



Special Report

The Smart Investor's Guide to U.S. Real Estate Tax Strategies

A Companion Report for Viewers of
The Real Estate Investors' Tax Secrets Roundtable

Presented by Copper Beech Financial Group, in partnership with WorthNet

About the Authors



John J. Parise and Michael J. Parise, Esq., are co-owners of the generational wealth management firm Copper Beech Financial Group.

John, whose experience in the industry spans more than 40 years, is the firm's founder and architect. Early in his career, he was fortunate to work with and share notes with the managers of some of the prominent family offices of their time, where he quickly recognized that the tools and philosophies that seemed to separate those who'd managed to preserve wealth across generations were not well understood by families earlier in that journey. He built Copper Beech to tackle those challenges and make that view on generational planning accessible to the successful entrepreneurs, savers, and investors whose focus is turning from accumulating wealth and building value to protecting and preserving it.

Michael is a tax attorney and has spent his career leading Copper Beech into ever more advanced and nuanced planning strategies intended to help the firm's clients preserve wealth across generations, balancing control, flexibility, the need to access capital, and the desire to protect it from the many risks life can throw at a nest egg over two or three generations of business, economic, and family dynamics.

Vanessa Clunies is CFO & COO of Tangible Property Tax Methods, a real estate tax consulting firm specializing in the application of TPRs, cost segregation, and Form 3115 method changes. She contributed her expertise as a source for the webinar and report and is a regular partner of Copper Beech for tax optimization planning.

Want to Connect with Copper Beech?

Copper Beech works with client families across the wealth spectrum – from \$1 million households to \$100 million-plus family offices – on the challenges of creating multi-generational wealth, with a keen focus on tax efficiency. They are proud to have been invited into the WorthNet partner adviser network. If you want to consult with them about your own financial plan, connect with the team at <https://worthnet.com/copper>

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Leveraging Real Estate's Unique Tax Treatment

The United States tax code is chock full of provisions geared toward real estate investors – with generous deductions, deferrals, and exemptions not available to other investment assets like stocks and bonds. Taken together, when used to their highest effect, these tools provide the potential to **reduce taxes and increase after-tax returns**.

For many years, especially through the early part of the 21st century, politicians have seen fit to try to stimulate economic activity by incentivizing real estate ownership using their most potent tools: tax and rate policies. This has continued right through 2025, with the passage of the One Big Beautiful Bill Act (OBBBA) on July 4th – a bill that has made permanent and expanded some of the most generous incentives to real estate investors we've seen in our lifetimes.

But, taking advantage of the many tools available starts with knowing they exist and learning their upsides and downsides, as many come with important trade-offs.

As advisors, we've helped clients manage, grow, and protect wealth for more than 40 years. And other than family businesses, no investment has occupied more of our clients' portfolios than real estate. It's the tool through which many of our families have built their wealth or sheltered it from more volatile sides of their balance sheet. And, in that time, we've helped them navigate complexities, bend the tax code to their advantage, and potentially avoid costly mistakes and oversights. Experience we want to share with you.

In this report, we'll explore a few strategies worth understanding. From leveraging retirement accounts and "tax-free" Roth growth to structuring deals via trusts and life insurance wrappers, there are many tools available to U.S. investors. Understanding when they apply, the potential upsides and downsides of each, we hope will help investors better understand ways to leverage the tax system's incentives to try to keep more of their real estate profits, and to realize those returns sooner, rather than losing them to taxes.

The following concepts illustrate how U.S. tax law applies generally to real estate investors. These illustrations are educational, hypothetical, and do not represent actual results, expected performance, or advice. Outcomes differ significantly by taxpayer.



Strategy Overview

At a high level, **real estate enjoys numerous tax breaks** in the U.S. that other investments simply don't. It straddles a position somewhere between an active trade or business, with the ability to deduct all costs before paying tax on any profits, and more passive investments like stocks and bonds, where every bit of interest, dividend, or capital gain is taxable when received.

Anyone remotely experienced with real estate investing will immediately recognize the first two big distinctions between real estate and other passive classes of income:

- You can deduct depreciation on rental properties each year, often sheltering much or all of the rental income from current tax. Buy a million-dollar building and make a 4% net yield; it could be virtually tax-free after depreciating that building over a 27.5-year lifespan. Buy a million dollars' worth of a stock that pays a 4% dividend yield, and the treatment could hardly be more different. That profit has already been subject to corporate tax on one side and then is personally taxable to you when paid – there's no deducting the depreciated cost of your stock from that income.
- When you sell appreciated property, you benefit from favorable capital gains rates, and can even defer those gains indefinitely through 1031 like-kind exchanges or special programs like Opportunity Zones, both designed explicitly to spur re-investment.

Yet, in spite of these remarkable treatments, we often find that investors underutilize these aspects of real estate investment, electing to under-depreciate assets or not take full advantage of the many bonuses and incentives available, delaying after-tax profitability with a costly drag. We will review the application of these rules with an eye toward accelerating returns.

This favorable treatment does not just apply to gains earned within an investor's lifetime, either: if they hold real estate until death, the built-in gains are wiped away for heirs through a step-up in basis to fair market value. Depending on an investor's specific situation, this could mean decades of appreciation can pass income-tax-free – even though the investor already benefited from the depreciation. While other capital assets like stocks also receive a basis step-up, real estate's illiquidity and depreciation history often make the benefit especially impactful.



Often, too, these simple tax optimizations can be supplemented with potentially even more powerful tax planning tools – from specially designed tax-advantaged retirement accounts to custom crafted life insurance policies – designed to shield rental income and capital gains from income and estate/inheritance taxes across generations, reduce or eliminate deferral restrictions allowing investors to move into and out of the asset class without tax implications, and even improve the practical liquidity to make tapping into real estate for cash a bank-free proposition.

In short, U.S. tax law provides real estate investors with a toolkit for building wealth efficiently. Let's dive into some of these tools and how we tend to deploy them.

Before we do, to reiterate in plain English what the disclosures at the beginning of this document say: This report is meant to help educate you on how we, as wealth managers, look at real estate investing and some of the strategies we employ to manage the tax exposure. It is by its very nature general and not comprehensive of every applicable law or nuance of those laws that are described. Nothing in here should be construed as personalized tax, legal, or investment advice, nor as a solicitation to buy or sell any security. You should always consult with a professional before employing any of the strategies we describe.

Should one of the techniques described herein appeal to you, or if you are inspired to take a broad look at your investment and tax strategy, we would welcome the opportunity to discuss helping you build a personalized plan. Please visit worthnet.com/copper to request a complimentary consultation with our team.

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Tackling Three Major Tax Drags

When it comes to real property, there are 3 major categories of taxes where we can generally have a planning impact:

1. Income taxes – generated by the rental income from our properties
2. Capital gains taxes – on the sale of appreciated real estate
3. Estate taxes – which only apply to a small subset of people, but we often find catch investors by surprise and are easily mitigated with early planning

There are, of course, other tax and regulatory expenses like property taxes, local rental sales and use taxes, various fees for permits, inspections, and more. But for the most part those are simply a cost of doing business and there is limited financial engineering that can impact them – and in the cases like property taxes where impacts can be strategic the facts differ so much property to property that the only thing worth saying here is just be sure to check with a locally knowledgeable resource to ensure you're not overpaying on those fronts.

We'll start our dive into tax optimization on the income side of things first.

Optimizing Taxable Properties for After-Tax Yield

In our experience, many real estate investors leave money on the table by not taking full advantage of existing rules on depreciation, expenses, and losses.

Here are a few strategies we often find underutilized:

Optimizing TPR and Cost Segregation Deductions

Repairs vs. Improvements – Know the Difference

A pivotal tax skill for any property owner is distinguishing between capital improvements (which must be depreciated over years) and repairs/maintenance (which can be deducted in the current year... and in fact, must be).

The IRS's **tangible property regulations** (in force since 2014) provide criteria for this. In practice, we often see owners and even some CPAs default to capitalizing every property expenditure – essentially over-depreciating and under-deducting – to reduce the cost and complexity of tax prep.



However, by properly expensing all qualifying repairs and routine maintenance, you increase current deductions and preserve cash flow. There are even safe harbor rules: for instance, small expenses (under a certain dollar threshold) or work that doesn't materially add value or extend the property's life can often be deducted now. Take advantage of that.

It's worth reviewing past improvements, too – if a prior capital expense should have been classified as a repair, a competent tax advisor can sometimes adjust and claim a catch-up deduction. And, failing to do so also risks the IRS disallowing the remaining depreciable life of the asset on audit – an often-misunderstood risk.

While it is obvious that if you replace a few shingles on a roof or fix a plumbing leak, those outlays likely qualify as immediate repairs rather than part of a capital renovation, and can be fully expensed in the tax year they occurred.

But what about larger repairs? A qualified engineering-based analysis can often unveil significant missed deductions from that kind of activity.

Let's break this down into a practical example to hopefully make the benefits of using (and risks of not using) the TPRs appropriately.

A note on illustrative examples: This and other illustrative examples throughout this report are provided to help you better understand the mechanics and potential outcomes of applying a specific strategy. To ensure clarity, we have utilized round numbers and simplified assumptions to demonstrate the mathematical logic.

These examples are not case studies of actual client results, nor are they a projection of the returns you should expect when engaging our firm. They are strictly for educational purposes.

Actual results will vary materially from these illustrations due to market conditions, timing, and economic factors. All investing involves risk, including the risk of loss of principal. No strategy, including those illustrated here, can guarantee a profit or protect against loss.

The tax implications of the strategies discussed may differ significantly based on your specific financial circumstances, tax bracket, and jurisdiction. This report does not constitute tax or legal advice. We strongly recommend consulting with a qualified tax professional regarding your specific situation before implementing any strategy discussed herein.

Example: One HOT Summer, One Cool Deduction

Let's look at a situation most property owners will encounter sooner or later.

Imagine you own a 20-unit residential building. Each unit has its own independent air conditioning system, and during a particularly hot year, five of them go down. You spend \$25,000 per unit to replace them, for a total outlay of \$125,000.

The natural question is, can you deduct that full \$125,000 as an expense this year, or will you have to capitalize it and depreciate it over time because you fully replaced the systems?

This is exactly the kind of gray area the IRS tried to clarify with TPRs.

The rules say that if what you're doing constitutes a "restoration" of a **major component or substantial structural part** of the property – or of one of its systems – then it must be capitalized and depreciated over the appropriate period (the aforementioned 27.5 years for residential buildings in the U.S.).

In this case, you're not restoring the entire building, just part of the HVAC system. But under IRS rules, each major building system – like HVAC, plumbing, electrical – is considered its own "unit of property." So the question becomes: Is replacing 5 of 20 individual AC systems a substantial restoration of the HVAC system?

Most tax professionals use a rough benchmark: if you're replacing **more than 30%** of a system, it's generally considered substantial and must be capitalized. Less than 30%? It may qualify as a repair – something you can deduct immediately.

Five units out of twenty is 25%. That likely falls under the deductible threshold. So, in this case, you may be able to expense the full \$125,000 in the year the ACs were replaced.

This is why recordkeeping and property-level analysis matter. Replacing five units may feel like a major project – but from a tax perspective, it could still qualify as a **routine repair** to part of a broader system, especially if it's not part of a major upgrade.

If instead you had replaced eight or ten units at once, the answer might change, and you'd likely have to capitalize the cost.

Successfully applying the TPRs in this case could mean the difference between having a \$125,000 deductible expense upfront or a roughly \$4,500 annual one (using the 27.5-year depreciation schedule for residential property).



Not Just a Bonus You Can Decide When to Take.

Be warned: TPRs are a required part of the IRS code.

If you simply decide to capitalize the repair to keep life simple, you also run the unfortunate risk that upon audit, the IRS chooses to disallow the remaining depreciable life of the asset. While the chances are arguably low, we have seen it in action. And the results are not pretty...

In the case of our example, imagine the property owner were to capitalize those repairs under the assumption that any project that large would automatically capitalize, or because they simply did not need the additional deduction, nor wanted the trouble of justifying the classification. If an audit uncovered that the repairs and maintenance were improperly capitalized, it could result in losing the ability to depreciate those repairs over their remaining life, costing the taxpayer \$125,000 in write-offs against their income taxes.

This is one case where the IRS will force you to take the more favorable tax treatment. If you decide to take the “easy” route and capitalize everything without regard to TPRs, you could be facing the loss of tens or hundreds of thousands in deductions.

The undepreciated cost could still be added back cost basis when it's time to sell, so there is still a chance to recover it. But that's hardly solace, given the time value of that money today versus capturing it when selling 10, 20, or 30 years down the road – years of lost compounding. And if the investor wasn't going to recognize that gain in their lifetime, relying on a 1031 exchange or just holding and letting the cost basis step-up do its magic, then that tax savings is lost entirely.

What if the Old Units Were Already on the Books?

If you had previously capitalized those five AC units when you first bought the building or later replaced them, there's an additional related strategy available: **partial asset disposition**.

Under this rule, if you dispose of a component (like an AC unit) that was already part of your depreciable basis, you can “write off” the undepreciated portion of its value when it's replaced. That means not only do you deduct the new units (if eligible), but you also remove the old, now-worthless assets from your books – avoiding continued depreciation of something you no longer own and instead capturing that loss of useful value today.



The key is tracking asset-level detail from the time you purchase your property or make any capitalized improvements. If your depreciation schedule lumps all mechanical systems together in one number, you're out of luck. But if you've done a cost segregation (more on that in a second) or component-level capitalization, this rule can add even more tax benefit in the year of the replacement.

A Little Help from a Friend...

In our experience, TPRs tend to be underutilized, leaving a lot of potential tax savings on the table and risking disallowances. We understand why it happens. Many of our clients come to us either self-managing their depreciation schedules or relying on a generalist CPA to do that work. But the rules for TPR calculation fill guidebooks that make *War & Peace* look like a light weekend read. So it is easy to make mistakes or, far more often, overgeneralize and leave money on the table.

It starts with doing an engineering-based analysis of your properties and projects, breaking down the components into unique, segregated systems with their own depreciation schedules. For one or two properties, or if you are operating as a full-time real estate professional, if you want to put in the time and effort, this can usually be done yourself with a little study. For anything larger, or for clients with significant other demands on their time, we often recommend and help manage for our clients, enlisting professional help.

There are numerous specialized consultants you can draw on for help who can efficiently put together the needed analysis. This report was co-authored by one such consultant – Vanessa Clunies, the CFO of Tangible Property Tax Methods. Her firm works with clients of all sizes, with real estate portfolios from a handful of properties into the billions of dollars, to optimize their use of TPRs, cost segregation, and other tax strategies. We coordinate with teams like Vanessa's as they can usually accomplish a remarkable output in a few hours' work, thanks to years of experience, countless templates, and practical experience knowing what auditors are looking for.

It may all sound like a burden to take on, but in our experience, the value of what you capture in accelerated deductions tends to far outweigh the cost and complexity of implementing TPRs correctly, not to mention the risk reduction.



Cost Segregation Studies

If you own rental properties and haven't done a cost segregation analysis, consider it. Even if you have, we have seen numerous cases where the analysis fell well short of expectations and a quick restudy found deferred deductions stretching into the millions of dollars.

Cost segregation breaks a building into its components (appliances, fixtures, land improvements, etc.) and lets you depreciate those components faster than the standard schedules for residential real estate.

The result can be dramatically larger depreciation deductions in the early years of ownership – sometimes creating tax losses that shelter your rental income, or other passive income, or active (for those who qualify) income.

This is another of those cases where it is easier to demonstrate by illustration.

Example: U.S. Residential Rental Property – Cash Purchase

This example is for educational purposes and does not represent actual client experiences or guarantee future results. The figures used (e.g., 5.3% interest rate, specific allocations) are assumptions; actual cost segregation results and market rates will vary. Real estate investing involves material risks, including illiquidity and loss of principal. The use of leverage magnifies these risks. Furthermore, this example does not deduct the cost of the cost segregation study itself, which would reduce the net financial benefit shown. Tax laws, including depreciation schedules and passive loss limitations, are subject to change and depend on individual circumstances. Consult a qualified tax professional.

Imagine you purchase a residential rental property in Austin, Texas for \$1,000,000. You allocate \$200,000 of that to land – because land isn't depreciable – and \$800,000 to the structure and improvements.

Without cost segregation, you'd depreciate that \$800,000 evenly over 27.5 years. That gives you roughly \$29,000 in depreciation each year.



But let's say you engage a firm for a cost segregation analysis, which analyzes the property and reclassifies a portion of the structure into components that the IRS allows to be depreciated faster.

In this case, the study finds that:

- 20% of the building value qualifies for 5-year property (e.g., appliances, carpets, lighting fixtures),
- 10% qualifies for 15-year property (e.g., landscaping, certain site improvements),
- The remaining 70% stays on the standard 27.5-year schedule.

That breaks down as:

- \$160,000 in 5-year property
- \$80,000 in 15-year property
- 560,000 remaining in 27.5-year property

Instead of a flat \$29,000 deduction, your first-year depreciation would now look like this:

- 5-year: $\$160,000 \div 5 = \$32,000$
- 15-year: $\$80,000 \div 15 = \$5,333$
- 27.5-year: $\$560,000 \div 27.5 = \$20,364$

That gives you a total depreciation deduction of **\$57,697** in year one – almost double the standard depreciation.

Let's assume you earn \$60,000 in rent and spend \$20,000 on operating expenses. That leaves \$40,000 in net income before depreciation.

With the standard schedule, you'd deduct \$29,000 and report \$11,000 in taxable income. With cost segregation, you deduct \$57,697 – more than your net income – so you report a **\$17,697 passive loss** instead. That loss could offset other income (like income from other rental properties or investments in stocks and bonds, even active income like from a trade or business, in some cases we'll detail shortly), or be carried forward to apply to future years.

Add Financing

Much of the wealth-building power of real estate resides in the ability to deploy low-cost leverage. So, let's add that to the mix.

Say you finance 75% of each property with a mortgage, so you put down \$250,000 and borrow \$750,000. At 5.3% interest, annual mortgage interest comes out to roughly **\$40,000**, to give us a round number.

That changes the cash flow math for both:

- \$60,000 rental income
- Minus \$20,000 operating expenses
- Minus \$40,000 interest
- Net cash flow: **\$0**

But depreciation still applies:

- You still get \$57,697 in depreciation
- So you report a \$57,697 passive loss on your return

With accelerated deductions, you can turn neutral or even cash-positive investments into paper losses, potentially usable against other income or capital gains, to reduce the taxes on those, or carried forward to future years.

If you haven't revisited your properties' depreciation in a while (or ever), a cost seg study can potentially increase your deductions, unlocking higher after-tax returns in the near term.

Adding Tinder: Bonus Depreciation and Section 179

If you like the benefits of accelerated depreciation through TPRs and cost seg, then there are a couple of important incentive programs – designed to boost domestic investment in real estate – which are worth noting.

These programs can be short-lived and often surprise investors when they land – like the passage of the 2025 One Big Beautiful Bill Act (OBBBA), which restored major incentives in the midst of phase-outs.

It can be difficult to plan investments around bonuses and incentives, but when they exist, they can add significantly to deductibility and unlock the cash necessary to make additional investments. In other words, Uncle Sam can help finance more acquisitions by essentially lending you some of your future tax payments interest-free. Isn't it nice when those tables turn occasionally?

Let's look at a few that apply now, as of our writing in late 2025.

Bonus depreciation under the OBBBA

In mid-2025, the OBBBA restored the “supercharged” version of bonus depreciation – reinstating the ability to **immediately deduct 100% of qualifying property costs** in the first year they're placed into service.

This mirrors the original rules from the 2017 *Tax Cuts and Jobs Act*, before the phase-out schedule began reducing the deduction each year. Under OBBBA, most tangible personal property and certain land improvements qualify, including building components identified through a cost segregation study – items like fixtures, specialized electrical systems, or interior finishes with shorter useful lives.

Bonus depreciation lets investors accelerate deductions for qualifying components (generally that 5-, 7-, and 15-year §1245 property) that a cost segregation study carves out from a building acquisition. The result is a meaningful front-loading of tax benefits. For those with established rental income or other sources of passive income, it can be one effective tool for neutralizing tax drag and freeing up cash flow to reinvest. It's probably easiest to understand with an example.

Illustration: How Tax Savings Could Cover 20% of Your Down Payment

Imagine you currently own a portfolio of rentals that produces approximately \$300,000 of taxable passive income per year. Your interest expense across the existing portfolio averages about \$250,000 per year. Two years of that interest (~\$500,000) is a handy, realistic scale for an acceleration target.

You purchase a \$2,500,000 multi-family asset financed at 65% loan-to-value (debt \$1,625,000; equity/down payment \$875,000). A third-party cost segregation identifies \$500,000 of short-life components eligible for 100% bonus depreciation in the year placed in service.



The \$500,000 bonus deduction shields your \$300,000 of current passive income from taxes. If that rental income is the extent of your passive income, then the remaining \$200,000 becomes a suspended passive loss to use against future years' taxes. If total deductions exceed passive income and other limits, an NOL may result; under current rules, an NOL can offset up to 80% of taxable income in future years.

Once used in full, at a 32% marginal rate on that income, the immediate tax savings could be roughly \$160,000 – nearly 20% of the down payment. That's additional equity in the deal you can immediately put toward paying down that debt, or use to accelerate your next purchase. This "gift" from the government does come with one string attached, and worth understanding for all types of depreciation. When (or if) you eventually sell the property, the portion of gain equal to your accumulated depreciation – including bonus depreciation – is recaptured and then taxed (often at ordinary income rates, depending on the type of property). In other words, the deduction defers rather than erases tax.

Yet that deferral can be potentially valuable: you've had years of use of those tax savings to grow your portfolio or pay down debt, compounding your wealth on the back of a generous tax deferral. And, if you recall what we said earlier about basis step-up, that obligation can potentially be reduced or, in some cases, eliminated if you pass the property down to the next generation within your estate – so it truly becomes a gift and not just an interest-free loan, a pretty good deal either way if you ask us.

Bonus depreciation may not be around forever, and timing matters (the property must be placed into service before year-end of the eligible tax year). But while it lasts, it can be an impactful tool for compressing tax liability and improving after-tax returns in the early years of ownership. And its paper losses can potentially help unlock funds that would otherwise have just gone to taxes from other income streams.

Section 179 Expensing

While bonus depreciation applies automatically to qualifying property, Section 179 allows investors to elect to immediately expense certain tangible assets – often smaller improvements, furnishings, or equipment – up to an annual limit.

Section 179 was originally aimed at small and mid-sized businesses, but Congress has expanded it dramatically over the past few years. As of 2025, the deduction limit stands at

roughly \$1.5 million, with phaseouts starting around \$4 million of total qualifying purchases – meaning many real estate operators can now take full advantage.

The key difference is control. **Section 179 must be actively elected and cannot create a net loss**, whereas bonus depreciation can. That makes it especially useful for smoothing taxable income between years or aligning deductions with a specific transaction or sale.

Qualifying assets generally include tangible personal property (like vehicles or equipment) and certain improvements to nonresidential real estate, such as roofs, HVAC systems, fire protection, and security systems. For many operating businesses or property management entities, Section 179 can cover the smaller but recurring investments that keep a property efficient and up to date.

In practice, Section 179 acts as the scalpel to bonus depreciation's sledgehammer – both designed to accelerate recovery of investment, but each suited to different scenarios depending on the investor's income profile and timing needs.

Other 2025 Changes

OBBBA contained various other provisions – many beneficial to real estate businesses – such as making the 20% **Qualified Business Income (QBI)** deduction for pass-throughs permanent (no more 2026 sunset), increasing the phase-in thresholds for that deduction, and preserving full deductions for business state and local taxes.

Presumably, most rental real estate owners in the U.S. were already taking the QBI deduction on net rental profits (provided income and W-2/asset tests were met). Now, that 20% deduction is here to stay – or probably at least until Congress changes hands again.

In short, the 2025 law mostly reinforced real estate-friendly provisions for domestic investments and raised estate exemptions (covered later), which is broadly positive.

These deductions can be valuable fuel to the fire for those looking to acquire new properties, especially, which appears to be exactly Congress's intent in rolling them out.

As we'll cover in the second half of the report, though, deductions are only a small part of the picture. More lasting tax mitigation strategies that tackle both income AND capital gains can



have an even more significant impact on long-term after-tax returns in the situations where they apply.

Quickly, before that, though, a note on getting more leverage from those deductions.

Passive Loss Rules and the “Real Estate Professional” Status:

Many part-time real estate investors – especially high earners with jobs outside real estate – are frustrated to find that paper losses from their rentals are deemed “passive” and can’t offset their W-2 or business income.

These passive losses aren’t wasted (they carry forward to offset future rental income or gain on sale), but they don’t give an immediate tax benefit against active income, so their value erodes with inflation and missed opportunity.

There are two key points to consider here:

First, ensure you’re using passive losses to the max within your portfolio. If you have one property generating taxable income and another throwing off a loss (perhaps due to heavy depreciation from that cost seg study or a big repair expense), those will generally offset each other if they’re both in your name or in passthrough entities you own. All your passive activities aggregate on your return.

We’ve seen investors compartmentalize properties in a way that inadvertently siloed losses away from income; a quick review can correct that and increase your current deductions. Second, if you devote a majority of your time to real estate investing, or can have a spouse qualify, aim for **Real Estate Professional Status**. This IRS designation (achieved by meeting certain hours and participation thresholds) makes rental losses non-passive – meaning they can offset wage or business income.

It’s not easy to qualify unless real estate is truly your primary work, but for those who do, it’s a game changer: you can use depreciation and expenses from your rentals to potentially shelter other active income in your household – like that from a business operated or W-2 salary earned by one partner offset by deductions gained by their real estate professional spouse. If your holdings are multiplying and you haven’t double-checked if you meet the designation, it’s worth looking into. Especially because those deductions could generate even larger tax

savings for most higher net worth families, given the higher relative tax brackets that apply to earned income.

There's one important – and often misunderstood – opportunity especially relevant for short-term rental owners. A so-called “Airbnb rule.” **If the average rental period of a property is seven days or less, the IRS treats the property as a trade or business**, not as a rental activity at all. That means deductions from those properties may be **non-passive by default**, even if you don't meet the full real estate professional status. However, you still need to materially participate – typically by being actively involved in bookings, maintenance, or guest communication.

For investors managing short-term rentals themselves, this opens the door to using depreciation and other deductions against ordinary income, not just passive income. It's a powerful exception – but one that requires careful tracking of occupancy and participation hours to stand up under audit.

If you don't qualify (most busy professionals won't), don't fret – just remember that any passive losses you accumulate now from U.S. properties will be there to use later, against future rental profits, when you sell, or against any other passive investment income like dividends and gains from your stock and bond investments.

Bottom Line on Income Deductions

Cost segregation and TPRs, especially coupled with bonuses like the OBBBA 100% allowances and recently expanded Section 179 limits, can turn a break-even or mildly profitable investment into one that produces meaningful paper losses. Even more so when applied with financing. These losses can offset other income streams or carry forward to offset future rental income or capital gains.

In a nutshell: Don't needlessly delay tax benefits by stretching deductions over 27.5 years when the law might allow you to take them today.

Are Your Advisors Asking Enough Questions?

When we engage with a client who has significant real estate holdings as a percentage of their assets, our checklist includes reviewing cost segregation studies, application of the TPRs, bonus depreciation and Section 179 deductions, active/passive allocations, QBI eligibility, and



other aspects of their tax picture as part of an overall wealth management plan.

We find that quite often, even for investors with significant real estate holdings, these deductions are not optimized. Overly conservative allocations can leave money on the table or, worse, result in disallowed deductions. This is hardly their fault; real estate is a complex investment category. The questions that are part of many tax preparation checklists rarely dive deep enough to get to the nuanced points that can make a difference. And not all CPAs and financial advisors are deeply versed in the subject.

The facts and circumstances of each building, each project, and each taxpayer matter. If you are not getting into that level of detail with your tax team, consider engaging with a consultant, accountant, or wealth management firm that is familiar with the rules and knows how to navigate them effectively.

Unlocking near-term tax savings, especially when coupled with tax-advantaged investment wrappers like the ones we will review next, can have a compounding effect on wealth building – by delivering the most precious asset of all, more time.

■ Real Estate in a Tax-Advantaged Wrapper

The header for this section may seem like a bit of a misnomer, having just talked about many tax optimization options for real estate.

But, in our experience, one of the most powerful wealth-building tools available to U.S. investors is the various flavors of tax-advantaged accounts and structures – from IRAs and 401(k)s to life insurance or charitable trusts – that allow long-term growth of wealth on a tax-deferred or tax-free basis.

I'm always reminded whenever I talk about this subject of the story of the now billionaire investor and technology entrepreneur, Peter Thiel. Famously, Thiel shared how, as an early employee of PayPal, he made it a point to max fund his Roth IRA... and use it to buy some of the stock available to him in those startup days.

When PayPal eventually sold to eBay, Thiel's choice paid off. The exact amount he made on that transaction, and what portion was in his IRA, we will probably never know. What we do



know is that he wasn't content to leave it at one investment. Thiel went on to leverage his PayPal payday into a career as a venture capital investor.

Thiel's been publicly tied to very early investments in household names like Facebook (where he was the first outside investor in 2004, putting in \$500,000, the majority of which he sold post-IPO for over \$1 billion), Palantir, SpaceX, Airbnb, Lyft, and more.

As a part of his personal stake in the above investments, Thiel managed to **amass more than \$5 billion in that Roth IRA as of last known count in 2019... all of which has grown and could eventually be withdrawn tax-free under current rules.**

Interestingly, there are some disadvantages to owning such a massive asset inside that wrapper, however. And, we'll get to them in a moment, as they are germane to real estate investors whose assets share some critical qualities with Thiel's startup investments.

But there is little doubt what the ultimate after-tax performance of his IRA could be compared to a taxable alternative, should the rules not change because of his widely publicized story. Especially if he might need or want to sell any of those investments along the way.

So, let's dive into a few tax-advantaged structures real estate investors might want to apply, and some they might want to avoid.

The 1031 Exchange... and When It Comes Up Short

I'd be remiss not to start any section about capital gains taxes in real estate without acknowledging one of the most widely discussed advantages available to investors of this asset class alone: the 1031 exchange.

Imagine buying Apple Stock, riding it up the curve to a trillion-dollar company, then selling your shares in 2020 to buy Nvidia instead, because you think AI is going to become the next big thing. **Now imagine the government giving you a tax break on all those capital gains from selling Apple... just because you bought stock in another U.S. company?** Would be nice.

Yet, that's the reality every real estate investor lives in by default. Under the U.S. tax code, you can defer capital gains tax on real estate by exchanging one property for another of "like-kind" within a limited period.



That's not news to anyone who's invested in this category before. What can be is just how broad the definition of like-kind really is.

Many investors might assume that in order to defer capital gains, you'd need to swap, say, a duplex for a duplex. But the reality is much more generous.

A vacant raw land parcel in Nebraska can be exchanged for a high-rise condo in Miami. An industrial warehouse can be swapped for a strip mall. A single-family rental in Texas can roll into a short-term vacation property in Colorado. As long as both properties are held for investment or productive use in a trade or business, they are considered "like-kind" – regardless of location, size, or type.

This flexibility allows investors to reposition their portfolios tax-deferred, moving out of underperforming or management-intensive assets and into more strategic holdings, possibly without triggering immediate capital gains. Used wisely, the 1031 exchange becomes more than a tax tool – it becomes a mechanism for potentially compounding equity growth over decades.

It's quickly worth noting that 1031 exchangers are not limited to just U.S. properties. They are available to U.S. investors who purchase international properties anywhere in the world. With one important wrinkle: **foreign real estate is only like-kind with other foreign real estate**, not with U.S. properties.

Translation: you can swap a rental condo in France for an office unit in Dubai and defer recognizing a U.S. taxable gain, but you cannot 1031-exchange a foreign property into a U.S. property (or vice versa). The tax-deferred exchange must stay within the international realm.

This rule effectively isolates any offshore holdings for purposes of exchanging – the gains from selling your overseas property can't be rolled into a domestic investment without triggering tax. If you plan to eventually repatriate international real estate wealth back into U.S. assets, know that a taxable event will likely occur at that transition (barring some creative strategies we'll discuss later).

But the 1031 only applies if you intend to sell, of course. However, **we see many real estate families adopt a "buy, hold, and borrow" approach: rather than selling appreciated property, they refinance to pull cash and acquire new assets.**

The 1031 has other downsides, too. If you are selling to capture what you feel are high overall market valuations, unfortunately, you don't get to just sit on the sidelines for a couple of years to wait that out – a strict 45-days-to-identify and 180-days-to-close timeline necessitates you move quickly or lose the abeyance – or rotate into another class altogether.

Better Than a 1031? Real Estate Tax Wrappers

1031 exchanges also only cover half the tax picture – helping defer capital gains while doing nothing to alleviate the complexity of managing taxable income from rentals.

What if you could obviate the need for 1031 exchange altogether... giving yourself the ability to exchange into and out of real estate without the proverbial gun to your head... AND provide deferred or potentially tax-free withdrawals on the income side of your real estate investments as well?

There are some tools that hold promise to impact those two major categories of taxation. Like any strategy, they are not without their drawbacks and limitations. However, under certain circumstances, they can be effective tools in the wealth-building kit. The right approach (or combination of approaches) will depend on your goals, time horizon, and scale of investment.

Here are several of the top strategies:

Tax-Advantaged, Self-Directed Retirement Accounts

A powerful tool for many real estate investors is the tax-deferred (or tax-free) growth offered by retirement accounts. Many investors don't realize that both traditional IRAs and Roth IRAs can be used to purchase real estate, not just stocks and bonds.

By using a **self-directed traditional or Roth IRA** (through a custodian that allows real estate, of which there are many strong, established firms to choose from), you can have rental income and capital gains accrue inside a tax-advantaged bubble – **no income or capital gains tax on those earnings each year.**

This is a bit like doing a 1031 exchange continuously, without the deadlines or like-kind restrictions. In fact, using an IRA completely sidesteps the 1031 limitation problem: *you can sell a property held in an IRA and reinvest the cash into any other eligible investments without current tax*, because it's all inside the IRA.



There's no need to scramble for a like-kind replacement or worry about the exchange clock. You could even liquidate your real estate and hold the proceeds in stocks or bonds or a REIT within the IRA if you wanted to simplify – with no immediate tax impact. This flexibility is a huge advantage for anyone who is considering someday selling part or all of their real estate holdings with diversification in mind.

Traditional vs. Roth:

With a traditional self-directed IRA, you get the benefit of tax-deferral – no tax on rental income or sales at the time they occur. You only pay tax when you withdraw funds from the IRA.

Of course, eventually, with a traditional IRA, you'll pay ordinary income tax on withdrawal, which could be higher than the capital gains rate would have been. This is the trade-off: you defer and perhaps grow more, but at possibly a higher exit tax rate.

For these reasons, **Roth IRAs are often favored for real estate investors.**

You always fund a Roth with after-tax dollars, but then all growth and withdrawals are tax-free (provided you follow the rules).

When looking at a sufficiently long-term projection, the after-tax funding is hardly of consequence to note – you give up the upfront deduction, but decades of appreciation become tax-free. For most high-earning families, the tax deductibility of some traditional IRA contributions is subject to income limit phase-outs anyway. And, of course, all taxable investments are initially made with after-tax dollars as well.

A Roth is also far superior for inheritance purposes (under current rules, heirs pay no income tax on distributions, whereas a traditional IRA's deferred gains turn into ordinary income for them).

The real challenge is getting significant funds into a Roth, since contributions are limited and high earners are barred from direct contributions.

That's where tactics like the “Backdoor Roth” and “Mega Backdoor Roth” come in – these allow larger sums to be moved into Roth accounts through conversions or after-tax 401(k) contributions. Sophisticated investors can potentially roll over \$50k+ per year, per person, into



Roth accounts using these methods, building up enough in relatively short order to make real estate deals an investment option, especially with leverage.

(Explaining backdoor Roths is beyond our scope here, but we note it so readers don't dismiss Roths due to contribution limits – despite their tongue-in-cheek name, the various backdoor funding strategies are actually purposeful and well-established means of max-funding Roths for those who cannot simply contribute directly. We don't all need to be as foresighted as Peter Thiel to build our Roth nest-eggs when we're young.)

To summarize the IRA strategy: **It converts current taxable real estate income and realized capital gains into tax-deferred or tax-free income.** You don't worry about depreciation or exchanges – all that matters is maximizing ROI, since the tax is deferred. Over a long hold, this can save an immense amount in annual taxes, letting your rental income compound. And when you do sell, if it's a Roth IRA, you can – provided the account has been established for over 5 years, and you are above the age of 59 ½ – potentially withdraw proceeds with zero U.S. tax.

It's as if you had a permanent 1031 exchange followed by a permanent exclusion – pretty powerful.

IRA Limitations:

As mentioned in the Peter Thiel story upfront, IRAs are not a magic panacea. In exchange for that powerful tax advantage, they are subject to numerous restrictions and 'gotchas.' Whether those hurdles are worth jumping is a very personal choice, but let us lay out the big ones for you. They range from how much you can mix business with pleasure to tax implications for you later in life and even for your heirs.

First and probably foremost to anyone considering our primary focus of this report – rental real estate in far-flung locales – **you cannot personally use any property held in an IRA or Solo 401(k).** It must be purely investment, no personal vacations, or even staying overnight, not even if you pay market rents... which applies to immediate family as well. That kind of personal benefit would violate IRS self-dealing rules, potentially causing the entire IRA to be invalidated and immediately subject to taxes and penalties.

Related to this, **you cannot buy a property you already own** from yourself into the IRA, nor have your IRA purchase from or sell to family members – all transactions must be arms-length and for the exclusive benefit of the IRA.

Your **personal taxes cannot benefit from paper or real losses** within an IRA. Were you to have negative cash flow or a tax loss on a property held in an IRA, you cannot use that to offset other income on your personal taxes. That's one of the benefits you give up in exchange for the tax-deferred or tax-free growth.

IRAs also reduce your access to capital by **limiting the age or circumstances under which you can withdraw any earnings without facing penalties**. Once funds are deposited into an IRA, nearly any withdrawal (except for some very limited exceptions) before age 59 ½ is considered "ineligible" and subject to penalties. And because of the self-dealing rules mentioned above, you also cannot take a loan out against your IRA assets. So the value of those assets is locked away inside the IRA with very little access to it for other purposes.

As any real estate investor knows, part of the appeal of the asset class is the ease and relatively low cost of tapping into the equity with a loan, **which makes financing probably the most notable limitation**.

- An IRA is not allowed to take on a recourse mortgage (where you personally guarantee the loan) – that would be a prohibited extension of credit.

But it *can* take a **non-recourse loan inside the account**, where the lender's only remedy is to foreclose on the property. Many U.S. banks don't offer non-recourse loans. However, some do (there are niche lenders for IRA real estate, albeit at slightly higher rates than standard mortgages – a trade-off for the tax benefits). So you can make some use of leverage, just not to use the proceeds for any personal benefit outside of the investment account's goals.

- If you use leverage, it can magnify returns – but note that it creates another consideration altogether: Unrelated Business Income Tax (UBIT).

Rental income itself is generally exempt from UBIT when earned in an IRA (rental income is passive). However, **if you used debt financing in an IRA, a portion of the income (and gain) is treated as Unrelated Debt-Financed Income (UDFI)** and becomes subject to UBIT – meaning the IRA would owe tax (at trust rates) on that portion. This can reduce the benefit of leverage inside an IRA. For example, if your IRA buys a rental 50% with cash and 50% with a mortgage, roughly 50% of the net income might be subject to UBIT. There are ways to manage or calculate this, but it gets complicated. Enter the Solo 401(k)...



The Solo 401(k) Advantage – No UDFI Tax on Leverage

For those who have their own sole-practitioner business, or other legitimate self-employment activity or side business, a Solo 401(k) (a 401(k) plan for an owner-only business) can be a superior vehicle for real estate investing compared to an IRA.

One huge benefit: **Solo 401(k)s are exempt from UDFI on debt-financed real estate investments.** If your 401(k) buys a rental property and takes a non-recourse mortgage, the financed portion of income is not subject to UBIT (whereas it would be in an IRA).

This exemption only applies to 401(k) (and other qualified plans), not IRAs. So a savvy investor who wants to maximize leverage might roll their IRA funds into a Solo 401(k) and then invest, allowing them to use bank financing freely without incurring an unrelated business income tax drag.

Solo 401(k)s can be self-directed just like IRAs. You typically form a trust or LLC for the 401(k) and invest through it. In fact, the Solo 401(k) allows the plan owner to act as the trustee, sometimes simplifying administration. **Solo 401(k)s have higher contribution limits as well.** You can contribute up to \$69,000 per year, per person (more if you are over the age of 50), depending on eligible income, which can rapidly grow the investable pot. And those limits rise each year.

Additionally, Solo 401(k)s have a more lenient penalty system for prohibited transactions compared to IRAs, as a prohibited transaction with a Solo 401(k) will not automatically disqualify the entire plan (it may only incur a 15% penalty, if the transaction is corrected in time, on the specific asset involved).

Solo 401(k)s do allow a very limited amount of lending to participants, too. However, there is a limit of \$50,000, and it must be paid back within 5 years. While limited, this provides liquidity for short-term needs without triggering a taxable distribution.

Solo 401(k)s also allow Roth sub-accounts in many cases, enabling you to contribute or convert to Roth with after-tax dollars and get the same tax-free treatment on growth.

Overall, for those who qualify, the Solo 401(k) is often the most tax-efficient vehicle for leveraged real estate. It provides all the deferral benefits of an IRA, with more flexibility and fewer taxes on leveraged deals. The limitations are that you need self-employment income



to set one up (and no full-time employees other than you/your spouse), and you'll have to do some plan paperwork and perhaps file a Form 5500 once assets exceed \$250k. But many of our entrepreneurial clients happily take on those minor tasks in exchange for the powerful tax-sheltering of real estate returns. The deduction for pre-tax income is not where the value lies for them; it is the ability to shelter those assets from future taxes through the rest of their lives and on to inheritance.

Whether using an IRA LLC or Solo 401(k) LLC, it's worth repeating: **be extremely mindful of prohibited transactions.** You and certain relatives cannot live in, vacation in, or even personally manage (in terms of physical labor) the property. Hiring third-party managers and keeping everything at arm's length is crucial. Also, pay ALL expenses from the IRA/401(k) funds – don't commingle personal funds.

Lastly, one more very important thing to understand about all these accounts is how they are treated for estate and inheritance tax purposes.

The SECURE Act's "Stealth Tax" on Inherited Accounts

If you own real estate in tax-advantaged retirement accounts, the **SECURE Act dramatically changed the rules for what happens when those accounts pass to your heirs.**

We've called this change a "stealth estate tax" because it can quietly siphon wealth from the next generation, much like the estate tax does for those families to whom it applies.

Enacted at the end of 2019, the SECURE Act eliminated the long-used "stretch IRA" strategy for most beneficiaries. In its place, Congress imposed a strict 10-Year Rule: Most non-spouse inheritors of retirement accounts (including traditional IRAs, Roth IRAs, and 401(k)s) must withdraw the entire account balance by the end of the 10th year following the original owner's death. It doesn't matter if the account holds publicly traded stocks or illiquid real estate – after ten years, it must be fully distributed out of the tax-deferred wrapper.

This has significant implications for real estate investors using retirement accounts as holding vehicles. Under prior law, a child who inherited your IRA, for example, could "stretch" distributions over their lifetime – potentially decades of continued tax-free growth. Now, for most non-spouse beneficiaries, that IRA must be emptied in 10 years.



For Traditional IRAs/401(k)s, the consequence is a compressed tax hit: the beneficiary might have to recognize large amounts of income (the cumulative deferred rent and gains) in a relatively short window, often bumping them into higher tax brackets.

For instance, imagine your daughter inherits a \$2 million traditional IRA LLC that owns a number of rental properties. Under the 10-Year Rule, she might try to withdraw roughly 1/10th of the assets each year – say \$200,000 of value (which can thankfully be withdrawn ‘in kind’ and on a prorata basis) – on top of her own salary. Those IRA distributions would be taxable ordinary income to her, potentially thrusting her into higher tax brackets and eroding much of the benefit of your years of tax deferral.

In the past, she could have stretched withdrawals over maybe 30+ years; now Uncle Sam wants its share within 10.

We often illustrate to clients that every \$1 million inside a traditional IRA could trigger a six-figure annual taxable income to heirs under the new rule – a significant drag that was often not part of the plan when many of the clients we meet with first decided to invest via an IRA, especially those who started prior to 2019.

Secondly, because real estate is illiquid, the taxes on that amount cannot be easily drawn against the withdrawn balance. Imagine a combined state and federal effective tax rate of 35%; that means each year, about \$70,000 in taxes would be owed on those withdrawals before factoring in growth over the withdrawal period. **That liquidity must come from somewhere – usually from borrowing against those assets, selling some of them,** or drawing from other pools of capital if it’s available. In any case, it comes at a cost.

Forced withdrawals are not limited to heirs, either. Once you reach the age at which required minimum distributions are owed on your IRAs, generally around 73, you must also take withdrawals within your lifetime. The rules are nuanced, but the amount increases each year, such that if you live to your full life expectancy, then the account will generally be liquidated fully around that time. For planning purposes, expect ~3% of the value of the investment in the first year, rising to roughly 8% annually, should you live into your 90s, which you must withdraw and pay taxes on each year.

So, for example, on that same \$2M real estate portfolio, you might need to recognize around \$60,000 in additional income from the withdrawal of those assets or the rents they are

producing, in year one. If your marginal tax bracket in retirement is 25% then you are looking at a \$15,000 tax bill that first year, and increasing each year to around \$40,000 annually in your 90s.

Paying that tax in your lifetime reduces the effective after-tax yield, **but those pro-rated percentages of the assets are now outside of the account, and the effects of the SECURE Act** – you are just prepaying taxes now instead of leaving the obligation to your heirs.

Even Roth IRAs face the 10-year distribution requirement (the account must be empty by the end of the decade). **The silver lining is that those Roth withdrawals won't incur income tax – a huge advantage of Roth vs. traditional when it comes to legacy planning.**

With a Roth, any qualified distribution is tax-free, including the SECURE Act's required ones. Better still, when the assets 'pour out' from the Roth to its new owner, the property's basis resets to the distribution value. This is similar to if they inherited it outside an IRA, but with one additional bonus (as if the tax-free compounding of rental income wasn't bonus enough): they have 10 additional years before that must happen.

That means if the Roth property doubled in value during that period, all that additional growth is also tax-exempt, and the heir can take full fair market value as their new basis going forward.

This "step-up inside a Roth" is a very powerful combination – effectively, the Roth IRA can **operate as a tax-free growth vehicle for up to 11 additional years after your death** (the year you pass plus the 10-year requirement thereafter), then transfer the real estate to your beneficiaries with a stepped-up basis, leaving it with no built-in gain.

Similarly, Roth IRAs and "Roth Designated Accounts" such as the Roth 401(k) are not subject to Required Minimum Distributions within your lifetime either, avoiding that need for capital to cover the ~3% annual distribution of a traditional IRA.

Many families, recognizing the potentially powerful benefits, have pursued Roth conversions or contributions to ensure any real estate held in retirement accounts ends up on the Roth side rather than the taxable IRA side.

In summary, the SECURE Act makes **inheritance planning for tax-deferred accounts** much more urgent. If you intend to buy and hold real estate inside a self-directed IRA or Solo 401(k), *plan for the exit strategy early.*



You might aim to gradually withdraw or Roth-convert assets during your lifetime (especially if you expect to be below your heirs' tax bracket), or to ensure ample liquidity to pay taxes.

For high-net-worth families, we often integrate Roth IRA real estate with other estate planning (e.g., pairing it with an irrevocable life insurance trust to handle estate tax, or leaving traditional IRA assets to charity and Roth to family, etc., to sidestep taxes altogether).

The key takeaway: the 10-year rule changed the game for using retirement accounts as a real estate vehicle. It's absolutely still a viable path – the deferral while you're alive is just as powerful as before – but the endgame needs more thought, and usually a bias toward Roth structures to avoid saddling your kids with a tax time-bomb.

There are, thankfully, some structures that can offer Roth-like tax treatment but which do not suffer from all of the same drawbacks of the IRA – providing for access throughout your life and your heirs, significantly higher contribution limits, and without the SECURE Act's 10-year requirement. We will get to one of those shortly.

Taxable vs. Traditional vs. Roth: Same Property, Different Tax Engines

If your head is spinning a little with these comparisons, you're probably not alone. Sometimes it's easiest to understand with a little math.

What draws investors to these accounts, despite their stricter rules, is how much less work your money has to do just to reach the same investment size.

- In a taxable deal, every dollar must first pay the income-tax toll before it ever goes to work, pays taxes along the way on income, and then risks another tax on the way out...
- Whereas in a tax-deferred plan like a SEP IRA or Solo 401(k), your contribution goes in pre-tax – meaning you need to earn less to reach the same investment, and the only other taxes are on the far end.
- In a Roth, you pay that tax toll once up front, but then compound tax-free for the rest of your life and into the beginning of the next one.



Let's walk through a single example to see how dramatically these differences can play out in practice. Imagine three investors each purchasing the same \$500,000 all-cash rental property. They each face a 30% marginal tax rate, and we'll assume a modest 6% annual net yield from rent and 5% annual appreciation over 25 years. We'll ignore reinvestment of rents to start, then add it back in to see the compounding effect.

In a taxable account, the investor must first earn roughly \$715,000 to net \$500,000 after paying 30% income tax. Each year, they collect about \$30,000 of net rental income, pay \$9,000 of tax, and keep \$21,000. Over twenty-five years, that produces about \$525,000 of after-tax cash flow. The property itself appreciates to around \$1.7 million. Upon sale, they'll owe ~20% capital gains and depreciation recapture taxes on roughly \$1.2 million of appreciation – at least a \$240,000 bill (we're hand-waving away the complexities of depreciation and higher tax rates of recapture here for simplicity). After paying that, the investor walks away with roughly \$1.985 million after tax. On the full \$715,000 of pre-tax income they had to earn to get started, that works out to about a **4.17% after-tax compound annual growth rate**.

But if they never sell, the story improves. Under current law, the step-up in basis at death erases the built-in capital gain. The heirs inherit the property as if they bought it that day, tax-free. Including the after-tax rent collected along the way, the estate has roughly \$2.225 million of value. That brings the effective after-tax compound return to about **4.65%**, without ever having paid capital gains tax. This is why so many wealthy families love holding real estate through life: the annual income is steady, and the embedded gain can vanish for heirs with a single line of the tax code.

Now contrast that with a tax-deferred account, such as a traditional IRA or Solo 401(k). Here, the investor only needs to earn \$500,000 pre-tax to fund the purchase – no 30% haircut before investing. Inside the account, both rental income and appreciation compound without tax. After 25 years, the property and its accumulated cash flow are worth about \$2.45 million. When the investor retires and begins withdrawals, every dollar is taxed as ordinary income. At a 30% effective rate, that leaves roughly \$1.715 million after tax. On the \$500,000 pre-tax effort required to fund the account, that equates to an after-tax return of about **5.05% per year**.

The tax-deferred route thus lets you reach the same \$500,000 investment with \$215,000 less earnings effort, and it keeps the government's share compounding beside yours for decades. That is the quiet power of deferral – you are, in effect, investing the IRS's money alongside your own until you finally settle up. The Solo 401(k) structure has another subtle advantage:



unlike IRAs, it can use nonrecourse leverage without triggering UDFI/UBIT taxes. That means you can borrow to magnify returns without sacrificing the tax shelter. The trade-offs are mostly administrative and behavioral: you cannot personally use the property, you must avoid self-dealing, and heirs must liquidate within ten years under the SECURE Act, paying ordinary income tax as they withdraw. Still, for long-term compounding, it is a remarkably efficient engine.

Finally, consider the Roth approach. It starts the same as the taxable path – you earn \$715,000, pay \$215,000 in tax, and invest \$500,000 of after-tax money inside a Roth IRA. From there, all rent and appreciation grow entirely tax-free. After 25 years, the same \$2.45 million balance belongs to you with no taxes due under current rules. That translates to a **5.05% after-tax CAGR** on the same \$715,000 of pre-tax earnings as the taxable scenario. The difference, of course, is that the Roth eliminates all future tax uncertainty. Your heirs still must empty the account within ten years, but their withdrawals are tax-free.

Up to this point, we have ignored the reinvestment of rental income. In reality, few investors simply pocket their rent checks. Most redeploy them – perhaps into index funds, future property purchases, or short-term instruments that keep the money working. Here, **tax drag** becomes important. The annual taxation of investment income means reinvested dollars in a taxable account compound more slowly than those inside a retirement wrapper.

To illustrate, assume reinvested rents earn a nominal 7% inside the tax-advantaged accounts, but only 6% after-tax in the taxable account. That one percentage point gap reflects the ongoing taxation of dividends, interest, and realized gains that can realistically shave 0.5% to 1% off annual returns in a high-income bracket. Over a 25-year horizon, that seemingly small difference compounds dramatically.

With reinvestment:

- The taxable investor grows roughly \$0.9 million from their reinvested cash flow, bringing total wealth at sale to about \$2.35 million (a 4.6% after-tax CAGR) or \$2.58 million if held to death (about 4.9%).
- The tax-deferred investor, reinvesting at the full untaxed 7%, finishes with around \$3.0 million before tax, or \$2.1 million after withdrawal taxes – roughly a 5.3% CAGR.
- The Roth investor, enjoying the same 7% compounding but no tax at the end, ends at about \$3.05 million, a 5.7% CAGR on the same \$715,000 of earnings.



That modest one-percentage-point difference in the reinvestment rate restores much of the separation between the taxable and tax-advantaged paths. It reflects the hidden cost of annual taxation on investment income – a slow leak that, over time, drains a quarter or more of the potential compounding power from the reinvested rents.

Which approach makes sense depends primarily on your ability to access each structure, not on performance differences – because once the dollars are inside, the hierarchy is clear.

- The Roth provides the most efficiency under today's tax rules: it compounds at the same untaxed rate as a traditional plan but ends entirely tax-free, it sidesteps future rate uncertainty, and it even gives you an extra decade of compounding after death before heirs must withdraw. In numeric terms, the Roth's roughly 5.7% compound growth rate is nearly one full percentage point higher than a taxable investment sold during life and about 0.8% higher even than a property held to death with a basis step-up. Over twenty-five years, that difference equates to roughly 25–30% more total wealth on the same economic input. And that's before calculating the benefits of getting more than an additional decade of tax-free growth under the SECURE Act versus taking an immediate step-up in basis with taxable assets.
- The tax-deferred version remains a close second when cash flow is tighter or when large pre-tax contributions are the only viable route, but its eventual tax bill always reduces the advantage over time. Its after-tax compound return of about 5.3% still represents a meaningful edge – roughly 0.6–0.8% higher than taxable outcomes – but the deferred taxes ultimately limit its long-term efficiency compared to the Roth.
- The taxable route, while still viable and often simpler for ongoing access or estate logistics, is the slowest compounder once you factor in annual tax drag and the limits of the step-up in basis. Its appeal lies mostly in flexibility and familiarity, not in financial efficiency.

In short: if you can get real estate exposure in a Roth, and deal with the restrictions, you're probably smart to do it. If you can't, you can still gain some advantage from using a tax-deferred plan strategically. And if neither fits, a well-managed taxable property can still perform respectably – but it will never outgrow the math of compounding free from tax.

In short, the tax code offers three very different roads to the same property. Each can build wealth powerfully, but they compound on different timelines and with different companions – either you, the IRS, or your heirs. Understanding that partnership is the key to using the right account for the right purpose.

Managing Estate Taxes on Real Estate

Another critical point: **Retirement accounts are also subject to estate tax if your estate is large enough**, just like any other asset.

Unlike other investments, you generally cannot shield an IRA or 401(k) from estate tax by putting it in a trust during your life – by law, these accounts must be owned by an individual, a “natural person.” In other words, the full value of your IRA/401(k) is included in your taxable estate (minus any charity portion) at death.

If your net worth, including retirement assets, may exceed the estate tax exemption, then your heirs could face a double hit: first an estate tax of ~40% on the account’s value, and then the income tax on distributions over the following 10 years (for a traditional IRA).

We sometimes meet clients with large IRAs who haven’t realized this one-two punch: the IRS will take 40% off the top (if over the exemption), and the remainder, as it’s withdrawn, is taxed as income – leaving less than half of the original value net to the beneficiary.

State estate and inheritance taxes can erode this total further and often start after much lower exemptions.

Proper planning can often alleviate this compounded erosion (for example, purchasing life insurance in an irrevocable trust, which can cover the tax bills due on an IRA... or simply choosing a different vehicle altogether).

And, while you may consider estate taxes to only apply to a small fraction of taxpayers who have significant assets, we often find clients surprised when we tell them an analysis shows it might hit them someday as well. There are two important questions to ask to know if you are planning:

- **Have you done a projection of the growth of your total portfolio of assets?** This especially includes the value of any business interests, which the IRS will value for estate purposes often at levels that surprise owners, and the growth you might expect out of stocks, bonds, real estate, and other investments. When we’ve done this with our clients, the results have often surprised them.



- **Are you prepared for potential changes in the threshold at which estate taxes apply?** Prior to the passage of 2025's OBBBA, the estate tax threshold was due to reset in 2026 down to \$6M per individual, or \$12M for a married couple. That act changed the sunset provision and increased the limit to \$15M per person, \$30M per couple, starting in 2026 and indexed for inflation thereafter. In practical terms, this means fewer families will face U.S. estate tax – and those who do have a higher bar to clear. Real estate often comprises a large portion of a wealthy estate's value, so this higher exemption provides more breathing room to pass down property without tax.

This relief could ultimately prove temporary, however. Those limits can be lowered again (all the while your assets are expanding), and you could once again find yourself in the crosshairs of the estate tax. So proactive planning is still vital – including possibly using the current exemptions before you lose them.

Estate exemptions are portable and can be used via lifetime gifting, as the exemption is applied retroactively to when the gift was made. For example, if a couple were to gift assets – directly to heirs or to a trust with them as beneficiaries – at today's value, say \$20 million, and they elect to use both spouses' lifetime exemptions, the entire transfer could be sheltered from gift tax.

If the gifted assets later appreciate to, for example, \$35 million at the time of the couple's deaths, that appreciation occurs outside of their taxable estate. By using their exemptions now, they've effectively "frozen" the value of those assets for estate tax purposes – the IRS treats the exemption as having been applied at the time of the gift.

If Congress were to lower the exemption again, previously completed gifts should still be protected under the anti-clawback regulations. Under current IRS regulations, the amount of exemption used is locked in by the law in effect when the gift was made – it is not recalculated later.

So how do we practically reduce exposure to estate taxes?

Holding Property in Trusts for Estate & Legacy Planning

Trusts are a staple of estate planning for wealthy families, and they can be extremely useful in a real estate context – if structured correctly. The core idea is to remove the asset (and its future appreciation) from your taxable estate, and to provide a vehicle for multi-generational

ownership that avoids probate and ensures the property is used according to your wishes.

There are a few ways trusts come into play:

- **Revocable Living Trusts (RLTs):** These are common for U.S. estate planning to avoid probate. If you buy a U.S. rental property, you might title it in the name of your living trust. The trust is disregarded for tax, and you maintain control. But when you pass the trust is outside of your estate, the assets are not subject to probate (providing privacy on what's being handed down), but are generally still considered part of your estate and taxable if you meet those thresholds.
- **Irrevocable Gifting Trusts:** For estate tax mitigation, you may consider transferring the property into an **irrevocable trust** during your lifetime.

For example, you create a Family Dynasty Trust, and you deed a property to that trust (or contribute the holding company shares). This is a completed gift, using up part of your gift/estate exemption. The benefit is that any future growth in the property's value is outside your estate, and the property can be managed and enjoyed by your beneficiaries per the trust terms, potentially for generations.

If you expect an investment property you bought for \$2M could be worth \$10M in 30 years, putting it in a trust now could save your heirs up to \$4M in estate taxes down the road (40% of \$10M, assuming you are over the exemption).

Additionally, the trust structure can ensure the property isn't sold off unwisely or fought over – you can lay out rules for usage (perhaps it becomes a family vacation home that's shared) and provide for expenses.

- Other specialized trusts for specific real estate scenarios exist, too, like a **Qualified Personal Residence Trust (QPRT)**. This is commonly used for a primary home or vacation home: you put the home in a trust but retain the right to live there for a term of years, after which it passes to heirs (or stays in further trust) at a reduced gift tax cost.

If, say, you have a highly appreciated home in Greenwich, or a beach house in Boca, that you personally use, a QPRT might let you transfer it at a fraction of its value for gift tax, while you continue to enjoy it for X years. At the end of the term, it's out of your estate... so you'd need to pay rent at market rates to the trust if you keep using it, money that also flows out of your estate and helps fund the trust.

QPRTs have some risk (you must outlive the term to avoid the property being included in your estate), but they are an option for high-value properties you intend to keep in the family but want excluded from estate tax calculations.

Beyond estate taxes, certain types of trusts can potentially provide a layer of asset protection, provide professional management of assets separated from the division of value among beneficiaries, and ensure continuity.

In some cases, families put real estate into a trust not to save estate tax (maybe they're under the exemption) but to make sure the property is not lost due to divorce or lawsuits down the generational line, and to clearly define each branch of the family's usage rights for a cherished property.

For example, a trust might specify that a beach house is to be used by all descendants of the grantor, outline a scheduling system, set aside funds for maintenance, etc. It effectively prevents any one heir from forcing a sale.

We've seen an uptick in such legacy trusts, as real estate is an emotional asset and often families deeply want to keep particular properties for future generations. If "no matter what happens, this house stays in the family," a trust is usually the vehicle to fulfill that wish.

Trust Drawbacks: One important note on balancing when/if to grant properties to a trust: If a property is in a trust when you die, it does not get a basis step-up if it was already outside your estate (the trade-off for estate tax savings). Heirs inherit the trust at carryover basis. But that might be moot if the property won't be sold (like a legacy holding), or if estate tax savings were more important than saving income tax on a future sale...

We often run projections: it might be better to remove a \$5M property from the estate (saving 40% of all future appreciation from estate tax) even though you sacrifice a step-up (potential 20% capital gains tax if sold later). If heirs keep it, who cares about step-up? If they sell, they pay capital gains, which is usually less than what the estate tax would have been on the larger value.

In essence, **trusts are indispensable for larger estates** and those wanting to plan long-term.

Among those, long-term planning is one strategy that combines the estate side-stepping and probate avoidance power of trusts with tax benefits similar to the Roth IRA above. It is limited to accredited investors only, which we suspect most of the readers of this report already are, and



best deployed for those who take a more passive role in their overall portfolio management – trusting managers and funds to oversee specific investment choices. But for those it suits, it can provide many of the benefits of the aforementioned tools with far fewer of the drawbacks.

“Super Roth” Life Insurance Strategies

For mid- to high-net-worth investors, **Private Placement Life Insurance (PPLI)** has emerged as a potent tax mitigation tool.

These are sometimes described in financial media as “Super Roth” or “Rich Man’s Roth” because the strategy allows potentially unlimited contributions, tax-free internal growth, and even avoidance of the 10-year rule (since life insurance isn’t subject to SECURE Act rules at all) – albeit with trade-offs that are important to understand. Here’s how it works and why it can be relevant for real estate:

A PPLI policy or Custom Designed Life Insurance (CDLI) policy is essentially a custom-tailored variable universal life insurance contract designed for investment rather than pure death benefit.

It’s “private” in that it’s offered via a private placement (exempt from SEC registration) to accredited investors.

These policies have very little in common with their retail-focused brethren, like whole and universal life policy, from the commissions they charge (usually none – they are sold most often through advisors and wealth managers using them as part of an asset management plan) to the amount of cash value that can build inside of them to the investment choices available therein. With PPLI, you can contribute a large premium, seven figures or more in many cases, which goes into a separate account within the insurer. You choose an investment strategy for that account (often via an investment manager or fund menu). Crucially, the cash value can be tied to alternative investments – hedge funds, private equity, real estate partnerships, etc., which typical retail policies wouldn’t allow.

All income and gains on those investments are tax-free inside the policy (just like in a Roth IRA or 401(k)). There’s a death benefit paid to your beneficiaries tax-free. And unlike a Roth, there’s no forced payout after 10 years or at any age – you could insure your child or grandchild, theoretically deferring gains for not only your lifetime but through theirs as well.



This has the potential to provide a multi-generational tax shelter.

For real estate, you wouldn't usually put a physical property directly into a PPLI (insurers don't want the complexity of managing actual property). But you could invest the PPLI account in a real estate fund or REIT, or in loans secured by real estate, or even shares of a closely held management company owning property.

Any income (interest, gains) from that activity is never taxed to you personally; it accumulates in the policy.

In researching such a structure, you might read that should you ever surrender the policy, you'd owe tax on gains, like withdrawing from a traditional IRA (and you can withdraw up to your basis if needed, free from taxes).

But, typically, you never surrender. Instead, you borrow against the policy. The low-interest loan just builds debt against the investments held therein. The cash you draw against it is tax-free to you and just becomes an obligation from you to the policy. Ultimately, assuming the policy remains in good standing, the death benefit pays out, paying off the loan.

This is particularly useful for illiquid investments, like real estate, or ones that produce appreciation without income, like closed-end funds or even precious metals. Those assets continue to grow, and in the case of real estate, also produce income inside the policy. That increased value can be drawn upon through the loans, without having to liquidate the underlying asset and realize gains, and without any tax on that income.

It's a strategy that has been in use for the better part of a century, but has come into more common use over the last few decades as technology and competition have driven the minimums required to fund such a policy down to as low as \$1 million total commitment (over some period, like 10 years), or even lower in some cases. We've had clients choose to put away as little as \$25,000 per year for each of several grandkids, for example.

The potential benefits of PPLI are numerous:

- **Extremely high contribution limits** – essentially, whatever amount the insurer will accept, subject to IRS modified endowment contract rules that require a certain ratio of death benefit to cash to keep it tax-favored;

- **Tax-free investment flexibility** – you can switch between assets without triggering tax – no 1031 needed when you decide to redeploy capital;
- **Can grow outside of your estate** – PPLI contracts have no SECURE Act 10-year deadline, as they are not qualified retirement accounts. If structured properly (often through an Irrevocable Life Insurance Trust or ILIT), the policy can also be outside your estate entirely, meaning the value of the assets in the policy and its death benefit is free of estate tax as well.

The combination of a PPLI and a trust deliver benefits we've not seen in the same combination anywhere else in the estate planning world: no income tax, no capital gains tax, and no estate tax on the growth, ultimately.

Of course, there are downsides and costs.

- While the minimums are falling, they still exist. It is typically only practical above about a \$500,000 contribution – over some period of time – and much more cost effective when you reach scales of \$2M+ investments, due to setup and insurance costs. The policy may have mortality charges and fees that one must outweigh with the tax benefits. The math usually works quite well, but not in every case – an advisor can help you run projections before you invest so you understand the different scenarios.
- The **tax treatment is dependent on the policy remaining in good standing**. There is a material risk that should the policy lapse, because of poor performance or loan costs, then any loans outstanding at that time can be immediately treated as taxable income. So, it is important to ensure you understand the funding and performance requirements of the policy and ideally work with a qualified advisor.
- **You also cede control over specific investment decisions** to avoid the “investor control” doctrine (the IRS says if you dictate investments too much, it's essentially a taxable account). So you must be a passive investor – you can set overall strategy and hire a manager, but you can't say “buy that specific building” or “sell unit 267 but hold onto the penthouse for those condos” personally. However, for those contributing existing assets – more on that in a moment – investment decisions are minimal and can be outsourced to a trusted manager. We find that for investors who are looking for a way to ensure their portfolios remain as multi-generational assets, who will manage the properties over the long run is a consideration



regardless, and the PPLI can be a good catalyst for (and provide the additional yield to allow) that conversation.

These investor control doctrines are similar to, but not the same, as those governing the self-dealing rules that govern IRAs. For example, there are also no strict rules about personally benefiting from the use of a property, but we would generally recommend against it.

- The general advice says you must be comfortable with illiquidity; while you can access cash via loans or partial withdrawals, it's not as straightforward as an IRA distribution. Though in practice we believe that access is superior, since there are no penalties or age limits, unlike with an IRA or 401(k). You can draw against that balance at virtually any time for any reason, with a little notice.
- You – or a family member, such as a spouse or adult child if you're building a generational plan – must qualify both medically and financially for the policy. The medical side is obvious: the insurer needs to assess health risks. Financial qualification simply means the insurance company has to see an economic reason for the amount of coverage – that the benefit makes sense in light of your income, assets, or the role you play in the family's finances. It's their way of making sure the policy reflects a real financial stake, not just a number pulled from thin air. One should also note the expense – PPLI typically has lower fees than retail insurance (no hefty commissions, it's institutionally priced), but there are still mortality charges and administrative fees that effectively act like a small annual asset-based tax. And the insurance cost reduces the cash value of your initial investments by a modest percentage, reducing long-term returns. Though we find the tax benefits usually outweigh this drag by a healthy margin.

If your income would otherwise be taxed 37% each year, paying perhaps 1-2% in insurance costs to avoid that is usually a trade qualifying clients gladly take. But if your investments are tax-efficient already (like real estate with depreciation to offset income taxes and which would benefit from a step-up), the relative benefit is smaller.

PPLI tends to shine if you have high-income assets or you need to shelter things like operating business income, hedge fund interest, large capital gains from rapid appreciation, etc.

As a general rule, policies should be funded with cash. **However, in some select circumstances, it is possible to partially fund a PPLI policy with pre-existing appreciated assets.** It's a complex

subject, and requires balancing the recognition of gains up to that point. However, for instance, if someone holds a real estate property with embedded gains, they may be able to contribute that property (through partnership or LLC interests) into a PPLI structure, allowing future appreciation to occur within the tax-free insurance wrapper, shielding the future growth from income and capital gains tax.

While investment diversification requirements apply – for example, under IRS section 817(h) rules, no single investment can typically exceed 55% of the account’s value, no two can be 70% and so on – these are usually manageable by combining multiple properties or blending real estate with securities and cash contributions.

The insurability requirement cuts both ways, too, and you can leverage it to delay the “pour out” beyond your generation by insuring a younger person. Indeed, you could set up PPLI on your adult daughter’s life, fund it with \$X million in cash and assets, and let it grow through real estate deals for decades. When she eventually passes, the death benefit goes to your grandkids, or more likely into trusts set up for them – potentially many decades further than your own lifespan – compounding tax-free all the while.

It’s a way to emulate a dynasty trust, but with the tax exemption of life insurance.

For real estate investors, PPLI can be appealing if you’re looking at *diversification of investments with minimal tax friction*. We often position it as part of an integrated plan: perhaps you keep direct ownership of some properties (using strategies above for those) and concurrently use PPLI to invest in additional real estate or alternative assets without tax.

The PPLI basically acts as a tax-efficient asset envelope with high contribution limits and flexible access to funds. It’s worth considering once your investment portfolio reaches a size where incremental tax savings yield big dollar benefits.

The Best Defense is a Good Offense

Building and preserving wealth through real estate doesn’t happen by accident – it’s the result of careful, informed investing. You are doing the work to diligently select properties, to manage expenses, and to build a portfolio that will prove an asset to your family for generations.

The same goes for making it more tax-efficient. The U.S. tax code gives real estate investors a remarkable set of advantages, from deductions and deferrals to the ability to pass appreciated assets to the next generation with little or no tax drag. But realizing those benefits takes foresight, coordination, and a deep understanding of how the various tools fit together.

With the right strategy, you can minimize current income and capital gains taxes, maintain control and flexibility, and create a structure that supports your family's goals long after your own investing years. The earlier you begin, the more options you'll have – and the more powerful the compounding of those tax efficiencies becomes over time.

Want to Connect with Copper Beech?

At Copper Beech, our mission is to help families turn that complexity into clarity – building plans intended to make your wealth last for generations. If you'd like to explore how these strategies could apply to your holdings, we invite you to connect with our team through worthnet.com/copper for a complimentary consultation.

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¹ <https://www.iraresources.com/blog/prohibited-transactions-iras-vs-solo-401k-plans>

