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How to Invest in Real Estate Without Paying a Penny of Tax (Legally): Part 2: "Defer, Defer and Die"

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You can pay $0 in tax by pairing depreciation with a technique humorously called "defer, defer and die". Also, the new tax law opens up additional options...

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No one wants to pay more tax than they have to. So many investors spend a lot of time thinking about how to reduce the tax burden.

Part 1 of this article looked at **traditional retirement-vehicle** tax-sheltering methods and why they **don't stack up**.

Here in Part 2, we'll look at how experienced investors like John Frederick use non-retirement money to **pay zero taxes** while still maintaining maximum financial flexibility. And then we'll look at the **best ways to implement** this without breaking the bank.

Then 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.

Taxed Both Ways

To recap from part one: 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. This profit 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.

So let's first talk about **how to avoid paying any tax on *income***.

Appreciating Depreciation

Some new real estate investors get a nice surprise/bonus at tax time. They find that their **income** reported to the IRS is *less* than they actually got in **cash**. This isn't a tax scam, and has to do with something called **depreciation** (which I'll talk about in the second). But the net result is that some investors find they are only taxed on **about 40%** of their income. Others even find that **100%** of their income is **tax shielded** and they don't have to pay **any tax**. How is this possible?

First, let's discuss depreciation. Accounting rules allow all business owners to **deduct depreciation** from their profits. This deduction is intended to take into account the fact that most things that you buy **lose value** by the day as they wear down. So if you're a manufacturer and buying a new machine to produce parts, the depreciation deduction makes up for the fact that every year the machine gets a little more worn down and work less. **Eventually** your machine will break down permanently and be worth nothing, so **depreciation accounts for this**.

However, **real estate** is a little weird and **different** than most businesses because it generally isn't like this. When you buy property and sell it five years later, not only has it *not* reduced its value to $0, but it is also (hopefully) **worth more** than you bought it for. But due to the depreciation accounting rules that applies to all businesses, you **still** get to take this **deduction**. So the net result is that you actually have a **tax bill for less than the income** you made!

How much less depends on **what** you invested in, and **how long** the property is being held (because the accounting rules are set up so that the amount of the deduction goes down over time). If you invested in real estate debt, you're not going to get any depreciation, so there's no shielding. However, if you invested in **real estate equity**, then you'll **benefit** in some way. On a **single-family house** investment, it might be about **40%** of your income that you don't have to pay taxes on. **Core real estate fund** with an average asset being held for 25 years, might shield **50%**. And a **brand-new multi family/apartment** that uses cost segregation depreciation, it might shield **100%** of your income.

*(Side note: And with the **new tax rules**, many investors may find that they have an **additional 20% of tax shielding** on top of this in 2018).*

Obviously, this is a **pretty fantastic** situation.

The Catch

However, **there is a catch**. The IRS recognizes how much of an unfair tax break this is. And of course they don't let it go. So when you **sell** the property, they do something called **"depreciation recapture."** What this means is that you end up having to **repay back all the tax breaks** enjoyed previously.

So that awesome tax break was **not** really an a **true** tax savings or permanent deduction. In the end, it only does gives you a **delay** in paying the IRS. This is a really important limitation that many investors don't fully understand, and many real estate promoters gloss over (or don't understand themselves) when they are pitching the tax benefits of their deal.

And for 99% of investors, the story ends here. However, this article is about **investing completely tax-free**. So of course we're going to talk about how to get around that.

"Defer, Defer and Die"

Fortunately, the IRS has set up a **second rule** that allows savvy investors to **transform the temporary** tax break (which has to be paid back) into a **permanent** one. The rule is called a **1031 exchange**. (There are also some **other rules** that allow this which we will discuss below). While the details of the 1031 exchange can be very complicated, it essentially allows a real estate investor to **sell one** investment, **buy a second** investment, and **not have to pay** any taxes on the depreciation (called "**deferring**" it) until the second property is sold.

That alone is **nice**, but **not enough** to avoid paying taxes completely. Thankfully, the rule **also** allows investments to be **daisy-chained** one after another, and still retain their ability to defer taxes. In other words, you can keep **repeating** this over and over again as many times as you want. And as long as you do, you **don't owe any taxes**.

And amazingly, the strategy **doesn't end** when an investor **dies**. You'd think that at that point the IRS would get their due and collect all the taxes. But the rules state that when the investor dies and passes the property to their heirs, it's inherited on what's called a "**stepped-up basis**". What this means is that **the heirs don't owe the tax either**. This is a **pretty amazing** thing. They say that death and taxes are unavoidable, but clearly in this case taxes can be.

Then to make it even more mind blowing, not only does this work on the depreciation, but it **also works on** the second part of the taxable return: **price appreciation**. Normally this is taxed as capital gains, but by using the strategy, it also **infinitely deferred and never paid**.

This is a pretty **fantastic** loophole. And the set-up is why some people humorously called the strategy "**defer, defer and die**".

"Uncertain, the future is"

The biggest **danger** to this strategy, is that of course, no one knows what the **future** holds. In an environment with rising deficits and tight budgets, the future **Congress could revoke** some or all of the **rules** required to make "defer, defer and die" work. If that happened, then presumably some taxes would be owed at some point. So anyone considering the strategy, has to take that into account.

The other danger is that the 1031 **rules are complicated**. There's lots of gray areas, and even conflicting information from the IRS versus court rulings, etc. So it's vital that you **consult** with a knowledgeable **tax attorney** going forward with any such strategy.

"Devil in the details"

If an investor is okay with the above risks, then how is a passive real estate investor to implement it? There are **several options**:

1. Tenants-In-Common (v1.0)
2. Delaware Statutory Trust
3. UpREIT
4. Economic opportunity zones
5. Tenants-in-common (v2.0)

Tenants-in-common (v1.0)

Tenants-in-common (TIC) is an ownership method that the IRS approved in 2002 as a way to allow multiple, unrelated investors to invest in a 1031 exchange.

TIC v1.0 was extremely popular over two decades ago, but **less popular today** due to problems that were exposed in many during the Great Recession. First, since every investor is a **partial owner**, they all have to become a **borrower on the mortgage**. This means the loan shows up on your private credit. Additionally, **major decisions** (one to sell, when to raise more money, etc.) require **unanimous consent** to accomplish. This can be difficult when there can be up to 35 people involved, and there are many stories of important actions that couldn't be taken because a single person dissented. Also, the **35 investor limit** constrained the TIC to smaller properties.

Delaware Statutory Trust

Delaware Statutory Trusts (DSTs) were approved in 2004 by the IRS as a way for investors to do a 1031 exchange. The DST, all of the **investors are completely passive** and have no say in the major decisions of the property. The sponsor does this instead, which makes coordination much easier and **solves many of the problems of TIC v1.0**. Of course, this makes choosing the sponsor a lot more important.

However, DSTs retain some **significant limitations**, such as being **prohibited from raising more money**. During the great recession, many **funds** would have **imploded** and gone into **foreclosure**, without the ability to raise more funds. Most DSTs try to minimize this risk by setting up **reserves** in advance. However, doing so produces a **drag** on the ultimate return, so many DSTs **don't have severe recession reserves** set up. And if the reserve is insufficient, then the investors in the DST are **out of luck** and the deal may implode.

The other issues with DSTs is that they tend to have **very expensive** hidden (or not so hidden) **fees**. For example, it's very typical for there to be a **front-end commission** that costs as much as **9%**. Right now, property prices are at all-time highs, and if they don't increase by at least 9%, you might expect to **sell at a loss**. So this is something else to watch out for.

One site that has a lot of DSTs is 1031crowdfunding.com

UpREIT

UpREIT is a tax-deferred process, similar to the 1031 DSTs/TICs, that allows you to take an existing property that you own directly and do a **tax-free exchange** into a REIT. For example, Broadstone Net Lease has such a capability.

One big **advantage** over DSTs, is that there is **no restriction on raising additional money**. Also, if you are using a fund like Broadstone Net Lease, the **fees are extremely reasonable** and many times **lower** than a DST.

The downside is that an investor can only transfer in existing property that they own, and **can't transfer in LLC interests** (like a crowdfunding or syndication deal). And once in the REIT, there is **no capability** to do a **tax-deferred transfer out**. This is fine if you are doing buy-and-hold (in which a REIT makes possible easier than an individual property or small fund). However, if that's not your intention, then this **could be a limitation**.

Economic Opportunity Zones/ Opportunity Zone Funds

This is a **brand-new** tax-deferred process that was created by the **tax overhaul** passed at the **end of 2017**. It allows investors to **sell property** (or **stocks**...any type of capital gains) and then transfer into a property in a **low-income** area, to **defer capital gains**. (It's unclear if this will allow the deferral of depreciation as well, but we will get more clarification as time goes on). They are done **through Opportunity Funds** certified by the U.S. Treasury to make the investments.

These investments have **some small advantages** over 1031/DST/TICs for some investors. If the investor **holds for 10+ years**, any **capital gain** on the Opportunity Fund is **completely wiped out/excluded**. With 1031/DST/TIC, it is only deferred, which requires repeating the process over and over again, to avoid eventually being taxed.

Also, there are some other **special perks** if the investor wants to cash out earlier. After **5 years**, the **tax basis** of the *original investment* is **increased** by 10% (meaning the **capital gains will be only 90%** of what they would've been). If they hold it for **7 years**, the basis is increased by a total of 15% (meaning **capital gains will be only 85%**). In a 1031/DST/TIC, there is no discount.

This is a **brand-new and very interesting** development where a lot of the details have not been finalized.

The private investor club has a master list of **more than 30 opportunity zone funds**, and has conducted **due diligence** on **many** that club members have found interesting. Club membership is free but requires verification that the investor is not associated with any sponsors or platforms and signing a nondisclosure agreement to keep the information private. Click here to view the list or learn more.

Tenants-in-common (v2.0)

In part one of this article, we talked about how **Gary Frederick has not paid taxes** on 54 investments over the last 21 years. Fredrick used a technique that I call **tenants-in-common (TIC) v2.0.**

TIC2.0 was created as a **response to the limitations of TIC v1.0 and DSTs** by some sponsors. They use a combination of one or more **LLCs with a TIC** to **bypass** many of the traditional **restrictions and limitations** of TIC 1.0 (such as liability, or the 35 investor limit). They also use a number of **techniques** (such as "drop and swap") to thread the needle of IRS issues and **restrictions**. Note that some sponsors may employ riskier strategies than others. And if the IRS disapproves a strategy, it could result in taxes and penalties. So it's **important to check with an experienced tax attorney** when dealing with these.

Fredrick chose to **use a single sponsor** for his TIC v2.0 strategy. The advantage of this is that the sponsor handles all the **tricky issues of timing** the move between the old investment and the new one,. (For example, if you take too long to move into the new property, you can lose the tax deferral). Also, the sponsor that he chose (MG Properties**) does not charge an additional fee** for the 1031 exchange at the end (and it is optional, so the investor can choose to cash out).

Note: As of 1/2021, MG Properties currently has an open TIC v2,0 "defer, defer and die" offering (a value-added multifamily deal that is expected to shield 100% of distributions from tax, and offer a 1031 exchange at the end).

Note: the above link is limited to members of the private investor club. Membership is free, but requires verifying that the investor isn't associated with a crowdfunding platform or sponsor.

But how do I take it further?

However, **many** of the above only work on **limited investments** and **most investors** would **prefer** a much more **diversified** portfolio.

In part 3 of this series we'll look at how investors can use "passive-pairing" to dramatically cut or eliminate their tax bills on a wider variety of investments. (And since many of us also invest in other alternative-finance assets, I'll talk about how you can integrate those into a tax savings plan, too).

Continue to part 3.