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SPEAKERS

Trisha Talbot, Thomas Castelli

T **Thomas Castelli** 00:00

So this one is something I don't talk about too often so but it's called a 721 exchange. So in a 721 exchange, you're able to, so you're able to put real estate into a partnership and get an interest in the partnership. And that's non taxable. So if you have a piece of highly appreciated real estate, you could, again, just you could could, excuse me contribute that to a partnership, and you're gonna get the interest in the partnership.

T **Thomas Castelli** 00:24

Now, this is used for is people will usually contribute the property to a to a partnership that rolls up into a REIT that ultimately so it ultimately rolls up into a REIT. So the partnerships that do that the REITs that do this, basically, you contribute your office building, they probably already own office buildings like yours, and that's the reason why they're doing this. And now all of a sudden you're getting effectively an interest in the REIT where now you don't have to manage it. You don't have to you don't have to worry about all of those headaches, you have a passive investment. But this is a more complicated rare strategy.

T **Thomas Castelli** 01:01

But with an office building, it's more likely you'll be able to execute this with an office building a single family house. This is why it makes sense for for people to get educated on this strategy where again, you roll it up into a REIT effectively tax free.

T **Trisha Talbot** 01:16

This is the Providers Properties and Performance podcast. The podcast that brings together leaders in healthcare and investment real estate to consider the possibilities in future at the intersection of practicing medicine and healthcare real estate investment returns.

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Trisha Talbot 01:31

Welcome to the Providers Properties and Performance podcast. I am your host Trisha Talbot. As a healthcare real estate adviser to providers and investors the best solutions occur when the two collaborate together as partners in delivering better patient care. Providers can deliver care to their patients when and where they need it and investors realize the returns to build and manage facilities. We explore changes in medicine and wellness the future of healthcare and using real estate as a strategic and financial tool.

T

Trisha Talbot 01:58

Today's episode is with CPA Thomas Castelli to discuss tax strategies with real estate ownership. We dive into specific strategies for physician owned properties and planning your tax strategy approach for your property ownership hold period. We touch on appreciation, depreciation or cost recovery and strategically using leverage.

T

Trisha Talbot 02:21

So Thomas, welcome to the Providers Properties and Performance podcast.

T

Thomas Castelli 02:26

Thank you, Trisha for having me here. It's it's an honor to be here today.

T

Trisha Talbot 02:28

So you're a CPA and you focus on real estate tax strategies, you want to tell me a little bit about your background and how you ended up where you are?

T

Thomas Castelli 02:36

Yeah, absolutely. So when I was growing up, my parents always encouraged me to go school for accounting. So that's kind of how I ended up in college for accounting. And while I was in college for accounting, I started to realize, okay, if I really wanted to get to where I want to go in life, I'm going to need to start investing. That that was the theme. And so I picked up the Rich Dad Poor Dad books. While I was in college, I stumbled upon real estate, and really started reading as much as I could.

T

Thomas Castelli 03:02

So the year I graduated college, I went to a real estate event where I learned about real estate syndication, that's when you buy like apartment complexes or office buildings, and you've raised money. And this, it's an entire business. And I really fell in love with that strategy. So

when I started my first job in accounting, it was at a firm called BDO, which is like a top 10 accounting firm, national, really, really, really cool job really good people. But while I was there, I realized that, you know, audit really wasn't my thing. So we're auditing big companies. So I ended up exploring the options to get out of that into like small business accounting and tax. So that's ended up how I how I met my partner, Brandon, who started the firm where I work at now. And that's how I kind of got on the path of being a tax strategist for real estate investors.

T

Thomas Castelli 03:55

Now, while that was all going on, I was like, on the side of doing all of this, building up my network to start investing, because I really wanted to be this real estate sponsor or syndicator. So I started investing as a limited partner and a bunch of multifamily deals with someone who would eventually become my mentor. And he always told me, he goes, Look, if you find a deal that I don't find, we'll syndicate it, assuming the deal makes sense, of course.

T

Thomas Castelli 04:22

So I started, you know, picking up the phones, calling brokers I ended up finding a deal. It was an 80 to two unit apartment complex in Jacksonville, Florida. So we ended up syndicating it, in 2017 sold it at the height of the pandemic, which was a very interesting situation but so that's kind of how I got, you know, on the investing side, and then also how I got in, you know, into where I'm at being a tax strategist for real estate investors on being a CPA. So it's kind of very synergistic, how it all came together, and kind of fed into each other and now I have a team of advisors and we advise clients on how to minimize taxes through real estate investing.

T

Trisha Talbot 05:03

So I've had other CPAs on the podcast, and they've mentioned, you know, the tax strategies were for my target audience of physician owners owning the properties where they practice but you know, moving W2 income over to investment income with a lease and, and all of that, but what I wanted to pick your brain about is going to, you know, discussing tax strategies associated with owning a property versus leasing, you know, surrounding appreciation, depreciation, and then strategically using leverage and how that combined with owning the property in an LLC, and then you know, the practice paying the LLC, rent and all of that,

T

Thomas Castelli 05:41

right, right.

T

Thomas Castelli 05:43

So okay, so let me break this down. There's a lot, there's a lot that goes into this. So the first thing to realize, or the first concept to understand is the difference between passive activities and non passive activities. So underneath the tax code, this is putting into place under the Tax Reform Act of 1986. There's passive activities are include all rental activities, by default are

considered passive. And then there's businesses in which you where you don't, where you're not actively involved, the term is called materially participating. But you know, if you if you're passive, you're just the money partner, chances are you're you're passive.

T **Thomas Castelli** 06:25

So again, all rental real estates are is passive by default, and then businesses could also be passive. Now, businesses in which you are actively involved in are non passive, and so is say, a W2 job, right, those are both non passive sources of income.

T **Thomas Castelli** 06:42

The downside or the bad thing is that losses from rental activities which are passive cannot offset the non passive income, unless you're a real estate professional, or you use short term rentals, or you use what I'm about to talk about right now, which is why I had to introduce all of this first.

T **Thomas Castelli** 07:00

So when you own a medical practice, and you buy an associated building, usually your attorneys are going to strongly advise you not to put the building in the same LLC, as your medical practice, because for liability reasons, and I'm not an attorney, I can't discuss that. But so what commonly happens is, you'll have someone buy the building through an LLC, and then rent it back to and then rent it to their medical practice.

T **Thomas Castelli** 07:30

The challenge that that creates is it's a rental activity. So you'll have this building with all this depreciation, which can be accelerated with through some things I'll talk about a little bit. But you can't use those losses against the income from the medical practice, because it's a passive activity and the medical practice is presumably a non passive activity.

T **Thomas Castelli** 07:51

So there's an election as an exception to this way around this. It's an election under Section 1.469-4, and it allows you to group your rental activity with your medical practice or your operating business. But medical practice counts. So there you go there as long as each owners the same and each entity. So in other words, if you're 100%, owner of the medical practice, and you own 100% of the building, or the LLC that owns the building, rather, you make this grouping election.

T **Thomas Castelli** 08:26

What happens is, effectively, your building becomes part of your medical practice. And for tax

purposes, not legally. And then you could take the losses from your rental property, or from your office building that you own against the income from your medical practice, and this is a relatively common strategy that people use. And that's that's one of the big benefits of owning the building versus say leasing a building is that you can accelerate your depreciation expense and take these big losses against your, your non passive income you're getting from the medical practice.

T Trisha Talbot 09:04

And how does that work? If so, say it's a partnership of four doctors but they own they all are on the same. They all own the property and they all own the practice. Does that still work? Or does it have to be one solo practitioner?

T Thomas Castelli 09:17

So that works. The key, the key in the regulations is that each owner has the same percentage ownership interest in both activities and I was speaking to one of my advisors today before before this podcast and they mentioned that there might be a way around that. So the only reason I'm saying that is something that if you don't have proportional interests, go speak to your advisors about that they might be able to find a way around it. I can't say this 100% way, but I do know that it 100% works if you are proportional owners, you own the same pro rata basically.

T Trisha Talbot 09:53

Very nice. And then so talk about depreciation and you talked about a lot of things like accelerating depreciation which some may be familiar with, and some may not. So can you explain that for the audience?

T Thomas Castelli 10:04

Yeah, absolutely. So when you buy an office building, it's going to be depreciated over 39 years. So for, you know, basically, this is rounded to 40, for the sake of

T Trisha Talbot 10:13

I think it's 39 and a half to be exact, right?

T Thomas Castelli 10:15

Yeah. It's something like that, right. So, you know, just think about that over that period, 1/39th or 1/39 and a hakf that I have is going to be depreciated right over each year. That's a long time. Now, there's different components of the building, right? The building isn't just, you know,

the walls, right? You have various different, you have to think of an office buildings, I don't think about these too often.

T Thomas Castelli 10:39

But you're gonna have like, office equipment, you're gonna have furniture, you're gonna have all these different things, right? Exactly, all these different things that are within the building itself. And these things have different class lives.

T Thomas Castelli 10:52

So what you would do is typically you have a cost segregation study performed. The Cost Segregation is just somebody, an engineer comes to your property and breaks down these various components, and segregates them out into different class lives. So typically, a five, seven and 15 year property, and the five, seven and 15 year property is eligible for something.

T Thomas Castelli 11:13

Well, first, before I go there, let me break this down. First of all, the five, seven and 15 year property is normally depreciate over five, seven and 15 years, which is a lot shorter than 39 years, so you're recovering your costs much more quickly.

T Thomas Castelli 11:26

Now, to add an even better thing, on top of all of this, there's something called bonus depreciation. And bonus depreciation allows you to completely depreciate property with a class life of 20 years all in the first year, that you acquire the property. And so usually somewhere between 20 and 30% of the property's value can be allocated into this five, seven and 15 year property. So that allows you to significantly increase that depreciation expense. And, you know, the best thing about depreciation is it's non cash. So I always like to give this example and this is gonna be a little bit different for the medical practices.

T Thomas Castelli 12:04

But say you have, let's just say you have $500,000 in income from the medical practice. And you have, you know, I don't know what to say you have I'm just pulling a number of hat you have. I'm blanking on the number. And let's just say you have $200,000 of expenses, right? Well, now you have $300,000 of income. Now, those $200,000 of expenses, you know, salaries and stuff, you have to pay out, that money actually left your pocket, right, and that took cash flow away from you, well, depreciation is non cash. So you might have, say, a $300,000, depreciation expense, thanks to bonus depreciation, and now you're sitting at $100,000 tax loss, despite the fact that you really generate $300,000 in cash flow from your business. So that's really a kind of an illustration of the power of depreciation. And really, what bonus depreciation can do for you.

T Trisha Talbot 12:57

So it would mitigate your tax liability.

T Thomas Castelli 12:59

Right. It reduces your tax liability.

T Trisha Talbot 13:01

Right. Right. So talk about, you know, strategically using leverage to, you know, as a tax strategy as well, because some I know, a lot of people are like, I don't want that I want to pay all this off. But what are some of the strategies for using leverage?

T Thomas Castelli 13:17

Right, right. So if you're in a, if you're in a growing market, or even if you're in just a stable market, you know, your property is going to be increasing in value over time. You could also increase the value of your property by making renovations and things like that to the property to force the value of the property to go up. And what happens is, and also, as you kind of pay down the loan you have on the property, you're also going to be increasing your equity. So all of this increases your equity in the property.

T Thomas Castelli 13:18

So you can actually go and and as your equity grows, go to the bank and take a loan against your property and use it to buy other things or fund, you know, maybe it's to expand your medical practice, maybe it's to buy another building, maybe it's to use it for other reasons, whatever the purpose is, you're able to tap into the equity and take loans out against the property very easily with real estate and other assets just aren't, there aren't many other assets, that's easy just to go to the bank and just get a loan in the way that you can with real estate.

T Thomas Castelli 13:43

And one of the best things about real estate is that it's an asset that's very easy to collateralize, right. You go to the bank, banks are very, very used to putting mortgages on properties or putting, you know, elocks or lines of credit against a property.

T Thomas Castelli 14:00

Right? And then, you know, and obviously, having an interest payment decreases your tax liability.

Thomas Castelli 14:39

Right, Right. So the interest is going to be tax deductible. So that, of course decreases your taxable income and thus the amount of money you pay the amount of taxes you're gonna have. Right? All right.

Trisha Talbot 14:49

I just want to make sure that we connect the dots so that all of this ends up at their bottom line by reducing their tax liability.

Thomas Castelli 14:55

Oh, yeah, absolutely. Let me say some things I kind of blanked on that one, the interest for a second. So the interest I just wanna say it is tax deductible if you use it for business purposes, right? If you go in, you take that interest, you go and you do a cash out refinance, or you go and get a line of credit against your office building, you go buy a Corvette or Ferrari or something like that, and you use it for personal purposes, there's something called the interest tracing rules that say that the debt is categorized, however, excuse me, the interest on the debt is categorized, however the debt proceeds are used.

Thomas Castelli 15:29

So that would be personal purposes. So in that case, the Ferrari or the Corvette, that's not going to be tax deductible. However, if you did use it to buy another building, or to expand your medical practice, or pay expenses for your medical practice, or whatever the case may be for business purposes, then it will be tax deductible, but if it's used for personal reasons, it's not tax deductible.

Trisha Talbot 15:49

And this is to clarify. So this is not a mortgage interest. So the mortgage interest, you know, is different, what you're talking about is taking debt on a property that either may be paid off, or has a huge amount of equity into it, and you're trying to get some cash out to strategically use the leverage on top of or in place of an actual mortgage.

Thomas Castelli 16:09

Absolutely, exactly. Right. Exactly.

Trisha Talbot 16:12

Okay. So I do a lot of what's called sale lease backs, you know, let's say that a physician owner

Okay. So I do a lot of what's called sale lease backs, you know, let's say that a physician owner has owned a property, and they're saying, you know what, couple things we're either, you know, we want to get the proceeds out of the markets great. So we're at the top of the market type of thing and they say, look, I, which is, you know, they're at the top of the market for selling, and then they need to go and buy something, but they could buy something that maybe needs a little bit of work.

T

Trisha Talbot 16:41

So, you know, they decide, hey, you know what, we're going to put a 10 year lease on this, and then we're going to sell the property to an investor. We're gonna get the proceeds now, and then we're going to either expand our practice, or we're just looking to cash out because we have different partners at different ages and stages. And, you know, we want to sell the real estate and there's a variety of reasons, strategic reasons to do a sale leaseback. These are just two examples, you know, a lot of them, all of a sudden, they're like, Well, what am I going to do, because I do not want all of these proceeds, because I don't want to pay taxes on all of it. It's going to be a huge bill and I don't want to write that check. I mean, pay Uncle Sam what he needs.

T

Trisha Talbot 17:18

But is there other things that I can do in order to defer or convert or, you know, reduce my tax liability?

T

Thomas Castelli 17:28

Well, there is, and it all depends on kind of what your goals are for that money. If you're going to use it to say pay partners, to have them exit the practice, or whatever the case may be, it's going to be challenging to find a tax deferred way to kind of defer that money.

T

Trisha Talbot 17:44

No, I'm not talking about paying partners off, I'm just saying, you know, it might be partnership that owns the real estate, but they're in different ages and stages. They just want to cash out of the real estate, they're not looking to be bought out of the partnership.

T

Thomas Castelli 17:54

Okay, so there's a lot, there's a few things that can be done. Okay, so the first thing is I'm gonna break some of them down, right. So I'm going to be more complex than others.

T

Trisha Talbot 18:04

You can give examples too. So because this is a lot of information, without some context is sometimes hard to get.

sometimes hard to get.

T Thomas Castelli 18:11

Okay, so I have a few that are going to involve real estate that you're gonna have to manage. And then another one that you can exit the real estate and not have to manage real estate. So this is okay.

T Thomas Castelli 18:21

So the first one is at 1031. Exchange. So real estate can be so you can sell a property. And you can defer the capital gains tax and depreciation recapture tax, if anybody is concerned about that, by buying a another property, but you have to roll over, generally the entire sales proceeds, and replace whatever mortgages on the property.

T Thomas Castelli 18:44

So in other words, you're gonna have to buy another piece of real estate. So you can sell the medical practice, excuse me sell the office building and buy a another office building somewhere else, you could buy a multifamily property, you could buy whatever type of rental real estate you want, and kind of continue kicking that can down the road.

T Trisha Talbot 19:01

Well, can't you also buy like two properties as long as it equals the proceeds?

T Thomas Castelli 19:07

Right? Right, it is possible to buy multiple properties. The bottom line is you have to use that the entire sales proceeds and replace the mortgage. If you don't do those two things and there are some nuances in there. But if you don't do those two things, you're generally going to have what's known as taxable boot. And that boot is going to be taxed at capital gains rates typically.

T Thomas Castelli 19:26

And so that's kind of what happens if you don't use the entire sales proceeds. But it could be one property, it could be several properties that you kind of spread the money around. But the point is with a 1031 exchange, kind of the bottom line is you're able to defer the taxes, but you're buying into more real property more real estate

T Trisha Talbot 19:43

Right. Perfect.

Right. Perfect.

T Thomas Castelli 19:43

There's another one. There's another alternative version of that where you actually buy another property and you use a cost segregation study to generate this bonus depreciation from the other property and use the losses from that from the new property to all set the gain on the sale of the old property.

T Thomas Castelli 20:02

It's kind of it's like a 1031 exchange, but it's a way around a 1031 exchange. But in that case, two, you're still buying real property.

T Thomas Castelli 20:11

Now, this one, I think, is going to be interesting for some people. So this one is something I don't talk about too often. So but it's called a 721 exchange. So in a 721 exchange, so you're able to put real estate into a partnership and get an interest in the partnership and that's non taxable.

T Thomas Castelli 20:32

So if you have a piece of highly appreciated real estate, you could, again, just you could contribute that to a partnership. And you'll get the interest in the partnership now this is used for is people will usually contribute the property to a to a partnership that rolls up into a REIT that ultimately, so it ultimately rolls up into a REIT. So the partnerships that do that the REITs that do this, basically, you contribute your office building, they probably already own office buildings like yours.

T Thomas Castelli 21:00

And that's the reason why they're doing this. And now all of a sudden, you're getting effectively an interest in the REIT, where now you don't have to manage it, you don't have to you don't have to worry about all of those headaches, you have a passive investment. But that this is a more complicated rare strategy.

T Thomas Castelli 21:15

But with an office building, it's more likely you'll be able to execute this with an office building than a single family house. So this is why it makes sense for people to get educated on this strategy where again, you roll it up into a REIT effectively tax free. And then when you sell the REIT shares, you start to recognize your capital gain a little by little, but usually with a REIT, usually with REIT shares, you have a lot of them, and you don't have to sell them all at one

time. So you could sell a little bit here, a little bit there, you know, year over year, and you're not going to recognize this gigantic capital gain, that you would probably recognize if you just sold the building outright.

T Trisha Talbot 21:52

And you can strategically use it in years where, you know, you may have a loss that you can then you know, have a gain, and it sort of makes your net tax liability more manageable than if you just take it all at once.

T Thomas Castelli 22:05

Right. And I have another one too while we're actually talking.

T Trisha Talbot 22:07

Yeah no. Before we move on. That's called almost that's an UpREIT what you just described.

T Thomas Castelli 22:12

Yeah. Right.

T Trisha Talbot 22:13

And that's something that a lot of the REITs, some of the REITs. But you know, there are REITs in healthcare real estate asset class that do do that.

T Thomas Castelli 22:22

Yeah, you know, I've seen only one of them actually done. I've just only seen one of them actually transacted in my life. But I do know, it's very popular strategy for office buildings. So something to explore.

T Thomas Castelli 22:34

The other one is an installment sale. So an installment sale what basically happens, installment sale is instead of the the seller, the buyer, excuse me going to the bank and getting a loan, they take the loan, you carry the note back. So in other words, you sell the property to the end buyer, and you get usually some cash for the downpayment, and then you get this note, and then basically, as the buyer pays back the note, they're going to start each year, you're going to recognize the capital gain little by little as they paid off.

T Thomas Castelli 23:06

So in other words, you're not having to recognize the capital gain all in one year, you're able to spread that capital gain out over several years. And this can be important if you're trying to stay under certain income thresholds. And or you just don't want to take that big hit on one year, an additional benefit to this actually is you get to put a piece of you usually put interest on it too. So you're also going to get an income in the form of interest. So it's another nice little perk of doing an installment sale. Installment sales are relatively common, because they do allow you to spread that capital gains tax out. And people like that when they're exiting a property and want a source of income.

T Trisha Talbot 23:44

Absolutely. And you can agree or not. But in all of these, like if you're going to become a bank, for a buyer, you really need to have an attorney help you because you need some legal documents.

T Thomas Castelli 24:00

Right, right. When it comes to legal documents, you know, I always recommend when it comes to legal documents, hire an attorney, have it done right the first way and the reason why I say that is I've seen a lot of entity structures. I've seen a lot of different agreements in my time working as a CPA, and it's a lot more costly and painful to go back and try to fix something if it can be fixed in the first place than it is to get it done. Right. And some people try to you know, cut costs, I'm gonna go on, you know, what are these cookie cutter websites and grabbing a promissory note, but you realize you didn't do it the right way or it's not filled out and now it's not legally binding or it's not what you intended. It's just hire an attorney. That's my two cents there.

T Trisha Talbot 24:45

Right, exactly. They pay for themselves. Okay, so we're gonna move into the Q&A and get to know you part of the podcast. So what was your first job?

T Thomas Castelli 24:56

So my first job. My first job was was in high school and I worked at a place called ShopRite. I was a cashier. That's my first job. My first real job, I guess you could say, was at BDO as an audit associate at BDO.

T Trisha Talbot 25:11

Very nice. And what else do you think you would be doing for a living?

Thomas Castelli 25:16

If I wasn't doing this? I would? It's a good question. I would probably be even doing one or two things. I'd either be a real estate agent and have a brokerage. Or I would be in tech doing something tech related.

Trisha Talbot 25:31

What or who are you reading or listening to right now for news, information or inspiration?

Thomas Castelli 25:36

Okay, for news, Bloomberg. I have a subscription in Bloomberg that I really like. And as for inspiration, there's a gentleman named Alex Hormozi and he has a wife, her name is Leila Hormozi. They built and sold the company for like $100 million. And everything that they put out on the internet, books, everything podcast is super valuable, super powerful, unlike anything that like anybody else is putting out. So

Trisha Talbot 26:01

Really? How do you spell that?

Thomas Castelli 26:04

It's H O, R. M Ozi.

Trisha Talbot 26:09

And what is one thing you do every day for healthy self care?

Thomas Castelli 26:13

Every day I brush my teeth. But no, in all seriousness, I am big into fitness. I go to the gym probably six days a week at this point. So it's not every day, but I go to the gym frequently enough, I can almost say that. So that's what I do big in the fitness, big into dieting, and just controlling the way I eat controlling, you know, what I put into my body. So

Trisha Talbot 26:35

Do you think leaders are born or trained?

Thomas Castelli 26:39

Trained? Trained. I think that some people have a natural inclination towards it. But I think that is definitely trained or learned on the job if you will.

Trisha Talbot 26:49

Not they don't come out being able to lead.

Thomas Castelli 26:52

No, no.

Trisha Talbot 26:54

Well, Thomas, this has been a great interview, I appreciate your time, I think it was a lot of super helpful information that a lot of the audience will bump into being real estate owners, and it's really good to go into real estate knowing a lot of these strategies instead of figuring them out after.

Thomas Castelli 27:15

Yeah, if I could just say one more thing, I would say, please don't take what you've learned here on this podcast and just run with it. Please speak with your advisors because there's always there's always a lot more nuances than we can cover on a podcast episode. So please talk to your advisor.

Trisha Talbot 27:31

Everybody's situation is different. Everyone's tax situation is different. There is not a one size fits all. So everyone has to you know, based on their entire, you know, landscape of tax liability. They need to speak with somebody that hopefully is doing their taxes or you know, familiar with it, to advise them. Perfect. Well, thank you.

Thomas Castelli 27:54

Thanks for having me.

Trisha Talbot 27:58

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