Mainstar Trust

GETTING STARTED

INVESTING IN REAL ESTATE THROUGH YOUR IRA

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One of the primary benefits of owning a self-directed IRA is the freedom to diversify from the more traditional investments – certificates of deposit, mutual funds, and ETFs – used for retirement savings. IRA owners often use self-directed IRAs to invest in alternative investments that give them more control over the direct investment of their assets, such as real estate. You don't have to be an HGTV pro at flipping houses or have a gigantic IRA balance to add real estate to your IRA investment portfolio because investing in real estate through an IRA not only provides the flexibility to invest in different aspects of the real estate market but also the opportunity to invest in different ways, from 100% ownership to purchasing shares of a real estate-investing entity.

BENEFITS

The reasons why investors seek real estate investments through their IRA are as varied as the types and ways to invest in real estate.

INVESTMENT FLEXIBILITY & VARIETY

A single IRA may hold many different types of investments, including a variety of types of real estate and real estate-related investments.

- Single family homes
- Multiple family residential properties
- Rental income property
- Commercial property
- Undeveloped land
- Tax liens
- Mineral rights
- Water contracts
- Mortgage notes and trust deeds
- Real estate investment trusts (REITs)

The actual investment options available through a self-directed IRA will vary depending upon the specific IRA custodian. For example, some institutions do not have the legal power under their governing documents to hold certain types of alternative investments, such as real estate. And some IRA custodians may specialize in only certain types of real estate investments.

BENEFITS CONTINUED...

DIVERSIFICATION & OPPORTUNITY

Investing in real estate allows IRA owners to diversify their investments beyond the more traditional stock and bond options typically available in retirement plans. And some investors simply prefer investing in a physical investment over something less tangible, like mutual funds. Another attraction to real estate is the opportunity to tap into different types of properties and different geographic locations. Varying the types of positions held (commercial vs. residential) or location (West coast vs. East coast) can protect against slumps in one area of the market and balance both short-term and long-term growth and income needs. Some investors believe this type of market diversification provides the potential for a larger return on investment than more traditional options. An IRA owner who has business experience handling real estate may be able to capitalize on that expertise to maximize their investment potential. Real estate also offers IRA owners an opportunity to leverage their IRA assets by obtaining non-recourse loans or partnering with other investors to expand their purchasing power.

BENEFITS OF REAL ESTATE INVESTING THROUGH IRAS

- Flexibility
- Diversification from stock market
- Tangible investment
- Industry & regional market differences
- Investor expertise
- Tax-deferred investment growth
- Tax-free investment growth with Roth IRA
- Non-probate asset

TAX BENEFITS

One of the main benefits of investing in an IRA, of course, is the tax benefits. The growth of an IRA investment is tax-deferred until the assets are distributed, so the appreciation or the profit made on the sale of real estate assets within the IRA will be tax-deferred until the IRA owner takes a distribution from the IRA. In the case of real estate assets owned through a Roth IRA, the gain in value of the real estate investment may even be tax free if the Roth IRA distributions are qualified. A qualified Roth distribution generally occurs if the account holder has reached age 59 1/2 and the account was funded five years earlier. In addition to the appreciation in value, some real estate investments also generate rental or lease income. That income also generally accumulates tax-deferred within the IRA.

Owning real estate through an IRA may have estate planning benefits as well. IRA assets are excluded from probate after the IRA owner's death as long as the IRA has a designated beneficiary (not the estate). This means that an IRA owner can name beneficiaries and design a distribution strategy for the real estate investment that bypasses the lengthy, and sometimes costly, probate process.

WAYS TO INVEST IN REAL ESTATE THROUGH YOUR IRA

In addition to the different types of real estate investments available, you have multiple options as to how to invest in real estate with your IRA. Some methods allow you to invest a smaller amount than you would typically need to purchase property outright. These methods can help IRA owners invest in the real estate market even if they do not yet have a large enough balance to acquire 100% ownership of real property. The methods of investing can be separated into two categories: direct and indirect ownership. Here are a few examples of each type of ownership.

DIRECT OWNERSHIP

With direct ownership, the IRA may own 100% of the investment or a partial interest, but the IRA is listed as owner on the title of the property.

Purchasing 100% Ownership: Purchasing an entire parcel of property with IRA assets is the simplest way to obtain full ownership of real estate in an IRA if your IRA has enough cash to pay the purchase price, closing fees, taxes, and other expenses of the transaction.

Here are the possible steps to complete this type of investment:

STEP 1 *The IRA owner works with a financial advisor and a realtor to identify a property worthy of investment and negotiates a purchase price and terms with the seller.*

STEP 2 *The IRA owner directs his IRA custodian to use his IRA assets to purchase the property at the price negotiated with the seller.*

STEP 3 *The IRA custodian signs the purchase agreement and other documents on behalf of the IRA and delivers funds from the IRA to the closing/escrow agent to purchase the property pursuant to the direction of the IRA owner.*

STEP 4 *The IRA custodian will take title to the property for the benefit of the IRA (e.g., "Mainstar Trust, Custodian, FBO John Jones Traditional IRA").*

STEP 5 *While the IRA custodian holds title to the investment on behalf of the IRA, the custodian will use IRA assets to pay expenses related to the investment, as directed by the IRA owner. Management agreements and/or lease contracts are signed by the custodian for the benefit of the IRA.*

STEP 6 *The title remains in the name of the IRA custodian for the benefit of the IRA until the IRA owner decides to sell or distribute the investment.*

WAYS TO INVEST IN REAL ESTATE THROUGH YOUR IRA CONTINUED...

Purchasing a Partial Interest (Partnering): You may also choose to partner with another IRA, a private party, or a business to purchase a partial interest in real property. The process is much the same as for the purchase of a sole interest in real property, although it may be complicated by having multiple co-owners and their representatives/agents. Generally, when partnering to purchase real estate through an IRA, each partner benefits from income or proceeds generated by the property, and pays any expenses, in proportion to their percentage of ownership. For example, if the IRA owns 50% of the property, the IRA will receive 50% of the proceeds of the sale of the property and must pay 50% of all expenses associated with the property. The custodian still acts on behalf of the IRA to execute any agreements, transfer funds, and pay expenses related to the IRA's share of the investment, as well as takes title to the asset with the percentage of ownership documented (e.g., Mainstar Trust, Custodian, FBO Mary May's Traditional IRA Undivided Interest 30%, Jack James Undivided Interest 30%, and ABC Company LLC, Undivided Interest 40%).

CAN MY IRA PARTNER WITH MY FAMILY TO PURCHASE REAL ESTATE?

In limited circumstances, your IRA may partner with a family member or other disqualified person, including your own personal funds, to purchase real estate. This arrangement can be structured to avoid a prohibited transaction only if it is the initial purchase of the property. Each purchasing partner must receive only their proportionate share of any gain and must pay their share of expenses so as not to cause the IRA owner or disqualified person to benefit outside of the investment. It is recommended that IRA owners obtain legal or tax advice regarding the specific arrangement.

Obtaining a Non-Recourse Loan: Although an IRA generally may not borrow money or obtain credit, there is one type of loan that is permitted with real estate investments: a non-recourse loan. With this type of loan, the real estate purchased must be the only collateral for the loan, and the lender's only remedy in case of default is to repossess the property and foreclose on the loan. The lender cannot pursue other assets in the IRA or the IRA owner's personal assets. Because of the potentially higher risk of not recovering all losses upon default, non-recourse lenders may require a large down payment (from the IRA) and may charge a higher interest rate.

WAYS TO INVEST IN REAL ESTATE THROUGH YOUR IRA CONTINUED

INDIRECT OWNERSHIP

Another way of purchasing real estate in an IRA is to purchase shares in an entity that has underlying ownership rights in real estate. In this indirect ownership structure, the IRA is not listed on the title as owner of the real estate; the entity is named as owner of the real estate and the IRA owns shares of the entity.

Multiple Member Limited Liability Company (LLC): An LLC is a business entity that has the limited liability characteristics of a corporation with some flexible taxation features under federal law. Those who purchase shares in an LLC (members) are shielded from legal and financial liability incurred by the LLC. If an LLC is taxed as a partnership with flow-through income, any income flowing into the IRA generally will be not be taxed until distributed (and may be tax-free in a Roth IRA). Other benefits to investing through an LLC are that multiple investors can pool their money to invest on a larger scale, and real estate transactions and expense payments are managed by the LLC. This may create efficiencies and cost savings for the IRA, but the costs related to operating the LLC must also be considered.

Single Member Limited Liability Company (LLC): With a single member LLC, the IRA is the sole investor in the LLC. The IRA benefits from the limited legal and financial liability of an LLC much like the multiple member LLC for the purpose of owning real estate. There are some differences to be aware of, however. The custodian of the IRA will send funding to the bank account for the single member LLC. At that point, the single member LLC may buy the real estate with the IRA money. The LLC will be named on the title. Utilizing an LLC to purchase real estate affords greater control and enables the LLC to sign closing documents and allows check-writing privileges. This form of ownership requires a high level of familiarity with IRS regulations for IRAs because of the potential for prohibited transactions. Investors should review all requirements with their CPA to ensure that the underlying transactions within the LLC comply with IRC Section 4975 and are not considered prohibited transactions.

Additionally, if purchases into the LLC are invested into an operating company that is a pass-through tax entity, the IRA may be subject to Unrelated Business Taxable Income (UBTI). If an investment is deemed to generate income that is not substantially related to the tax-exempt purpose of an IRA (i.e., saving for retirement), that income may be taxable in the year it was earned. Without these tax rules, a business operating within a tax-deferred environment, such as an IRA or other tax-exempt entity, would have a competitive advantage over a business that is paying taxes on its business income.

WAYS TO INVEST IN REAL ESTATE THROUGH YOUR IRA CONTINUED

Mortgage Notes and Trust Deeds: Another option is to invest in mortgages and deeds of trust (i.e., real estate loans) where your IRA lends money to a borrower and receives repayments on the loan, plus interest, under the terms of a promissory note. The real property is the collateral for the loan and is secured by a mortgage note or trust deed. These may be good options for investors who want to invest in real estate as an asset class, but on a passive basis. With this type of investment, investors are not responsible for the many challenges of overseeing a piece of real estate. Investors only directly own the real estate if the borrower defaults on the loan and the IRA forecloses on the property.

Real Estate Investment Trust (REIT): IRA owners may use their IRA assets to purchase shares of REITs. A REIT is a corporation or trust that pools the assets of multiple investors to purchase and manage real estate assets or mortgages. Many REITs focus on owning and operating income-producing real estate (e.g., office buildings, shopping malls, apartment buildings, hotels). REITs may be private, public non-traded, and publicly traded. When an IRA owns shares in a REIT, the IRA receives dividends from the REIT. Tax on the dividends is deferred until the IRA owner takes a distribution from the IRA. Investing in a REIT may be an attractive way for IRA owners to invest in real estate without the burdens of being directly involved in researching, buying, and selling real estate. REITs also offer both capital appreciation and income generation. Shares in publicly traded REITs may be bought and sold on the stock market or as a mutual fund, so it is a liquid investment for the IRA.

CONSIDERATIONS

There are a few considerations investors should be aware of when exploring real estate investments within their IRA. For many investors, these considerations do not pose any real concern; others may find that they offset the benefits of investing in real estate through their IRA vs. personal ownership outside the IRA.

LOSS OF CERTAIN TAX ADVANTAGES

When real estate is purchased through an IRA, the investor is not able to take tax deductions for depreciation or mortgage interest. Also, the proceeds on the sale of real estate, although tax-deferred until distributed from the IRA, will be taxed at the investor's income tax rate at the time of the distribution not the more favorable capital gains tax rate that may be available when real estate is owned and sold outside of an IRA.

VALUATIONS

To properly complete the required reporting for IRAs, including specific requirements for investments that do not have a readily available fair market value, IRA custodians need annual valuations for each real estate investment or shares of ownership held by the IRA. The IRA owner is typically responsible for obtaining valuations from a licensed or certified real estate appraiser. The IRA owner should check with the IRA's custodian to understand what documentation is required.

FEES & LIQUIDITY

Any expenses associated with managing or maintaining a real estate investment inside an IRA must be paid from the IRA. This includes expenses such as closing fees, taxes, insurance, utilities, and property management fees. The IRA should have enough liquid assets to pay for these expenses. Additional liquidity concerns arise for traditional IRA owners who must take required minimum distributions (RMDs) each year.

UBTI/UDFI

The unrelated business taxable income (UBTI) and unrelated debt financing income (UDFI) rules ensure that a business operating within a tax-deferred environment like an IRA does not receive tax advantages over a business that must pay taxes each year on its business income. UBTI tax may be owed on income from a trade or business that is not substantially related to the IRA's tax-exempt purpose, which is growing retirement savings. UDFI tax may be owed on a portion of income earned by a debt-financed real estate (non-recourse loan) investment in an IRA. If an IRA receives $1,000 or more of UBTI/UDFI in a year, the income is taxed at trust tax rates in the year it is earned. The tax is reported on IRS Form 990-T, Exempt Organization Business Income Tax Return, and must be paid from the IRA. To learn more, please read our blog: What is Unrelated Business Taxable Income (UBTI)?

CONSIDERATIONS CONTINUED

PROHIBITED TRANSACTIONS

Individuals owning self-directed IRAs are accustomed to a high level of control over their investments. Sometimes this level of involvement can create the potential for an IRA owner or related party to engage in a transaction that is not permitted under the tax laws for IRAs. To avoid a prohibited transaction, IRA owners must be aware of the rules and ensure that their IRA investments are made for the purpose of saving for retirement—not to benefit the IRA owner or a "disqualified person" personally before the assets are distributed.

The following types of transactions are not allowed to take place between an IRA and a disqualified person:

- Sale, lease, or exchange of property
- Lending of money or extension of credit
- Furnishing of goods, services, or facilities
- Transfer or use of IRA income or assets
- Fiduciary using IRA assets for his or her own interest

Here are some examples of ways IRA owners could violate the prohibited transaction rules:

- Using an IRA to purchase real estate that will be used by the IRA owner's business or that will provide housing to the IRA owner or other family members is not permitted.
- An IRA owner or a family member cannot provide services to property owned by the IRA, such as an office building or apartment complex, for free or pay. IRA owners must hire an independent third party to handle tasks such as collecting rents and performing repairs.
- The IRA cannot purchase real estate from the IRA owner or other disqualified person.

A "disqualified person" under the prohibited transaction rules includes the following:

- IRA owner
- IRA beneficiary
- IRA owner's spouse, ancestors, and lineal descendants (i.e., children, grandchildren) and their spouses
- IRA custodian
- Fiduciaries to the IRA (includes those who exercise discretionary control over the IRA or its assets and those who provide investment advice to the IRA owner for a fee)
- A corporation, partnership, trust, or estate that is 50% or more owned by the IRA owner (directly or indirectly)
- An officer, director, or 10% or more shareholder or partner of a disqualified entity

CONSIDERATIONS CONTINUED

If a prohibited transaction occurs, the IRA loses its tax-qualified status and ceases to be an IRA as of the first day of the year in which the prohibited transaction occurred. The IRA owner must include the entire amount of taxable assets in the IRA as income for the year. If younger than 59½, the IRA owner is also subject to an additional 10% early distribution tax on the taxable amount in the IRA. If a disqualified person, other than the IRA owner or beneficiary, engages in a prohibited transaction, the IRS may also impose an excise tax of 15%, which raises to 100% if not corrected, on that disqualified person.

To learn more, please read our blog Do You Need to Worry About Prohibited Transactions?

PROHIBITED TRANSACTION: PURCHASING PROPERTY FROM YOUR IRA

Samantha has a traditional self-directed IRA worth $1 million (all pre-tax) as of January 1, 2020. Her IRA owns a beach house in Aruba that has generated rental income for many years and is now valued at $500,000. Samantha wants to retire this year (age 65) and move to this beach house. She knows she cannot live in it while it is an IRA investment, so she plans to purchase the property from her IRA before she moves in.

Purchasing the real estate directly from the IRA is a prohibited transaction because it involves the sale of property from the IRA to a disqualified person (the IRA owner). If Samantha were to purchase the real estate from her IRA, the IRA would cease to be an IRA as of January 1 this year. She would have to include $1 million (the value of her entire IRA, not just the value of the investment), in her taxable income for the year.

What Samantha can do is take an "in-kind distribution" of the property. She would have to pay income tax on the value of the property in the year of distribution, but she could then take ownership of the house outside of her IRA.

PROHIBITED TRANSACTION: LENDING MONEY TO A DISQUALIFIED PERSON

Darren, age 51, has a traditional IRA worth $250,000 (all pre-tax) as of January 1, 2020. Darren's son, Thomas, asks to borrow $25,000 for the down payment on a house. Darren figures he can help his son and earn a guaranteed 7% return on the investment by making the loan from his IRA. Darren's son signs a promissory note on September 1, 2020, for the loan at 7% interest for a 5-year term, with monthly payments to Darren's IRA.

This arrangement is prohibited because the IRA is lending money to a disqualified person (the IRA owner's son). An IRA may invest in loans as a lender but cannot lend to a disqualified person.

In this scenario, Darren's IRA would cease to be an IRA as of January 1, 2020. He would have to include $250,000 in his taxable income for 2020, and would be subject to the 10% early distribution tax because he is under age 59½.

HOW YOUR IRA CUSTODIAN CAN HELP

Your IRA custodian will not be involved in assessing the merits of a real estate investment or the potential for a prohibited transaction. You, as the IRA owner, are responsible for consulting with your financial, legal, tax and real estate advisors and performing the due diligence on a potential investment before directing your IRA custodian to purchase the investment through your IRA

Your IRA custodian's role is to act on behalf of your IRA, at your direction, to take ownership of the investment. This includes signing documents on behalf of the IRA and transmitting IRA assets to purchase the investment. The IRA custodian will hold legal title to the investment in the name of the IRA and physically safeguard copies of the title and other documentation related to the investment. Once the real estate investment is purchased by the IRA, the IRA custodian generally must pay ongoing expenses related to the investment from IRA assets, as well as accept rental payments or other income on behalf of the IRA. IRA custodians also perform all the administrative tasks required for all IRAs including accounting for the assets and generating required IRS reporting.

CONCLUSION

Real estate can be an attractive investment option for self-directed IRA owners who want more diversification and control over their investments. If you are thinking about investing in real estate through your IRA, make sure you understand the prohibited transaction rules and weigh the benefits and considerations along with your personal investment objectives. Most investors engage financial, tax, and real estate experts to help them evaluate the potential risks and rewards of investing in real estate through an IRA.

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