Lowenstein Sandler's Real Estate Podcast: Terra Firma

Episode 17:
Real Estate Investing: The Tax Perspective

By Sophia Mokotoff, Matthew F. Cammarata, Stacey Tyler, Stephen Tanico

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Stacey Tyler: Welcome to Terra Firma: Conversations on Commercial Real Estate. I'm Stacey Tyler.

Stephen Tanico: And I'm Stephen Tanico. Stacey and I are real estate attorneys at Lowenstein Sandler. And on today's episode, we have the pleasure of being joined by our colleagues in the tax group Sophia Mokotoff and Matthew Cammarata. Thanks so much for joining us.

Matthew Cammarata: Thanks for having us.

Stacey Tyler: So, I know tax issues may be big and scary for a lot of real estate professionals who are maybe just starting to build up their portfolio and maybe not everyone is ready to have their tax counsel on retainer, thinking about how tax issues might impact their real estate decision making. So, we thought it might be interesting for our listeners to just kind of have a high-level conversation with you two, our friends and tax experts, about just kind of the big picture things that people in the real estate world should be thinking about, tax-wise.

So, I just wanted to kind of kick things off, just generally, what kinds of things do you recommend that people in the real estate world keep top of mind as far as taxes?

Sophia Mokotoff: So, I guess to start off with some high-level concepts of phrases you'll hear thrown around a lot. One, are the difference between different types of tax rates.

So, you'll hear references to long-term capital gains, versus ordinary income. Long-term capital gains right now is subject to preferential tax rates, meaning lower tax rates than ordinary income for the most part. And so oftentimes with investors in real estate, they'll be looking to maximize long-term capital gains. And that rate is lower and you have to hold on to property for a certain period of time to qualify for it.

This is different than, you know, your W-2 wages, for example, that you might have reported for performing services which are generally ordinary income rates. I think another thing we think about is holding something for investment versus holding

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something as part of your active trader business. And distinguishing between those types of situations.

Stacey Tyler: So, give us an example of that. That sounds like it's a different thing. If you are, you know, you manufacture something and you own your factory, then if you have a building that's leased as part of an investment, is that what you mean?

Sophia Mokotoff That's a great example. Yeah, exactly. So, you know, if you have a normal day job that you spend most of your time with and you choose to invest some additional cash that you might have into real estate, for example, an apartment that you're going to rent out on the side, that's holding something for investment as opposed to, you know, someone whose full time job it is to purchase real estate assets and sell those real estate assets, almost like inventory. And that plays into what types of deductions you can take, but also plays into what rates your gain on sales will be taxed at.

Matthew Cammarata: I think another high-level item and we'll get more into this because my specialty is state taxes. And I think another high-level item that should be on everyone's radar when they're thinking about investing in real estate is what potential non-income taxes you'll have to deal with upon acquisition or sale. And the big one is transfer taxes, which are imposed at the state and local level.

Sometimes state and local both impose separate transfer taxes. So that's always something to keep in mind. You know, as a high-level item, the cost of doing business when you're investing in real estate.

Stacey Tyler: For sure. We even see a lot of states having tax on the transfer of a controlling interest. So, you know, a lot of people think that, oh well, I won't own the property myself. I'll own it through an LLC. And that way I can sell my LLC tax free. But depending on the state, that's not going to be the case.

Matthew Cammarata: That's definitely true. You used to be able to do that until states caught on and started passing all of these controlling interest transfer taxes. And I think also it's really important when thinking about transfer taxes to understand that transfer taxes follow form. And so, unless you structure things and are thinking proactively about structuring things with transfer taxes in mind, you can sometimes have transfer taxes on each step of a transaction.

If you purchase something, say purchased real property, contributed to an entity because you want to limit liability and have other business reasons, you can pay transfer tax on that initial acquisition and on the transfer to the entity. So you have to be paying attention closely to the rules where you're buying the property to make sure that you're not tripping that up and paying more transfer tax than you want to.

Stacey Tyler: And then you might even pay mortgage tax when you decide to finance still. So definitely do some googling before you decide to buy or call your tax attorney. Nice plug!

Matthew Cammarata: Do some googling or call us. Yes.

Stephen Tanico: Now, we kind of talked about the, you know, at a high level, the differences between types of income, between kind of the way real estate is viewed. For someone just starting out in this, you know, is there benefit to setting up an LLC from a tax perspective, for example, or investing individually? Does the tax treatment change if Stacey and I decide to do a joint venture together versus, you know, myself investing in a project Stacey's already doing?

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Sophia Mokotoff: That's a tax person's favorite question because the answer is yes, it definitely changes, and could potentially change how things are treated. And there might be advantages and there might not. Again, it's a very fact-sensitive analysis. So, you know, for example, if you are investing solo, as just an individual/one person then forming an LLC might be beneficial from a non-tax perspective for liability purposes, but it might not make a difference from a tax perspective.

Because it's treated as a pass-through and sort of disregarded from you individually. But if two people want to invest in the same piece of real estate and form an LLC and hold the real estate through an LLC, then you have an entity that might be treated as a partnership for federal income tax purposes, and you get into a whole slew of tax rules related to partnerships.

Stephen Tanico: And you mentioned, pass-through their disregarded entity. Could use expand a little bit on what those two terms mean from a tax perspective?

Sophia Mokotoff: Sure, and Matt can chime in with how this differs for state tax purposes. Generally, for federal income tax purposes, a pass-through entity, isn't subject to tax at the entity level. It's rather the owners of the entity are subject to tax on the income that's earned by the entity. A disregarded entity doesn't file its own tax return, for example. So, if I own a single member LLC, generally I would just report the operations of that LLC on my personal tax return.

Stephen Tanico: Got it.

Matthew Cammarata: And I think the only thing to point out there, when you're thinking about potential state and local tax issues is that, you know, the general rule really is that most state and local jurisdictions will follow the classifications that Sophia just described for how entities should be treated for tax purposes. But again, tax lawyers' favorite thing to say— it depends.

There are certain jurisdictions where entities that are, you know, flow-through, as Sophia just described for federal income tax purposes, are actually taxable at the state level. New York City, for example, has what's called an unincorporated business tax. So, it will tax partnerships that otherwise are not subject to tax federally. And then the only other thing to think about as well, at the state level, you know, disregarded entities, again general rule, the state and local jurisdictions will follow the federal tax classification

But in terms of transfer taxes, those follow legal entity. And so typically, even if an entity is disregarded for income tax purposes, that "disregarded" entity would have to pay the transfer tax upon acquisition or sale of real property.

Stephen Tanico: Now, I fully understand why your rates are so much higher than everyone else's at this law firm.

Stacey Tyler: So, you talked a little bit about the kinds of things that you could help people with if they came to you well in advance of making the investment, of deciding to do the thing, the ways that you could think about going about it differently depending on tax advice. Can you talk a little bit about the opposite of that, where somebody just went ahead and did something and the types of things, you see that people have messed up, or those kind of tax pitfalls that happen when maybe you didn't get the tax advice first.

Sophia Mokotoff: One example that comes to mind are limitations under the tax code about expenses you can take deductions for when it is a dwelling unit that has a personal use. And

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so, a common mistake I'll see is that someone you know purchases a vacation house, for example, and maybe rents it out for part of the year and thinks of it as though it is purely an investment property. And that just really isn't the case. There are a lot of detailed rules that try to prevent people from taking deductions for property, that is, for a personal use, which is, for example, the reason that you can't necessarily get a deduction for tax purposes if you paint the bedroom of your primary residence.

Right. So here with a vacation house or sort of a second property like that, you have to be really careful about these rules to make sure that you can get deductions. And so, I would definitely recommend that people consult with a tax advisor before they do something like, you know, spend the summer at a rental property that they've acquired for investment purposes, for example, or, before they decide to rent it out.

Sort of like family friendly rates, to a relative. And that way, you know, you can understand the parameters of how much personal use you can get out of it without jeopardizing the tax treatment. And your tax advisor can help advise you on what type of documentation to be pulling together, sort of contemporaneously to make sure you really have the best position for your tax position.

Stephen Tanico: Makes sense. You know, it's interesting to me because in your world you have accountants, which is, you know, kind of another professional. How in your world do you see the overlap between kind of your role as a tax attorney and an accountant's role as an accountant, and whether there's kind of, I assume there is overlap, but if you know a listener who is just getting into real estate, what are some of the benefits of going to an attorney versus an accountant to maybe vice versa?

Sophia Mokotoff: Sure. So, I think in an ideal situation, tax attorneys and tax accountants really work together. So, your tax accountant is the person who's actually plugging in the numbers onto your tax return, right. Compiling the receipts that you give them and the information that you give them, turning those numbers into numbers on your tax return, which your tax attorney will not necessarily do, certainly not without putting up a fight.

A tax attorney might be better positioned to help advise you sort of in advance or after a transaction if you're looking for sort of a more detailed technical analysis, and support for a position. Sometimes we work with tax accountants where the client wants to take a certain position and the accountant can't get the comfort level to report that position without having another tax professional, like a tax attorney, provide an opinion on that position, for example.

Stacey Tyler: Do you find yourself working with accountants, like running out different strategies for clients? It sounds like for a lot of investments, you might have a few different ways you could go about something. So, are you involved with that kind of modeling process?

Sophia Mokotoff: Yeah, I'd say as lawyers we probably work with Excel sheets more than a lot of other lawyers.

We're asked to sort of dig into models and projections. And ideally, you know, clients are getting their tax accountants involved early as well, so that by the time, you know, a year down the road when they're actually preparing the tax return, to report that position that you took in the prior year, they're aware of all the nuances about, you know, what was done to ensure a particular tax treatment.

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Matthew Cammarata: Yeah, I actually love when clients have accountants involved early in the process because I think it's so important to have your lawyers and accountants on the same page precisely for the reasons Sophia was just describing. You don't want to have your lawyer structure something that you later find out the accountant is maybe uncomfortable with and has a lot of questions about, or perhaps doesn't want to take the position on the return.

I think it can ease a lot of administrative burdens later on in the process when you have your lawyers and accountants on the same page from the start.

Stephen Tanico: Now, in an ideal world, what do you like to see your client's kind of show up for that first call with you guys, you know, how can our listeners come prepared and at least, you know, bring something to the table if maybe they're not entirely sure of the tax structure of the deal they're looking at.

Sophia Mokotoff: Well, I think we see a little bit of everything. We see people who are trying to be overly prepared and coming to us before they've even made an investment. In which case, you know, we're just going to talk through the business side. I like to say we try to avoid having the tail wag the dog, right? Tax shouldn't dictate everything, right?

You should start with a good investment idea from a business perspective and then we can work around it to sort of optimize tax around that. So, you know, being ready to talk about what your game plan is or why you want to make this investment, and sort of what some of the benefits you're looking to get out of it are, you know. For other clients, they'll come to us after the fact.

They've already made the investment. And now, you know, they're looking to document that position on their tax returns or figure out what they can do from there. In those situations, you know, it's helpful to have copies of documents. I feel like tax lawyers are always asking for copies of documents. Because in addition to sort of hearing someone recount how the transaction went down and what the details are, it is also helpful to see if, you know, the lawyers might have snuck in some words in the document that might change how we're sort of viewing it.

Stacey Tyler: You know how we lawyers are constantly sneaking words in.

Stephen Tanico: Now, another kind of word I feel like I hear quite a bit in the real estate world as it relates to tax is "depreciation." Could you, explain a little bit about what depreciation means? And you know why it's involved and important from a tax perspective in real estate.

Sophia Mokotoff: Sure. So, very high-level depreciation. The concept generally is the decline in value of property over time, right. The erosion of investment in property over time.

So, the tax rules recognize that this happens and give investors the benefit of being able to take deductions for the price paid for property over a period of time. And there's different rates of depreciation. Different types of property are depreciable over different time periods. And sometimes you can accelerate depreciation and take more depreciation over a shorter period of time.

But the real benefit here is the fact that you get a tax deduction without actually incurring sort of cash out the door as an expense. Or for example, you put up cash upfront to purchase an asset and then you get to depreciate that price that you paid over time. Basically, deduct the value or the depreciation in the value over time.

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Stephen Tanico: Yeah, I have so many more like specific questions that I'm going to avoid that definitely don't relate to investment properties I own because that's not a good use of this. But I think, you know, it's interesting because like, you know, obviously, Matt, and you see things a little bit differently depending on if it's at kind of a state level or federal level. But, you know, with the removal of the SALT deduction, what are still some of the common, advantages real estate might play from a tax perspective?

You know, we just talked about depreciation. That feels like something that's a benefit. I guess like is there anything that comes to mind kind of in that vein that, you know, a real estate investor could be thinking about at the outset or just generally thinking about with all of that person's real estate investing?

Matthew Cammarata: I mean, I think from an income tax perspective, right, any time a deduction gets taken away, like the SALT deduction that Stephen was referring to, is now individuals are limited to deducting state taxes that they've paid during the year to $10,000. That used to be unlimited. And so, to the extent you're investing in real estate and you can generate deductions, you know, the more deductions you have, the more you're offsetting kind of the loss of that benefit you had from the state tax deduction.

The other thing to think about is in response to the loss or the limiting, I should say, of the state tax deduction, many states passed what are called pass-through entity taxes.

Stephen Tanico: Okay.

Matthew Cammarata: So, pass-through entities that have a filing obligation in the state and earn income, can elect to pay a tax at the entity level. So, a partnership normally wouldn't pay tax in most jurisdictions but can elect to under these pass-through entity taxes. What that does is the payment of the tax at the entity level, allows the entity to deduct the taxes paid on behalf of the individuals, and it reduces the individual's federal tax liabilities.

So, you can get a benefit. So, it is something to think about if you're looking at some sort of joint venture or investing with others. If it's in an entity and you're expecting to generate income from it, putting it in a partnership or a limited liability company can generate additional benefit, because you'd be able to deduct providing the state you're operating in has a PTET, you'll be able to deduct taxes paid by the entity.

Stephen Tanico: Well, what was that very savvy PTET you just used there?

Matthew Cammarata: Oh, the acronym?

Stephen Tanico: Yeah.

Matthew Cammarata: Oh, sorry. It's “pass-through entity tax.” We call it PTET for short.

Sophia Mokotoff: I guess the other point that I'll flag about, you know, maximizing deductions, deductions for the most part correspond directly with expenses. And so, you know, you've actually spent money on something and that sort of gets you the benefit of the deduction. So just to bring it back to sort of the economic reality, you know, if you pour a lot of money into a real estate investment, you would hope that you could get deductions. But it does require you most of the time to have to pour that money in first.

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Stephen Tanico: No, that's a very good point, that the deductions are not just free money, somehow.

Stacey Tyler: I think about that every time I get my mortgage interest deduction. Oh, that's nice. Oh wait, no, it's actually only a small fraction.

Matthew Cammarata: That's a lot of what we do in these situations though. And that's what, you know, when Sophia and I work together on looking into what is the most tax efficient way to approach a situation, it's a lot of balancing, you know, what are the income tax consequences of doing it this way? What are the potential state and local transfer tax consequences?

Are they getting a deduction via pass-through entity taxes? And, what's most important? What best aligns with business objectives? And sometimes it does come down to, you know, well, we're going to take the hit with the transfer taxes because overall we think we're getting a really good income tax benefit here. So, that's I think part of the value too of having advisors that can look at things holistically at the federal and state level.

Stephen Tanico: Yeah, it reminds me of the other point. I wanted kind of a little bit more clarity from you guys on carryforward losses, which I think is a fascinating place in real estate where, you know, it definitely is not something you want on your tax returns, but there does seem to be certain benefits to it from a pure tax perspective. Am I totally off base with that?

Sophia Mokotoff: So, the term “carryforward” losses can sort of apply to a wide range of things, but generally, it relates to the idea that in certain contexts you won't be able to take more deductions, sort of to get a refund for deductions in excess of the income that you've earned during a taxable period. Or for numerous other reasons, there might just be limitations on the amount of certain types of deductions that you can take in a particular period.To give you the benefit of those deductions. They generate a carry forward, for example. So, generating potential losses and deductions that you can take in future periods.

So, I mean, the nuances of those rules will depend on a lot of situations. So, whether you're in a trade or business, whether it's a for profit activity, whether it's personal use, so that's, you know, one example of how deductions can get complicated and figuring out whether or not you qualify for a particular deduction. You might qualify for a particular deduction, but might be limited as to the amount of that deduction you can take in a particular period.

So that's another thing that you can work with either a tax attorney or a tax accountant to figure out sort of how to take that into account and projecting out, you know, cash flow for the next year or two.

Matthew Cammarata: And that is also one area, the idea of carrying forward losses where state and federal law can really vary significantly. A lot of times you can take losses and carry them forward federally, but you cannot for state purposes. So, that's a particular area where the tax result can sometimes be very different at the federal and state level.

Stacey Tyler: So, Matt, I know you are our state and local expert. I'm just curious if I own a property in a particular state, is that necessarily the state where these tax rules are going to be pertinent, or is it about the state where I've incorporated my ownership, LLC?

Matthew Cammarata: That's a really good question. Typically, with real property, it's where the real property is located, right? It makes it a bit easier. But you do have to keep in mind if you have

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a business that has, you know, different types of operations or investments in multiple jurisdictions, then you have to take into account the rules in the various jurisdictions.

Simple case of I'm setting up an entity to invest with other partners in real property. Things like transfer taxes, mortgage recording taxes, things like that are going to be wherever the property is. But as things become more complex and you have different investments, perhaps in different places, you're going to have to be looking at rules and laws in various jurisdictions, for sure.

And, also the residence, if you're talking about individuals here, another important thing to keep in mind is in terms of balancing the benefits and burdens to the individuals. That is something where you have to look at where each individual is resident.

Stephen Tanico: So, you're saying it's super easy and straightforward if you own real estate in a bunch of different states?

Matthew Cammarata: Yes, yes, that's exactly what I'm saying.

Stephen Tanico: You know, we like to ask a lot of our guests this kind of more general question. If you had a wish list of things your clients did before coming to you, we see a lot of times where, you know, the worst-case scenario has happened, and then they're picking up the phone to call a tax attorney in this situation.

What are some of those things that an investor / developer could be proactive with from a tax perspective? Even something super small that might have like a more meaningful impact.

Sophia Mokotoff: I think a key one, and in this probably plays into a lot of practice areas, is keeping good contemporaneous documentation of different things that you've done over the course of the year. You know, different transactions or different agreements. Contemporaneous documentation is always going to be helpful for supporting a particular tax position.

Stephen Tanico: And I never even thought about this, but supporting a tax position, you know, you and an accountant or is it like the IRS for example, is that kind of the scenario you're describing for those contemporaneous notes?

Sophia Mokotoff: Both, you know, for purposes of being able to show something to either your tax attorney or your tax accountant, to have them either plug it onto a tax return or write you a memo about the consequences of something. But also on audit, it's a lot easier to support a position if you have contemporaneous documentation. For example, you know, if you got a valuation done for a particular property, in connection with making a charitable donation or something like that.

Right? Contemporaneous documentation is always going to be better than sort of after the fact, three years down the line, when you're being audited, trying to go back and get a retroactive valuation of three years ago, when it's a lot harder to dig up the documentation.

Matthew Cammarata: Yeah, and I actually do a lot of tax controversy work. And just on that audit point, you know, proving a position you took on a return is correct requires some documentation in almost every circumstance. And it's always the taxpayer's burden to prove that they're correct. And so, when you lack that documentation, even if something at the time when you had the documentation that you perhaps don't have anymore, even if at that time it was correct, if you can't substantiate it properly, you're potentially going

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to lose that benefit. If you really can't come up with the proof to show that, for example, a deduction was valid or, you know, an expense you claimed was actually incurred.

Stacey Tyler: All the more reason to just keep detailed notes and ask questions at the time. Don't just hold your nose and hope it works out. Well, thank you both so much for joining us today and helping us get a little bit smarter about taxes. Sophia and Matt, you have been super helpful to us. Thank you very much.

Stephen Tanico: And thank you, listeners for tuning in today. Be sure to like, subscribe, and follow Terra Firma wherever you're listening to this episode. Stacey and I would love to hear from you, so feel free to reach out to us at Terrafirma@lowenstein.com. Until next time.

Stacey Tyler: Ciao!

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