Self-Directed IRAs and Real Estate

A Modified Excerpt From The Self-Directed IRA Handbook

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Publisher: SoKoh Publishing, LLC

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ACKNOWLEDGMENTS

I would like to thank my clients, who have given me challenging questions, interesting research projects, and creative ideas regarding self-directed IRAs. Because of them it inspired me to write my book, *The Self-directed IRA Handbook: An Authoritative Guide for Self-directed Retirement Plan Investors and Their Advisors.* It was released in December 2013 and is now an Amazon Best Seller. This free e-book is a modified version of Chapter 9 of *The Self-directed IRA Handbook* and is meant to serve as a beginning guide to those interested in using retirement plan funds to invest in real estate.

TESTIMONIALS

"The "Self-directed IRA Handbook" by attorney Mat Sorensen is the most comprehensive book ever written about one of the best investment and retirement savings tools ever created: the Self-Directed IRA. Mat has performed the impossible by effectively delivering complex information in an easily understandable manner for the layperson, while providing the necessary legal basis to suit the professional. Mat's book is a "must read" for investors, attorneys, CPAs, and other professionals and other interested individuals wanted to learn about all there is to know about Self-Directed IRAs." – Tom W. Anderson, *President, RITA, and Founder and Former CEO, PENSCO Trust Company.*

"Mathew is an excellent attorney, well versed in the Self-Directed IRA market… His ability to distill the complexities of the Self-Directed IRA so that the average person can understand them, and ensure that they don't get "tripped up" is second to none. Anyone interested in this Self-Directed IRA Market would do well to connect with Mathew and learn from the best." – Gary Shumm, *Vice President, IRA Services Trust Company.*

"I highly recommend The Self-directed IRA Handbook to anyone seeking to enhance his or her knowledge of how best to invest retirement funds in alternative assets through a self-directed retirement plan." – Mary L. Mohr, MBA, JD, *Executive Director, Retirement Industry Trust Association.*

"A great reference guide for self-directed IRA investing – Best I've seen in 30 years of being in the business." – Harry Veldkamp, *CEO, Polycomp Trust Company.*

“A must-read for any self-directed IRA investor.” – Kaaren Hall, *President, uDirect IRA Services.*

“Mat’s book is the most practical and comprehensive self-directed IRA guide in our industry. Reading this handbook should be the first step for any alternative asset investor, investment sponsor, or trusted advisor that seeks to become informed about how to maximize the value of IRAs.” – J.P. Dahdah, *CEP, Vantage Self-directed Retirement Plans.*

“This handbook is an excellent resource for self-directed IRA owners and their advisors. It is the first of its kind in our industry. Mat has truly written an “Authoritative Guide” for self-directed IRAs.” – Pamela Constantino, *President, Polycomp Trust Company.*

“Mat is truly an expert on self-directed IRAs and this is the one book every self-directed IRA investor should own.” – Mark J. Kohler, *Attorney, CPA, Best-Selling Author.*

For more testimonials and information regarding my book or my services, please visit www.sdirahandbook.com.

ABOUT THE AUTHOR

Mat is a partner at KKOS Lawyers in its Phoenix, AZ office. KKOS Lawyers assists clients nationwide from its offices in Arizona, Utah, and California. Mat's practice areas include retirement plan law, business, tax, estate planning, and real estate. His law firm's website is www.kkoslawyers.com.

Mat's law practice has a particular emphasis on self-directed retirement plan law. Mat has assisted thousands of clients with self-directed retirement plan investments and has established IRA/LLCs, partnerships, private offerings, corporations, and other investment structures with self-directed IRAs and 401(k)s. Most of Mat's clients are self-directed retirement account owners who are structuring their investments. Mat's clients have also included trust companies, financial institutions, insurance companies, hedge funds, and third-party administrators. In addition to his legal practice, Mat also serves as an instructor for the Retirement Industry Trust Association's ("RITA") Self-directed IRA Professional certification program. RITA is the premier national association representing the self-directed retirement plan industry.

Mat regularly consults self-directed retirement account owners on IRC § 4975 and the prohibited transaction rules applicable to self-directed retirement account investments, on IRA/LLCs, on UBIT and UDFI taxes, and he has represented self-directed IRA owners before the IRS Appeals Office and the U.S. Tax Court.

CHAPTER 1: What Is a Self-directed IRA?

INTRODUCTION TO SELF-DIRECTED IRAs

A self-directed IRA is an IRA (Roth, Traditional, SEP, Inherited IRA, SIMPLE) where the custodian of the account allows the IRA to invest into any investment allowed by law. These investments typically include; real estate, promissory notes, precious metals, and private company stock.

KEY POINTS
▪ *Among other things, a self-directed IRA can invest into real estate, private companies, promissory notes, or precious metals.*
▪ *A self-directed IRA is administered by an IRA custodian who allows the IRA owner to invest into any investment allowed by law.*

The typical reaction I hear from investors is: "Why haven't I ever heard of self-directed IRAs before, and why can I only invest my current retirement plan into mutual funds or stocks?" The reason is that the large financial institutions that administer most U.S. retirement accounts don't find it administratively feasible to hold real estate or non-publicly traded assets in retirement plans. Additionally, most of these institutions are in the business of selling stocks, bonds, and mutual funds. This is their primary business and source of revenue, and many of them view real estate or non-publicly traded investments as a hassle. As a result, most investors aren't aware of alternative assets as an investment option.

Despite the major financial institutions' lack of interest in the self-directed retirement plan market, there are plenty of retirement plan custodians who specialize in catering to self-directed investments. These self-directed IRA custodians allow customers to invest their retirement accounts into real estate, private companies, hedge funds, note/trust deed lending, precious metals, and other "alternative" investments.

SELF-DIRECTED IRA INVESTMENT GAIN TAX TREATMENT

A self-directed IRA can invest in real estate or other alternative assets, and it will receive the same tax-deferred (Traditional) or tax-free (Roth) treatment that an IRA receives when you buy and sell stock or mutual funds in a retirement account. So, for example, when you buy and sell stock in your company 401(k) or a typical brokerage IRA, you don't pay capital gains tax on the gains from the sale of the stock. That is one of the key benefits of using retirement accounts to save and invest. Similarly, if you buy real estate or private stock and sell it for a gain from your self-directed IRA, you also don't pay capital gains tax on any gains from the sale.

The table below illustrates the identical tax favorable treatment between a self-directed IRA buying real estate or private company stock versus a standard IRA buying and selling publicly traded stock.

TABLE 1.1, IRA & SDIRA IDENTICAL TAX TREATMENT

	IRA	**Self-directed IRA**
Investment	Publicly traded stock in IRA	Real estate or other alternative asset in a self-directed IRA
Purchase	1,000 shares at $50 a share = $50,000	Buy real estate for $50,000
Sale	$75,000	$75,000
Gain	= $25,000	= $25,000
Tax	No capital gains tax on $25,000 gain.	No capital gains tax on $25,000 gain.

A self-directed IRA can be any type of IRA. It can be a Roth IRA, a Traditional IRA, a SEP IRA, or even an inherited IRA. So, the first question you may be asking yourself is: "Can I self direct my retirement plan funds?"

<u>CAN I SELF DIRECT MY CURRENT RETIREMENT ACCOUNT FUNDS</u>

Most retirement account owners have their funds in company 401(k) accounts, government or private pension plans, or in brokerage account IRAs. These retirement plans typically allow for investment options into publicly-traded stocks, bonds or mutual funds. Account owners are usually not allowed to invest their funds into real estate, non-publicly traded businesses, precious metals or other "alternative" investments.

According to federal law governing retirement plans, a retirement account can invest into any investment allowed by law, so long as the plan or the administrator of the account does not in some way restrict the account's investments. As a result, if you are unable to invest your retirement account into real estate or some other "alternative" investment, it is because your retirement plan administrator or the financial institution for your retirement account restricts your investments to specific types of investments. This is due to their business practices and not as a result of any legal restriction.

LEGAL TIP
❖ Your ability to self direct your current retirement plan funds depends on whether you are able to rollover or transfer these funds to a custodian who allows you to self direct your IRA.

Your ability to self direct your retirement account funds is typically dependent upon whether you are able to do a rollover or transfer of your current retirement account funds to a custodian who allows you to self direct your IRA. For example, if you have an existing IRA with a brokerage or bank, that IRA can always be transferred or rolled over to a custodian who allows you to self direct your account and who won't restrict your investments to mutual funds, stocks, and bonds. Also, if you have an old 401(k) account from a former employer, you are able to roll over those funds from your 401(k) account to a self-directed IRA custodian by doing a rollover.

PRACTICAL TIP
❖ If your retirement plan is with a current employer plan (e.g., 401k), then you likely won't be able to roll those funds out to a self-directed IRA custodian until you are at retirement age or until you leave that employer.

If you have a 401(k) or other type of company-sponsored retirement account with a current employer, then you are likely restricted from rolling over those funds to a self-directed IRA. The reason for this is that most employer retirement plans restrict their employees from moving funds outside of their plan. This is a restriction that is binding on the employee's account as long as the employee is employed by that employer.

If you are in this situation, then in order to roll out your funds you either have to leave employment with that employer or you need to see if the employer's plan (e.g. 401(k)) allows for what is called an "in-service withdrawal." An in-service withdrawal is a withdrawal whereby you can roll out a portion of your retirement plan funds for a specific use. Some of those uses are for things like disability or financial hardship but many plans also allow an employee to roll out a portion of the plan to an IRA of his or her choice as a rollover in-service withdrawal. Under law, the employee must be 59 ½, and you can only withdraw employee deferrals/contributions as employer contributions cannot be rolled out while still employed.

According to the IRS, 62% of 401(k) plans allow for in-service withdrawals that are not based on hardship. (IRS 2010 401(k) Questionnaire Results, www.irs.gov/retirement-plans.) If you have an existing 401(k) or other employer-sponsored plan and if you are 59 ½, it is likely that you will be able to do an in-service withdrawal from the employer plan, and that you will be able to roll/transfer funds over to a self-directed IRA. Be persistent to make sure that you get the right answer, as the typical easy answer is always "no." When in doubt, I'd recommend reading your employer's actual plan document to see if an in-service withdrawal would be allowed in your situation.

TRANSFERRING OR ROLLING OVER EXISTING RETIREMENT FUNDS TO A SELF-DIRECTED IRA

A retirement account may be moved to a different custodian by one of the following three methods.

1. Trustee to Trustee Transfer. A trustee to trustee transfer is a tax-free movement of your retirement funds from the current custodian directly to a self-directed IRA custodian. For example, a trustee to trustee transfer would occur when your brokerage IRA at your current custodian (e.g., Fidelity) is transferred directly to your IRA at a self-directed IRA custodian. No tax reporting or withholding occurs on a transfer.
2. Direct Rollover. A direct rollover is a trustee to trustee transfer from your 401(k), 403(b), or other employer account directly to your self-directed IRA custodian. The account owner does not touch the funds and since they go

directly to the new IRA custodian no tax reporting or withholding occurs on a direct rollover.

3. 60-Day Rollover. A 60-day rollover occurs when your funds are distributed to you from your current retirement account (IRA or employer plan) and re-deposited into a new retirement account, such as a self-directed IRA, within 60 calendar days. Failure to re-deposit the rollover funds into an IRA within 60 days will result in distribution of the account funds and any applicable taxes and early withdrawal penalties will apply. When conducting a 60-day rollover, your custodian reports the distribution to the IRS and may also withhold 20% for taxes. Additionally, you can only conduct one 60-day rollover per account per year. As a result, the preferred method of moving funds to a self-directed IRA is by a trustee to trustee transfer or as a direct rollover.

Regardless of the method used, the amounts transferred or rolled over (within 60 days) stay as tax favored retirement account funds and are *not* distributions subject to any tax or penalty. When moving existing IRA funds, the transfer and rollover process is simply the mechanism of changing the custodian of the account. When moving former employer plans funds (e.g. 401(k)) it is the process of changing the type of retirement account and the custodian of the account. In the end, transfer or rollover is the process of moving from a custodian who will *not* allow you to self direct your IRA to a custodian who *will* allow you to self direct your IRA.

The chart below summarizes common transfer/rollover situations and explains when you'd be able to transfer/rollover your current plan to a self-directed IRA.

TABLE 1.2, CAN I TRANSFER/ROLLOVER TO A SELF-DIRECTED IRA?

Situation	Transfer/Rollover
I have a 401(k) account with a former employer.	Yes, you can rollover to a self-directed IRA. *If it is a Traditional 401(k), it will be a self-directed IRA. *If it is a Roth 401(k), it will be a self-directed Roth IRA.
I have a 403(b) account with a former employer.	Yes, you can roll-over to a traditional self-directed IRA.
I have a Traditional IRA with a bank or brokerage.	Yes, you can transfer to a self-directed IRA.
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.

TABLE 1.2, CAN I TRANSFER/ROLLOVER TO A SELF-DIRECTED IRA? (cont'd)

Situation	Transfer/Rollover
I don't have any retirement accounts but want to establish a new self-directed IRA.	Yes, you can establish a new self-directed Traditional or Roth IRA and can make new contributions according to the contribution limits and rules found in IRS Publication 590.
I have a 401(k) or other company plan with a current employer.	No, in most instances your current employer's plan will restrict you from rolling funds out of that plan. However, some plans do allow for an in-service withdrawal if you are at retirement age.

Case Example 1.1: Jane has left her employer, ABC Corp., and is now working elsewhere. She is advised by ABC Corp. that she can roll her 401(k) plan over to her new employer's 401(k) or to an IRA account at an institution of her choice. Jane hears from a friend that she can invest her old 401(k) funds into real estate but is told by the bank where she'd like to establish an IRA that she can't buy real estate with an IRA. This is not because an IRA cannot hold real estate as an investment. It is because the bank she is questioning will not allow *their* IRAs to hold real estate as an investment. Therefore, in order to purchase real estate, Jane needs to do a direct transfer of her 401(k) account to self-directed custodian.

FREQUENTLY ASKED QUESTIONS

Q. Can I self direct my current IRA at a brokerage firm?

A. Most likely, no, since most financial institutions which offer IRAs do not allow your IRA to invest in any investment allowed by law. Instead, they only allow your IRA to invest into investments which are easy for them to transact and administer, such as electronically traded stocks, bonds, and mutual funds.

Q. Can I self direct a Roth IRA or an SEP or SIMPLE IRA?

A. Yes. In addition to traditional IRAs, you can self direct all IRA accounts including Roth IRAs, SEP IRAs, and SIMPLE IRAs.

Q. Can I self direct my health savings account (HSA) or my 401(k) account for my self-employed business?

A. Yes, you can self direct 401(k) accounts for your own business, health savings accounts, and Coverdell education savings accounts.

Q. How are self-directed IRA custodians regulated?

A. In order to be an IRA custodian, the custodian must either be a bank, credit union, or regulated-trust company. All of these types of companies are licensed and regulated by the FDIC/OCC and/or by a State's Department of Financial Institutions.

Chapter 2: Self-directed IRAs, Real Estate Investment, and The Prohibited Transaction Rules

Real Estate is the most common investment made by self-directed retirement plan investors. IRAs may invest in all types of real estate, including: residential and commercial properties, apartment complexes, land, water or mineral rights, and new construction and development. Real estate owned by a retirement plan must always be held for investment, and the IRA owner and disqualified persons (e.g., certain family) cannot live in or benefit from the property as this would result in a prohibited transaction. Additionally, all income derived from the property should be paid directly to the IRA custodian for the benefit of the IRA, and all expenses for the property should be paid from the IRA (except when an IRA/LLC is used).

KEY POINTS
▪ *All contracts, deeds, and legal documents must be in the name of the IRA and not the IRA owner's name. When applicable, documents may be in the name of an IRA/LLC.*
▪ *The IRA owner and other disqualified persons may not receive a commission or other personal financial compensation for the IRA's purchase, management, or sale of real estate.*
▪ *Any loan in connection with the IRA's purchase must be nonrecourse and may result in UDFI tax.*
▪ *The IRA owner and certain family members (disqualified persons) may not reside at or personally benefit from the real estate. The real estate must be held for investment.*
▪ *The IRA owner and disqualified persons may oversee and direct repairs or management of the property through their IRA (or IRA/LLC as applicable) but the IRA owner and disqualified persons are prohibited from physically working on the property.*

AVOID PROHIBITED TRANSACTIONS

There are a set of rules known as the Prohibited Transaction Rules that dictate whom your IRA may transact with. These rules are found in IRC § 4975. You should always avoid prohibited transactions with your IRA as the consequence of a prohibited transaction between an IRA and the IRA owner is that the entire IRA becomes disqualified and is no longer an IRA. This disqualification results in a distribution of the total amount in the IRA to the IRA owner personally. The distribution is subject to applicable taxes and penalties. IRC § 408(e)(2)(A), IRS Publication 590 (2012 Pg. 50). Chapter 7 of *The Self-directed IRA Handbook* provides an in-depth explanation of the consequences of a prohibited transaction.

The prohibited transaction rules restrict your self-directed IRA in three ways. For a more thorough discussion refer to Chapters 4, 5, 6, and 7 of *The Self-directed IRA Handbook*.

First, your IRA may not "transact" with anyone who is a "disqualified person". This type of prohibited transaction is a per se prohibited transaction. A "transaction", under the rule, would include a purchase, sale, or lease. IRC § 4975 (c)(1). A "disqualified person", includes the IRA owner, spouse, parents (ancestors), and children and their spouses (lineal descendants). IRC § 4975 (e)(2). So, for example, your IRA could not purchase real estate from your father as your IRA's purchase would be a "transaction" and your father is a "disqualified person". However, your IRA could purchase real estate from your sister as your sister is not a disqualified person.

Your IRA may engage in many transactions and those transactions will not be prohibited unless they are with a "disqualified person." Similarly, your IRA may have dealings with a disqualified person but those are not prohibited transactions unless the dealings with the disqualified person constitutes a "transaction." As a result, a per se prohibited transaction only occurs when an IRA engages in a transaction with a disqualified person. For further information on per se prohibited transactions refer to Chapter 4 of *The Self-directed IRA Handbook.*

Second, a disqualified person may not benefit from your IRAs transactions or investments. IRC § 4975 (c)(1),(D)(E)(F). This is called a self-dealing prohibited transaction. For example, if your IRA owns real estate, then a disqualified person may not use the property. Use of a property or compensation from an investment (e.g. commission to a disqualified person) will result in a self-dealing prohibited transaction as a disqualified person ends up personally benefitting from the IRA's investments or assets.

Third, the prohibited transaction rules restrict all extensions of credit between an IRA and a disqualified person. IRC § 4975 (c)(1)(B). This type of prohibited transaction is known as an extension of credit prohibited transaction. In practice, this means that the IRA owner (and other disqualified persons) may not personally guarantee or otherwise offer their personal credit or assets for their IRA investments. Because of this rule, most IRAs obtain what are known as non-recourse loans, which loans do not require a the personal guarantee or personal credit of the IRA owner and are merely loans secured by the IRAs asset. Additionally, the extension of credit prohibited transaction rule prohibits the IRA from lending its funds to a disqualified person.

While an IRA may make loan investments, those loans may not be made to disqualified persons.

PURCHASING REAL ESTATE WITH AN IRA

When purchasing real estate with an IRA, the IRA must be listed on the contract as the buyer, and it is the custodian of the IRA and not the IRA owner who signs the contract to bind the IRA. For example, the buyer to the contract would be ABC Trust Company FBO Sally Jones IRA. Once the contract is ready to be signed, the IRA owner will send it to his or her self-directed IRA custodian with a direction of investment form, instructing the custodian to sign the contract for the IRA. In most instances, the custodian of the IRA will require the IRA owner to sign the contract as "read and approved" so that the custodian is certain that the IRA owner has read the terms and approved them for his or her IRA. Remember, that the IRA is buying the property and not the IRA owner, so all contracts must be signed by the IRA custodian, who is the only party that can legally bind the IRA.

All funds due by the buyer and relating to the purchase of the property must be paid by the IRA, including: earnest money deposit or down payment, closing costs, inspection and due diligence costs, and the final funds necessary to close the property. Since the IRA owner is a disqualified person to his or her own IRA, the IRA owner (and any other disqualified person) cannot make the earnest money deposit and cannot cover other expenses to the property with personal funds outside of the IRA.

The purchase contract for a property cannot be assigned from a disqualified person (e.g., IRA owner) to an IRA. Similarly, the IRA cannot assign a property to the IRA owner or other disqualified persons. Assignment of a contract between an IRA and a disqualified person is a per se prohibited transaction.

LEGAL TIP
❖ The IRA is the party to all contracts and pays all money to acquire the property.
❖ The IRA owner should not use personal funds to acquire the property.
❖ The IRA needs to be on the initial contract to purchase the property. The IRA owner cannot assign the contract from the IRA owner to the IRA as that is a prohibited transaction.

A real estate contract could be assigned to the IRA from someone else who is not a disqualified person; conversely, any assignment from a disqualified person will likely constitute a prohibited transaction. In the event that an IRA owner mistakenly enters into a contract in their personal name, then the IRA owner should seek to unwind the contract in his or her personal name with the seller and should obtain a new contract, properly listing the IRA as the buyer. Any earnest money or deposits made by the IRA owner personally should be returned to the IRA owner personally and the IRA should then bear those expenses and contract requirements in the new contract.

If the contract cannot be undone in the IRA owner's personal name, then an addendum to the contact can be added, clarifying that the buyer is the IRA. The addendum should not transfer or assign the contract but shall instead clarify who the buyer is. For example, if John Smith is intending to use his IRA to buy a property and mistakenly listed himself as the buyer, then an addendum to the contact can be added, clarifying that the buyer is not John Smith but is ABC Trust Company FBO John Smith IRA. This should be done only as a second resort and in the case of mistake as there are some prohibited transaction issues involved when doing an addendum such as this. Again, the first attempt to correct the contracts should always be unwinding the contract in the IRA owner's name and obtaining a new contract with the IRA correctly listed as the buyer. The addendum practice should only be used in the case of mistake and when completing a new contract in the IRA's name is not possible.

MULTIPLE OWNER TITLE HOLDING OPTIONS

As discussed earlier, title to the investment must be held in the IRA's name. For example, the grantee and owner on the deed will be ABC Trust Company FBO Sally Jones IRA.

LEGAL TIP
❖ If the IRA is on title to real property with other parties the form of multiple-party ownership to the property should be tenants in common.

If the IRA is going to be on title to real property with other owners, then the multiple-party form of ownership must be tenants in common. Other forms of multiple-party title ownership, such as joint tenancy and tenants by the entirety, should *not* be used because those ownership interests have characteristics whereby ownership passes to the other party on title following the death of the owner. Because the IRA cannot die and because the IRA's ownership following the death of the IRA owner is determined based on the IRA beneficiary designations, the IRA's ownership cannot be transferred via joint tenancy or survivorship methods. Tenants in common, on the other hand, is a form of holding title whereby upon the death of an owner, the title to their ownership passes to his or her heirs. In the case of the death of the IRA owner, the heirs to the IRA pursuant to the IRA beneficiary designation forms will receive the ownership to the property. This change of ownership upon death of the IRA owner may occur by an inherited IRA to the beneficiary or via distribution to the beneficiary.

Chapter 3: Nonrecourse Loans & UDFI Tax

It is possible for an IRA to obtain a loan in connection with its cash investment to purchase real estate. However, the loan must not result in an extension of credit prohibited transaction under IRC § 4975 (c)(1)(B). As discussed previously, an extension of credit prohibited transaction will occur when an IRA owner's credit qualifies the IRA for the loan or when the IRA owner (or other disqualified person) personally guarantees a loan for the IRA.

As a result of the prohibited transaction issues, any loan obtained by the IRA to purchase real estate must be a nonrecourse loan. A nonrecourse loan is a loan where the lender's sole recourse in the event of default is to foreclose and take the property back. The lender does not have any additional recourse against the IRA or the IRA owner. Additionally, the qualification rules and criteria for an IRA compliant nonrecourse loan are solely based on the property being used to secure the loan.

Since the non-recourse loan lender is restricted from pursuing the IRA owner or IRA in the event of default, lenders who offer non-recourse loans to IRAs typically require 30-40% down on a property and require that the property be income-producing.

<u>UDFI TAX EXPLAINED</u>

Unrelated debt financed income ("UDFI) tax applies to the income and gains received by an IRA that are attributable to debt.

IRC § 514. UDFI tax only applies when debt, such as a nonrecourse loan, is used in connection with an IRA's purchase. UDFI tax is technically a type of UBIT tax, so if UDFI tax is due, it is paid at the UBIT tax rate which reaches up to 39.6%. Additionally, if UDFI tax and UBIT tax are due, there is no double payment of the tax since it is one income tax and not paid twice on the same income.

UDFI tax will apply to any income that is derived from "debt." This includes rental income and capital gain income, which is otherwise exempt from UBIT tax.

The best way to understand UDFI tax is through an example. Let's consider an IRA which purchases a $100,000 rental property. The IRA invested $40,000 for the purchase and obtained a $60,000 loan for the balance of the purchase price. If the property is sold a year later for a net profit of $10,000, UDFI tax would be calculated as follows.

First, we must take the debt leverage ratio of the property. In this example the property is 60% leveraged with debt. As a result, 60% of the investment is non-IRA dollars and is subject to UDFI tax.

Second, we calculate the amount of income subject to the UDFI tax by taking the gain of $10,000 and applying the leverage ratio of 60%. This results in $6,000 being subject to UDFI tax.

And third, $6,000 of income (the amount attributable to the debt under the rules) is subject to UDFI tax. The UDFI tax rate for a property held a year or longer is the long-term capital gains tax rate of 20%. As a result, tax of $1,200 would be due (20% of $6,000). If the income was net rental income, then the tax rate is the UBIT tax rate which ranges from 0 to 39.6% depending on the income.

Chapter 4: Leasing the Real Estate and Management Structures

When IRA-owned property is held for rent, it must be structured such that rental income is received by the IRA, and expenses are paid by the IRA. The IRA owner and other disqualified persons cannot personally be the "middle man" by paying expenses personally or by collecting the rent in their personal account and then forwarding the funds to the IRA. There are essentially three different methods whereby the IRA's investments may be structured to properly collect rent and pay expenses.

TABLE 1.1 METHODS TO MANAGE REAL PROPERTY OWNED BY A SELF-DIRECTED IRA

3 METHODS TO MANAGE THE PROPERTY
❖ *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.
❖ *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.
❖ *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.

First, the IRA may be receiving the income directly and paying the expenses. This method involves a lease between the IRA and the tenant directly. Under this method, the tenant pays rental income to the IRA (e.g., ABC Trust Company FBO Sally Jones IRA) and sends the actual payment to the IRA custodian. The custodian then deposits that income into the respective IRA. If expenses are due, the IRA owner will need to direct the custodian to pay them by completing a written form (e.g., payment authorization letter) and instructing the IRA custodian as to the expenses to be paid from the IRA. There is usually a fee each time an instruction letter is issued to a self-directed IRA custodian. This method can be tedious and can be fee intensive ,and as a result, it is not the most common way of managing a rental property held by an IRA. This method does work well for properties that do not have on-going transactions or liability issues such as raw land.

Second, the IRA hires a property management company who receives the rental income to the property and pays the expenses to the property. The property management company cannot be a disqualified person to the IRA owner, and the property management company will typically take a percent of the rental income collected as payment for their services. Under this method, the IRA enters into an agreement with the property management company, and the property management company then enters into leases with respective tenants. The IRA receives rental income minus property expenses and fees charged by the property management company.

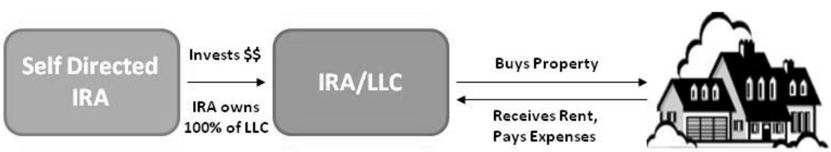
The third example is known as an IRA/LLC or a checkbook control IRA and is discussed in the following chapter.

Chapter 5: IRA/LLC (Checkbook Control)

Most self-directed IRA real estate investors use an IRA/LLC to conduct their IRA's real estate investments. The IRA/LLC is sometimes referred to as a "checkbook control IRA" because the IRA/LLC consists of an LLC whereby the IRA owner may manage the LLC checking account and thus has control of the funds.

Many IRA owners with rental property decide to use a structure known as an IRA/LLC. This structure is more fully outlined and explained in Chapter 13 and 14 of *The Self-directed IRA Handbook: An Authoritative Guide for Self-directed Retirement Plan Investors and Their Advisors*. Under the IRA/LLC structure, the IRA invests into a newly created specialty LLC, and the IRA's investment is then the ownership of the LLC. The IRA will invest an amount designated by the IRA owner into the LLC, and then funds are typically deposited into an LLC checking account at a bank selected by the IRA owner. See the following Diagram 1.1.

DIAGRAM 1.1, IRA/LLC STRUCTURE FOR REAL ESTATE



The IRA owner then, as manager of the LLC, signs the contract for the LLC to purchase the real estate. The property should close in the LLC's name with funds from the LLC bank account, and the LLC, in turn, rents the property, receives the income, and pays the expenses all from the LLC checking account. The LLC is entirely owned by the IRA, and all funds in the LLC checking account must eventually be returned to the IRA when the IRA owner desires to take a distribution. Please refer to Chapters 13 and 14 of *The Self-directed IRA Handbook: An Authoritative Guide for Self-directed Retirement Plan Investors and Their Advisors*, for an extensive discussion as to the IRA/LLC structure and for a case and legal history of the structure.

Regardless of the method used to own and manage the IRA-owned rental property, the property cannot be leased to a disqualified person. So, for example, the IRA cannot purchase a property and allow the IRA owner's son to lease the property as that lease would be a transaction with a disqualified person, which results in a prohibited transaction.

In addition to prohibited transactions that are involved in leasing the property to family members, the IRA owner should closely analyze any leasing arrangement to a company where the IRA owner or other disqualified persons are owners of the IRA or company. For example, any lease to a company that is owned 50% or more by the IRA owner or other disqualified persons would constitute a prohibited transaction. IRC § 4975(e)(2)G). Additionally, any investment structure whereby the IRA invests into a company (even when the IRA owns less than 50%) and the company is then required (or its sole purpose is) to lease to a disqualified person would constitute a prohibited transaction as the IRA's investment cannot be made with the intent to benefit a disqualified person. DOL Advisory Opinion 2006-01A, 29 CFR 2509.72-2.

Chapter 6: Managing the Real Estate of an IRA

When managing IRA investment assets, the IRA owner should limit his or her activities to administrative and investment-oversight tasks. While it is permissible to administer the investment, it is generally viewed impermissible to physically work on investment assets (such as rental real estate) since such actions can constitute a per se prohibited transaction or a self-dealing prohibited transaction. IRC § 4975(c)(1)(C). The following table outlines what activities are permissible and prohibited activities.

TABLE 1.2 PERMISSIBLE AND PROHIBITED MANAGEMENT BY DISQUALIFIED PERSONS

PERMISSIBLE	PROHIBITED
Making decisions as to the property manager or tenants. Making all decisions for the property. When to buy, sell, at what price, etc.	Taking title or entering into contracts in the IRA owner's personal name as opposed to the IRA (the IRA custodian should sign all contracts).
Setting terms for the lease or other legal agreements. When the property is owned directly by the IRA, any contract must be signed by the IRA custodian.	Receiving rental income in the IRA owner's personal account or paying IRA expenses from a personal account of the IRA owner.
Visiting the property and overseeing repairs and maintenance.	Physical work on the property. Work by the IRA owner or other disqualified person (s).

Chapter 7: Real Estate Development & Short-Term Flipping

An IRA may invest into real property that is being developed and may also purchase properties on a short-term basis and flip them for profit. A retirement plan's investment into real estate development or on real estate flips, however, can subject the IRA to a tax known as unrelated business income tax ("UBIT tax"). IRC § 511, 512. The UBIT tax applies to the net profits that arise from the development of real property or from property held without any investment intent (e.g., bought and held immediately for sale). Real property held for investment (e.g., rental, or held for 1 year or more) is exempt from UBIT tax so all efforts should be made to holding the property for investment as opposed to holding for development or acquiring and holding for immediate sale. Please refer to Chapter 15 of *The Self-directed IRA Handbook: An Authoritative Guide for Self-directed Retirement Plan Investors and Their Advisors,* for an extensive discussion as to when UBIT and UDFI tax applies.

LEGAL TIP
❖ Significant short-term real estate transactions in an IRA can subject the IRA to UBIT tax.

Chapter 8: Real Estate Investment Considerations and Frequently Asked Questions

The IRA owner should avoid overextending the IRA into an investment where the IRA may end up being unable to cover unexpected property expenses. For example, if the IRA owner has $300,000 in his or her IRA to purchase real property, he or she should avoid buying a $300,000 property as there may be unexpected repairs or costs, which the IRA may need to pay and that it would be unable to afford should those costs arise. The IRA could use rental income from the property, or the IRA owner may be able to make an annual contribution to the IRA to cover the shortfall. However, if those funds are inadequate, the IRA is left in a difficult position and may be unable to cover its own expenses.

The IRA owner (and other disqualified persons) cannot just pay the expenses owed by the IRA personally to cover the shortfall as that would constitute a transaction from a disqualified person and would be a prohibited transaction. I typically recommend that the IRA maintain 10% of the purchase price of the property on hand in a liquid investment to cover unexpected expenses. In other words, if the IRA buys a $250,000 property it would be well-served by having an additional $25,000 available in the self-directed IRA (or in other IRAs that could be transferred) to cover unexpected costs or expenses.

In the event that an IRA becomes overextended and cannot pay its obligations, the IRA owner may rely on Department of Labor Prohibited Transaction Exemption 80-26, which allows the IRA owner to loan money to his or her IRA so that his or her IRA may pay obligations that it owes. DOL PTE 80-26, 71 CFR 17917

Amendment to Prohibited Transaction Exemption 80-26 (April 7, 2006).

Tom W. Anderson explained that PTE 80-26 (and related 2002-13) can be used "…if you held a rental property in your IRA that you had a mortgage on and you lost your tenant, you could lend money to your IRA to pay the mortgage." Anderson, Tom W., *Prohibited Transactions for Investors*, pg. 17, Retirement Industry Trust Association, 2012, http://ritaus.org.

This loan from the IRA owner to the IRA is specifically exempt from the prohibited transaction rules in IRC § 4975 and is permissible so long as the following conditions are present:

1. *The proceeds of the loan to the IRA must be for the payment of ordinary operating expenses of the plan, including the payment of benefits in accordance with the terms of the plan (e.g., required minimum distributions) or a purpose incidental to the ordinary operation of the plan*. Many practitioners take the position that a loan or other obligation incurred from an investment asset meets the criteria of an operating expense to the plan.
2. *The loan must be interest free and un-secured*. The loan should not cost the IRA money or jeopardize its assets.
3. *Any loan over 60 days must be in writing.* Most custodians who will allow an IRA owner to utilize PTE 80-26 will require a written agreement, regardless of the duration of the loan.

A PTE 80-26 loan from the IRA owner to the IRA must be coordinated and documented with the IRA custodian. It should not be used to fund new obligations or to make new investments but can be used as a last resort when the IRA owner can only save an investment asset by using PTE 80-26 and by loaning funds to his or her IRA.

CHECKLIST FOR IRA OWNERSHIP OF REAL ESTATE

- ✓ Is the contract and deed/title in the IRA's name (e.g., ABC Trust Company FBO Sally Jones IRA)?
- ✓ Did the IRA custodian sign the contract and legal agreements for the IRA, or, where applicable, did the manager of the IRA/LLC sign them?
- ✓ Did the IRA owner refrain from using personal expenses in purchasing and maintaining the property?
- ✓ If the IRA obtained a loan to purchase the property, was the loan nonrecourse, and is the IRA owner aware of possible UDFI taxes on any net profits from the debt?
- ✓ Is the IRA custodian, the property manager, or a properly established IRA/LLC, receiving the rental income and paying the expenses for the property?
- ✓ Does the IRA have sufficient capital available to cover an unexpected property expense?
- ✓ Is the IRA owner holding the property for investment, and are the IRA owner and other disqualified persons avoiding personal use or benefit from the property?
- ✓ Was the broker or agent in the transaction (when applicable) a non-disqualified person? Did the IRA owner refrain from personally benefitting from the IRA's purchase?

FREQUENTLY ASKED QUESTIONS

Q. Can I buy real estate with my IRA, hold it as a rental property, and then later move into that property and live in it during my retirement?

A. Yes, this is possible, however, before the IRA owner may live in the property he or she must first distribute the property from the IRA to the IRA owner personally. Once the property is distributed from the IRA to the IRA owner, it is owned personally and is not subject to the IRA rules that prohibit personal use. While many IRA owners consider this strategy, I frankly don't think it is that great of a structure for traditional IRAs because the property must first be distributed from the IRA, and upon distribution, the IRA owner will pay taxes (if Traditional; no tax if Roth) on the fair market value of the property. This type of distribution is called an in-kind distribution (distribution of property other than cash) and is acceptable for an IRA to do but requires an appraisal of the property at the time of the distribution to set the value of the distribution. The value of the distribution is what will be taxable to the IRA owner. Also, if the property is distributed before age 59 ½, then there is an additional 10% early withdrawal penalty.

Q. What do I do if I own property in my IRA and have to take a required minimum distribution ("RMD") from my IRA because I have turned 70 ½? I do not want to sell the property and don't have other cash in my IRA to take my RMD.

A. If you do not want to sell the property or if you are unable to sell, you can take a portion of the property owned by the IRA as an in-kind distribution to satisfy the RMD. For example, if the property is worth $100,000 and if your RMD for the year is $5,000, you would take a 5% tenant in common interest in the property as an in-kind distribution from the IRA to yourself personally. This is not a prohibited transaction because it is part of a distribution which is not a transaction. In the end, you would own 5% personally, and your IRA would own the remaining 95%. You need to be careful moving forward to make sure that you properly share expenses and income in this scenario. This is not the easiest course to satisfy RMD, but is an option if all others are unavailable.

Q. I'm obtaining a loan for a property with my IRA, and I live in California. The state law does not allow a mortgage lender to go after a borrower for any deficiency still left after foreclosure of the property. Does this anti-deficiency statute mean that any loan I obtain in California will be a nonrecourse loan?

A. No, a standard loan written in a state with anti-deficiency terms will still violate the rules for retirement plan nonrecourse loans, and as a result, will result in a prohibited transaction. This is because these loans still require the IRA owner's credit to be used or require a personal guarantee for the debt. As a result, they end up being a personal extension of credit to the IRA.

Q. My daughter is moving away to college. I'd like to buy a rental property in her college town with my IRA to let her stay at the property. Is this allowed? What if her friend is the tenant on the lease, and my daughter lives in the property as her roommate?

A. No, the daughter of an IRA owner is a disqualified person, and the leasing to her would be a prohibited transaction. Additionally, even if a non-disqualified person (the daughter's friend) was the tenant on the lease with the IRA, if the daughter is living at the property, she is a disqualified person benefitting from the IRA's property, which results in a self-dealing prohibited transaction.

Visit Mat's website www.sdirahandbook.com for testimonials and for additional resources for self-directed IRA investors.