By **Michael Held**

Real Estate and the Self-Directed IRA

An investment worth considering

Income producing real estate is a valuable asset class for a diversified portfolio because of its potential for high (and stable) current yield, inflation protection and, more importantly, diversification. Real estate maintains a low correlation to the movement of other assets.[1] These attributes make real estate equally attractive to an asset allocation strategy within an individual retirement account.[2] Yet, despite IRAs having been introduced nearly 40 years ago,[3] most IRA custodians don't permit an investment in real estate. Instead, those custodians can only offer real estate investment trusts (REITs) or a mutual fund with real estate holdings—but there's no mechanism to make a direct real estate investment, despite the advantages of doing so. An investment in real estate through a mutual fund may be the best option for many people, but those with specialized knowledge who want more leverage can reap a higher return—especially after considering the management expenses in a REIT.

Tradeoff

Many professional advisors mistakenly believe that an IRA may not purchase real estate. This is untrue. There are only two prohibited IRA investments: life insurance contracts and collectibles.[4] Accordingly, real estate is a permissible investment by a self-directed IRA.[5]

Investors should note that direct IRA investments in real estate forfeit certain traditional benefits of real estate investing: (1) depreciation deductions (as a non-cash expense to offset income), and (2) favorable capital gain rates on any gain on disposition. Tax on investment income within an IRA is deferred until distributions are made.[6] It's only when distributions begin[7] that (ordinary) income is realized. Thus, an investment in real estate by an IRA forgoes the benefit of a non-cash expense—such as depreciation—but that detriment may be more than offset by the deferral of tax until distributions are made. The tax that would have been paid when the income was originally earned can be used to grow the asset pool until distributions are required. Unfortunately, the favorable capital gains treatment on sale of the real property is lost forever: Any gains, when distributed, are taxed as ordinary income. Considering the recurring threats to further raise the top ordinary income tax rate,[8] this disadvantage of IRA real estate investments may worsen. In short, an IRA's purchase of real property offers a tradeoff: Depreciation deductions are forfeited and capital gains treatment is lost, but taxes are deferred until the time of distribution. (Many states don't tax distributions from an IRA.)

When considering real estate as an IRA investorment, each investor must determine whether the deferral of income for a period of time (perhaps decades) is sufficient to overcome the loss of the capital gain treatment. That computation must also take into account the recapture provisions, if applicable, of Internal Revenue Code Section 1250.[9] In general, if straight-line depreciation is used, then there would be no recapture, but any gain allocable to depreciation in excess of straight-line depreciation (accelerated depreciation) is taxed at ordinary income—not capital gains—rates.[10]

Leveraged Real Estate

Archimedes said that with a lever (and the right place to stand), he could move the world.[11] Likewise, in real estate, a return on invested capital can be multiplied many-fold if debt is used to finance the purchase. If the income stream and/or appreciation exceed the interest rate on the debt, leverage can significantly boostan investor's return. However, as with any investment, putting 20 percent down and borrowing the balance

Michael Held is a 2013 JD candidate at the University of Illinois, in Champaign, Ill.

doesn't mean that the return is five times the return of the same investment made without leverage. There are interest expenses and origination fees, which reduce the return. However, one can boost a 10 percent cash-on-cash return on an unleveraged investment to 21 percent through the use of debt. For example, if 80 percent of the investment is borrowed at a 6 percent interest rate, the cash-on-cash return would be 21 percent.[12] Another factor that would increase the rate of return is that long-term commercial leases generally provide for annual rent escalations, while the financing costs from the lender can be fixed for three to 10 years. Thus, the return on investment could go up every year the lease requires an increased rent payment.

Many lenders require an individual to personally guarantee a loan. In the case of an IRA's investment in real estate, the borrower would be the self-directed plan itself, not the IRA owner. The IRC prevents an IRA owner from guaranteeing a loan made by an IRA.[13] An IRA can, however, obtain a non-recourse loan so long as there's an amenable lender. Typically, the borrower can't obtain as much leverage as with recourse debt because the lender, knowing the underlying property is its only security, won't want the greater risk associated with a loan balance that exceeds 70 percent of the property's fair market value. This key point—that an IRA owner can't guarantee a loan, has important ramifications. As noted, the lender likely won't allow the debt to exceed 70 percent of the purchase price. Further, if the net rent, after expenses, becomes insufficient to make the loan payments, the IRA owner is limited in the amount of contributions he can make to the IRA to cover that repayment. Subject to income limitations, in 2013, an IRA owner can contribute only $5,500 ($6,500 if over age 49) in any one year.[14] Accordingly, an IRA owner should leave sufficient cash or cash-equivalents in the IRA to cover any contingencies, that is, capital improvements (if not required to be paid by the tenant). A direct payment by an IRA owner to cover the loan payment isn't permitted.

There are lenders that specialize in making non-recourse loans to IRAs, and many custodians will supply lists of such lenders or brokers.

Prohibited Transactions

Congress has created a harsh penalty that can apply to an IRA that engages in a so-called "prohibited transaction." If, during any taxable year, an IRA owner (a disqualified person (DQP)) engages in any transaction prohibited by IRC Section 4975, the IRA will be treated as having been distributed as of the first day of the taxable year.[15] Thus, ordinary income tax will be due on the entire value of the IRA; further, if the IRA owner hasn't attained age 59½, a penalty will apply.[16] Prohibited transactions include:

(1) Sale of any property between a plan and a DQP;
(2) Lending of money between a plan and a DQP;
(3) Furnishing of goods, services or facilities between a plan and a DQP; and

UDFI is payable by the IRA and is applicable only to the portion of the rel estate investment that's leveraged.

(4) Transfer to, or use by or for the benefit of, a DQP of the income or assets of a plan.[17]

Additionally, prohibited transactions include any act by a DQP whereby he deals with the income or assets of a plan for his own interest.[18] The Department of Labor (DOL) is responsible for enforcing Section 4975,[19] and the DOL has stated that the determination of whether an IRA owner has dealt with the income or assets for his own interest must be judged on the facts and circumstances of each case.[20]

The IRC defines a DQP to include a fiduciary of the plan and a person providing services to the plan.[21] In the case of an IRA, the IRA owner is a DQP,[22] as is a partnership in which the IRA owner has more than a 50 percent interest[23] and a partnership in which certain members of the IRA owner's family own more than 50 percent.[24] However, a partnership more than 50 percent owned by the sibling of an IRA owner isn't a DQP.[25]

Tax Treatment

Tax-exempt organizations may be subject to a federal

corporate income tax on income derived from unrelated trade or business activities. IRAs may be subject to this same tax when a self-directed IRA borrows money to purchase real estate.[26] When real estate in an IRA is subject to tax on unrelated debt-financed income (UDFI), the income generated by the real estate is generally taxed under the rules and rates that apply to trusts, which is ordinary income at the trust tax rate.[27]

UDFI is payable by the IRA and is applicable only to the portion of the real estate investment that's leveraged. Thus, UDFI is computed based on a proportion, the numerator of which is the average principal balance on the loan and the denominator of which is the adjusted tax basis of the property during the tax year. Thus, when leverage is used to purchase real property in an IRA, a proportionate part of the income produced by the real property, including rental income and gain when the property is sold, is classified as taxable UDFI. A proportionate part of the deductions may be deducted from such income. However, gains from the sale of real estate are generally not unrelated income, unless the gain is debt-financed income.

For example, if an IRA acquires a commercial property for $5 million, puts $1 million down and takes out a $4 million mortgage, only 20 percent of rental income can be excluded from UDFI in that year. The other 80 percent is taxable UDFI. With debt-financed real estate, any excess cash flow could be used to pay down the debt so the interest expense is reduced. In contradistinction to traditional real estate investments outside the IRA context, a reduction in interest expense won't increase taxable income. As discussed above, other than UDFI, tax isn't paid until distributions are made (in a traditional IRA). Savvy IRA owners could use excess cash flow for capital improvements or maintenance. Effectively, such a strategy could convert UDFI into ordinary income whose recognition would be deferred until distributions were made.

As a technical matter, IRAs don't appear to be grantor trusts, and Sections 408 and 408(a) govern their taxation. Unlike grantor trusts, IRAs exist separate from their owners for federal income tax purposes. Were that not the case, Congress wouldn't have needed to subject IRAs to the unrelated business income tax.[28]

A bank may not lend an IRA money to buy more stock, but an IRA can likely borrow two-thirds of the value of a real estate investment. A relatively low risk commercial property with a good tenant could boost an IRA's return from single to double digits. Long-term real estate returns have been analogous to long-term stock market returns. An IRA portfolio should contain a variety of investments, and a direct investment in real estate, for certain investors, should be considered.

Endnotes

1. Jeff Benjamin, "Real estate: Surprising king of noncorrelated assets," *Investment News, www.investmentnews.com/article/20111204/REG/312049998.*
2. 26 U.S.C.A. Section 408.
3. 29 U.S.C.A. Section 101, *et. seq.,* originally enacted by PL 93–406 (HR 2) Sept. 2, 1974.
4. 26 U.S.C.A. Section 408(a)(3); 26 U.S.C.A. Section 408(m).
5. Many private letter rulings have addressed issues associated with real estate investments in individual retirement accounts. *See* PLR 200919066 (May 8, 2009), PLR 201218040 (May 4, 2012).
6. *See* 26 U.S.C.A. Section 401(a)(9).
7. 26 U.S.C.A. Section 408(e)(1).
8. *See, e.g.,* Jason Easley, "Obama Uses His Own Tax Return To Call For Raising Taxes on the Wealthy," *www.politicususa.com/obama-tax-return-call-raising-taxes-wealthy.html.*
9. 26 U.S.C.A.Section 1250.
10. *Ibid.*
11. *See www.math.nyu.edu/~crorres/Archimedes/Lever/LeverQuotes.html.*
12. The payment on a 6 percent loan, amortized over 30 years, is about 7.2 percent of the debt each year (or 5.7 percent of the purchase price). If that debt payment is subtracted from the 10 percent net operating income, there's 4.2 percent of the purchase price available as net cash flow each year as a return on the initial down payment. That 4.2 percent cash flow divided by the 20 percent down payment yields a 21 percent rate of return.
13. *In re Daley*, 459 B.R. 270, 278 (Bankr. E.D. Tenn. 2011) (citing 26 USCA 4975(c).
14. 26 U.S.C.A. Section 219(b)(5).
15. 26 U.S.C.A. Section 408(e)(2).
16. 26 U.S.C.A Section 401(a)(9).
17. 26 U.S.C.A. Section 4975(c)(1).
18. *Ibid.*
19. Enforcement of the prohibited transaction rules regarding IRAs was transferred from the Internal Revenue Service to the Department of Labor (DOL) pursuant to the Presidential Reorganization Plan No. 4 of 1978. 5 USC App. 1 Reorg. Plan 4 1978. The Treasury is bound by such interpretations.
20. *See, e.g.,* DOL Advisory Opinion 2000-10A, which can be found at *www.dol.gov/ebsa/programs/ori/advisory2000/2000-10a.htm.*
21. *See* 26 U.S.C. Section 4975(e)(2).
22. 26 U.S.C. Section 4975(e)(2)(A).
23. 26 U.S.C. Section 4975(e)(2)(G).
24. 26 U.S.C. Sections 4975(e)(6) and 4975(e)(5).
25. *Ibid.,* applying Section 4975(e)(6) to 26 U.S.C. Section 267(c)(4).
26. 26 U.S.C.A. Section 512.
27. 26 U.S.C.A. Section 1(e), 26 U.S.C.A. Section 511(a)(1) and 26 U.S.C.A. Section 512(c).
28. *Taproot Admin. Servs. v. Commissioner,* 133 T.C. 202, 211, 2009 U.S. Tax Ct. LEXIS 29, 133 T.C. No. 9 (T.C. 2009).