

**PURCHASING REAL ESTATE  
IN A SELF DIRECTED IRA OR QUALIFIED PENSION PLAN**

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**GLAZER FINANCIAL NETWORK**

In today's market or lack of market, most baby boomers have most of their retirement funds in a Pension or Individual Retirement Plan, their closely held businesses and their principal residence.

One of the most common methods of purchasing real estate or other self directed investments is in a Self Directed Individual Retirement Plan.

These IRAs can be Individual Originated IRAs or rollover of Qualified Employee Retirement Plan Accounts.

The kinds of Self Directed Investment that are very popular are real estate, notes, and private placements in Limited Liability Corporations and Limited Partnerships.

In order to purchase these investments you would open a Self Directed IRA. There are a number of Custodians that permit full self direction.

Operating Income and Debt Financed Self Directed Investments in IRAs are subject to unrelated Business Income Tax and/or unrelated Debt Financed Income Tax which are in the same IRS Code Section.

**An alternative to Self-Directed IRA's for Real Estate Investment**

Many people believe that a Self-Directed IRA is the only way to invest in Real Estate. It is not. Another alternative is to utilize a Defined Contribution (DC) or Defined Benefit (DB) plan as an alternative. There are three key advantages to using a DC or DB plan:

1. Less expensive to setup and maintain
2. Foreign investment allowed
3. Can accept current contributions from \$50,000 to \$200,000 per year

Creating a Defined Contribution (DC) or Defined Benefit (DB) Plan that permits investment in Real Estate is the same as creating a defined contribution plan (like a 401k) for small business. For plans that invest in Real Estate there is some additional work to administer the plan versus a plan that invests in Stocks, Bonds and Mutual

Funds. The additional work varies depending on the type of Real Estate investment. For example, raw land has different requirements than rental property. In addition, depending on the type of investment, Fidelity bond requirements vary. Independent of the type of Real Estate investment, this alternative can save thousands of dollars in setup and annual administration costs when comparing the costs of the self directed IRA approaches being offered. If you have researched using a Self-Directed IRA for Real Estate investment, you will have learned that titling requirements, proper documentation (e.g. for a loan), annual appraisals, and operating issues exist. The same issues exist for a DC or DB plan.

Pension plans in the United States have been investing in real estate since the beginning. At The Pension Specialists, Inc. we have helped our small business clients create either Defined Contribution or Defined Benefit Plans enabling them to invest the assets in either Domestic or International Real Estate for over 35 years. This is not a new approach; we are just one of the few companies that allow Real Estate as a plan asset.

If you are currently operating a business with U.S. (United States) generated income, you can make traditional or Roth contributions as well as DC or DB contributions to the plan. This facilitates tax deferral and provides the opportunity for additional investment capital.

DC or DB plans offer a viable alternative with more flexibility and possibly less cost to the Self-Directed IRA.

In a Qualified Plan, Acquisition Debt for real estate is not subject to UBIT or UDFI unless you have established a Real Estate Business. If you have a Qualified Plan you can have provisions in your trust that allows the purchase of these assets including International Real Estate.

#### **Issues with Real Estate as Investment in Retirement Plan:**

- Trustee cannot buy or sell the real estate between self or spouse or any other party of interest and must buy it in the name of the retirement plan (owner/trustee would need to determine what options are available for legal title in the state where real estate is located);
- Real estate cannot be held jointly or as tenants in common with the trustee, plan sponsor or any other party of interest;
- The Plan will need an annual formal appraisal of the real estate

- There could be liquidity problems if you need to pay out benefits – this is less of an issue if just trustee/owner and spouse are in the plan; and
- Small plan audit requirements have been required since 12/31/02 for non-publicly traded property, if the plan files 5500 EZ (if owner and/or spouse only are the participants, it is exempt from this audit requirement).

**Additional considerations if Income producing Real Estate:**

- May not be able to take full tax advantage of depreciation inside plan;
- Expenses such as cleaning, mortgage payments and rental costs must be paid by plan, not owner/trustee; and
- Trustee or any party of interest may not use the rental property for personal use (i.e. a vacation home).

The difference between a Self Directed IRA versus a DC or DB Plan is control and UBIT and/or UDFI. In the Qualified Plan you would also have less cost in most instances. Capital gains in both instances are tax deferred. They are taxed at ordinary income tax rates when distributions occur.

**Follow these steps to purchase property in either Plan:**

1. You open a self directed IRA or you become a participant in a qualified plan which permits full self direction – *At the same time;*
2. You locate investment property – *Then;*
3. You make an offer on the property, generally in the name of the plan (e.g., Purchaser: Bob Smith IRA or Bob Smith Profit Sharing Plan) – *If the offer is accepted;*
4. You complete a Buy Direction Letter to the Trustee of the Plan in a form acceptable to the Trustee or Custodian (this describes the purchase in detail and may include purchase agreement or contract) – *At the same time;*
5. You read and approve documents from the Title Company/Escrow Agent. These include Property Description, Title Report and Others;
6. The Title Company/Escrow Agent sends the approved documents to the Trustee or Custodian who signs them on behalf of your IRA or Plan;
7. Rental or Lease Agreements are assigned by the Seller to the Plan. Any new Rental or Lease Agreements are then made in the name of the Plan. If external servicing is desired, servicing agreements are made between the Plan and the Servicer;
8. The Trustee or Custodian sends funds to Escrow. – *The transaction closes, and;*

9. The Deed is recorded in the name of the Trustee or Custodian for the benefit of your account. The Deed is then sent to the Trustee or Custodian; and
10. All income is paid to the IRA or Qualified Plan. All expenses are paid from the IRA or Plan in direct proportion of ownership.

**To buy a rental property with debt in an IRA or Qualified Plan there are 10 basic requirements:**

1. You locate a lender;
2. The lender may not have recourse to you, only to the asset being financed;
3. Your credit may not be used to facilitate the loan;
4. The Seller may carry back financing;
5. Debt financing will be subject to Unrelated Debt Financed Income Tax (UDFI) involving an IRA. Acquisition debt in a Qualified Plan is not subject to such tax;
6. Additional debt incurred in an IRA is subject to Unrelated Debt Financed Income;
7. Factor in that even if your account paid UDFI tax, the account will be subject to tax again when withdrawals are made, except in the case of Roth IRAs;
8. UDFI does not apply if the debt has been paid off for a 12 month period;
9. UDFI must be paid by the IRA; and
10. Debt may be paid from other funds in other IRAs, or other Plans. Debt paid from funds not in IRA or Plan will be an excess contribution and may be subject to penalty.

**An example of buying a property and rehabbing the property is as follows:**

**Rehab Property**

<b>Total Purchase Price</b>		<b>\$30,000</b>	
<b>IRA Portion</b>	<b>Original Investment</b>	<b>Rehab Costs</b>	<b>Total Costs</b>
	\$10,000	\$5,000	\$15,000
<b>Loan Portion</b>	<b>Original Amount</b>	<b>Interest Expense</b>	<b>Total Loan Expense</b>
	\$20,000	\$1,000	\$21,000
<b>TOTAL COST OF ACQUISITION AND REHAB</b>			<b>\$36,000</b>

**Solutions to a Shortage of IRA Money**

- Make a contribution to IRA or rollover funds from another plan
- Increase “debt finance”
- Sell another asset in the plan to raise cash
- Bring in partners
- Sell the property as is

### The Sale of the Rehab

- Rehabbing completed 110 days
- Prepare Sell Direction Letter for \$56,000

### Unrelated Business Income Tax on Debt Financed Property in an IRA

#### **Profit on borrowed funds:**

- IRS code requires payment of tax on the portion which is debt financed
- Unrelated Business Income Tax Return, IRS Form 990 T for the IRA

<u>Taxable Income</u>	<u>Tax Rate</u>	<u>Deduction</u>
0 to 50,000	15%	0
50,000 to 75,000	25%	5,000
75,000 to 100,000	34%	11,750
100,000 to 335,000	39%	16,750

### Proportions

### IRA + Loan

41.67% Percentage Not Subject to UBIT or IRA portion

58.33% Percentage Subject to UBIT or loan portion

Sales Price \$56,000

Gross Profit \$20,000

### **IRA PROFIT \$8,333**

### \$20,000 as Gross Profit

Loan of \$20,000, plus interest of \$1,000, was repaid out of escrow.

### **\$8,333.33 attributable to IRA**

### Results

The unrelated business tax was \$2,167.

**IRA increased by \$17,833 after UBIT.**

### IRA Profit from Non-UBIT Portion

IRA Profit from Non-UBIT		\$8,333
Profit Allocation:		
To Loan Subject		
To UBIT	\$11,667	
Expenses:		
Allocated to UBIT	\$ 2,917	
Amount subject to UBIT	\$ 8,750	
UBIT paid by IRA	\$ 2,167	
Profit on Loan Portion		
After IRA Paying UBIT		\$9,500
<b>Total Net Profit to IRA</b>		<b>\$17,833</b>

### A comparison of IRAs and Qualified Plans

**Qualified Plan(s)**

	<b>IRA-IRC 408</b>	<b>IRC 401(a)</b>
Available To	Individual	Businesses
Deadline to Establish	April 15 <sup>th</sup>	Last Day of Business's Tax Year (i.e. Dec 31 For Calendar Year)
Contribution Limit	\$4,000	\$45,000 to \$200,000+
Invest in Real Estate	Yes	Yes
Leverage in Real Estate	Yes	Yes
UBIT in Leveraged Real Estate	Yes	Yes
UDFI	Yes	No
Loan Out	Yes	Yes
Borrow From	No	Yes
Annual Filings	No	Yes

As you can see, it is beneficial to use your Pension or IRA assets to buy real estate.

The issues are Unrelated Business Income Tax or Unrelated Debt Financed Income Tax in the Self Directed IRA and the use of a Limited Liability Corporation to avoid these taxes.

The income tax impact is minimal on the Self Directed IRA and you can see you still can have a profit if you can find a Custodian that allows the purchase of real estate.

In a memorandum dated October 1, 2008 from the Department of the Treasury, there are direction/guidelines in regards to the rollovers as business start-ups. The IRA concept of using could be construed as a business start-up.

In a retirement plan these issues are not an issue as long as the trust allows the purchase of real estate either directly or in a partnership.

**Please contact me for further information.**

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