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INVESTING IRAs in REAL ESTATE *—AVOIDING THE PITFALLS*

2014 OSCPA REAL ESTATE CONFERENCE

June 18, 2014   Portland, Oregon

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WHAT WE'LL COVER TODAY

- Ground rules for investing IRAs in real estate
  - Types of investments allowed
  - Drawbacks of investing in real estate in an IRA
  - How to structure the IRA
- Pitfalls to avoid
  - Fraud
  - Prohibited transactions
  - Unrelated business income tax

POPULARITY OF S-D IRAs

- Spurt of popularity following 2008 crash
  - Stock and bond returns were uncertain
  - Foreclosures and short sales created opportunities with underpriced real estate
- Still, S-D IRA market is relatively small
  - There's over $5.7 trillion in IRAs
  - About $11 to $57 billion (2% to 10%) in S-D IRAs
  - But the market is growing

GROUND RULES FOR INVESTING IRAs IN REAL ESTATE

WHAT KIND OF REAL ESTATE CAN A SELF-DIRECTED IRA HOLD?

- Homes, apartments, condominiums
- Commercial properties (retail stores, hotels, office buildings)
- Raw land and undeveloped lots
- Trust deed notes, mortgages, tax liens
- Real estate options
- Other types of property such as timberland, farmland and boat slips

THINK OF IT AS A LOAN

- You're basically lending yourself the money to buy real estate
- The proceeds from the investment property (e.g., rental income) go to repay the loan plus expenses
- All funds must stay in the IRA until you take withdrawals (including required minimum distributions)
- Withdrawals (from non-Roth IRAs) taxed as ordinary income

DOWNSIDE OF INVESTING IN REAL ESTATE INSIDE AN IRA *Slide 1 of 2*

- The property is bought, held and sold by the IRA, not you
- Revenue/expenses <u>must</u> go through the IRA
- You can't deduct property taxes, mortgage interest or depreciation on your 1040
- You and your relatives can't:
  - Use the property for personal reasons
  - Do repairs/maintenance or operate the property

DOWNSIDE OF INVESTING IN REAL ESTATE INSIDE AN IRA *Slide 2 of 2*

- Hard to get mortgage for purchase in an IRA
  - Must be nonrecourse loan, so interest rate and down payment higher
  - Makes it hard to leverage and flip
- A mortgage results in UBTI upon sale
- And, with a traditional (non-Roth) IRA
  - Sales proceeds taxed as ordinary income when distributed from the IRA to you
  - Need to have liquidity to make required minimum distributions after age 70½

PENALTY IF RULES VIOLATED

- Tax-deferred status of the entire IRA is lost
- Treated as if the entire IRA was distributed on the first day of the year of the violation
- Have taxable gain to the extent FMV of the IRA as of January 1 exceeds your basis
- Plus 10% penalty if you're younger than 59½
- Plus 20% accuracy-related penalty
- Plus earnings after the IRA is disqualified are taxed to the IRA holder personally

NO SYMPATHY FROM THE IRS

- No “foot faults”
- No IRS correction procedure

HOW TO STRUCTURE THE IRA

- Need a self-directed IRA
- Need a “special assets” IRA trustee/custodian
  - Bank or mutual fund IRA won’t work
  - The players include: Pensco, Guidant, Equity Trust and many others. *(This listing is for information only and is not an endorsement!)*
- Read the paperwork <u>very</u> carefully

READ THE PAPERWORK CAREFULLY

- What services will the IRA custodian provide?
- What are the IRA custodian's fees?
- Beware the disclaimers (taken from the materials of one of the providers listed earlier)—
  - "We will…ensure the deal is IRS compliant"

    but later on it says:
  - "We do not provide legal or tax advice"

CAVEAT: UNDERSTAND YOUR ROLE AS THE IRA HOLDER

- Self-directed IRAs do not operate like conventional IRAs
- It is important for holder of a self-directed IRA to know what has to be provided to the custodian…and when
- Failure to communicate properly with the custodian could result in penalties or even disqualification of the IRA

THE "CHECKBOOK IRA" *Slide 1 of 3*

- Typically, the IRA custodian processes the payment of the expenses on the real estate held in the IRA
  - And charges a per transaction fee
- To reduce fees and the processing delays, an IRA holder can set up a "checkbook IRA"
- Directs the IRA custodian to invest in an LLC in which the IRA is the sole member and, typically, the IRA holder is the manager

THE "CHECKBOOK IRA" *Slide 2 of 3*

- IRA custodian creates the LLC on behalf of the IRA
- Funds are transferred from the IRA to the LLC
- LLC places the funds in its own bank account
- LLC's manager (the IRA holder) has check writing and contract signing authority
- LLC purchases and manages the real estate

THE "CHECKBOOK IRA" *Slide 3 of 3*

- The prohibited transaction rules continue to apply, however
  - So, generally, LLC is a newly formed one, not one in which IRA holder had a prior ownership interest
- There is some authority for this concept
  - E.g., *Swanson v Comm'r,* 106 TC 76 (1996); IRS Field Service Advice Memorandum 2001128011; *Peek v Comm'r,* 140 TC 12 (2013)
  - Caveat: these don't directly address single-member LLCs

PITFALLS TO AVOID—*FRAUD*

BEWARE OF FRAUD!

- Self-directed IRAs are attractive targets for fraud promoters
- There's about $11 to $57 billion in self-directed IRAs
- Self-directed IRAs allow investors to hold unregistered securities
- Self-directed IRA custodians do not evaluate investments or promoters (and disclaim any responsibility to do so)

BEWARE OF FRAUD *(continued)*

- Financial and other information about the investment and its promoter may not be readily available
- And when it is, usually not audited
- Again, the self-directed IRA custodian does not review the accuracy of any financial information or other offering materials

FRAUD ALERT WARNING

- The SEC and the NASAA (North American Securities Administrators Association) jointly issued an investor fraud alert regarding self-directed IRAs
- According to the NASAA, there was an increase in fraudulent schemes involving self-directed IRAs
- This September 2011 "Investor Alert" is at:

    www.sec.gov/investor/sdira.pdf

REAL LIFE EXAMPLES

Example 1—

- SEC brought fraud charges against Utah-based company and its founder/president/CEO for losing $22 million in investor funds
- Investments were made in bankrupt ventures, including an office building
- The company concealed losses and issued account statements with inflated values

REAL LIFE EXAMPLES *(continued)*

Example 2—

- Portland/Bend husband and wife team promoted real estate “mortgage securities”
- Claimed these “mortgage securities” were exempt from registration
- Posted great returns…for awhile…turned out to be a Ponzi scheme
- Both convicted and jailed

PITFALLS TO AVOID—
PROHIBITED TRANSACTIONS

TYPES OF PROHIBITED TRANSACTIONS UNDER IRC § 4975

There are 2 unofficial categories:

- Direct PTs
- Personal benefit/conflict of interest PTs

DIRECT PTs

- IRC § 4975 prohibits certain transactions between an IRA and any "<u>disqualified person</u>" (DQP)
- Purpose: To encourage use of IRAs for accumulation of retirement savings and prohibit those in control of IRAs from taking advantage of tax benefits for their current personal benefit

DIRECT PTs *(continued)*

- If IRA holder (or a beneficiary) violates the PT rules, the IRA ceases to be tax-deferred
- Typically, the disqualification is retroactive several years, so the tax plus interest plus penalties can be significant
- See Slide No. 8 for the horrific tax consequences

“DISQUALIFIED PERSON” MEANS

- You if you’re the IRA account holder
- Your spouse
- Your parents and grandparents
- Your children and grandchildren
- Spouses of your children and grandchildren (but not parents-in-law)
- Brothers, sisters, aunts, uncles and cousins are NOT disqualified persons

“DISQUALIFIED PERSON” MEANS *(continued)*

- An entity more than 50% owned by any combination of foregoing
- A 10% owner, officer, director or highly compensated employee of such an entity
- A trust if 50% or more of beneficial interests are owned by DQPs
- Any person providing services to the IRA (i.e., CPA preparing IRA tax return)
- The IRA custodian

TYPES OF DIRECT PTs

IRC § 4975 prohibits:

- Sale, exchange or leasing of property between IRA and DQP
- Lending of money or other extension of credit between IRA and DQP
- Furnishing of goods, services or facilities between IRA and DQP
- Transfer to or use by DQP of income or assets of IRA (other than regular taxable distributions)

PERSONAL BENEFIT/CONFLICT OF INTEREST PTs

IRC § 4975 also prohibits:

- Indirect use of IRA income or assets for the personal benefit of a DQP
- Receipt of any consideration by a DQP who is a fiduciary for his own account from any party dealing with IRA in connection with transaction involving income or assets of IRA

PITFALLS TO AVOID—*UNRELATED BUSINESS INCOME TAX*

UNRELATED BUSINESS OR DEBT FINANCED INCOME

In addition to PTs, self-directed IRAs have another briar patch to pick through:

- Unrelated business income tax (UBIT)
- Unrelated debt financed income (UDFI)

UNRELATED BUSINESS INCOME TAX

- Generally, earnings within an IRA (or an LLC owned by an IRA) are generally tax-exempt
- However, "unrelated business taxable income" ("UBTI") is taxed currently at the IRA level
- UBTI is taxed at the <u>trust rates</u>
- These same tax rules apply to qualified plans, charities and other tax-exempt organizations
- Unlike PTs, UBIT is not a penalty; it's just a tax on certain types of investments (albeit at a penalizing tax rate)

WHAT'S "UNRELATED" MEAN?

- Rationale for UBIT: Exempt orgs shouldn't get tax breaks for business activities not substantially related to their exempt purpose
- IRA is supposed to be a passive investor
- So, <u>any</u> active trade or business is unrelated to an IRA's purpose
- However, most income typically earned by an IRA invested in real estate is exempt from UBIT

EXCEPTIONS TO UBTI

- First $1,000 of net income
- Dividends
- Interest (including points)
- Royalties
- Rents from real estate (<u>unless</u> they're a disguised profits interest)
- Gains from sale or exchange of property (<u>unless</u> it was held as inventory or in the ordinary course of business)

UNRELATED DEBT FINANCED INCOME (UDFI)

- Net income generated from debt financed property is subject to UBIT even if it qualifies for an exemption from UBTI
- I.e., the UDFI rules apply to dividends, interest, royalties, rents and gain from sale or exchange of property

HOW IS UBIT CALCULATED?

- By filing Form 990-T
- For UDFI, UBIT is calculated only on the percentage of income attributable to the debt-financed part of the property
- *E.g.,* IRA purchases rental property with 50% down and 50% seller financing
  - —50% of the rent is taxed as UBTI
  - —50% of the expenses (e.g., depreciation) can be applied to offset the UBTI

990-T TRAPS

- 990-T must be filed (generally by April 15) if gross UBTI/UDFI is over $1,000 for the year
- Need to aggregate all IRAs for the $1,000 threshold
- IRA needs an EIN to file
- IRA needs a checking account to pay the tax
- Many self-directed IRA custodial agreements say that the IRA holder has to file tax returns
- Even if self-directed IRA custodian is responsible, IRA holder has to get information to the custodian

ESTIMATED TAXES

- If the IRA has to pay over $500 in UBIT for the year, it also has to start filing and paying quarterly estimated taxes
- Again, many self-directed IRA custodial agreements make filing tax returns and paying taxes the IRA holder's responsibility

QUESTIONS?

Ask me now or contact me…

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AND THANKS FOR LISTENING!