Reality Check on IRA Investments in Real Estate

April 29, 2012

Multiple times each year I am asked by prospective clients whether, and how, they can invest traditional IRA assets in real estate. In this time of distressed real estate and very low interest rates, many investors have maxed out on their after-tax investments in real estate, and their IRA account balances beckon as a new source of investment capital. If these folks look online, they will find many sources of purported "advice" on how to get rich through IRA investments in real estate. Unfortunately, the information available online usually obscures or overlooks altogether some significant practical and tax hurdles to making IRA investments in real estate work from both the technical/legal and "return on investment" perspectives.

Below I summarize those obstacles. They are not barriers, per se, but prospective investors should assess them carefully, preferably in consultation with their attorneys, CPAs, or other tax advisors, before committing IRA assets to an investment in real property. Failure to steer clear of them could result in immediate taxation of the entire IRA account – including conventional investments.

1. **Understand How the IRS Views Your IRA**

A very important concept that much of the online marketing around IRAs overlooks is that, from the perspective of the IRS:

- the IRA is solely meant to provide a source of retirement income and is not a ready source of capital for an investment opportunity; and
- You are a fiduciary with regard to your IRA account.

The IRS applies a term – prohibited transaction or "PT" – to any use of IRA assets for personal gain other than preservation of a retirement income stream. The prohibited transaction rules disallow a number of specific transactions, such as selling real estate to or buying it from your IRA, or personal or immediate family member use of real estate owned by an IRA, but they also generally prohibit "self-dealing" which is defined to include any act of a fiduciary (i.e., you) by which IRA income or assets are used for the fiduciary's own interest. Examples of self-dealing could include purchase of real estate built on speculation by a son in law, purchase of real estate adjoining your own property or that of a family member in order to control how the property is used and who lives there, or , outside the real estate context, use of IRA assets alongside personal assets in order to meet a minimum investment account threshold.

If your IRA investment in real estate constitutes a prohibited transaction of any stripe, the total account balance of the IRA will be treated as if it were distributed to you on the first of the year in which the investment is made, and thus included in your taxable income for that year. If you are under age 59 ½, you also may have to pay an early distribution penalty equal to 10% of the prohibited investment.

Even if the purchase transaction satisfies PT rules, management of the IRA-owned real estate can also trigger violations, as is discussed in section 4, below.

2. **Analyze the Tax Consequences: Income Tax Rates, versus Capital Gains (plus deductions)**

Investing IRA assets in real estate means that gains on your investment - when realized through sale of the real estate and distributed from the IRA – will be taxed at regular income tax rates, rather than the lower capital gains rates that apply to after-tax real estate investments. Also, during the time that your IRA holds the real estate, depreciation and the many deductions for property expenses claimed on Schedules C or E will not apply as they would to after-tax real property investments.

3. **Pay Cash – Avoid Unrelated Debt Financed Income**

Your IRA must pay cash for the real estate, otherwise tax will be owed on "unrelated debt financed income" under Internal Revenue Code Section 514 if the leveraged property generates income (such as rents) or if it is sold for a profit while the mortgage is still outstanding (or within 12 months of paying it off). The IRA trustee or custodian must pay the tax.

In determining how much your IRA can afford to pay for a parcel of real estate, you must arrange ahead of time, preferably with the help of a CPA or other tax advisor, to maintain liquid investments in the IRA to pay off certain recurrent costs and expenses, and for other reasons outlined in 5 – 7, below.

4. **Follow Correct Procedures (the Natalie Choate 4-Step Test)**

As mentioned, the IRS views you as a fiduciary with regard to your own IRA. Because the PT rules prohibit an IRA fiduciary from engaging in business transactions with the IRA itself, you will need to use third parties both to purchase the real estate, and to manage the real estate. Natalie Choate, a nationally recognized authority on the estate planning aspects of IRAs and qualified retirement plans, specifically recommends the following four steps:

- Find a specialized IRA custodian. Not all IRA custodians are well versed in the intricacies of the prohibited transaction rules, and how real estate investments may trigger violations. You will want to find a bank custodian who has experience in this area. Work through trusted contacts such as your CPA or other tax advisor until you have found the right match.
- Custodian engages in purchase transaction, not you. The PT rules require that the IRA custodian, not you as IRA fiduciary, uses your IRA assets to purchase the real estate. You cannot buy the real estate and transfer it to your IRA, or sell it to your IRA. The latter transaction would be a PT; the transfer would not work because generally only cash may be contributed to an IRA.
- The Custodian engages a third party property manager. This step is recommended if your real estate has residential tenants or commercial tenants in anything other than a "triple net" lease requiring that they assume costs the landlord otherwise would pay. The property manager, not you, should run the property (e.g., make repairs, collect rent, pay expenses and property taxes, etc.) and send the IRA custodian a check each month that is net of all such costs. This arrangement makes it unlikely that you will intermingle your personal assets with the IRA assets, for instance by directly hiring a painter or gardener, or by paying a bill associated with the IRA owned property.

- No family use or sweat equity. For the same reasons that a third party property manager is recommended, you must avoid any personal use of the IRA-owned real estate, or use by direct family members. Even use by extended family members or family friends could comprise a "self-dealing" type of PT as described above. You must also resist the urge to work on the property yourself, show apartments, or have family members fill any of these roles. Ideally, your property manager will anticipate and take care of such needs on an arms-length basis, without involving you.

5. **Set Aside Liquid IRA Investments for Required Minimum Distributions**

When you reach age 70 ½, the IRS requires that you begin taking annual minimum required distributions from your traditional (i.e., non-Roth) IRA. If you have multiple traditional IRAs, you can choose one from which to take distributions, but you must pool all IRA account balances together to determine the minimum required amount you must withdraw each year. Failure to timely take out a sufficient amount could result in a 50% tax, based on what you should have withdrawn. Needless to say, minimum required distributions can only be made from liquid IRA investments – stock that can be sold, money market accounts, etc. Before investing IRA assets in real estate, make sure that you preserve sufficient liquid IRA investments from which to take required minimum distributions. You CPA or other tax advisor can help you do some advance planning in this regard, to determine the principal amount you should set aside for this purpose, and income you can expect it to generate.

Failure to preserve liquid investments for this purpose will make it very hard to take minimum required distributions. You might have to distribute fractional interests in the IRA-owned real estate, which would be an expensive process (both in determining the value of the fractional interests, and in documenting the interest transfer).

6. **Set Aside Liquid IRA Investments for Annual Valuations of the RE Investment**

Most reputable IRA custodians will require annual valuations of real estate investments or other non-traditional investments (privately held stock, etc.) The valuation may cost several thousand dollars, possibly more. The IRA must pay for this expense; you cannot use personal funds. Before committing IRA assets to the real estate purchase, you need to determine how much in liquid IRA investments you need to aside in order to pay this recurrent expense from either the liquid investments themselves and/or anticipated investment income they generate.

7. **Set Aside Liquid IRA Investments for Property Taxes, Expenses, Insurance Improvements, Management Fees**

As mentioned, your third party property manager will be using IRA funds to pay property taxes, maintenance and other expenses, insurance, improvements, and will also draw on the IRA to pay its own management fees. Before committing IRA assets to the real estate purchase, you will need to determine how much in liquid IRA investments you need to set aside in order to pay these expenses from the investments themselves and/or anticipated investment income they generate. Some amounts will be predictable and recurring; others, such as large repairs (roof replacement, etc.) are not predictable and you will have to use good judgment in estimating a set-aside.

Bottom line, IRA investments in real estate can be done, but there are many rules that must be followed to avoid disqualification of the IRA and immediate taxation of the entire IRA account. The

availability of required minimum distribution amounts, the loss of capital gains treatment, and the self-dealing restrictions, generally make an IRA investment in real property unsuitable and problematical at best. For investors who are still "game," some advance financial and tax planning strongly is advised both before the transaction occurs, during the life of the real estate investment, and well in advance of any minimum required distribution start date.

Finally, you will note that this post does not discuss strategies using business entities within an IRA, such as IRA-owned single member limited liability companies ("LLCs"). Often marketed as "checkbook control" IRAs, these arrangements raise a host of compliance issues over and above the ones discussed below. The Groom Law Group has an excellent article debunking this and a number of other questionable IRA strategies that you can read here.

I:\cpr\Articles\042912 Reality Check on IRA Investments in Real.doc
http://www.groom.com/resources-363.html