Ep #302: Marcus Crigler - Real Estate Tax Advantages for Passive vs. Active Investors

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Dr. David Phelps

Dentist Freedom Blueprint with Dr. David Phelps

Ep #302: Marcus Crigler - Real Estate Tax Advantages for Passive vs. Active Investors

David Phelps: Hi, David here. This is the second half of my conversation with Mr. Marcus Crigler the CEO and founder of BEC CFO. Marcus is a tax expert, runs a company that is a chief financial officer and controller for many high capital, high net worth businesses and individuals. Today, the second half of our recording, which is a standalone, you don't have to go back to the last one if you don't want to, but I think you should. Today, we'll talk about the differences between an active real estate investor, what we call a real estate professional, and a passive investor, which is what I am today, and what most of the people in freedom founders are. What the differences are in terms of the tax code, the IRS tax playbook, what that means to you. We'll dig in today and give you some real clarification because I see a lot of confusion out there in the space today about who gets the tax benefits, how they work, and what happens to those who can't take them today. Enjoy.

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David Phelps: Let's pivot to one other topic, and we'll call this a great discussion today. Marcus, enjoyed it so far, very, very good insights. In terms of real estate, and I'm talking to an

audience that's primarily going to be "passive investors", not active boots on the ground, doing development or finding deals, but investing in, could be turnkey properties, or syndications, or managers that have fund investments in various types of real estate. As a passive investor, what are the benefits, potential benefits I should say, in terms of tax preferences or tax benefits?

We talked a little bit earlier today, but I think it's an area that there's a lot of confusion out there today, because people again could go to Google, or they can go to a syndicators' promo page for the latest syndication. And they're going to talk about, we are using the 2017 tax law that gave us a bonus depreciation and cost segregation. And we were going to roll all these great tax benefits. And you, the investor, should realize this kind of a return plus these tax benefits. How should really a passive investor look at that? And compare and contrast passive investor with a syndicator or a real estate professional, so we have those definitions clear if you would.

Marcus Crigler: Yeah, absolutely. So let's start with passive, passive is easy, right? If you're not actively in the real estate business, if you're not actively going out there finding the properties, flipping the properties, sourcing the properties, you're not active.

David Phelps: You're not managing the properties. I mean, you're not-

Marcus Crigler: If you're just putting your money in, the chances of you being active is pretty much zero.

David Phelps: Right.

Marcus Crigler: So if you're an investor in the strictest sense of investing, right? I'm going to allow my money to work for me. I'm going to be passive. Then you need to understand what the passive consequences are, they're not necessarily bad, but they're consequences. When you put your money in and you're not active... And we're going to talk about syndication just because that's a hot button topic right now, it's been one that's been confusing to a lot of people. You go out there, you get the 2017 tax cuts, and jobs act was fantastic for apartment investing or really any real estate investing, creates large depreciation deductions in the first year, which creates a loss. That's one misnomer that a lot of people don't understand is, Hey, you're going to receive X amount of dollars in depreciation.

Well, not necessarily. You're going to receive X amount of dollars in deduction, that's going to create a loss that's going to flow through to you individually. You're not actually going to see... I've had several times where, Hey, where's my depreciation deduction on this K-1? Well, it's in that box too, that big loss that you see, it's actually not depreciation that's actually going to you, it's actually lost. Well, those losses, and a couple of things happens with those losses. The first one is, if you are passive and you make over $150,000, married filing joint, again we're probably, if you're investing in these things, you're typically in that category. Any losses above the income that you've made, so if you have zero, if you've made income on that, and I'm saying any losses that you've received off that K-1 is probably going to be carried forward until you receive income off of it.

David Phelps: Income from that particular investment, IE the syndication?

Marcus Crigler: From that, yes.

David Phelps: Yes.

Marcus Crigler: It ties to that investment. Okay? Now this is where it gets confusing, if you receive passive loss from this syndication here, and passive income from this syndication here, in that one year, they can offset. Okay? After that one year is up, if you didn't have the passive income and passive loss at the same time in the same year, this passive loss carries forward until this syndication produces income. This one's going to get taxed, right? So it's kind of tricky on following the money, if you will. So that's for passive investors. And so a lot of people get frustrated when they invest into something because they see these big losses and they're like, "Ah, man, I really wish I could take these losses." Well, you have received income, right? You've received cash.

I shouldn't say income, incomes not the right terminology. You've received distributions out of that partnership, right? Those distributions are now coming to you tax-free because, or tax deferred, I should say, because you have received a loss on your tax return, but you've actually received cash. And so if you receive $10,000 in cash and you've received $10,000 loss, you don't pay any taxes on that $10,000. So that $10,000 for that years, is net 10,000, which is, that's that after-tax return on investment that we talked about earlier.

So a lot of people get frustrated that they're missing out on those deductions, but they're not, they're carried

forward until that income does pop up. And now you can use that income against, or those losses against future income on that syndication, which you're going to eventually receive income off of these syndications. They don't always spit off losses because their goal is to make income, right?

David Phelps: Right.

Marcus Crigler: That's what they're out there for, so they will eventually shoot income. Your losses will carry forward, and you'll be able to use those losses at that time, which is great, right? That's not a bad deal. It's not the best deal, like a real estate investor, which we can go to next. Real Estate investor-

David Phelps: Well, yeah, we'll go there next. Just to clarify those passive losses excess beyond the distributions from that syndication. So you net those out, if you have additional losses, the point is they're carried forward. As a non-professional real estate investor, which is where you're going next, meaning a passive investor, the way the tax code is today Marcus, we can not take passive losses against our active earning income, correct?

Marcus Crigler: Yes, that's correct.

David Phelps: Okay, okay.

Marcus Crigler: So unfortunately we're not going to be able to do that. And that's one thing that's very, very critical, if you typically have a tax preparer that is not used to syndication's, they can mess that up. And I've seen it messed up before, so something very, very important for you to look at is make sure that those losses, if you've

invested in a syndication, aren't offsetting your income. And you might look at it and be like, Oh, sweet. It offset my income, we're good. Just because it did, it doesn't mean it's right. And this is something that's little known to most taxpayers, your tax return is always your problem. Always. It doesn't matter who prepared it, it doesn't matter what they put on there. I can promise you, go read the fine print of the engagement letter that you signed in order to get them to, because I had the same engagement letter, by the way, I know this from experience, that all of it says, Hey, this is your return. You've got to double check it. You've got to know. They just CYA on everything.

So we're giving you that, I'm giving you that information now because you not knowing is not an excuse to the IRS. Okay? So if they call you out on it, and I've seen it happen, I've seen it happen, that's why I'm bringing this up, you're going to be the one that's charged with the interest. You're going to be the one that's charged with the penalties. Sure, you may be able to go back to the tax preparer and if they're the right person, they're going to help you make sure you're taken care of. But end of the day it's still incorrect, and it's still a hassle.

David Phelps: The IRS is going to look to you first-

Marcus Crigler: Exactly.

David Phelps: Is what you're saying. Yeah. Okay. All right. So now let's go to the professional real estate investor. Yeah. So again, now we're talking about active, which again, for my listeners, probably very few, unless they have, one exception could be, and we actually have one in our group, in our Freedom Founders, Marcus. The dentist is a dentist, so no active real estate participation there.

However, his wife is an active real estate licensee, who's out there selling houses, they actually have some little rental houses, managing those. So in that case, I'm guessing married, filing jointly that that probably enables that couple, because they have one active participant, to actually enjoy the benefits of being a real estate professional. So with that little context, why don't you dive into that and give us a little bit more definition.

Marcus Crigler: Yeah. So we'll hit on this very slightly, but just so you guys can get the gist. Basically the active real estate professional, and by the way, I love the wives strategy. It's a strategy that I've helped employ with a couple people as well. The wife, husband, spouse, we should say. That strategy is a great strategy, but it's got to be legit, right? It's not a, Hey, we can escape around this. But what an active real estate investor can do, and why Trump and some other large developers can zero out their tax bill, or next to zero out their tax bill, is because they can actually take those losses against their income, against their active income.

David Phelps: Active income. Yeah, very good.

Marcus Crigler: And so now these huge depreciation losses, which by the way, depreciation loss, it's not a 2017 tax cuts and jobs act only. This isn't the first time we've ever had it, up until the tax cuts and jobs act, it was a 50% bonus depreciation, which still created tens of millions of dollars of losses for real estate developers across the country. So the depreciation game is a game we've played for a lot of years, but it allows them to offset their ordinary income with their real estate losses. Now, one thing that's confusing, and I don't want to dive into this too much

because I don't know if there's a ton of value for your listeners, but you have to be a real estate professional, but you also have to be actively managing those properties of which you're taking losses.

David Phelps: Okay. That's says-

Marcus Crigler: So it's got to be both.

David Phelps: Yeah, yeah. So in other words, you could do that, take the losses, if you have your own rental houses that you're managing locally. That would be probably the pretense where that would happen. But if you're also invested in a syndication for which you are not actively managing, that's going to be separate and you can't then use any excess losses from that syndication to go against your active income?

Marcus Crigler: Generally speaking, yes. Now again, this is where a tax strategist comes in and can solve that problem, and it's a problem that can be solved fairly simply, which basically we make an election to group all of your real estate activity together. And if, in all of your real estate activity you're considered active, then you can do so. But first you got to be a real estate professional, then we got to make a grouping election, and all of your real estate activity can then be considered active if we make that election. Not a big deal to do that, but you just have to know how to do it, it's something that we do quite a bit.

David Phelps: All right. That's really good. Thank you for that. So I'm thinking, Marcus, I'm just thinking out loud here, I'm not proposing it's something that you do, but it just came to me, that I know so many relatively high net worth, high income people, probably not ready for a family office

planning or the strategists that you do. But what if you set up, within your firm, an opportunity to help one spouse or the other become licensed, and create some kind of a material participation opportunity, then you could put together the all inclusive, real estate holding company, I guess, whatever you would do. Now, is there something there? I mean, again, it has to be legitimate but.

Marcus Crigler: I love that idea, it's one that I've thought about for years. The problem is you find in those conversations that the spouse doesn't really want to be a participant.

David Phelps: Oh, you mean, you're saying you have to have compliance within that? Oh I thought, I'm surprised that even crossed my mind, but you're right.

Marcus Crigler: So a real estate professional, as simple as this, what the spouse would have to do in order to be considered a real estate professional is they'd have to spend 750 hours a year certain specific real estate activities. And that has to be over 50% of their active earning time, right? Basically their job, over 50% of their earnings, or active earnings, is going to be in real estate. So typically that 750 hours, if you've got a spouse that's used to not spending 15 to 20 hours a week working in real estate or whatever that might be, it's tough to get there. And sometimes even the return to get them there doesn't make sense for you as the business owner.

Now, I will say, in the ones that I've been able to execute, the spouse basically went from earning zero to earning roughly $75,000 a year because it was a reduction in taxes, right? So they basically took their salary, working 15 to 20 hours a week in real estate, making $75,000 a year in tax savings. Well, if you're working 15 to 20 hours

a week, and you're making $75,000 a year, most people are going to say, okay, I'm good with that. That's a nice little side income. And that's basically what you're looking at if you've got the right scenario.

David Phelps: Okay. All right. Really, really helpful. Marcus Crigler. Also, I need to give, very cool name of your company, BEC CFO, and the BEC are the first initials of your three children, Bennett, Ellen and Carter. BEC CFO out of Springfield, yes? It's close by?

Marcus Crigler: Yes.

David Phelps: Yeah. Springfield, Missouri.

Marcus Crigler: Springfield, Missouri.

David Phelps: Kansas City Chiefs all the way, right?

Marcus Crigler: Absolutely. Kansas City Chiefs, St. Louis Cardinals. Used to be St. Louis Rams, but they-

David Phelps: That's right.

Marcus Crigler: That was back when they were the greatest show on turf out in California. That's okay, I still root for them to win too.

David Phelps: That's awesome. Marcus, thanks for your time today, I really appreciate it.

Marcus Crigler: Hey, I appreciate you.

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