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How to Invest in Real Estate w/o Paying a Penny of Tax: Part 1 Why IRAs + 401k's don't cut it

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You can pay $0 in tax. IRA's/Solo 401k's are okay but won't get you the whole way there, due to limited tax sheltering and/or significant limitations.

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Back in 1997, Gary Frederick **scraped together $52,000** and placed it in a **passive real estate investment**. He had no idea that he'd repeat this **53 more times** over the next 21 years. And that today he'd be generating **so much income** that he banks all the money from his "day job."

"It changed my life," says Fredrick. That alone would be amazing enough. But what's even more amazing is that Frederick did this **without paying a penny of tax**. And when he dies, he'll pass the property on to his **heirs** and they **won't pay any tax either**.

How did he do this? Many traditional financial advisors (who only know public markets) would **say it's impossible. But** savvy investors like Frederick have been quietly **doing this for years**. They don't rely completely on IRAs or traditional retirement vehicles. Instead, they use more advanced techniques like **coupling depreciation** with the humorously named **"defer, defer and die" technique** and **1031 exchanges**. And they use **"passive-pairing"** and **more**. (Also, in 2018, the **new tax law** opened up **additional options** for zero tax investing). This article series examines how it works.

Part 1 of this article looks at **traditional tax sheltering methods** (IRAs, solo 401(k)s) and why they often don't quite stack up. Then in **Part 2**, we'll look at how to **maximize** your **tax savings** while retaining your flexibility, using **"defer, defer, and die"** and other techniques. In part 3, we'll see how "**passive-pairing**" can **drastically reduce or eliminate** your investment **taxes**. And then in Part 4, we'll look at **how to implement** that.

The Tax Man Cometh

When you invest in real estate, you're potentially **taxed in two ways.**

First, the **profit from renting** it (net operating income) is taxed as ordinary income. Ordinary income is taxed at the same marginal rate as if you had made more money with your employer (which for most accredited investors is between **22 - 37%**).

Second, you also hope that the property is worth more when you sell it. If so, then the **profit from that is taxed as capital gains** (which for most accredited investors is relatively lower and ranges from **15 - 20%**).

Then on top of this, some people may have **state and local taxes** as well. It all adds up to a lot, so it's no surprise that many people want to **minimize** the amount of taxes they have to pay.

Old-school

If you complain about this to some traditional financial planners, they'll probably recommend that you put the money into a **self-directed IRA/solo 401(k)**. This definitely works to reduce **some** of your taxes (and I did an article on how to liberate your traditional IRA to be able to do this).

However, **none** of these methods let you invest **completely tax-free**, and all have **significant limitations**.

Self-directed Traditional IRA

In a **traditional IRA**, you put in money with the idea that you're going to keep it in there **until you're 59 1/2 years old** (otherwise you pay a penalty). Some people can also **deduct** the contribution from their income (although most accredited investors can't, because they make too much money to qualify). Then it **accumulates tax-free**. However, at some point you have to pull the money out, and then you **do get taxed**. You're taxed at whatever your marginal rate is at the time.

So an IRA investor is counting on/hoping that their **future tax rate** in retirement is **lower** than their current rate, because they will have **less overall income**. (**Others question that belief** by pointing out that tax rates are currently at extreme historical lows, and that record deficits will eventually require tax hikes to fix. I won't get into that debate, for the purposes of this article, and assume that the investor will probably have a lower tax rate.).

So the **main limitation** of the traditional IRA is that it obviously **isn't completely tax-free**. It's also **very limited** as to how much you can put in. (Only $5500 per year or $6500 if you're age 50 or older). And if you want to pull the money out before you turn 59 1/2, you **can't without paying a hefty 10% penalty**. Finally, it **can't be invested** in all types of real estate, because you may be subject to UDFI/UBTI.

So this is alright, but not great.

Self-directed Roth IRA

In a **Roth IRA**, you **don't get the initial tax deduction** when you contribute like a traditional IRA. This isn't a big deal to most accredited investors, since they didn't qualify for the deduction anyway. Like a traditional IRA, and also **accumulates tax-free**. However, the big difference is that when you **pull your money out, you're not taxed**.

So this is a pretty good deal, and on the surface **seems** like the **ideal** way to achieve the goal of tax-free investing. **However**, a Roth IRA comes with **significant downsides**.

1. **Can't invest in all types of real estate**, because you may be subject to UDFI/UBTI penalties.

2. **Can only use W-2 and self employment income**.
   So **none** of your **money from your taxable investments** can be put into a Roth. And if you're **retired** and/or **living** exclusively **off investment income,** this means you **can't put any money** into one.

3. **Can't add significant money.**

   A Roth limits you to **adding only $5500 per year or $6500** if you're aged 50 or older. This is a **showstopper** for many.

   (A few lucky souls have a 401k at work that lets them use a technique called the mega-back door Roth to contribute up to $32,000 per year. However, this is not a technique that the typical person can use).

4. **Impossible or difficult to qualify** to contribute yearly to a Roth.

   Many accredited investors **make too much money to qualify** to contribute to a Roth. If you make more than $135,000 per year single or 190,000 per year married, you can't contribute to one.

   But there is a technique called a **"backdoor Roth"** that allows high income earners to bypass this restriction. And it was just made explicitly legal by Congress in January 2018.

   However if you have **other IRA funds**, there are some complicated **limitations**, and you may not get the tax savings you were expecting. If you're considering this, make sure to consult your tax advisor and attorney first.

   Some investors may already have a **decent pot of money in an IRA/work place 401k** that has been accumulated slowly over time, and can be converted to a Roth. If so, that **can make a lot of sense**...even if they will run into all of the above issues with trying to adding money to it.

5. **Limited access**. If you pull your money out **before you turn 59 1/2**, you have to **pay taxes** on whatever earnings occurred in the account. This is probably not a big deal for people who are close to retirement and a lot better than paying an additional 10% penalty with a traditional IRA. But is more of an **issue for younger people**.

Self-directed 401(k)/Roth IRA

If you have a **legitimate self-employment activity** (and **without full-time employees**), there's an appealing option called a **self-directed 401(k)**. When **paired** with a **Roth** IRA, it gives you the **same tax sheltering** as a Roth. But you can **put in up to $53,000 per year** (or $59,000 if you are at least 50 years old). However, the contributions can't be more than your earned income, which may **limit the usefulness significantly** unless you have significant business activity.

One advantage is that **unlike an IRA,** it is **not subject to UDFI/UBIT** tax. However, it does come with some other issues, because you are the custodian, and it's **possible to violate the rules and owe the penalties** if you invest in the wrong thing.

Note: that another way to **get around contribution limits is to transfer** an existing IRA pot of money into one, which may be a good option for some. Again this gets around limitations of putting money in the very first time, but will still be subject to the other limitations on a yearly basis.

So limitations here are:

1. **Impossible to set up for many**. Have to have a legitimate self-employment business without full-time employees or an IRA to rollover.

2. **Severe to moderate restrictions** on how much money you can put in (depending on your situation).

3. **Not suitable for a newbie investor or someone who doesn't have the time** to dive into the details to make sure they are not violating the rules.

This just isn't an ideal solution for everyone. And even if it does work for an investor, this technique would **not be usable as a multi-decade wealth-building** tool like Frederick did (who ended up putting in far in excess of $59,000 in many of his later years as his nest egg grew larger over time).

There must be a better way?

In part two of this article, we'll talk about the holy grail: **how to invest taxable money and pay no taxes at all**, by combining two strategies (**depreciation and "defer, defer and die")** and also how the **new tax law** opens up additional options.

Click here to view part 2.

#SelfdirectedIRA #IRA #Solo401k #taxfreeinvesting