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# How to Invest in Real Estate w/o Paying a Penny of Tax (Legally): Part 4: "Passive-Pairing"

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## How to implement "passive-pairing" to drastically cut or wipe out your investment tax bill.


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Part 1 of this article looked at **traditional** retirement-vehicle **tax-sheltering methods** (self-directed IRA, solo 401k)... examining how they are **good** and how they **fall short**. Part 2 looked at how **experienced** investors like

John Frederick use non-retirement money to pay zero taxes while still maintaining maximum financial flexibility ("defer, defer and die" via serial 1031 exchanges). Part 3 looked at how to dramatically cut or eliminate your tax bills on a wider variety of investments using "passive-pairing". Here in Part 4, we'll explore how to actually do that, by identifying investments that work with this technique. And then we'll talk about how to apply that to your portfolio in the most efficient way to max out your tax savings.

## I Know It's "Passive". But is it "IRS Passive"?

As we mentioned in Part 3, this technique only works on investments that generate passive income. So how do you identify these?

The first thing is to understand what the IRS means by "passive" income. It has almost nothing to do with what you and I mean by "passive" in ordinary life.

Most people would say a "passive" investment is any investment where somebody else makes all the decisions and we have no control and are just along for the ride. This describes pretty much every single syndication/crowdfunding deal, as well as investments in stocks, bonds, CDs that generate interest, etc. All of these are "passive" in the everyday sense.

That's not what the IRS is talking about. For example, CD interest, stocks and bonds are not passive in their minds, and neither are certain syndication/crowdfunding deals. To make things more complicated, it's possible for two funds to look the same on the surface and for one to be ruled as passive by their accountants and the other is nonpassive. Getting a handle on this is crucial to harnessing the tax savings of passive-pairing.

So what exactly does the IRS mean?

## "IRS Passive"

The first hoop an investment has to jump through, to be deemed passive, is that it needs to be (per Investopedia) "rental property, limited partnership or other enterprise in which a person is not actively involved". When they say enterprise, they mean a business. So that's means CD interest, stocks and bonds are all ruled out.

Since we're talking about real estate and alternative investments, they are all going to easily qualify here. So then let's look at the next hoop.

## 1099-DIV or K1?

Generally, your investment is going to give you one of two tax forms at the end of the year. You'll either get a 1099-DIV tax form (like many real estate REITs). Or you'll get a K-1 (like many non-REIT real estate deals and alternative finance deals). This is key to figuring out if an investment is truly passive or not.

If it's a 1099-DIV, then unfortunately you're out of luck. 1099-DIV income is non-passive income. Generally, all REITs fall into this category (such as Blackstone Real Estate Investment Trust (BREIT), Broadstone Net Lease and Broadmark). These investments can have other advantages (including tax shielding before they get to your tax form, which I'll discuss below). But for passive-pairing, they're tax dogs. And you'll need to plan to deal with them, which we'll talk about in a minute.

On the other hand, if the investment produces a K-1, then it passes this test and we can move on to the last hoop.

## Which Little Box?

Just producing a K-1 isn't enough, though, because not all K-1 income is passive. So you need to ask the fund how their accountant characterizes the income they produce ("passive or non-passive")?. It's also helpful to get a redacted K-1 from the previous year so you can show your own accountant to confirm.

In the IRS's most recent version of the K-1 form, income shown in boxes 1-3 is great news. These are generally considered passive for limited partners like us. (Box 1 is "Ordinary Income/Loss from Trade or Business Activities", box 2 is "Net Income/Loss from Rental Real Estate Activities", box 3 is "Net Income/Loss from Other Rental Activities"). The other boxes are usually not so good and many are guaranteed to be nonpassive. (See TaxSlayer for more information.)

I said earlier to always ask the fund, and wanted to say again how important this is. As an example, for many years, the accountants for a certain hard money loan fund ruled it to be passive. However the accountants for a very similar hard money loan fund ruled *it* to be *non-passive*. And by the way, the accountant for one was the auditor for the other, so it's difficult to claim that one of the accountants was wrong. So the rules are complex, and looks can be deceiving. And this is why I recommend to always ask.

## Putting It All Together

So now you know how to identify passive income. And you can identify the super-shielders and also other passive investments that can be paired with them to lower or eliminate your tax bill.

So here's how you *maximize* your passive-pairing tax savings. Take a look at the two different types of income and then allocate appropriately:

- 1) Non-passive income: these can't be passive-paired, so you want to neutralize the tax effect as much as possible. You do that by putting as much of this into your IRA/solo 401(k) as possible. Here's the best order of priority (from the highest tax burden to the lowest):

- a) **No tax shielding (0%)**: This includes **non-passive** real estate debt investments (which don't enjoy **any depreciation**) as well as certain **alternative** investments with **no shielding** (such as **litigation finance...sometimes. Always check** with the sponsor to find out for sure).

- b) **Minor tax shielding (10-20%)**: This includes **debt REITS** (which have **QBI shielding**) and certain **life insurance settlement funds** (that are domiciled in countries with **tax treaties** with the US to give them **favorable tax shielding**).

- c) **More tax sheilding (20%+)**: This includes **equity REITs** (which have **QBI** and **depreciation shielding**)

If you've gotten this far and were able to put all of your **non-passive income** into your **traditional retirement vehicles**, then you're looking **really good**. You may **ultimately** end up with a **$0 tax bill** for your investments (**after** doing the **"passive-pairing"** in the **next** step). But even if you didn't, you will still have **maximized** your tax savings by doing the above.

**Next,** you take a look at your **passive income**.

- 2) <u>Passive income</u>: here's where you use **passive-pairing** to greatly **reduce** or **eliminate** your **taxes**. You take one or more **super-shielders** and **pair them** with other **passive** investments to **wipe out** that **tax burden**. Here's the **order of priority** (from **most** tax-burdened to **least**).

- 2a) <u>Low tax shielding (0-35%)</u>: These are investments whose **moderate depreciation shields 0-35%** of the **distribution** from showing up on your **K-1**. That's a **nice start**, but with passive-pairing, you can **wipe out the rest** of the tax burden.

  Usually these are **real estate equity investments** that are **held long-term** (more than **7 years**). **Depreciation doesn't last forever**, and once it's **used up**, the **shielding** can **drop dramatically**. So funds that **hold** properties for **longer** than seven years tend to opt taking depreciation **slower schedule** which results in **lower shielding**.

- 2b) <u>Medium to high tax shielding (36-80%)</u>: So these start off with **36-80%** of your **physical distributions not showing up** on your K-1. That's an **even nicer** start than the previous category. But again, you can use **passive-pairing** to **wipe out** the **remainder** as well.

  These are typically **equity investments** with **shorter-term holds** (**7 years** or less), but they're in real estate **asset classes** that are **less depreciation efficient** (retail, office, hotels, single family homes).

- 2c) High-tax shielding (80-100%): these are **pretty sweet** on their own, with **80-100%** of the **physical distributions not appearing** on your **K-1**. These are typically **equity investments** with **shorter-term holds** (**seven** years or less) and in real estate **investment classes** that are **favorable to depreciation**, such as multifamily (especially with a cost segregation analysis), mobile home parks, etc.

If you've gotten this far and were able to **pair** all of them with **super-shielders** (**after** previously **shielding** all your **non-passive** income) then **congratulations**! You now have a **$0 investment tax bill!**

And again, even if you didn't, applying these techniques to **any** of your **holdings** will **reduce** your **taxes** and **maximize** your **tax savings**.

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