MLG Capital
Real Estate Investments

The Powerful Tax Benefits of Private Real Estate Investing: Highly Compensated Individuals, A Case Study

By: Timothy J. Wallen

Find Smart Real Estate Deals First, Then Wrap Great Tax Planning Around Your Investment.

Sophisticated tax planning is not a “DIY” activity: like the other aspects of your wealth preservation plan, you should leverage your personal CPAs to help you build a tax-efficient strategy aligned with your objectives.

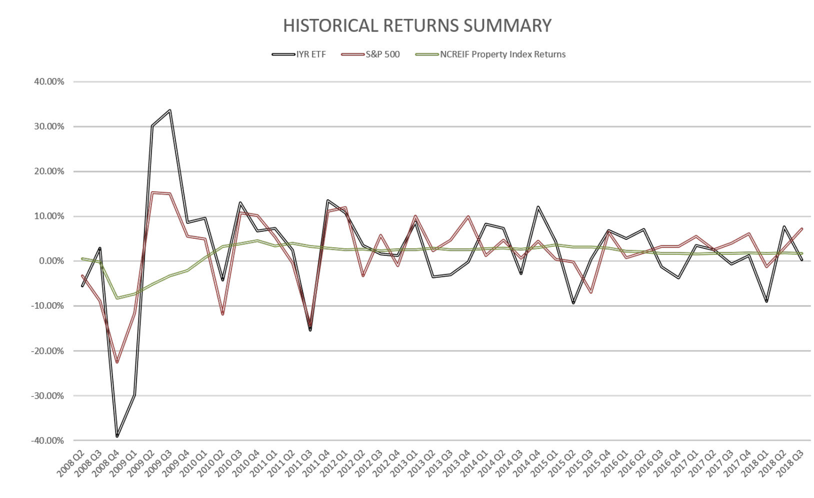
You’ll want an expert there to answer the many tax-related questions that inevitably spring up during the planning and execution of your tax and wealth preservation strategy. This article focuses on the powerful income tax advantages of MLG’s Private Real Estate Funds. These advantages may significantly impact highly compensated individual’s overall personal income tax picture by addressing the following questions:

- Are your overall investments tax advantageous? If not, what can Private Real Estate do for you?
- How can one investment impact another for highly compensated individuals?
- Can tax efficiencies within a passive investment offset taxable income of another investment, or other highly taxed salary income?

Tax efficiency is an important aspect of your overall plan, but always remember the number one priority every real estate investor must **first** focus on is investing in **smart** real estate deals.

Letting the proverbial “tax tail wag the dog” leaves you open to the risk of making less attractive investments over the long haul. After finding a great opportunity you can then wrap powerful tax strategies around such investments. Never invest in private real estate just for its tax benefits.

Investing in private real estate can have many advantages including cash flow from operations, tax efficiency, and capital appreciation potential. With the volatility and uncertainty that continues to be demonstrated on Wall Street, investing in private real estate can be a very desirable investment that can offer low volatility and low correlation to the S&P 500. MLG Capital tracks the performance of the stock market with publicly traded REITs and private real estate investments. The graph below reveals a 10-year history of how volatile the stock market (S&P 500, red line) and public REITs (IYR ETF, black line) are when compared to private real estate investments (NCREIF property index, green line). It is easy to see that the publicly traded investments are significantly more volatile than private real estate.



MLG Capital's Approach to Tax Income Planning:

MLG does four key tax income planning strategies within their series of private real estate funds:

- Cost Segregation Studies
- Utilizing the ability to expense 1231 Assets
- Utilizing the Bonus Depreciation Rules
- Be willing to sell investments (vs holding indefinitely) to trigger long term capital gain tax rates

Typically, the biggest tax pain to highly compensated individuals are the high ordinary tax rates! Some of us pay the highest marginal tax rate of 37% in federal ordinary income tax rates, but also painfully pay even higher rates in total with state income taxes. In utilizing the above strategies, the overall goal is to eliminate most if not of the all ordinary income generated by our series of funds, so that most of the taxable income is taxed at capital gains tax rates.

Ok, that's great, but what does that mean to me as a highly compensated individual? How does this work?

Since MLG Capital targets to periodically sell assets within its series of funds, and these sales are generally staggered over time with other fund vintage acquisition and dispositions, we can trigger passive capital gain income that can potentially enable the use of passive losses.

Investopedia defines passive activity loss rules as, "a set of IRS rules that prohibit using passive losses to offset earned or ordinary income. Passive activity loss rules prevent investors from using losses incurred from income-producing activities in which they are not materially involved." Due to the passive loss rules an investors ability to use passive losses from passive real estate investments are limited.

This can be dramatic for highly compensated individuals who are taxed at the highest federal ordinary rates (37%). When the ordinary passive losses can be utilized due to triggering passive capital gains, a highly compensated individual may very well benefit from tax savings due to the income tax rate differential between capital gain rates (20-25%) and ordinary rates (37%).

Still with me? Good! See the following Example for a Highly Compensated Individual.

Example of the Simple Math of the Tax Savings:

Let's assume that you are making $1M in ordinary wage income (W2). Add in $900K additional ordinary business income and $100K in ordinary interest income and suddenly you're flirting with $2M in AGI (adjusted gross income). In normal fact patterns your effective federal tax rate quickly steps over 35.5%!

Now, let's assume that you've actively invested into a few of our funds within the series of MLG Private Real Estate Funds, totaling $2.5M of equity invested. Let's also assume that one of our funds has produced $400K of prior year suspended passive rental losses, a $600K current year passive rental loss and a passive net section 1231 gain of $1M (includes $300K of unrecaptured 1250 gain with a tax rate of 25% and the remaining $700K taxed at 20%) due to the sale of some of the real estate within the funds.

The hard facts are that both cases end up with the same taxable income of just under $2M of AGI. The big benefit, however, is that by investing in private real estate the taxpayer's effective tax rate drops from 35.62% to 27.83%, or a drop of nearly 7.8% in this example! This occurs due to the $1M net section 1231 gain being taxed at lower capital gain rates effectively replacing the $1M of ordinary income that would have been taxed at the highest marginal tax rate of 37%.

*(See Figure 1)****

INVESTOR RELATIONS
RequestInfo@mlgcapital.com
262-797-9400
19000 West Bluemound, Brookfield, WI 53045

(Figure 1)***

	No MLG PF Case 1	With MLG PF Case 2	Difference
Ordinary Income (Wages)	1,000,000	1,000,000	-
Ordinary Income (Business Income)	900,000	900,000	-
Ordinary Income (Interest Income)	100,000	100,000	-
CY Ordinary Passive Losses - MLG Private Funds		(600,000)	(600,000)
PY Ordinary Passive Losses - MLG Private Funds		(400,000)	(400,000)
	2,000,000	1,000,000	(1,000,000)
Gains From Asset Sales - MLG Private Funds			-
Net Sec.1231 (excludes unrecaptured 1250) - 20%	-	700,000	700,000
Unrecaptured 1250 Gain (depreciation recapture) - 25%	-	300,000	300,000
	-	1,000,000	1,000,000
Less Self-Employment Tax	(12,000)	(12,000)	-
Total Adjusted Gross Income (AGI)	1,988,000	1,988,000	-
Net Federal Tax Due	**708,173**	**553,173**	**(155,000)**
Effective Tax Rate (Net Tax Due/AGI)	**35.62%**	**27.83%**	**-7.80%**

****(Every tax paying investor has a different set of circumstances and may not achieve the tax benefits illustrated above. Every tax paying investor must independently verify with their CPA, tax professional or attorney tax advisor to determine if investing in the MLG Private Funds will produce similar results. To produce the results in the illustration above, the theoretical tax paying investor must not make any grouping elections under the passive loss rules. The aforementioned numerical example is for hypothetical demonstration purposes only and is not to be construed or taken as tax, legal or investment advice.)*

Resources :

Website- www.mlgcapital.com

MLG Capital Team- www.mlgcapital.com/team

LinkedIn- https://www.linkedin.com/company/mlg-capital/

Twitter- https://twitter.com/mlgcapital?lang=en

Facebook- https://www.facebook.com/mlg.capital.re/

Harvest Portal- https://www.hvst.com/organization/mlg-capital

***As of 12/31/2018. Value is consistent of disposed of assets as well as the current internal valuation of currently held assets as of 9/30/2018. Values may not have been reviewed by an independent 3rd party and may be internal projections.*

INVESTOR RELATIONS
RequestInfo@mlgcapital.com
262-797-9400
19000 West Bluemound, Brookfield, WI 53045

MLG Capital historically has been able to produce passive losses for our investors in the early years of fund life while still paying dividends (preferred returns). The passive losses are mainly a result of the first three strategies noted above which include;

Strategy 1: Cost Segregation Studies

Cost Segregation studies involve breaking up the building purchase price into different asset classes including, but not limited to appliances, furniture and fixtures, equipment, boilers, landscape improvements, and parking lot improvements. This allows the ability to maximize depreciation deductions and shorten depreciation lives. MLG usually gets a third-party engineer or CPA to perform this analysis providing key documentation to support the allocation.

Strategy 2: Utilizing the ability to expense 1231 Assets:

In addition, the cost segregation allows the taxpayer to allocate purchase price to items that may be discarded in the future and expense as 1231 Losses. For example, purchase price may be allocated to kitchen cabinets and appliances upon acquisition. In 12-24 months after acquisition as tenants turn over, MLG may replace such cabinets and appliances, and create a 1231 expense equal to the undepreciated balance of such original cabinets and appliances. If an asset is sold within five years, it may trigger a recapture of this 1231 loss as ordinary income reducing the benefit of this strategy.

Strategy 3: Utilizing the Bonus Depreciation Rules

In 2018, as part of the Tax Cuts and Job Act (TCJA), bonus depreciation under IRC Section 168(k) was substantially modified to allow businesses to deduct 100% of the cost of eligible property placed in service after September 27, 2017. These bonus provisions are set to expire at the end of 2022 at which time there will be a 20% reduction each year until fully phased out. Prior to that date, bonus depreciation was 50%. The results of this legislation have opened the door for far more generous tax write offs for both commercial and residential rental real estate. In general, all assets that have a class life of 20 years or less, and that meet the IRC definition of “eligible property” qualify for immediate expensing.

The passive losses that are created by the three strategies above can potentially be utilized to offset other passive income sources or can be carried forward to future years. Prior year losses that are carried forward or created in the current year that are combined with 1231 gains can potentially produce the beneficial tax results like the previous example. However, for this to occur there is a need for the fourth strategy noted above.

Strategy 4: Be Willing to Sell (vs. Holding Indefinitely) to Trigger Long Term Capital Gains:

MLG Capital has been willing to sell profitable investments which in turn trigger long term capital gains. Only in the year of sale is an investor able to potentially experience the Case 2 fact pattern above which allows them to offset other sources of ordinary income with passive ordinary loss.

Need Help Building Your Private Real Estate Investment Plan?

MLG Capital is more than happy to leverage it’s 30+ years of existing relationships in building a diversified fund of private real estate.

MLG Capital is currently raising its fourth private real estate investment fund, MLG Private Fund IV LLC * , a targeted $200 Million equity fund that is accepting new accredited investors through March 31, 2021. The series of MLG Private Funds were formed to acquire, directly or indirectly, a geographically diverse portfolio of commercial real estate, primarily consisting of commercial multifamily properties, industrial, retail, office, and other opportunities located in strategically identified areas throughout the United States. MLG Private Fund IV launched in October 2018.

Since the inception of MLG Capital in 1987, the firm, and entities associated, have had active, exited, or pending investments totaling approximately 18.3M square feet of total space across the United States, inclusive of more than 13,200 apartment units, with exited and estimated current value exceeding $1.6 billion**

MLG Capital’s series of funds target cash on cash yields, quarterly distributions, and appreciation over time for investors in a tax efficient manner.

MLG Capital
Real Estate Investments

MLGcapital.com

INVESTOR RELATIONS
RequestInfo@mlgcapital.com
262-797-9400
19000 West Bluemound, Brookfield, WI 53045