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How to Invest in Real Estate w/o Paying a Penny of Tax: Part 3: The Power of "Passive Pairing"

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Dramatically cut or even wipe out your investment tax bill with "passive-pairing."

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Part 1 of this article looked at traditional retirement-vehicle **tax-sheltering** methods (self-directed IRA, solo 401k)... and examined how they're **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).

However, these only work on limited investments and most investors would prefer a much more diversified portfolio. In this article (Part 3) 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). Then in Part 4, we'll look at how to identify investments that work with this technique.

"With Great Power Comes Great Responsibility"

Before jumping in, I want to give a small warning about going too crazy on tax savings. Once you understand "passive-pairing," it's easy to design a portfolio with a $0 investment tax bill every year. That may sound perfect, but if you're like most investors, doing that would require you to change your portfolio allocation. And depending on your situation, that might force you to take on more risk then you would have otherwise. So while I do think that minimizing taxes is important, I don't think it's wise to make it the end-all and be-all. And I recommend keeping the bigger picture of your portfolio allocation plan in mind at all times. (See "The Conservative Investor's Guide to Real Estate Investing").

Okay, with that little speech done, let's dive in.

Who This Article Is for

I'm assuming you're a fairly typical investor that has a small portion of your portfolio (or maybe none) in traditional retirement vehicles (self-directed IRA and/or Solo 401k). And that you have a larger amount (or all) in "cash" or taxable money.

On the other hand, if you have all your money in traditional retirement vehicles, then this article won't be very helpful to you.
So, if you're in the former camp, let's continue on.

Passive Versus Non-passive

The IRS calls certain types of investments "passive" and allows losses on one to offset real gains on another. That's not really useful on its own.

The trick is that some investments can actually make money in real life while they generate paper passive losses. That's incredibly powerful. I call those types of investments "super-shielders," because they allow you to make a profit while shielding the tax gains on other investments. Once you understand how to use this, you can dramatically cut or even eliminate your investing tax bill. It doesn't work on every type of investment, so you have to understand how the rules work (which we'll cover in more detail in Part 4). But once you have a handle on it, it can have a huge effect. I call this technique "passive-pairing".

So How Does It Work?

As an example, let's say an investor named Joe invested in this (real life) multifamily operator deal that came out in 2018. That deal generated about a 4% return. (The yearly return would've been higher but the property was only put into commission in the middle of the year). Through the depreciation deduction, it shielded not only 100% of its own return from taxes, but produced an additional 40 to 50% of paper losses. This is a "super-shielder".

Now let's say Joe has his eyes on another fund that he likes a lot, but is very tax-expensive on its own. Let's say he likes a hard money loan fund that creates passive shielding. In another real-life example, this fund in 2018 generated about 11% passive-income return. (Technically it switched in midyear to a REIT for other reasons, but I'm going to keep it simple to stay on topic). The tax problem with this fund is that it is a real estate debt fund. And as mentioned in part 2 debt funds have no depreciation shielding. So if Joe had invested in this on its own, he would've had to pay taxes on 100% of the income reported by it.

However, by pairing the two investments together, the paper passive losses from deal 1 offset the gains on deal 2. The net result is that Joe pays zero taxes. Most people would say that's pretty awesome.

If Two Is Great then Three Must Be Fantastic?

And even though I call it passive-pairing, it isn't actually limited to just 2 funds. You can take a single super-shielder, and use it to offset the gains on *any* number of other passive funds. It will probably require putting more money into the super-shielder versus the others, but then it will work the exact same way.

Here's where I would caution you not to let the excitement of saving or eliminating your taxes carry you away. If putting that much money into the super-shielder skews your portfolio with too much risk, I personally would be very hesitant to do it. On the other hand, if doing that fits with your plans anyway, then there's no reason not to do it. You can join as many of these together as you want, and get the same benefits.

Sounds Great. But What's the Catch?

The one catch with depreciation shielding, as we saw in part 2, is that it often has to be paid back. If you don't take other precautions, that happens when you exit the deal. So if that happened here, Joe's tax savings would only be temporary, and when the multifamily operator exits in 7 to 10 years he would have to pay it back. That's still a substantial tax savings to get the benefit now rather than maybe a decade from now. But Joe knows he can do better.

So, Joe plans in advance to go with a "defer, defer and die" strategy. (See part 2). This means he will 1031 exchange when the deal exits into another deal, defer paying back the depreciation (and incidentally defer paying any capital gains). And he will repeat this over and over again. As long as he sticks with the strategy, he will **never** have to **pay back** the **depreciation shielding**, and this tax benefit will be **permanent**. **Even when he dies**, his **heirs will inherit** this on a **stepped-up basis** and **not** have to **pay taxes**.

So now the **passive-pairing** benefit becomes **permanent**. That's really **nice**.

The Double Edged Sword of Acceleration

One other **potential issue** here is that **sometimes** a **super-shielder accelerates its depreciation**, using certain accounting rules (and perhaps **paired** with something called a "**cost segregation analysis study**"). What this means in English is that **instead** of giving the investor the **same** depreciation shielding each year, the **early years** have a **lot more** and the **later years** have a **lot less** (or **none**).

This is a **double-edged sword**. On one hand, it allows the **benefits** of passive-pairing to be **accelerated** and **enjoyed much earlier**. On the other hand, many times the investor will **use up 100%** of that accelerated depreciation because they have a **lot** of **other investments** to **tax shield** that year. Then as time goes on, the investment **will lose** its **super-shielder status**, and **eventually** be **unable** to **shield even its own** yearly distributions **fully** from being taxed.

Some investors just consider this the **price** of **doing business**. After all, **some** super shielding is **better than none**.

Others take a **different approach** and **eliminate** this issue by making sure that they invest in a ***new*** **accelerated "super-shielder"** *each year*. Each year they do this, they get a **big, new** accelerated tax shielding **boost**, that can be used to **shield against** the yearly fading powers of all their **former** super-shielders, and of other investments as well. Many investors consider **diversifying** a real estate portfolio into **vintage years** like this to be a **best practice** in **diversification**. For that type of investor, this strategy can make a **lot of sense**.

On the other hand, **if** investing in those **particular deals wasn't** already in the investor's **plan**, then they are **allocating** their portfolio to **save on taxes**, **rather** than to deal with **risk**. As I said earlier, that can **sometimes** be **dangerous**. So I think it's **important** for this kind of investor to **double check** and make sure they are **not** getting themselves into something **riskier** than they had **planned**.

Sounds Great. So How Do I Do It?

Now that we've talked about how **passive pairing** works, the **next step** is understanding **which** investments it works on and **applying** it to your portfolio. We'll talk about that next in

Part 4: Passive-Pairing Details.

#SelfdirectedIRA #IRA #Solo401k #taxfreeinvesting #defer #deferdeferanddie #1031exchange #TIC #Tenantsincommon #DST #DelwareStatuatoryTrust #passiveincome #taxdeferral #taxreduction #taxelimination