus

Assume a 200 unit multi-family property is purchased in November for $10MM. The total equity raise was $3.5MM. The syndicate engages in a cost segregation study and the first year depreciation expense in $3.2MM. Earnings before depreciation were $100k.

First, find net taxable income/loss. In this example, we have a $3.1MM loss ($100k - $3.2MM).

Next, distribute loss of $3.1MM to partners with positive capital accounts. Because we raised $3.5MM, our limited partners will absorb the entire $3.1MM loss. If you were a limited partner in this deal and you invested $100k, the loss passed through to you would be **$88,571!**

# Can You Use the Loss?

- Must have a positive capital account (cannot go below $0)
- Must have passive income, or
- Must qualify as a real estate professional **and** make the aggregation election under IRC Sec. 469(c)(7)(A)

# The 20% Pass Through Deduction (Sec. 199A)

- Taxable income, before the Qualified Business Income (QBI) deduction, is less than $157,000 if single and $315,000 if married
- Phased out once taxable income exceeds $207,500 is single and $415,000 if married
- When over the phase-out threshold, QBI is calculated by the lesser of:
  - 20% of QBI; or
  - The greater of:
    - 50% of the amount of W-2 wages paid to employees by the qualified business during the tax year, or
    - The sum of 25% of W-2 wages plus 2.5% of the cost of qualified property.
- Specified Service Trades or Businesses, once over the phase out threshold, do not receive a QBI deduction
  - Doctors, lawyers, accountants, actors, singers, consultants, investment managers

# What is Qualified Business Income?

- Qualified items of income, gain, deduction and loss from any qualified trade or business, including income from partnerships, S corporations, sole proprietorships, and certain trusts.
- Must be effectively connected with the conduct of a trade or business within the United States

# Does Rental Real Estate Count as a Qualified Trade or Business Under IRC Sec. 162?

- Maybe, but there's a safe harbor that makes it easier to claim the 20% deduction
- Notice 2019-07 allows rentals to qualify as a trade or business if:
  - Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
  - 250 or more hours of rental services are performed per year with respect to the rental enterprise; and
  - Starting in 2019, the taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services.
- Properties you use as a personal residence and NNN properties cannot use the safe harbor

# Every Syndicate We Have Seen Qualified as a IRC Sec. 162 Trade or Business

# What Does This Mean for Limited Partners?

- The 20% pass through deduction should be passed through to you as a limited partner
- Box 17 Code V - Z on your Form K-1
  - If positive, you have positive 199A income that you can then calculate the deduction amount off of
  - If negative, you must reduce your other 199A income from other trades or businesses
    - Almost always negative first couple of years
- The deduction amount is calculated on your personal return; the syndicate just tells you how much 199A income you have

# Investing With a Retirement Account

Many of our clients invest in syndications with a SDIRA or Solo 401(k). This can be a great tax mitigation strategy, but be weary of hidden traps and filing requirements.

- UDFI = Unrelated Debt Financed Income. If the property has debt, you have UDFI
  - But Solo 401(k)s are exempt from UDFI
- UBTI = Unrelated Business Taxable Income. This is a tax on income unrelated to the exempt purpose of your retirement account. Rental income is excluded.
- Though rental income is excluded from UBTI, you can still trigger UBTI by UDFI. This means if the property is leveraged, and if you invest via an SDIRA, you will have UDFI and, as a result, also have UBTI.

# Filing Requirements for Retirement Accounts

- SDIRAs
    - File Form 990-T if the SDIRA has more than $1,000 of gross income subject to UBTI. If you have losses, you may want to file Form 990-T as those losses can be carried forward to offset future positive income.
    - It is **your** responsibility to ensure you file Form 990-T when required. Many syndicates have CPAs who do not understand the reporting requirements and fail to report the appropriate information on Form K-1.
- Solo 401(k)s
    - File Form 5500-EZ if plan assets exceed $250,000
    - Less likely to result in a compliance black hole when investing in real estate syndicates due to not being subject to UDFI and rental income not being subject to UBTI

# Q&A

Contact Information:

Brandon Hall, CPA

brandon.hall@hallcpallc.com

www.therealestatecpa.com