

INVESTING IN REAL ESTATE WITH AN IRA: THE MOST OVERLOOKED OPPORTUNITY IN REAL ESTATE

With over \$9 Trillion in IRA accounts in the U.S., the IRA is the most overlooked opportunity for rental, flip, commercial, or other real estate investing.

IRAs are the most overlooked opportunity in real estate. Let me explain.

There are over \$9 trillion dollars in IRA accounts in the U.S. This number is staggering and makes IRAs one of the largest sections of investable cash in the world (Investment Company Institute & Federal Reserve Board). But what does this have to do with real estate? Well, contrary to popular belief, IRAs, have always been able to invest in and own real estate. They can own single-family rentals, or flip properties, or own LLCs that own multi-family or commercial real estate. They can also invest as a private lender on real estate.

At this point in the IRA and real estate conversation I'm usually asked, "Why have I never heard of this before?" Well, the major providers of IRAs have generally found real estate to be "administratively unfeasible," as real estate takes more work to handle and administer than a publicly-traded stock or REIT does. In other words, the brokerage and insurance firms who administer most IRAs restrict their IRAs to, well, the stuff they sell, like publicly traded stock, mutual funds, and annuities. You've always been able to own real estate in an IRA, but there have been few IRA custodians who allow it, and as a result, it isn't as widely known as it should be. With an increase in awareness, IRAs continue to own more and more real estate.

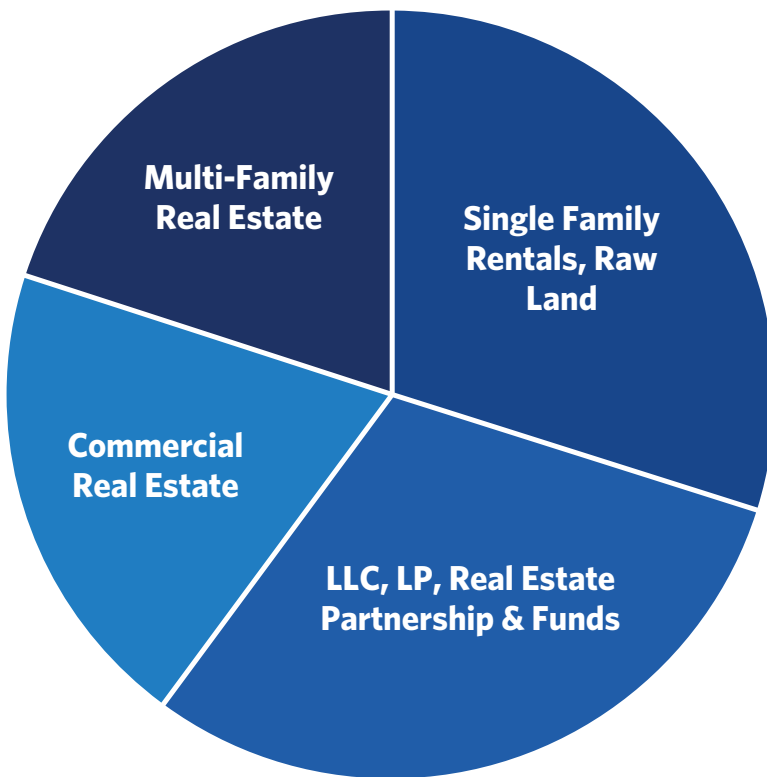
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INVESTING IN REAL ESTATE WITH AN IRA
WHAT KIND OF REAL ESTATE CAN AN IRA OWN?

IRAs can own single-family rental properties. IRAs can own properties being flipped for profit. IRAs can invest in small private LLCs that own commercial properties or multi-family properties with other individuals or IRAs. IRAs can own options on real estate. And, IRAs can lend money secured to other real estate investors as a private investor or hard money lender. However, you can't buy real estate for personal use or for use by certain disqualified family members. The assets owned by your IRA must be held for investment purposes.

"...the only investment assets restricted for IRAs are life insurance, collectible items (e.g. art, antique car), and S-Corporation stock."

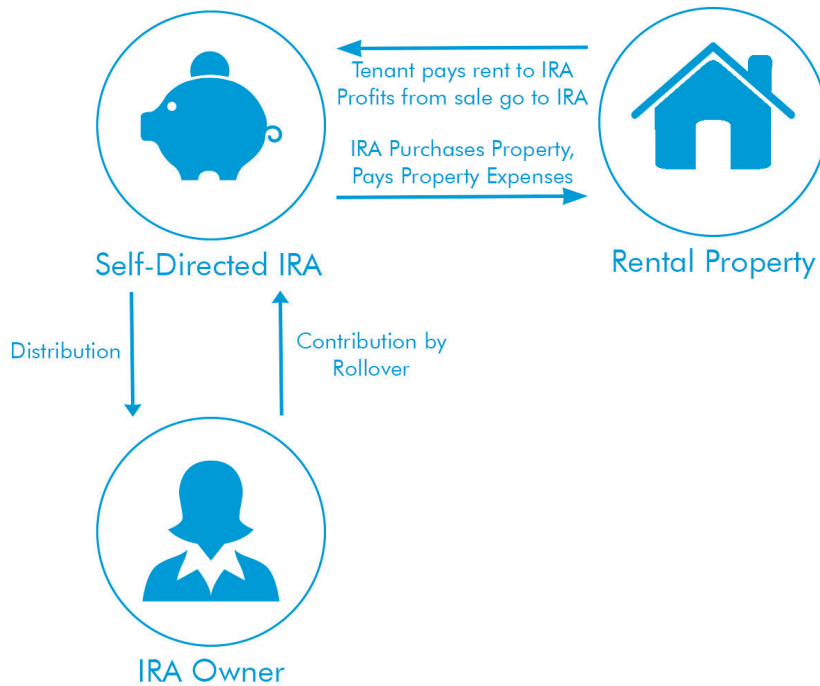
MOST COMMON TYPES OF SELF-DIRECTED REAL ESTATE INVESTMENTS



In sum, any real estate owned for investment purposes can be owned by an IRA. The law has very few restrictions on assets owned by a retirement account. In fact, the only investment assets restricted for IRAs are life insurance, collectible items (e.g. art, antique car), and S-Corporation stock (IRC § 408; IRC § 408(a)(3); IRC § 1361 (b)(1)(B)). So, all investment real estate is fair game for IRAs.

To own real estate with an IRA, you must establish what is called a "self-directed IRA" and transfer the funds from your current IRA provider (or prior employer 401(k)) to self-directed IRA provider. There are many companies who offer these types of accounts, like my own company, Directed IRA by Directed Trust Company.

SELF-DIRECTED IRA INVESTMENT PROCESS WITH REAL ESTATE



WHAT IS A SELF-DIRECTED IRA?

A self-directed IRA is an IRA that can invest into any investment allowed by law. Real estate is the most common investment for self-directed IRAs, but they can also be invested into start-ups, private equity funds, venture capital funds, precious metals, and even cryptocurrency. Though, let's focus on real estate.

There are a few critical issues to consider when buying real estate with an IRA

THE PROPERTY IS OWNED BY THE IRA, NOT YOU.

Let's go over a rental or property you plan to flip with the IRA. The purchase contract to buy the real estate must be in the name of the IRA, and the deed to the property will be in the name of the IRA.

The IRA funds, including the earnest money deposit, will come from the IRA account. Keep in mind, the IRA account owner is not buying the property, so the contract should not be in their personal name, nor should the IRA owner's personal funds be used. IRAs are held in the name of the custodian of an IRA. So, for example, if your IRA is with my company, Directed IRA & Directed Trust Company, the titling of your IRA would be "Directed Trust Company FBO John Doe IRA." That is the name of the buyer on the contract and is the name on title to the property.

Improvement costs and expenses for the IRA-owned property must be paid

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by your IRA and not personally by the IRA owner. Conversely, when there is rental income on the property or when the property sells for a gain, that income goes back into the IRA. Now, one of the huge perks of investing with an IRA is that there is no tax when the IRA makes money. That works with buying and selling stock for gain, as well as buying and selling real estate for gain. Consequently, the rental income and the income when you sell the property is not taxable. If this is a Traditional IRA, then the money comes out tax-deferred at retirement and you pay tax as you draw it out. But, if it is a Roth IRA, the money comes out tax-free at retirement. So, put your best real estate deals in your Roth IRA. But remember, even the Traditional IRA grows tax-deferred with all income accumulating and growing until retirement.

“In short, the prohibited transaction rules restrict your retirement account from engaging in a transaction with someone who is disqualified to your account.”

EXAMPLES OF HOW AN IRA OWNER INVESTING IN RENTAL REAL ESTATE MAY UNKNOWINGLY ENGAGE IN A PROHIBITED TRANSACTION



Source: GAO analysis of IRS publications. | GAO-17-102

AVOID PROHIBITED TRANSACTIONS

When self-directing your retirement account, you must be aware of the prohibited transaction rules found in IRC § 4975. These rules restrict whom your account may transact with, not what kind of investment your account may own. In short, the prohibited transaction rules restrict your retirement account from engaging in a transaction with someone who is disqualified to your account. A “disqualified person” to a retirement account includes the account owner, their spouse, children, parents, and certain business partners. So, for example, your retirement account could not buy a rental property that is owned by your father, since a purchase of the property would be a transaction with someone who is disqualified to the retirement account. Similarly you couldn’t buy a rental property from a third-party, and then rent to your child as your child is a disqualified person. On the

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other hand your retirement account could buy real estate from your cousin, friend, sister, or a third-party, as these parties are not disqualified persons under the rules.

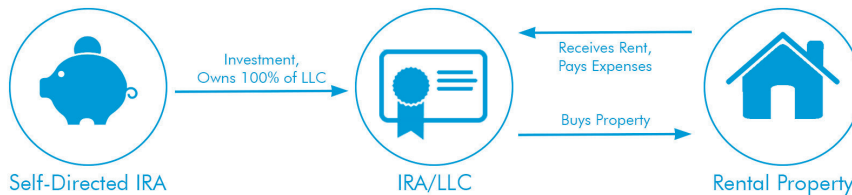
A prohibited transaction can also arise if there is self-dealing where the IRA owner or disqualified family members are personally benefitting or making money from the IRAs investments. For example, if you are a real estate agent/broker and your IRA buys real estate, you cannot receive the buyer's agent commission as that would result in a financial benefit to you personally. You would have to waive this fee and have the purchase price reduced or have someone else represent the IRA.

If an IRA engages in a prohibited transaction, the entire IRA account involved is deemed distributed and is no longer an IRA. Taxes and possible early withdrawal penalties apply under the normal distribution rules.

USE AN IRA-OWNED LLC (AKA "IRA/LLC" OR "CHECKBOOK-CONTROLLED IRA")

Many self-directed retirement account owners, particularly those buying real estate, use an IRA-owned LLC as the vehicle to hold their retirement account assets. Under the IRA/LLC structure, the IRA typically owns the LLC 100%, and the LLC in turn owns the real estate. So, rather than buying real estate and owning it directly in the IRA custodian's name, your IRA would invest and own an LLC, and the LLC in turn would own the real estate.

IRA/LLC RELATIONSHIP WITH REAL ESTATE INVESTMENT



The IRA/LLC is typically managed by the IRA owner. Under this structure, the IRA owns all of the membership/ownership units of the LLC, but the IRA owner can serve as the manager of the LLC. Manager of an LLC is like the president of the corporation. The manager can sign for the LLC, and can act on behalf of the LLC. As manager of the LLC, the IRA owner would establish a business checking account for the LLC, and the IRA funds would be invested and deposited into that LLC business checking account. Because the IRA is funding all of the investment dollars into the LLC, the IRA owns 100% of the LLC.

Now, the LLC is funded with the IRA cash, and the IRA owner is the manager of the LLC. The IRA owner can decide how much cash to invest into the LLC from the IRA depending on the real estate they are planning to buy with the IRA/LLC. When offers to purchase real estate are made with an IRA/LLC, the LLC is the buyer on the real estate purchase contract, and the earnest money deposit and final funds to

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close on the property would come from the LLC checking account. The IRA owner, as manager of the LLC, signs the real estate purchase contract, has control of the LLC checking account, and can sign checks or send wires for the LLC account. Keep in mind, the LLC is owned 100% by the IRA, and the LLC funds cannot be used for personal purposes and cannot be used to pay the IRA owner. If you ever want to take money from the IRA/LLC, you must send money from the LLC bank account back to the IRA - since the IRA owns the LLC - and you then take a distribution from the IRA.

Last, the IRA/LLC docs are unique and must contain IRA provisions in the LLC operating agreement and subscription sections. As a result, you should use a lawyer who is familiar with IRA/LLCs as many IRA custodians who allow for IRA/LLCs require an attorney or CPA to sign off on the docs. My law firm, KKOS Lawyers, has been drafting IRA/LLCs for over 12 years and charges a flat fee of \$800 plus state filing fees. Multi-member IRA/LLCs can involve multiple IRAs (i.e. spouses or other investors), or combinations of IRAs and individuals, and typically cost more to set-up.

HOW TO PROPERLY GET A MORTGAGE LOAN WITH YOUR IRA?

Your IRA, or IRA/LLC, can get a mortgage loan when you buy real estate, but you need to know two things before you do.

IRA/LLC RELATIONSHIP WITH NON-RECOURSE LENDER



First, the loan must be non-recourse to the IRA owner, as the rules regarding IRAs do not allow the IRA owner to personally be responsible for the loan or to personally extend credit to the IRA. Under a non-recourse loan, the bank lends money to the IRA, or IRA/LLC, and gets a deed of trust or mortgage against the property securing the loan. In the event of default, the lender can foreclose and take the property back, but cannot go after the IRA or the IRA owner for any deficiency in the loan. Because the lender's ability to collect is limited to the property they loaned on, the banks who lend to IRAs require 30-40% down. There are several banks who specialize in these non-recourse loans to IRAs, and an IRA owner is best served by using a bank or private lender who routinely provides these type of non-recourse loans.

Second, there is a tax called Unrelated Debt Financed Income tax ("UDFI") that applies to an IRA when the IRA leverages its investment dollars with debt. Essentially, the IRS will tax the income from the debt invested, while leaving the percent of the deal attributed to the IRA's cash investment not subject to tax.

"As manager of the LLC, the IRA owner would establish a business checking account for the LLC, and the IRA funds would be invested and deposited into that LLC business checking account."

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For example, let's say your IRA bought a rental property for \$100k with the IRA putting \$40k cash down and getting a non-recourse loan for \$60k. To the IRS, 40% of this deal is the IRA funds subject to tax, while the other 60% is non-IRA funds subject to tax. The tax on this 60% is UDFI tax. The tax rate on UDFI is the trust tax rates, which maxes out at 34% on rental income. This is after expenses of course, which include depreciation.

Upon the sale of the property, the IRS allows you to use the capital gains tax rate for the UDFI tax so you can move down from the 34% rate to the max long-term capital gains rate of 20%. Technically, UDFI is a form of UBIT tax discussed below. But, it applies in a very different way when there is debt.

Many self-directed IRA investors will only buy real estate with cash in their IRA, and won't bother with a non-recourse loan, while others view the UDFI tax as a cost of doing business and a tool to buy more property, thereby increasing overall returns. Keep in mind, UDFI tax is only due on net rent all income or net gain upon sale, after property expenses and depreciation expense.

WATCH OUT FOR UNRELATED BUSINESS INCOME TAX (UBIT)

There is a tax that can apply to an IRA's income called Unrelated Business Income Tax ("UBIT"). Usually, when we think of IRAs, we aren't expecting there to be taxes on the income, and this is typically the case. However, there are a few situations where IRAs will have to pay tax on the income they make. These tax situations arise when the income being made is considered "business income" (aka ordinary income) as opposed to investment income. Most real estate income is automatically exempt from UBIT. Exempt income from UBIT includes rental real estate income, capital gain income when you sell real estate, and interest income when you lend money on real estate (IRC § 512). So let's go over the common situations where UBIT tax is generally due.

First, there is the instance of debt mentioned above, which causes UDFI. UDFI tax on the profits. Real estate development income that is ordinary income in nature, as opposed to long-term capital gain, will cause UBIT for the IRA. It is possible to do real estate development with an IRA and hold the property for investment purposes. If a real estate development was done and the property held for investment, then the IRA would avoid UBIT tax. That being said, you should carefully consult with your tax lawyer or CPA on the details of your strategy and whether UBIT would apply.

The last situation where UBIT can apply is when you flip multiple properties with your IRA in a year. Since most fix and flip transactions are short-term in nature - under one-year hold time - IRA owners need to be careful not to do too many flips with their IRA in one year, as the IRA can be deemed to be "in the business of real estate." If the IRA is deemed to be in the business of real estate, then the income

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the IRA makes from the flips will be subject to UBIT. If the IRA is flipping one or two properties a year, you don't need to worry about the IRA being deemed "in the business of real estate."

However, if the IRA is flipping more than a couple of properties each year you should consult your tax lawyer or CPA on the exact details of your IRA's investments.

If your IRA is subject to UBIT, then the IRA files its own separate tax return called a 990-T, and the IRA pays the tax due. This return is separate from the IRA owner's personal tax return. The 990-T is the responsibility of the IRA owner and is not something that is generally prepared by your self-directed IRA custodian. You'll need to engage a tax lawyer, CPA, or accountant to prepare and file the 990-T. Or, you can complete it on your own, but it is a very technical return and there is a little guidance on how it should be prepared for an IRA.

SUMMARY

These rules can seem a little foreign and overwhelming at first. But, I like to say that learning how to self-direct your IRA is like learning a new board game. It's not that the board game rules are complicated. Rather, it is something you need to learn first before playing and moving the pieces. When we play a new board game, we first read the rule book, or we play with someone who already knows the game. So, consider my book, *The Self-Directed IRA Handbook*, and read up on the subject, or play the game with others who know the rules (i.e. a lawyer, CPA, advisor, or other investor). After you've properly self-directed your IRA into real estate once, you'll have the rules down...or at least until Congress changes the rules of the game. And if they do, I'll update my rulebook.

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BONUS: FREE digital copy of *The Self-Directed IRA Handbook* when you open a new account with Directed IRA

