Add a PIG to your pen

It may seem like ancient history, but taxpayers once were able to use “tax shelter” losses from cattle breeding, oil and gas and equipment leasing deals to offset highly taxed income. Then Congress imposed passive activity loss (PAL) rules that turned tax shelters into a dying breed.

Now you might search for a different kind of tax animal as year-end approaches.

Strategy: Consider investing in Passive Income Generators (PIGs). In a twist on the old theme, PIGs provide current income in the early years of ownership so you can absorb passive losses you’ve already realized.

Of course, any deal must make sense financially, but PIGs maintain a tax edge over other investments.

Here’s the whole story: The PAL rules, which were enacted back in 1986, effectively ended the practice of finding pure tax-shelter deals that generated losses in the early years of a partnership. Investors had used those losses to offset ordinary income (currently taxed at rates up to 39.6%).

Under the PAL rules, however, you may only use losses from passive activities to offset income from other passive activities. Any excess loss is carried over to the next year. The tax law characterizes most investment activities, like rental real estate and traditional tax shelter deals, as passive activities, although there are certain exceptions.

Key point: A rental estate activity is automatically considered a passive activity, but an “active participant” owning at least 10% of the property is allowed to use a loss of up to $25,000 to offset nonpassive income. This $25,000 allowance is phased out for a modified adjusted gross income between $100,000 and $150,000.

These rules may adversely affect upper-income investors. If you incur losses from a passive activity, you get no current tax benefit from those losses.

In fact, the losses are suspended until the time, if ever, you have sufficient income from other passive activities. For some investors, PALs may be suspended for several years, a decade or even longer.

This is where a PIG can come to the rescue. Certain types of investments are specifically designed to produce passive income in the early years of ownership. Thus, they can “soak up” passive losses realized from other activities. In effect, the income from the PIGs is tax free, up to the amount of your suspended losses. This strategy turns the tax shelter concept upside down.

The list of PIGs includes golf courses, ski resorts, conference centers and other investments. Typically, they are syndicated through public offerings and actively marketed as PIGs by their sponsors or brokers. If you need a PIG to offset a PAL, it’s relatively easy to find one, although you should use common sense in all your investment decisions.

Tip: Alternatively, you might sell an interest in a passive activity or use other methods to produce income that can absorb PALs.

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Are you a real estate pro?

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The IRS treats a “real estate professional” like any other business owner if certain requirements are met. Thus, you can deduct real estate losses in full against nonpassive income. But you still must pass a “material participation” test for the write-off.

Generally, to qualify as a material participant in real estate, you must put in at least 500 hours (or 100 hours if no one else does more).

New case: A taxpayer claimed rental real estate losses were fully deductible because she was a real estate professional. But she couldn’t prove she was a material participant. As a result, the Ninth Circuit Court denied the loss. (*Gragg*, CA-9, No. 14-16053, 8/4/16)

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