TAX IMPLICATIONS

Of Real Estate Crowdfunding

Written and published by

AlphaFlow, Inc. and
Sundin & Fish, CPA

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What is Real Estate Crowdfunding?

Real estate crowdfunding has become a new tool for raising real estate investment funds. It allows investors to "pool" their money together for a variety of real estate projects. These projects include single family homes, apartment buildings, commercial properties and even real estate development. In addition, many real estate crowdfunding investments are structured like loans and the investor is paid a stated interest payment.

Historically, real estate investment was only available through private investments and real estate investment trusts (REITs). Direct investment does not offer the ability to own a portion of a large property and comes with significant management responsibilities. But crowdfunding has changed the game.

Real estate crowdfunding is essentially a form of real estate syndication. Deals start with a "sponsor" who typically identifies, acquires and manages the deal. The sponsor will typically use a real estate crowdfunding site to solicit investors for the project. This will allow the sponsor to raise money quickly and tap into investment funds that they would not have otherwise had access to.

Even though this form of investment has become more common in recent days, investors often get confused on the tax treatment. The tax treatment is certainly different from other forms of investments, like stocks and bonds. In this ebook, we will examine some of the tax issues that investors face in this growing industry.

Portfolio Platforms

Most of the new real estate crowdfunding vehicles that invest in equity based deals are structured as partnerships. So, the tax attributes will flow through to the individual investors. However, some are structured as REITs and have a unique set of tax attributes.

REITs are typically exempt from taxation at the trust level if they distribute at least 90% of their income to the unitholders. The payments made by the REIT are split between a return of capital and profit. The profit portion is generally taxed to the unitholder as ordinary income and are made on Form 1099-DIV. This dividend will be taxed at the unitholder's marginal tax rate.

For the portion of payment that constitutes a return of capital, this income is not taxed immediately. It is a reduction of basis, which lowers the investment in the asset and defers the tax until the investment is sold. Once sold, the transaction is taxed as either long-term or short-term capital gains.

On the debt side, new companies like AlphaFlow aggregate many crowdfunding investments into a portfolio of investments. These portfolios are then professionally managed. They offer broad diversification as they utilize multiple origination platforms, range of borrowers, geographies, and loan amounts.

These pooled investments were traditionally structured as private funds, and this is still the most common investment vehicle for investing in multiple loans with a single sum, managed by a third party. A point of differentiation with companies like AlphaFlow is the use of automations (i.e. robo-investing) that are built into the way the investment portfolios are selected and managed. Best practices of professional investment management like diversification, rebalancing, and institutional-quality data analytics are automated so investors can receive these benefits without the high fees and high minimums of traditional real estate investing. And, unlike traditional pooled investments or REITs, investors can maintain full visibility into the underlying investments through a personal, online dashboard.

This approach will take the time burden of multi-platform selection and individual deal analysis from the investor, and provide a diversified investment with many of the benefits of short-term, fixed-income, real estate based debt securities, without all the hassles. Clients can typically re-invest earnings automatically, putting their money back to work quickly and efficiently, which may lead to better returns over time.

How are Deals Taxed?

Real estate syndication has been around for decades. But the syndication process has evolved in recent years with new crowdfunding options. Real estate crowdfunding deals are generally classified as either "equity" deals or "debt" deals and each can have different tax implications. Let's take a closer look at the differences.

Equity Deals

When it comes to real estate crowdfunding, much of the tax discussion has revolved around equity deals. I would define an equity deal as one where the investor typically owns shares in a limited liability company ("LLC") that invests into another LLC that holds title to real property. The investor holds essentially an indirect equitable interest and will participate in the financial upside (or possibly downside) of the property.

The first thing to understand is that an equity investor in a syndication is actually a partner in a partnership. Investments in syndications will generally be considered "passive" activities. For a real estate entity there are typically two sources of passive activities: (1) rental activities (rentals of apartments, commercial buildings, retail centers, etc.), unless the taxpayer is classified as a real estate professional; or (2) a business (flips, real estate development, etc.) in which the taxpayer does not materially participate. Passive activities will generate either passive income or passive loss. Interest, dividends, annuities and gains on stocks and bonds are not considered passive activities.

The K1 that the investor receives at the end of the year from the syndication will either report income or loss (as well as other items). The investor will then include this on his or her tax return, typically following the rules for passive activities. If the K-1 reports a loss then the investor has a passive loss. Passive losses can only be offset against passive income (subject to certain exceptions).

When combining all passive activities, if the investor has a net passive loss, then the remaining net loss is effectively "suspended" whereby they are carried forward to future years and subject again to the passive activity rules. If an investor has passive income then that is taxed at the taxpayer's marginal tax rate.

In the subsequent tax year, any passive losses that carried over can offset passive income that is generated. Be aware that the passive activity loss limitations are applied each year. Rental losses continue to carry forward year after year until the losses are used up by offsetting passive income.

However, if you have passive losses you will be able to take them at some point. Rental losses for a particular property are allowed in full (subject to other limitations) in the year in which a rental property is sold in a complete disposition to an unrelated buyer. So often you may find that a syndication investor will have a cumulative passive loss that may have been carrying over for several years. Once the property held in the syndication is sold and the syndication is closed, the investor will typically get to take the cumulative passive loss to offset other income.

Equity deals offer one additional special tax advantage and that is favorable long-term capital gains rates. When a property (apartment building, retail center, etc.) is acquired through a syndication and is held for longer than one year, the sale of the property would typically result in long-term capital gains. These gains are taxed at a rate of 15% (with certain exceptions). Any depreciation that was deducted on the property would be subject to tax rates not to exceed 25%.

Debt Deals

But more and more deals on real estate crowdfunding platforms are considered debt deals. Essentially the investor owns an interest in a promissory note that is often issued by a flipper or developer (the "sponsor") who is looking for short-term financing for a project. Aside from being collateralized by real estate, the note will typically provide for monthly interest payments and have a personal guarantee from the sponsor. These investors do not have an equitable interest in the property. They are merely acting like a lender in which they are providing the funds for a specific transaction and are receiving interest payments according to the agreement. This type of transaction is different from an equity deal and, accordingly, the tax implications can differ.

Taxpayers investing in debt deals are typically not partners to an operating trade or business and are merely acting as just investors. They do not get to participate in any financial upside of the property. Accordingly, the payments they receive are typically classified as interest income. They will often receive a 1099-INT at the end of the year that reflects the interest income they received, but also may receive a Form K-1 depending on the deal structure. Interest income is considered portfolio income (not passive income) and is also subject to marginal tax rates. However, portfolio income is not considered passive income and is not subject to the same restrictions.

Summary

Understanding the tax differences between equity and debt deals can be difficult. We have discussed some of the differences herein, but we need to acknowledge that close consideration of tax issues should be made when structuring any real estate crowdfunding transaction. At the outset of any deal, consultation with experienced tax and legal professionals should be made along with proper investor communications. Ultimately investors need to carefully review any crowdfunding deal and make sure that they understand the tax ramifications.

Depreciation

Equity deals are a popular way for investors to get real estate exposure. They don't have to manage the day to day operations of the property, but will be able to obtain cash flow and a percent of the profits upon disposition. Most real estate investors understand the basics of depreciation, but may not understand the benefits as much as they should.

No tax section on real estate investing would be complete without a brief description of depreciation. Depreciation is an income tax deduction that allows a taxpayer to recover the cost or other basis of certain property. It is an annual allowance for the wear and tear, deterioration, or obsolescence of the property. Most types of tangible property (except land), such as buildings, machinery, vehicles, furniture, and equipment are depreciable.

In order for a taxpayer to be allowed a depreciation deduction for a property, the property must meet all the following requirements:

- The taxpayer must own the property. Taxpayers may also depreciate any capital improvements for property the taxpayer leases.
- A taxpayer must use the property in business or in an income-producing activity. If a taxpayer uses a property for business and for personal purposes, the taxpayer can only deduct depreciation based only on the business use of that property.
- The property must have a determinable useful life of more than one year.

Depreciation begins when a taxpayer places property in service for use in a trade or business or for the production of income. The property ceases to be depreciable when the taxpayer has fully recovered the property's cost or other basis or when the taxpayer retires it from service, whichever happens first.

It is a result of depreciation that your taxable income (from the K-1) will likely be lower than your distributive cash flow. This is a major benefit for equity investors.

What About State Taxes?

Now that we understand the federal tax issues, let's take a look at state tax issues. These can be a bit more complex. Generally speaking, when a partnership actively conducts business activities or has "source" income in a specific state, that state will tax the individual partners. In most situations, the partners are required to file state income tax returns and pay tax on their respective share of partnership income. It does not matter what state the partners reside in. In addition, taxpayers must generally report all their income (regardless of where it was earned) in their state of residency and pay income tax.

With both states taxing the source income, it would seem to give rise to double taxation. So to avoid any double taxation issues, the state of residency will typically provide a credit for taxes paid to the other source state. The result is the taxpayer may end up paying a tax rate that is comparable to the state with the highest tax rate.

So as a general rule, the real estate crowdfunding investor may need to file a tax return in any state that the sponsor has real estate operations or activities. But there are some exceptions and exclusions to consider:

- When you consider the 50 states in the U.S., there are 43 that impose a state income tax. In these states you will typically be required to file, but in the 7 states with no income tax you will generally not have to file a tax return. It is important to note that some states do impose transfer taxes and other tax assessments.
- Many states do have a little known alternative to paying tax at the partner level. They will allow the partnership to file a tax return and pay tax on behalf of the partners based on what is called a composite (or "group") filing. This tax is normally calculated at the highest state tax rate and does not provide for graduated tax rates. This is typically not a favorable option.

- Each state can have minimum filing requirements. As an example, many states will not require you to file a state return unless you have earned a certain amount of source income in the state (say for example $2,000). If the nonresident investor has earned less than this specified amount he or she would not have to file a tax return in that state.

Withholding Requirements

To add another layer of complexity, many states impose withholding requirements on pass-through entities such as partnerships. So a partner who does not reside in the state in which the real estate is located may find that some of the cash distributions are being withheld by the partnership entity and remitted to the source state. Once the investor files a state tax return he will often have a portion of the withholding refunded to him. However, this withholding ensures the collection of tax at the state level.

States can differ on how the withholding is calculated and remitted. Many calculate it based on the amount of distributable income as evidenced by the state K-1 rather than the actual cash distributions made. States also can differ on when the withholding payments are made – annually or quarterly. Some states that have a withholding will not require it if the partner's pro rata share of income is less than a set threshold amount (as an example $1,000 to $3,000).

But if you are overly concerned about filing and paying tax in many states, there are a couple points to consider. As a result of depreciation expense, the partnership's taxable income will often be lower than cash distributions you will be receiving. You may find that your K-1 even reflects a loss. So many real estate crowdfunding investors may realize that they are not paying taxes to a source state and conceivably not required to file a state tax return (aside from reflecting a net operating loss carryforward).

Summary

So if you invest in a crowdfunding real estate syndication, how do you know if you are subject to taxes or withholding in a given state?

The answer is not as tough as you may have thought. A state specific K-1 will be issued to the partners which will reflect their applicable share of state sourced income and withholding. But make sure that you engage a CPA or other tax professional who understands state specific tax issues for partnerships.

A Word About Unrelated Business Taxable Income ("UBIT")

Self-directed IRAs ("SDIRA") are increasing in popularity. More and more investors are getting bored with traditional investments (stocks, bonds, mutual funds, etc) and seeking out alternative investments in the search for higher returns. The SDIRA landscape is changing as a variety of investments are being introduced to the market.

There is no doubt that SDIRAs are very flexible options and allow for a diverse set of investments. They can invest in almost anything, except for life insurance, S-Corp stock and certain types of collectibles. The problem is that there is often confusion about SDIRA tax rules. Compounding the issue is that the majority of CPAs don't understand the complexity associated with them. It's not that CPAs are naive to the issues it is just that they are not faced with them on a daily basis in their practices.

But even though an SDIRA can invest in most things, certain investments can trigger immediate tax issues. This is where the complexity lies. The two main issues for SDIRAs relate to income from a trade or business that is regularly carried on (this can be directly or indirectly) or income generated from debt-financed property. These issues are identified herein as: (1) unrelated business taxable income ("UBTI"); and (2) unrelated debt-financed income ("UDFI"). Let's take a closer look at these issues and then see how they apply to partnership syndications and real estate crowdfunding.

Unrelated Business Taxable Income

UBTI is generally defined as the gross income derived from any unrelated trade or business regularly conducted by the exempt organization, less any deductions associated with carrying on the trade. The business or trade itself needs to be "regularly carried on" in order to trigger UBTI.

So in most situations, UBTI occurs when an SDIRA owns a portion of an operating business (retail store, service business, etc). Rents from real property are specifically excluded in computing UBTI, but may be subject to UDFI. Interest income, dividends, royalties, annuities and other investment income are also typically exempt from UBTI but can be subject to other limitations (such as UDFI).

Unrelated Debt-Financed Income

UDFI is another issue that is important to consider. It is generally defined as any property held to produce income for which there is acquisition indebtedness at any time during the tax year. It also includes gains from the disposition of such property. UDFI applies to corporate stock, tangible personal property, and more importantly – real estate.

What this means in practice is that if your self-directed IRA acquires a rental home for $100,000 with a 25,000 down payment and obtains a $75,000 loan to finance the purchase, approximately 75% of the income generated by the property would be subject to UDFI. The UDFI calculation is actually a little more complex. It is calculated as the percentage of average acquisition indebtedness for a tax year divided by the property's average adjusted basis for the year (average debt/average basis).

How Does it Apply?

So now let's take a look at how UBTI and UDFI would apply as we examine syndications and real estate crowdfunding. There are essentially two types of deals when it comes to real estate syndication or crowdfunding: (1) equity; and (2) debt. An equity deal is basically when an investor owns shares in a limited liability company ("LLC") that either acquires a parcel of real estate or invests into another LLC that acquires real property. The investor holds an indirect equitable interest in the property and is taxed as a partner in a partnership.

In a debt deal the investor typically owns an interest in a promissory note that is issued for short-term financing on a real estate project. Accordingly, any payments they receive are typically classified as interest income.

Unfortunately, UBTI and UDFI extend to partners in partnerships. If a partnership that owns rental real estate has a partner that is an SDIRA then the rules for UDFI will be extended to the partners. Accordingly, if there is debt financing at the partnership level, then any income or loss will flow through to the partners along with the UDFI issue. The partner is treated as if it had conducted the real estate activity in its own capacity and the IRS does not make any distinction between limited and general partners. In addition, it does not matter whether or not actual cash distributions have been made.

So in a real estate syndication equity deal, rental income that is allocated to an SDIRA would partially be subject to tax under the UDFI rules (assuming financing was obtained for the property). In many cases though you may find that the tax consequences will be minimal due to depreciation that is passed through from the real estate held by the partnership.

However, the SDIRA will often still be required to file a tax return. Even if no tax is due, it generally a good idea to file a tax return so that any capital gains from the ultimate sale of the real estate (which is also be partially taxable due to the debt financing) are offset by any carryover losses that have generated over the years.

Tax Filing?

So what are the tax filing requirements if you have UBTI or UDFI? First, a filing is only required if there is gross income of $1,000 or more. Gross income is defined as gross receipts minus the cost of goods sold. Assuming this criteria is met, Form 990-T, Exempt Organization Business Income Tax Return, must be filed and the tax paid accordingly. Tax rates can be high because IRAs are taxed at trust rates. For tax year 2013, any income above $11,950 is taxed at 39.6%. State taxes will also need to be considered.

Summary

So just because an SDIRA can invest is almost anything, you must consider any immediate tax consequences. UBTI and UDFI are important considerations when it comes to real estate syndication and crowdfunding. UDFI is all too often overlooked and can certainly be a problem in an equity deal.

It is important to note that each deal is structured differently, so make sure that you do your own due diligence. As always, before you consummate any transaction make sure that you review the tax issues.

What About
Foreign Investors?

Over the past decade we have seen a significant increase in foreign investment in U.S. real estate. With recent real estate crowdfunding options in the marketplace, it clearly makes sense that certain non-resident investors are considering crowdfunding investments. Let's examine many of the tax considerations that will impact these foreign investors as they venture into this area.

As a general rule, non-resident investors must consider the following:

1. They will need to consider the best entity structure for their real estate crowdfunding investments. This includes determining whether their interest is held individually or through an entity like an LLC or corporation.

2. Even if no tax is due, they will generally be required to file a U.S. tax return and in many cases a state tax return.

3. If title is being held individually, they will need an Individual Taxpayer Identification Number ("ITIN"). This is merely a tax processing number that is issued by the IRS to international folks who have a U.S. tax filing requirement.

4. If investors do not visit the U.S. at all they will normally only be taxed on U.S. source income generated from their real estate investments. But if they decide to stay in the U.S. for extended periods they may find themselves being taxed on worldwide income, so they need to be careful.

5. Investors must consider how a certain U.S. tax structure impacts their tax situation in their home country.

6. Profit distributions are subject to U.S. foreign withholding requirements unless an exception is obtained. In addition, many states have withholding requirements as well. This means that an estimated tax will be withheld by the partnership entity and will be credited to them when the required tax return is filed.

7. In addition to federal and state income tax considerations, investors must also consider U.S. estate and gift taxes.

8. The U.S. tax code establishes certain "default" rules for non-residents. But the U.S. has established tax treaties with many countries that can alter the default tax treatment.

Individual Ownership vs. Entity Ownership

Many non-resident investors hold title to crowdfunding real estate interests as individuals. In this situation, they may find themselves taxed similarly to U.S. individuals. Income tax rates in the U.S. range from 10% to 39.6% based on an individual's taxable income. As a result of depreciation expense, rental real estate activities can often generate passive losses and many non-resident investors will find themselves paying at the lowest tax rates. When a syndication property is sold for a gain, it is subject to the long-term capital gains rate of 15% (subject to certain exceptions).

However, non-resident investors may find that it is beneficial for them to hold title in a corporation (either foreign or U.S. based), limited liability company ("LLC"), a trust, or even a partnership. In most cases, individual ownership or ownership through an LLC taxed as a disregarded entity will result in the lowest income tax liability. However, depending on the investor's situation, a different structure may be beneficial as a result of estate or gift tax issues. The advantages and disadvantages of each structure should be carefully analyzed with a tax professional who understands tax planning for non-resident real estate investors.

Obtaining an ITIN

In many situations, a foreign investor will obtain an ITIN when a tax return is filed. However, as a result of withholding requirements, real estate crowdfunding organizers will be seeking an ITIN upfront. The foreign investor will then need to obtain the ITIN prior to filing a tax return. Form W7 and proof of identity will need to be submitted. There are many documents that can prove identity, but the most common is your passport. In addition, the non-resident must include a copy of the section of the partnership agreement that displays the partnership's employer identification number (EIN) along with demonstrating that they are a partner in the partnership that is conducting business in the U.S.

Tax Treaties

Tax treaties between the U.S. and certain countries further complicate the situation. Under these tax treaties, residents of foreign countries may be taxed at different rates, or in some situations be exempt from U.S. income tax on certain income they receive from U.S. sources. Tax treaties can and do vary extensively between countries. Additionally, the U.S. has tax treaties in effect for certain countries that cover estate and gift taxation.

Summary

Tax issues facing non-resident investors can be complex. Non-resident investors in U.S. real estate must ensure that they are dealing with a tax professional who understands the tax issues they face. Advice and guidance on tax planning initiatives is critical before investing in real estate crowdfunding.

Tax Planning
& Strategies

As discussed, an equity syndication is typically taxed as a partnership and investors are classified as "passive" investors. So what does it mean when you are a passive investor? Even though you may be getting a preferred return, you may still find that the investment is generating a tax loss as a result primarily of depreciation deductions. As a general rule, the deduction for a passive activity loss is limited in each tax year to income derived from a passive activity.

Many investors may have cumulative passive losses relating to rental real estate that have been carried forward for years. With a syndication generating passive income, this can allow the investor to "free up" these passive losses and use them to offset the income from the syndication. Interest and dividend income is not considered passive income, so for an investor with passive losses this form of investment can offer benefits that stock and bond investments will not.

So what do you do if you have passive losses that you are not able to offset against other income? If you find yourself with losses that you are currently unable to deduct as a result of passive loss limitations, there are a few strategies that you should consider.

Invest in rental real estate that generates passive income. Considering the low interest rate environment these days, you may decide to invest in rental real estate that you are sure will generate net income even after considering depreciation deductions.

Invest in income generating passive business activities. You could consider investing in an operating business that you have no material participation in. Assuming that the business operations generate taxable income that will be allocated to you, then you can use that income to offset the passive losses from the other activities.

Increase participation in loss activities. For a crowdfunding investment this may not be possible. But depending on the investor's involvement in the activity, it may be possible to turn the passive activity into an active activity by increasing your hours of involvement so that you may meet the material participation rules. If you can accomplish this, you may be able to bypass the passive loss rules and fully deduct any losses in the current year.

Generate gains from the sale of other passive activities. Passive income will typically include gains from the sale of an interest in a passive activity or property that was used in a passive activity. The gain typically is not considered a passive activity if, at the time of disposition, the property was utilized in an activity that was not considered a passive activity in the year of sale.

Decrease your involvement in active income activities. You may have a business activity that you currently materially participate in that is generating active income. Accordingly, you could consider limiting your participation (or involvement) in this activity.

Understanding passive activity rules can be difficult. As you can see, there are a few ideas that you should consider if you have passive activity loss limitations. But these strategies can be complex, so make sure that you consult with a CPA or tax professional prior to implementing any of the strategies.

Conclusion

If you want to own real estate but do not want to be a landlord, then real estate crowdfunding may be for you. You will be able to participate in the cash flows and capital appreciation of the project, but will not have the responsibility of day to day management. It can be a win-win for both the sponsor and the investor.

There are plenty of advantages to real estate crowdfunding. You have the opportunity to make money through rental cash flow and capital appreciation. In addition, you will have favorable tax write-offs (including depreciation) and possibly favorable long-term capital gains rates.

Where To Find Professional Help

Real estate crowdfunding can present tax, legal, and compliance complexities that may require an experienced and licensed CPA firm.

Sundin & Fish, CPA is experienced in real estate crowdfunding and they have worked with leading platforms as well as investors. Their team, real estate tax professionals who not only understand the importance of high quality tax services, but also understand real estate transactions.

Sundin & Fish helps clients with the following:

- Entity structuring and review of your current real estate activities;
- planning so you can take advantage of all legal tax deductions;
- Compliance review so that you have no "red flags" or issues with the IRS;
- A comprehensive range of accounting, tax and advisory services:
- Preparing US federal tax returns as well as returns in all US states;

When it comes to real estate crowdfunding tax issues, Sundin & Fish offer industry expertise and specialized knowledge.

Call 480-361-9400 or email paul@sundincpa.com.

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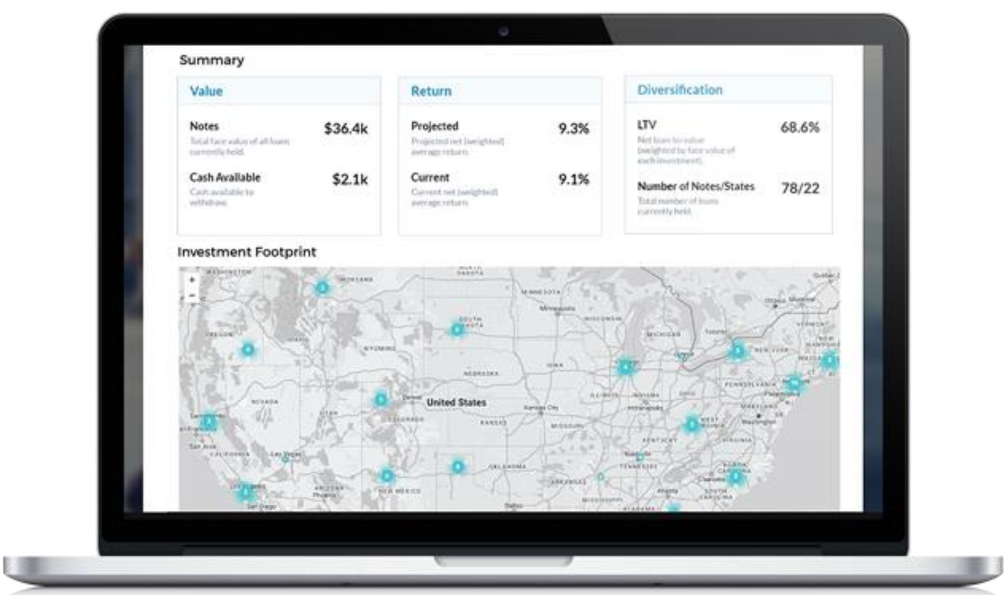

564 Market St. Suite 450 San Francisco, CA 94104

invest@alphaflow.com