SELF DIRECTED IRAS AND RETIREMENT PLAN OWNERSHIP OF REAL ESTATE: WHAT EVERY REAL ESTATE PROFESSIONAL SHOULD KNOW

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PRINCIPAL AT NAVIGATOR BUSINESS & RETIREMENT (SELF DIRECTED 401K PLANS).

AUTHOR OF THE SELF DIRECTED IRA HANDBOOK, AN AMAZON/KINDLE BESTSELLER. WWW.SDIRAHANDBOOK.COM. THE MOST WIDELY USED AND REFERENCED BOOK IN THE SELF DIRECTED IRA INDUSTRY.

HOST OF ANNUAL SELF-DIRECTED IRA SUMMIT, WWW.SDIRASUMMIT.COM

PRACTICE: ESTABLISH IRA/LLCS, SD 401KS, ADVISE ON PROHIBITED TRANSACTION RULES, UBIT/UDFI TAX, INVESTMENT STRUCTURING. REPRESENT CLIENTS BEFORE THE IRS AND U.S. TAX COURT ON SDRP ISSUES.
WHY

WHY ARE WE TALKING ABOUT RETIREMENT ACCOUNTS TO A GROUP OF REAL ESTATE PROFESSIONALS?

25 REASONS WHY
Assets in individual retirement accounts (IRAs) totaled $7.6 trillion at the end of the first quarter of 2015, an increase of 2.1 percent from the end of the fourth quarter. Defined contribution (DC) plan assets rose 1.8 percent in the first quarter to $6.8 trillion. Government defined benefit (DB) plans—including federal, state, and local government plans—held $5.1 trillion in assets as of the end of March, a 0.5 percent decrease from the end of December. Private-sector DB plans held...
Mitt Romney, former CEO of Bain Capital, and Presidential Candidate, who invested his self directed IRA into early stage or turn-around private businesses that were not publically traded. His IRA value was reported at around $100M. Bain Gave Staff Way to Swell IRAs by Investing in Deals, Mark Maremont, The Wall Street Journal (March 22, 2012).

Paypal founder and CEO, Peter Thiel, who reportedly bought shares in his self directed Roth IRA for $510,000 and received $31.5M for them when the company sold to eBay. Why—And—How Congress Should Curb Roth IRAs, Deborah L. Jacobs, Forbes (March 26, 2012).

Yelp founder and Chairman, Max Levchin, whose self directed Roth IRA acquired shares in the early stages of Yelp (at excellent value) and was worth $95M in 2012, when numbers were reported. Id.
HOW DO YOU INVEST AN IRA OR 401(K) INTO REAL ESTATE?

- Must move account (IRA, former employer 401k) to a “self-directed” IRA custodian. They will allow account to be invested into any investment allowed by law. IRA owns the real estate.

- What is a self-directed IRA? An IRA that can invest in any investment allowed by law.

- Why can’t my IRA at Fidelity or Charles Schwab invest into actual real estate? Company policy.
Understanding the Industry & Choosing a Self Directed IRA Custodian

- How are self-directed IRA Custodian’s regulated.
  - Must be bank, credit union, or trust company to qualify as an IRA custodian.
  - Administrator model (TPA).
- SDIRA Custodian’s act at client (or advisors) written instruction only.

- Choosing a self-directed IRA Custodian
  - Experience in the asset of the investor
  - Do they regularly work with advisors?
  - Regulatory model
  - Retirement Industry Trust Association (RITA) Members.
  
  https://rita.memberclicks.net/assets/documents/rita.membership.list.pdf
Why should every real estate Professional and Investor know about self directed IRAs and SDRPs?

1. IT IS HOW YOU CAN INVEST YOUR OWN MONEY INTO ASSETS YOU KNOW.

2. TAX DEFERRED OR TAX FREE GROWTH OR FEDERAL AND STATE TAXES?

3. THE LARGEST CONCENTRATION OF INVESTABLE CASH FOR AMERICANS IS THEIR RETIREMENT ACCOUNT. A PERSON WITH INVESTIBLE CASH IS MORE LIKELY TO HAVE MORE MONEY IN THEIR RETIREMENT ACCOUNT THEN IN THEIR PERSONAL SAVINGS OR INVESTMENT ACCOUNTS. HOW CAN YOU WORK WITH THESE CASH INVESTORS?

4. THE $1M PLUS ROTH IRA OR ROTH 401K. WHO HAS THEM? WHERE WOULD YOU RATHER MAKE $1M ON A REAL ESTATE DEAL? PERSONALLY, OR IN YOUR ROTH OR TRADITIONAL SDRP?
WHY WOULD A REAL ESTATE INVESTOR WANT TO USE RETIREMENT FUNDS IN REAL ESTATE?

- That’s where their money is?
- They understand and trust real estate over the stock market? Can’t tell you a mutual fund they actually want to own yet they own many.
- They can get better returns in real estate over the stock market?
- They want to make money in real estate tax-free or tax-deferred? IRA rules, no tax on income or gains.
IRA Buys 1,000 shares of stock at $50 a share ($50,000) in 2013, sells at $75 a share ($75,000) in 2015 and funds go back to IRA. $25,000 gain on share of stock. No taxes since gain was in IRA.

SDIRA Buys real estate at $50,000 in 2013, sells at $75,000 in 2015 and funds go back to IRA. $25,000 gain on real estate goes back to IRA. No taxes since gains was in IRA.

Best deal in the tax code, no federal or state income tax on gains from sale of real estate or on rental income (or interest if loaning to other investors).
Can Your Client Self Direct Their Funds?

Transfer/Rollover

- I have a 401(k) or 403(b) account with a former employer.
  - Yes, you can rollover to a self-directed IRA or SD 401k.

- I have a Traditional IRA with a bank or brokerage.
  - Yes, you can transfer to a self-directed IRA or SD 401k.

- I have a Roth IRA with a bank or brokerage.
  - Yes, you can transfer to a self-directed Roth IRA.

- I inherited an IRA and keep the account with a brokerage or bank as an inherited IRA.
  - Yes, you can transfer to a self-directed inherited IRA.
Rolling Over Existing Retirement Plan Funds
Can Your Client Self Direct Their Funds?

Transfer/Rollover

- I have a 401(k) or 403(b) account with a current employer and am over 59 1/2.
  - Yes, you can rollover to a self-directed IRA or SD 401k.

- I have a 401(k) or 403(b) account with a current employer and am under 59 ½.
  - Probably not, usually while employed and below retirement age (59 ½) you cannot transfer or roll over your retirement plan funds.
Who is the party on the contract?

ABC Trust Co. FBO Mat Sorensen IRA or Mat Sorensen?

- When contracting with an IRA that will buy real estate, the IRA is the client, buyer, and party to the contract. Not the IRA owner.

- Contract would read in the IRA’s name, ABC Trust Co. FBO Mat Sorensen IRA. Mat Sorensen would sign only to approve the document but then Mat’s IRA custodian would sign and actually bind on the contract.
What Type of Real Estate Can a Self-Directed IRA Own?

- **Rentals**
  - Single family, multi-family, commercial, retail.

- **Partnerships, Syndications, Private Offerings**
  - Larger real estate deals with other operators.
  - Can combine family/friends retirement accounts into a larger property.

- **Any property type or investment; land, rental, leases, tax liens, flips, re-habs, single family, multi, retail, commercial, water rights, etc.**

- **CANNOT** buy personal residence or property you or certain family personally use with IRA/retirement plan.
ADVISING A BUYER PURCHASING REAL ESTATE WITH AN IRA

Key Points

- Need a self directed IRA established.
- IRA is buyer, not IRA owner.
- IRA custodian signs contract, IRA owner only approves.
- IRA custodian sends earnest money to escrow/title.
- IRA custodian signs closing docs, IRA owner approves.
- IRA custodian send final funds to close.
- IRA is the vested owner on deed/title (e.g. ABC Trust Co. FBO Mat Sorensen IRA).
- All income and expense go through IRA custodian account.
Example: Purchase a rental property for $150,000 in a traditional IRA.
ADVISING A BUYER PURCHASING REAL ESTATE WITH AN IRA

- **STEP ONE:**
  - Establish an IRA with a self directed IRA custodian
    - Roth
    - Traditional
    - SEP
    - SIMPLE
  - Rollover or transfer existing accounts
ADVISING A BUYER PURCHASING REAL ESTATE WITH AN IRA

- **STEP TWO:**
  - Prepare a real estate purchase contract for the property, listing the IRA as the buyer/purchaser.
  - Example: Purchase agreement should be ABC Trust Company FBO Mat Sorensen IRA
ADVISING A BUYER PURCHASING REAL ESTATE WITH AN IRA

- **STEP THREE:**
  - Instruct custodian to complete the real estate purchase contract (sign). Contract must be prepared correctly
  - Custodian to wire funds as earnest money
  - Custodian **must** have written instructions from the IRA owner
    - Buy direction letter
    - Direction of investment
ADVISING A BUYER PURCHASING REAL ESTATE WITH AN IRA

□ STEP FOUR:

- IRA Custodian executes the real estate purchase contract
- Signs Contract
  - Example: ABC Trust Company FBO Mat Sorensen IRA
- Custodian sends funds to title/escrow company for earnest money deposit

The SDRP owner should NOT use personal funds to make the earnest money deposit.
STEP FIVE:

- Ensure closing documents are prepared in name of the IRA
- Deed vests title in the IRA’s name
- IRA owner issues buy direction letter to execute closing documents and send funds for the balance to the title/escrow company
ADVISING A BUYER PURCHASING REAL ESTATE WITH AN IRA

□ STEP SIX:
- IRA owner leases property
- Hires property manager
- Executes property management agreement between IRA and property management company
- Executes lease
ADVISING A BUYER PURCHASING REAL ESTATE WITH AN IRA

- **STEP SEVEN:**
  - Rental income/gains from sale of property paid directly to IRA custodian for the IRA
  - All expenses paid by the custodian

The IRA owner should *not* personally receive any income, *nor* should he or she pay for any expenses out of pocket related to the investment property.
How Does a Self Directed IRA Invest?

- Need a custodian (bank, credit union, trust company) for the IRA.

- Common investments are real estate, private companies, LLCs, and precious metals.
PURCHASING REAL ESTATE WITH AN IRA

SDRP buys real estate directly. Contract to buy and title are in the name of the SDRP (e.g. ABC Trust Co FBO Mat Sorensen IRA, or ABC Investments 401k Plan, FBO Mat Sorensen) and not the SDRP owner (Mat Sorensen). Expenses to property paid by SDRP. Income from property (rent, gain on sale) go to SDRP.

- SDRP owns property and receives income and pays expenses.
- SDRP Owner and disqualified persons cannot physically work on the property.
- In this structure you either direct everything through your custodian (e.g. pay bills, utilities, etc.) and they receive rental income directly for your IRA. Or, the second option is to hire a property manager who handles the income and expense and returns rental income to the IRA.
- We prefer the IRA/LLC or 401k/LLC for real estate investors for administrative convenience and asset protection reasons.
UNDERSTANDING SDRP: EXAMPLE 1, RENTAL

SDRP BUYS PROPERTY FOR $150,000

MONTHLY NET RENTAL INCOME: $1,200

ANNUAL CASH-FLOW = $14,400

ANNUAL RETURN ON INVESTMENT (JUST RENTAL INCOME): 10.5%

PLUS: APPRECIATION OF THE PROPERTY. ALSO, NO CAPITAL GAIN TAX WHEN SELL FOR GAIN.

PLUS: RENTS GO UP OVER TIME.

TAXES: ZERO ON RENT OR GAINS FROM SALE (DEFERRED UNTIL DISTRIBUTION/RETIREMENT TRADITIONAL, TAX-FREE ROTH).
SDRP AS LENDER

A self-directed retirement plan can lend money to another investor (cannot be disqualified person) and that investor pays back the SDRP (IRA or 401k) under the Promissory Note terms. The loan can be secured or un-secured.

- SDRP is the lender on the promissory note. Other investor is the borrower.
- The promissory note can have monthly payments or can be a lump-sum note.
- The SDRP can receive points and interest as the lender.
- The SDRP can also receive a share of the equity (watch out for UBIT tax) on the appreciation of the property.
UNDERSTANDING SDRP: EXAMPLE 2, IRA LOAN ON REAL ESTATE (LENDER)

SDPR Loans Other Real Estate Investor $250,000, 1\textsuperscript{st} position DOT
Investor is going to acquire, fix and then flip the property

Loan Term is 6 months

Annual Interest Rate: 12\% ($15,000)

Points: 2\% ($5,000)

SDRP Income = $20,000 (in 6 months)

Annual Rate of Return: 16\%

Taxes: ZERO on interest and points (deferred until distribution/retirement traditional, tax-free roth).
IRA OWNS REAL ESTATE With Non-Recourse Loan

- You can use a loan to buy real estate with an IRA. IRA makes down payment, loan funds balance.
- MUST COMPLY WITH TWO THINGS.
  1. Loan must be non-recourse. IRA owner or disqualified person cannot use credit or make personal guaranty.
  2. UDFI Tax. Tax on profits from debt.
LENDING LAWS AND TAX RULE RESTRICTION ON MORTGAGES FOR SELF DIRECTED IRA BUYERS

- NON-REOCOURSE LOAN – Lender loans on property. In the event of default, only remedy is to foreclose on property. Cannot go after borrower (e.g. IRA or IRA owner).
  - Usually requires 30-40% down
  - Only lend on income producing properties (rentals).
  - Need to find specialty lenders
    - Myiralender.com (North American Savings Bank)
    - Iralending.com (First Western Federal Savings Bank)
    - www.efirstbank.com, go to retirement based real estate (First Bank)
3 methods to manage the property owned by SDIRA.

1. **Manage directly through the IRA.** Money goes to the IRA custodian, and expenses are paid by the custodian at the direction of the IRA owner. Hassle.

2. **IRA/LLC.** Under the IRA/LLC, the IRA owner is the manager of the IRA/LLC and receives income and pays expenses from an IRA/LLC checking account. The IRA/LLC structure is very common in IRA-owned real estate investments. More on this later.

3. **Property Manager.** The IRA hires a property manager who manages the property and receives the income and pays property expenses. Cash flow is returned to the IRA.
CHECKLIST FOR SELF DIRECTED IRA
OWNERSHIP OF REAL ESTATE

☐ Is the contract and deed/title in the SDRP’s name (e.g., ABC Trust Company FBO Mat Sorensen IRA)?

☐ Did the IRA custodian sign the contract and legal agreements for the SDIRA, or, where applicable, did the manager of the IRA/LLC sign them?

☐ Did the SDRP owner refrain from using personal expenses in purchasing and maintaining the property?
CHECKLIST FOR SELF DIRECTED IRA
OWNERSHIP OF REAL ESTATE

☐ If the SDIRA obtained a loan to purchase the property, was the loan nonrecourse, and is the SDIRA owner aware of UDFI taxes (for IRA) on any net profits from the debt?

☐ Is the SDIRA custodian, a property manager, or a properly established IRA/LLC receiving the rental income and paying the expenses for the property?

☐ Does the SDIRA have sufficient capital available to cover an unexpected property expense (10%)?
CHECKLIST FOR SELF DIRECTED IRA
OWNERSHIP OF REAL ESTATE

☐ Is the SDIRA owner holding the property for investment, and are the SDIRA owners and other disqualified persons avoiding personal use or benefit from the property?

☐ Was the broker or agent in the transaction a non-disqualified person? Did the SDIRA owner refrain from personally benefitting from the SDIRA’s purchase?
PROPERLY COMPLETING THE REAL ESTATE PURCHASE CONTRACT

- **DO**
  - List IRA as buyer/seller
  - Have IRA pay earnest money/final funds
  - Have IRA custodian sign for IRA.
  - Instruct title escrow to vest ownership/title and to carry file in name of IRA (not IRA owner).

- **DON’T**
  - Allow IRA owner to use personal funds.
  - Assign contract from IRA owner (or their company) to their IRA. IRA needs to start and finish.
  - Allow IRA owner to use personal credit or to personally guarantee debt.
WHAT CAN’T AN IRA INVEST INTO?
WHO CAN’T AN IRA TRANSACT WITH?

- **IRA and Restrictions on Retirement Plan Investments.**
  - Collectibles such as art, stamps, certain coins, alcoholic beverages, or antiques, IRC § 408(m);
  - Life insurance, IRC § 408(a)(3);
  - S-corporation stock, IRS Letter Ruling 199929029, April 27, 1999, IRC § 1361 (b)(1)(B); and

- **IRA Cannot Transact with a Disqualified Person – Prohibited Transaction.**
  - Any investment that constitutes a prohibited transaction pursuant to IRC § 4975 (e.g., purchase of any investment from a disqualified person such as the spouse of the retirement account owner).
What is a Prohibited Transaction?

KEY POINTS

- The prohibited transaction rules restrict with WHO your SDIRA may transact. They do not restrict what investments an SDIRA may own.

- An SDIRA cannot transact (e.g. buy/sell) with the SDIRA owner and certain family members of the SDIRA owner.

- There are three types of prohibited transactions: 1) per se prohibited transactions, 2) extension of credit prohibited transactions, and 3) self dealing prohibited transactions.
PROHIBITED TRANSACTION RULES

IRC 4975 – OUTLINES THREE DIFFERENT CATEGORIES OF PROHIBITED TRANSACTIONS.

1. PER SE PROHIBITED TRANSACTION. OCCURS WHEN AN IRA ENGAGES IN A TRANSACTION WITH A DISQUALIFIED PERSON.

2. EXTENSION OF CREDIT PROHIBITED TRANSACTION. OCCURS WHEN THERE IS AN EXTENSION OF CREDIT BETWEEN AN IRA AND A DISQUALIFIED PERSON.

3. SELF DEALING PROHIBITED TRANSACTION. OCCURS WHEN A DISQUALIFIED PERSON (E.G., IRA OWNER) PERSONALLY BENEFITS FROM THE IRAS INVESTMENTS.

CONSEQUENCE OF PT IS DISQUALIFICATION OF IRA. BOTTOM LINE, AVOID PROHIBITED TRANSACTIONS.
PER SE PROHIBITED TRANSACTIONS

A PER SE PROHIBITED TRANSACTION OCCURS WHEN AN IRA ENGAGES IN A “TRANSACTION” WITH A “DISQUALIFIED PERSON”. IRC § 4975 (C)

WHAT IS A TRANSACTION? “TRANSACTION” INCLUDES A PURCHASE, SALE, LEASE, EXCHANGE, LOAN, EXTENSION OF CREDIT, SERVICES, GOODS, ETC.

WHO IS A DISQUALIFIED PERSON? “DISQUALIFIED PERSON” INCLUDES IRA OWNER (AS FIDUCIARY), SPOUSE, CHILDREN, AND PARENTS. ALSO, PARTNERS AND COMPANIES YOU OR OTHER DISQUALIFIED PERSONS OWN 50% OR MORE OF. SEE FOLLOWING LIST.
DISQUALIFIED PERSONS

Your SDRP may NOT engage in a transaction with these persons. IRC § 4975 (e)(2)

- Fiduciary to IRA
- SDRP Owner
- Spouse
- Children
- Spouses of Children
- Grandchildren and their spouses
- Parents and grandparents
- Companies (corps, LLCs, LPS, partnerships, trusts) where you or family above own or control 50% or more
- Certain Officers, Directors, or Highly Compensated Employees of companies where the IRA owner owns or controls 50% or more
- 10% or more partners or joint venturers
A REAL ESTATE SALES PERSON/BROKER IS A FIDUCIARY AND DISQUALIFIED PERSON

- **FIDUCIARY** – IRC 4975 (e)(3) says a fiduciary is someone who renders investment advice for a fee. So, if you assist investors in finding properties to invest their IRA into you are a fiduciary. If IRA owners select properties themselves then broker/salesperson is not a fiduciary.
  - Fiduciary = disqualified person.
  - Disqualified person who is fiduciary can receive “compensation” for services rendered. IRC (d)(17)
Personal Extension of Credit

KEY POINTS

- An SDIRA may use debt to leverage its investments but the debt cannot be secured, guaranteed, or extended from the personal assets of the SDIRA owner as that results in an extension of credit prohibited transaction.

- If an SDIRA is obtaining debt, it should get a nonrecourse loan in the SDRP’s name (or IRA/LLC’s OR 401K/LLCs name, as applicable).
EXTENSION OF CREDIT PROHIBITED TRANSACTIONS

IRC § 4975 (C)(1)(B) SPECIFICALLY STATES THAT A PROHIBITED TRANSACTION OCCURS WHEN THERE IS A “LENDING OF MONEY OR OTHER EXTENSION OF CREDIT BETWEEN A PLAN [IRA] AND A DISQUALIFIED PERSON.”

RULES FOR OBTAINING A LOAN WITH YOUR IRA


2. UDFI TAX DUE ON NET INCOME FROM DEBT. PROFITS ATTRIBUTABLE TO RETIREMENT PLAN CASH OR OTHER NON-DEBT INVESTMENT IS NOT SUBJECT TO UDFI TAX. (MORE LATER ON THIS). APPLIES TO IRAS, 401KS EXEMPT FROM UDFI TAX.
Self Dealing Prohibited Transactions

KEY POINTS

- Self dealing prohibited transactions occur when a disqualified person (e.g., SDRP owner) benefits from an SDRP’s investment.

- Self dealing prohibited transactions can arise when an SDRP invests into a company where the SDRP owner or other disqualified persons are owners or part of management.

*Also called conflict of interest prohibited transaction*
SELF DEALING PROHIBITED TRANSACTIONS

A SELF DEALING PROHIBITED TRANSACTION OCCURS WHEN THE IRA OWNER OR OTHER DISQUALIFIED PERSON BENEFITS FROM THE IRA’S INVESTMENTS. IRC § 4975 (C)(1)(D),(E), AND (F).

RULE IN PRACTICE

1. NO PERSONAL COMPENSATION OR COMMISSIONS PAID TO A DISQUALIFIED PERSON AS A RESULT OF AN IRA’S INVESTMENT. POSSIBLE REASONABLE COMPENSATION EXCEPTION (CONSULT LEGAL COUNSEL).

2. YOU CANNOT HAVE USE OF THE IRA ASSETS. FOR EXAMPLE, VACATION RENTAL OWNED BY YOUR IRA CANNOT BE PERSONALLY USED BY DISQUALIFIED PERSONS.

3. BOTTOM LINE, DON’T USE IRA ASSETS. USE OF IRA ASSETS WITHOUT PAYMENT RESULTS IN A BENEFIT TO A DISQUALIFIED PERSONAL AND IS A SELF DEALING PROHIBITED TRANSACTION WHILE USE AND PAYMENT BY A DISQUALIFIED PERSON IS A TRANSACTION WITH A DISQUALIFIED PERSON AND IS A PER SE PROHIBITED TRANSACTION.
The Consequences of a PT

- If an IRA owner engages his or her IRA into a prohibited transaction, then the consequence is disqualification of the IRA and distribution of the entire account. The IRA owner is subject to all consequences of distribution, including possible taxes and penalties.
Using an IRA/LLC
IRA/LLC STRUCTURE

Rather than a self-directed IRA taking ownership and buying an asset directly through your Administrator/Custodian, the self-directed IRA purchases the ownership in the LLC and the LLC takes ownership of the asset. In many instances, the IRA Owner manages the LLC (subject to legal restrictions).

- IRA invests $ into LLC Bank Account
- IRA Owner, Manager of LLC, No comp (Ellis v. Commissioner, case)
- LLC acquires investment (e.g., property)
- Single member LLC/disregarded entity, no LLC tax return.
Advantages of the IRA/LLC
Why Do Most SDIRA Real Estate Buyers Use It?

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<tr>
<th>ADVANTAGES OF THE IRA/LLC</th>
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<tr>
<td>Protect the IRA owner, the IRA, and the IRA custodian from liability that arises from the self directed IRA investments.</td>
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<tr>
<td>Allow the IRA owner to more easily manage his or her IRA’s investments by being able to accomplish investments as manager of the LLC (e.g., can sign contracts and checks, and receive income and pay expenses).</td>
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The IRA/LLC Structure

- The IRA/LLC must be a newly created LLC that is clearly owned by the IRA. The IRA owner cannot use an existing LLC they personally own.

- The IRA/LLC documents must be tailored to the IRA as an owner and must take into account the numerous IRA ownership issues.

- IRA/LLCs are subject to the prohibited transaction rules. An IRA/LLC should not be used as a method of circumventing the prohibited transaction rules.
DISQUALIFIED PERSON AS MANAGER

The IRA owner/member may serve as the Manager of the IRA/LLC but is limited in what he/she can do.

You **CAN** do the following as Manager of the IRA/LLC:

- Perform all administrative and investment oversight tasks.
- Receive income in LLC checking account and sign checks.
- Sign contracts for investments, documents at closing, visit and evaluate property/investments, and hire contractors or professionals.

You **CANNOT** do the following as Manager of the IRA/LLC:

- Pay yourself or a disqualified person compensation, *Ellis v. Commissioner*.
- Personally benefit from the LLC's investments.
- Co-Mingle Personal Funds with IRA funds in LLC bank account.
- Unfairly shift income to yourself or to a disqualified person.
The Multi-Member IRA/LLC Structure

**KEY POINTS**

- An IRA/LLC can be owned by multiple IRAs or a combination of IRAs and individuals, but careful attention must be paid towards the set-up and funding of the IRA/LLC.

- A federal partnership tax return must be filed annually by the multi-member IRA/LLC.
MULTI-MEMBER IRA/LLC

- **Benefit**
  - Combine cash from multiple accounts.

- **Requirements**
  - Ownership set once fixed (if DQP)
  - Annual Tax Return (form 1065).
IRA/LLC MULTI MEMBER STRUCTURE

- An IRA or IRAs can be owners/members of an IRA/LLC with individuals. Careful planning must be undertaken if individuals are disqualified persons to IRA(s).
- IRA ownership is divided between IRA(s) based on amount of money invested. For a 3rd party service partner (e.g., doing rehab on a property) who is not investing cash their ownership percentage share is negotiable and must have economic effect.
- Since there is now more than one owner/member, a federal partnership tax return is due.
# UBIT & UDFI Tax For IRAs

**KEY POINTS**

- UBIT tax typically applies when an SDRP receives ordinary income, as opposed to passive income, from its investments.

- Passive investments like rental income, interest income, dividend income, capital gain income, and royalty income are exempt and are never subject to UBIT.

- UDFI tax applies to IRAs when it leverages its investment(s) with debt. 401ks are exempt.

- If UBIT or UDFI tax is due the IRA owner must file a 990-T tax return for the IRA to the IRS. The IRA is responsible for the tax.
Unrelated Business Income Tax (“UBIT”) applies to ordinary income received by an SDRP. IRC § 511

COMMON SDRP REAL ESTATE SITUATIONS
WHERE AN SDRP IS SUBJECT TO UBIT TAX

Real Estate Development, Construction, or Significant Short Term Property Flipping

UBIT tax is due from real estate activities that are not passive in nature. Rental income and capital gain income from the sale of real estate are exempt from UBIT, but there is a special caveat to the capital gain exemption on the sale of real estate which does not allow it to apply when the real property was acquired with intent to immediately sell.
EXEMPTIONS TO UBIT TAX FOR REAL ESTATE

Interest Income 512(b)(1)
Interest income, such as interest payments on loans made from the self-directed IRA are exempt from UBIT tax.

Rental Income 512(b)(3)
Rental income derived from real property is exempt from UBIT tax. Personal property that is leased in connection with real property is also exempt. Equipment leasing or other personal property leasing can be subject to UBIT tax unless the income can be considered interest income when the leasing is structured as a financing agreement.

Capital Gains 512(b)(5)
Capital gains from the sale, exchange, or other disposition of property, except for “property held primarily for sale to customers in the ordinary course of the trade or business.” Limitation on real property held immediately for sale with no investment holding intent.

Dividend Income 512(b)(1)
Dividends from a c-corporation.
UBIT & UDFI Tax For IRAs

- UBIT max rate is 39.6% for income over $12,150
- UDFI is also taxed at 39.6% on income, get lower long term capital gains rate on sale of property held a year or longer.
# UBIT & UDFI Tax For IRAs

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<thead>
<tr>
<th>Annual Income</th>
<th>UBIT Tax Rate</th>
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<tr>
<td>$0–$2,500</td>
<td>15%</td>
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<tr>
<td>$2,500–$5,800</td>
<td>$375 plus 25%</td>
</tr>
<tr>
<td>$5,800–$8,900</td>
<td>$1,200 plus 28%</td>
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<tr>
<td>$8,900–$12,150</td>
<td>$2,068 plus 33%</td>
</tr>
<tr>
<td>Over $12,150</td>
<td>$3,141 plus 39.6%</td>
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Example – IRA buys property and develops and sells for $100,000 profit. Profit would be taxed as follows.
- $3,141 + $34,798 = $37,939

Alternatives
- Hold for investment (rent)
- Lend funds to other investor and be lender/bank.
Unrelated debt financed income ("UDFI") tax applies to the gains received by an IRA that are attributable to debt. IRC § 514. UDFI tax is applied to income from “debt financed property” that is subject to “acquisition indebtedness.”

**CALCULATING & REPORTING UDFI TAX**

To calculate UDFI tax, you need to know the following three numbers:

1. The income from the property for the year.
2. The average acquisition indebtedness for the year.
3. The adjusted basis for the year (e.g., the cost of the property minus any depreciation).
Calculating UDFI Tax

- To calculate UDFI tax, you need to know the following three numbers:
  - The income from the property for the year.
  - The average acquisition indebtedness for the year.
  - The adjusted basis for the year (e.g., the cost of the property minus any depreciation).
UDFI Tax Example

- For example, let’s consider a property
  - Bought $100,000
  - $40,000 from IRA
  - $60,000 from loan
  - Gain of $10,000 from sale 1 year later.
  - Tax applied to $6K of $10K gain (60% debt).
  - UDFI Tax Reported on IRS Form 990-T. IRA files and pays.
PRIVATE PLACEMENT OFFERING INTO REAL ESTATE INVESTMENT

- If an IRA invests into an LLC or LP as an equity investor then the IRA owner should know the following.
  - Is the offering company incurring debt (UDFI Tax for IRA).

- If the IRA investment is in debt, note, debenture, warrant, as long as the income is interest, then UBIT/UDIF tax do not apply.

- UDFI Tax
  - IRA ends up paying taxes on portion of profits attributable to debt.
  - Blocker corporation.
SELF DIRECTED Solo 401K

- For business owners and self employed persons (e.g. real estate professionals).
- Can contribute up to $53K a year.
- Can invest into real estate
- No UDFI Tax on leveraged real estate.
- No custodian required, account owner can self-trustee and administer.
- Requires pre-approved plan document.
Self Directed Solo 401(k)

IRA/401k Accounts

Rollover

XYZ, Inc. (Client's Co.)

Contributions

Compensation

Client/Business Owner

Self-Directed Solo 401k

Administered by the Client/Business Owner

Invest

XYZ, Inc.
Business & Retirement Services
401(k) Profit Sharing Plans

- Qualified Plan – documents & administration
- Employee - Roth or pre-tax deferrals
  - $18,000 annual limit
  - $ 6,000 annual catch up age 50 and over
- Employer – all tax deductible contributions
  - Matching, safe harbor, profit sharing
- Maximum annual: $53,000 + $6,000 catchup
- Must be self-employed
SEC Notice 5866, Self Directed IRAs and the Risk of Fraud.

**DUE DILLIGENCE TOP TEN LIST**

- Before you invest your self directed IRA into a “non-traditional” private business or into a real estate investment, you need to ask some hard questions to the person or business receiving your money. Here are some tips to minimize investment risks with your self directed IRA.
- If you don’t understand how the business or investment makes the returns being promised, then don’t invest.
- If you aren’t given adequate documents outlining what has been explained to you verbally or what has been put into a presentation, then don’t invest.
- If you’re told that you can get a commission for bringing others to invest into the same company and if you don’t have a license to receive such commissions, then don’t invest. If the investment sponsors are willing to violate the law to pay an non-licensed person to raise money from others, then what’s stopping them from misappropriating your IRA investment? It is only the law preventing them, which they’ve proved they will disregard.
- If your self directed IRA is loaning money for a real estate venture, then demand a recorded deed of trust or mortgage on title to the property, protecting your investment. Also, make sure that you get a copy of the title report or commitment showing what position your loan is being placed into when the deed of trust or mortgage is recorded. Many savvy investors (and what all banks do) create lending instructions to the title company or attorney closing the real estate transaction that instruct the closing agent to only use the funds being loaned when the borrower signs the note/loan documents, when the closing agent verifies the priority of the deed of trust or mortgage you are getting (1st position, 2nd, etc.), and when all other defects to title have been cleared.
Due Diligence for SDRP Investments

- If you’re investing into a PPM, a private offering, or a crowdfunding offering, you should receive numerous documents outlining the investment, the use of funds, the background of those managing the company, and also documents regarding your rights as an investor (e.g., offering memorandum and LLC operating agreement or LP limited partnership agreement). Also, check to see if the PPM or private offering was properly filed with the SEC by going to SEC.gov and checking the company name in the SEC database. If no filing record exists for the PPM or private offering with the SEC, then the person raising the funds has possibly disregarded the law. As stated earlier, if someone is willing to disregard the law to get your money, what is stopping them from disregarding the law to not pay you back (it’s just the law)?

- Investigate the background of the person(s) with whom you are entrusting your money. When you are investing with others, you need to think like the bank and do what the bank does. What is this person’s credit worthiness? What is their employment or prior business experience? What is their business or investment plan? What are the terms of the investment? Is there a realistic rate of return that fairly recognizes the risk being taken?

- If you’re pressured that this opportunity will pass if your self directed IRA doesn’t invest now, then let the opportunity pass. Most scams use this technique, and most legitimate investments never have this funding crisis.
Due Diligence for SDRP Investments

- Make sure a lawyer representing your interests reviews the documents. If a lawyer drafted the documents, it is still important to have a lawyer look at the documents as they relate to your interests and with an eye towards protecting your self-directed IRA. Sometimes, unfortunately, the devil is in the details, and many investments have clauses that can significantly impact your ability to get your money back or that give the company raising the money the ability to pay whatever compensation to themselves that they desire. These are obvious problems that will eat into the bottom line of the profits you may be expecting.

- Seek the opinion of another investor, business owner, or friend whose opinion you trust. Sometimes, when you explain the investment to someone else, he or she can help you find issues to consider and questions you should be asking.

- Be comfortable saying no and only invest what you are willing to lose. Non-traditional investments have made many millionaires over the years, but they have also caused lots of financial ruin. Just keep the risk in perspective and don’t “bet the farm” in one deal.
MISCELLANEOUS SDIRA SERVICES

- Selling SDIRA Property.
  - Remember, SDIRA is client, contract with SDIRA for property it owns (e.g. listing agreement).
  - Title/Escrow – Proceeds from sale go to SDIRA (or IRA/LLC, if they have one).

- Annual Valuations – Required for SDIRAs owning real estate
  - Realtors can offer CMAs or BPOs to help clients satisfy this.

- Property Management Services.
  - Because of the Prohibited Transaction rules (and because SDIRA investors often buy outside of their location), SDIRA investors often will use property managers for rentals owned by their SDIRA or IRA/LLC.
Questions

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Free E-Book

Text “sdira” to 435-245-1144 for my free e-book on Self Directed IRAs and Real Estate Investments

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LEGALLY RAISING CAPITAL FOR REAL ESTATE DEALS

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RAISING MONEY

- What is available?
  - Traditional banks
  - Seller financing
  - Hard money
  - Family
  - No money down strategies
  - What else????????
  - Why is it critical to follow the rules?
Securities Compliance

- If you have a security, it needs to be registered appropriately with the Securities and Exchange Commission and the state Divisions of Securities. This is costly.

Alternatives
- Lender
- Partnership
- Investor (PPM, Reg D)
Securities Compliance

- Why do you want to avoid securities laws?
IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

SECURITIES AND EXCHANGE
COMMISSION,

Plaintiff,

v.

PINNACLE DEVELOPMENT
PARTNERS LLC and GENE A.
O’NEAL,

Defendants.

Civil Action No. 06 CV 2431

COMPLAINT FOR EMERGENCY INJUNCTIVE AND OTHER RELIEF

Plaintiff, Securities and Exchange Commission ("Commission"), alleges that:

OVERVIEW

1. From October 2005 through the present, Pinnacle Development Partners LLC ("Pinnacle") and Gene A. O’Neal ("O’Neal") have been selling fraudulently unregistered securities in the form of nominal general partnerships which invest in real estate development. Pinnacle sold some investors notes in lieu
Case Example

Don’t be like Pinnacle Development Partners!

What Pinnacle did:
- Advertised in Newsweek, major newspapers
- Company advertised general partnership investments on foreclosed properties
- Promised 25% return in 45 days
Don’t be like Pinnacle Development Partners!

What Pinnacle did:

- $30 million was invested by individuals and by self-directed retirement plans
- Pinnacle had the sole right and authority to manage and carry out investments (Investors simply gave funds and had no voting rights)
Lender – Partner - Investor

Most investment structures where someone invests money fall into one of three categories.

**Lender**- Money is invested as debt against the property and is secured against the property. Lender is paid interest. In order to be in compliance with securities laws must have loan fully secured by a first position deed of trust.

**Partner**- Money is invested and cash partner receives a portion of equity in the property (share of profits/losses). Is treated like a partner and has voting rights and involvement in decisions. Must be in small groups.

**Investor**- Money is invested and cash investor’s money is pooled with other investors. Cash investor has no voting rights and another person or company manages the investment.
Lender

Money is invested as debt against the property and is secured against the property. Lender is paid interest. In order to be in compliance with securities laws must have loan fully secured by a first position deed of trust.

Securities Issues: To avoid a promissory note investment becoming a security the loan must be fully secured and in a first lien position against the real property.

What About Multiple Lenders On the Same Property?

What documents should be used for this investment?

What About Solicitation Rules?
Partner - Money is invested and cash partner receives a portion of equity in the property (share of profits/losses). Is treated like a partner and has voting rights and involvement in decisions. Must be in small groups.

Securities Issues: To avoid a partnership from becoming a security the cash partner must have voting rights and must be involved in decisions regarding the property.

How many partners can be in an LLC or partnership?

What documents should be used to structure this investment?
Investor - Money is invested and cash investor’s money is pooled with other investors. Cash investor has no voting rights and another person or company manages the investment.

Securities Issues: Most investor structures are completed in investments known as Rule 506 Offerings. These are also commonly referred to as Private Placement Memorandums (PPMs).

Unlimited Amount of Funds Can Be Raised

Typically Must Seek Accredited Investors- $1M Net Worth or $200K/$300K annual income.

What documents should be used to structure this investment?
Rule 506(b) PPM Offerings

Raise an unlimited amount of funds

May have total management control of investment

Must have at least annual accounting

Up to 35 unaccredited investors, no certification required beyond investor attesting to being accredited.

CANNOT MAKE A PUBLIC SOLICITATION
New Rule 506 (c) Offerings-

Formerly known as PPM’s or Private Offerings- Under the JOBS Act, Regulation D is to be amended to allow investment sponsors to raise money and to make public solicitations for said money so long as they only accept funds from accredited investors.

SEC Anticipates Significant Increases in Investment Activity and Potential Abuses for Fraud Under Regulation D- Red flags for fraud.

SEC Proposed Rule Change Summary and Rule 506(c) Offering:

- Rule 506 (c) removes ban on general solicitations and advertising so long as all purchasers are accredited investors. (e.g. $1m net worth, $200k/$300k annual income).
- May raise an unlimited amount of funds.
- Requires issuers to take reasonable steps to verify that purchasers are accredited investors, using methods determined by the SEC.
Rule 506(b) and 506(c) Compared

- **Rule 506(b)**
  - Up to 35 Unaccredited.
  - Accredited just self-attest.

- **CONS**
  - Cannot Solicit.

- **Rule 506(c)**
  - Can market to anyone.
  - Accredited investors only and must verify.

- **CONS**
  - No unaccredited investors.
Crowd-funding & Real Estate

Exemption to Securities Laws and Restrictions - Concept is to waive the securities law provisions and allow large groups of people to invest limited amounts of money into new businesses or investments.

A company can raise up to $1M

Basics of Crowdfunding
Investment amount based on income of investor, range is $2K to $100K based on income.
Must receive offering summary similar to PPM.
Transaction must be coordinated through a “Crowdfunding Portal”

Compliance Issues for IRA Custodians/Administrators

- Is the Crowdfunding Portal Approved by the SEC?
- Has the investment sponsor provided a offering summary that is in compliance with the law?
Distinguishing Crowdfunding

- **Title III Crowdfunding**
  - $1M total, small investors, must use portal.
  - Accredited an unaccredited.

- **Rule 506(c) Crowdfunding**
  - [www.realcrowd.com](http://www.realcrowd.com), [www.reatlymogul.com](http://www.reatlymogul.com).
  - Unlimited Amount, accredited only.
TAX AND LEGAL STRATEGIES EVERY REAL ESTATE PROFESSIONAL SHOULD KNOW

By: Mat Sorensen
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Business Organizational Plan

**OPERATIONS**

- **NEWCO, INC** (State ?) (taxed as S-Corp)
  - Ordinary Income Business Operations
  - Salary
  - 100% Savings for SE Tax and Ordinary Income

- **NEWCO, INC** (Arizona)
  - Sole Proprietorship
  - Future Self-Directed LLC
  - IRA
  - 100% Passive Losses

- **XYZ Living Trust**

**ASSETS/HOLDINGS**

- Arizona Rentals
- Personal Home
- Life Insurance Policies
- Investment Accounts
- NEWCO, LLC (Arizona) (Limited Liability Company)
  - 100%
"S" Corporation

XYZ Enterprises, Inc.

S-Corporation

Sales & Operations

Salary and FICA Tax

100%

1120S Tax Return – NO Corp Tax or SE Tax

Net Income/loss

Personal Tax
Choosing the Right Entity

Sole Prop

- Sales & Operations
- Rentals

Small Business
Sole-Proprietorship

NO ENTITY

100%

Ordinary Income
Schedule C

Passive Income
Schedule E
S-Corporation (if needed)

- Save on SE Tax
- Less chance of an audit
- Create the W-2 for borrowing
- Start building corporate credit
- Open the door for a solo 401k
Payroll planning

Kohler Payroll Matrix

1/3 to 2/3

33% (33k)

20% (96k)

Net-Income

Payroll as a percentage Of Net-Income

Mark J. Kohler, JD, CPA, PC

© 2020

100k $$

400k
Choosing the Right Entity

- **S-Corporation** – Short Term Real Estate Investors & Commission Inc.

<table>
<thead>
<tr>
<th>Sole-Proprietorship</th>
<th>Limited Liability Company</th>
</tr>
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<tbody>
<tr>
<td>$150k income</td>
<td></td>
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<tr>
<td></td>
<td>$60k Expenses</td>
</tr>
<tr>
<td>$90k Net Income</td>
<td></td>
</tr>
<tr>
<td>Self Employment Tax 15.3%</td>
<td>$13,500 (approx)</td>
</tr>
<tr>
<td>Before regular income tax and itemized deductions</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>S-Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>150k Revenue</td>
</tr>
<tr>
<td>$4,500 Employment taxes</td>
</tr>
<tr>
<td>$55,500 Dividend Income</td>
</tr>
<tr>
<td>No Self Employment tax on the Dividend</td>
</tr>
<tr>
<td>$8,500 SAVINGS!! (approx)</td>
</tr>
<tr>
<td>Before regular income tax and itemized deductions</td>
</tr>
</tbody>
</table>
Choosing the Right Entity

- Limited Liability Company (LLC)
  - Long Term Investor
  - Rentals

Notes:

Protects the business owner from the businesses liabilities. Primary benefit is asset protection.
Multiple Rental Properties

Limited Liability Co. (Colorado)
Limited Liability Co. (Arizona)
Limited Liability Co. (Illinois)
Series LLC Co. (Illinois)
"Series LLC" Limited Liability Company

XYZ Holdings, LLC

XYZ Holdings, LLC
Sub Series #1
Rentals #1

XYZ Holdings, LLC
Sub Series #2
Rentals #2

XYZ Holdings, LLC
Sub Series #3
Rentals #3
Series LLC States

- Delaware
- Texas
- Illinois
- Nevada
- Oklahoma
- Utah
- Wisconsin (mod)
- Missouri
- Tennessee
- Iowa
- Montana
- Alabama
- North Dakota
- Kansas
- Puerto Rico
- DC
Choosing the Right Entity

- **Limited Partnership**
  - Must have General Partner
  - Outside liability protection

- Second Home
- Farm land
- Raw Land

- Owners or their Trust as Limited Partners

- Firewall From “Inside” and “Outside” Liability
- Investment Accts.

- Limited Partnership
- Charging Order
- Limited Partners
- Charging Order

- Owners or their Trust as Limited Partners
Tax Strategies

- Tax Deferred Growth
- Long-Term Capital Gain
- Passive Loss Carry Forward Bucket
- Real Estate Professional Classification
- 1031 Exchange
- Installment Sale
- Charitable Remainder Trust
- Self-Directing Retirement Account
Sale of Property Tax Rates

• **Capital Gain rates** (12 month holding period):
  (1) 0% if taxable income falls in the 10% or 15% marginal brackets
  (2) 15% if taxable income falls in 25%, 28%, 33% or 35% brackets
  (3) 20% if taxable income falls in the 39.6% marginal bracket (over $400k annual income)
  (4) 25% on Depreciation Recapture

• **Net investment income tax (Obama Care)** at a rate of 3.8% on the lower of net investment income or modified adjusted gross income over the following thresholds:
  - Married Filing Jointly: $250,000
  - Single or Head of Household: $200,000
  - Married Filing Separately: $125,000

**TOTAL TAX COULD BE AS HIGH AS:** 23.8% or 28.8% (recapture) + State Tax
What is Basis?
(Rental Property example)

- Purchase Price: 200k
- Improvements: +75k
  
  immediately deductible expenses do not apply
- Depreciation: (50k)
- Fair Market Value: 450k

Sales Price (SP)

- Basis: 225k
- Gain: 225k

Calculate tax….

Basis = PP + Improvements - Depreciation
Gain = FMV or SP – Basis
Tax Rate X Gain= Tax
Depreciation does not apply to Primary Residence
1031 Exchanges

The Transaction
Selling a property and buying another at Equal or Greater value
Sell 1 and buy 3 OR Sell 3 and buy 1 (or more …)
1031 Exchanges

Timing Rules:

45 day “Exchange Period” – Must identify replacement property(ies) within 45 days of sale

180 day “Replacement Period” – Must close on all purchases of replacement property within 180 days
1031 Exchanges

Issues to Consider:

- Must hold both the property traded and the property received for business or investment purposes.

- The property traded must not be held primarily for sale, such as inventory.

- The properties must be tangible real estate. For example, they cannot be stocks, notes, securities, evidences of debt.

- Must use qualified intermediary if delayed exchange and get legal/tax advice.
More Issues to Consider:

• Within 45 days you can replace the Exchange Property with as many Replacement Properties as you choose, at any value, so long as you close within the 45 days.

• At the 45\textsuperscript{th} day you may identify 3 properties of any value, and close on any or all of the 3, so long as you close within the 180 days from the initial sale.

• At the 45\textsuperscript{th} day you can identify as many properties as you want, so long as the aggregate value of the properties does not exceed 200\% of the value of the Exchange Property (200\% rule).

• You can violate the 200\% rule, so long as you close on 90\% of the properties identified, within the 180 day Replacement Period.
1031 Exchanges

EXAMPLE:

• Buy a property for 300k (PP)
• Down payment 60k
• Loan (interest only) 240k
• Bought 3 years ago
• 50k improvements
• Depreciated 25k
• NOW….The property worth 500k
• Basis (300+ 50k -25)= 325k
• GAIN- 175k (do math – baseline ? Tax you would pay?)
• Option 1:
  • Sale and buy a NEW property 501K or more (no tax)
  • Sale and buy 2 properties of 251k each (502k worth of R.E.) (no tax)
  • Sale and buy 5 properties of 101k each (505k on new property) (no tax)
Types of Real Estate Investors

**Passive Investors**

ANYONE Qualifies, but ONLY deductible against other PASSIVE INCOME

**Active Investors**

Just make decisions and you Qualify. However, losses are limited to 25k and phase out at 150 Adjusted Gross Income.

**Real Estate Professionals**

Two-part TEST:
1) 750 Hours a year DOING Real Estate, AND
2) Primary Occupation is Real Estate

THEN….Must Materially participate under 1 of 7 tests.

IF YOU QUALIFY…ALL RENTAL LOSSES ARE DEDUCTIBLE!!
Installment Sales

Selling a property OVER TIME and receiving PAYMENTS. “Spreading out the Gain”

• Dealers don’t qualify (no rehabs...no contractors...)

• Actually ‘required’ if you are receiving payments over time UNLESS you elect out

• Does not apply if you have a ‘loss’

• In every year the $$ received it is broken down into the following sections:

  Return of Basis portion
  Capital Gain portion
  Interest on Note
Frequently Asked Questions

- Should I incorporate in Nevada?
- Should I use a C-Corporation
- Can I set up a Series LLC?
- Does a trust provide asset protection?
- What are the fees to set up an entity?
THE END

Text “sdira” to 435-245-1144 for my free e-book on Self Directed IRAs and Real Estate Investments

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