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INVESTING IN REAL ESTATE USING SELF-DIRECTED RETIREMENT ACCOUNTS
By Ken Holman

The most recognized types of retirement accounts are the 401(k) plan for private employers, the 403(b) plan for non-profit employers, the 457(b) plan for government employers and the SEP IRA (Simplified Employee Pension Individual Retirement Account (SEP) for employers and Individual Retirement Account (IRA) for individuals which the Internal Revenue Service calls Individual Retirement Arrangements.

In 1974, Congress passed the Employee Retirement Income Security Act (ERISA) that, among other provisions, provided for Individual Retirement Arrangements, which permitted individuals making below a certain income to make annual tax-exempt contributions to their retirement account. In 1997, Senator William Roth of Delaware spearheaded the Taxpayer Relief Act of 1997, which did not permit a tax deduction for annual contributions but enables the earnings on such plans to grow tax-free.

Modern pension plans, called defined benefit plans, began around 1920 but by the 1970’s it became apparent they we no longer sustainable for most companies. In 1978, Congress passed Section 401(k) of the Internal Revenue Code permitting high-earning individuals to invest in the stock market using income that was exempt from taxes. By 1980, Ted Benna, a benefits consultant and attorney, used the law to create a simple, tax-advantaged way to save for retirement, called defined contribution plans, which shifted the burden of saving for retirement from the corporation to the individual.

Even though these plans have only been around for less than 45 years, the stock market, insurance companies, and other financial institutions and the financial planners who consult for them have made billions of dollars on the trillions of dollars in these accounts. Real Estate Advisors, on the other hand, have been late to party. Most don’t even know these funds can be invested in real estate, but to do so, requires knowing some rules.

First, before the money can be invested in real estate, the retirement account must be self-directed, meaning the account is structured so that the account owner has the discretion to invest in both traditional and alternative investments. Traditional investments being mainly bonds and public equities like stocks, including mutual funds, and Alternative investments being real estate and other private equity investments.

Most real estate professionals and owners of retirement accounts don’t realize they can invest in both traditional and alternative investments. The IRS permits all types of investments for retirement accounts, but stock brokerages, insurance companies and other financing institutions prohibit their clients from investing in alternative investments.

Permitted Self-Directed Retirement Account Investments	
Real Estate-Related Products	**Non-Real Estate Products**
Agricultural (Farm) Real Estate	Annuities
Build-to-Suit Real Estate Developments	Bonds
Commercial Real Estate	Commercial Paper
Construction Loans	Commodities
Fix-and-Flip Properties	Convertible Notes
Hard Money Loans	Equipment Leasing
Home Equity Loans	Factoring Accounts Payable
Home Mortgages/Take Out Loans	Franchises
International Real Estate	Hedge Funds
Discounted, Mezzanine & Bridge Loans	Mutual Funds
Participating Loans	Personal Property (see exceptions)
Privately-Traded Real Estate Investment Trusts	Privately-Held Companies
Publicly-Traded Real Estate Investment Trusts	Privately-Traded Stocks
Real Estate Leases	Publicly-Traded Stocks
Real Estate Options	Rights & Warrants
Residential Real Estate	Start Up Companies
Tax Deeds & Tax Liens	U.S. Treasury Bills/Gold

In my opinion, the very best self-directed retirement account is what the government calls a One-Participant 401(k) plan. These plans are usually set up through a Third-Party Administrator (TPA) who has a relationship with a Custodian, which is typically a bank.

THIRD PARTY ADMINISTRATOR / CUSTODIAN

There are usually two entities that handle the administration of self-directed retirement accounts, i.e., the Third Party Administrator (TPA) and the Custodian. In a self-directed situation, the TPA and the Custodian could be the same entity, but generally they are not the same entity. A Third Party Administration (TPA) is the individual or organization who sets up, manages, an handles the administration of the account and reporting to the IRS. The Custodian is always the financial institution that holds the money, regardless of who handles the account administration. Sometimes the TPA and the Custodian are referred to as the Custodian, but don't be confused, the TPA handles the administration of the account and the Custodian is the depository where the liquid funds are kept until they are invested in an asset.

It is possible for the plan owner to act as the Trustee on the account, but the regulations, reporting, and compliance issues are complex enough that it would be unwise to do so, unless you are familiar with all the requirements of self-directed retirement account compliance and reporting.

Different TPA/Custodians call these accounts by different names, i.e., a Solo or Individual 401(k). Some of the best known are Equity Trust and The Entrust Group. Although I am familiar with both entities, I like using a smaller company out of Boise, Idaho called Mountain West IRA. Mat Sorensen, attorney and best-selling author of *Self-Directed IRA Handbook*, has created a TPA entitled Directed Trust Company.

Directed Trust Company is a model that works for sophisticated self-directed IRA and 401(k) investors who want to handle the responsibilities of managing their own self-directed retirement accounts.

One Participant 401(k) Plans

One Participant 401(k) plans are ideal for most real estate professionals and other small businesses where the owner is self-employed. To be eligible for such an account, requires basically three things:

1) The presence of Self-Employment activity;
2) Taxable compensation during the year; and
3) The absence of full-time employees.

Since a 401(k) is tied to an employer, there needs to be a business entity set up for the 401(k) to reside. The business can be a sole proprietorship, a partnership, a C-corporation, an S-corporation or a limited liability company (LLC). Both you and your spouse can be employed by the company, but all other employees must be part-time.

Contribution limits for 401(k) in 2019 are $19,000 for individuals under 50 years of age and $25,000 for individuals age 50 or over. The $6,000 difference in called a catch-up contribution. Additionally, the business (your employer) can make non-elective contributions to your 401(k) retirement account of up to $37,000 for a total annual defined contribution limit of $56,000, if you're under 50 years old and $62,000, if you're age 50 or older.

These contributions can be made for both you and your spouse. The contribution limits not only apply to 401(k) plans but also to 403(b) and 457(b) retirement plans. Plus, there is no income limit that will limit your contributing to your plan. And, not only can you contribute more to a One Participant 401(k) plan than to an IRA, but there is another huge advantage; 401(k) plans are exempt from Unrelated Business Income Tax (UBIT) and Unrelated Debt Financed Income (UDFI), which will be discussed later.

Example: Ben, age 51, earned $120,000 in W-2 wages from his S Corporation in 2019. He deferred $19,000 in regular elective deferrals plus $6,000 in catch-up contributions to his 401(k) plan. His business also contributed 25 percent of his compensation to the plan, $30,000. Total contributions to the plan for 2019 were $55,000. Ben could have actually contributed $62,000 to the plan if his earned income were $148,000 ($19,000 regular elective deferral plus $6,000 in catch-up contributions plus 25 percent of $148,000 or $37,000 for a total of $62,000).

Matching Contributions. If the plan documents permit, the employer can make matching contributions for an employee who contributes elective deferrals to the 401(k) plan, however, the sum of all contributions to the plan cannot exceed the total allowed by law.

Traditional 401(k) Contributions. A plan participant has the election to pay the employee elective deferrals either on a pre-tax basis or a post-tax basis. However, all employer plan contributions must be taken on a pre-tax basis which means any employer contributions and earnings attributable to those contributions will be tax at ordinary income tax rates when they are withdrawn.

Roth 401(k) Contributions. It is possible to designate the employee elective deferrals as Roth contributions, where no tax deduction is taken, and the contributions are paid post-tax. These Roth contributions and the earnings attributable to these contributions are tax free when they are withdrawn.

https://www.iravs401kcentral.com/401k-income-limits/

INDIVIDUAL RETIREMENT ACCOUNTS

There are four basic types of IRAs, two of which are for employees of small businesses and two of which are for individuals. The two IRAs for employees of small businesses are the SEP-IRA and the SIMPLE IRA.

SEP-IRA FOR SMALL BUSINESSES

A SEP-IRA (Simplified Employee Pension Individual Retirement Account) is an employer-provided IRA that allows business owners to provide retirement benefits to the owners and their employees. The 2019 contribution limit for a SEP-IRA is 25% of total compensation up to a maximum of $56,000. There are some eligibility requirements, which will not be discussed here, for employees to participate in a SEP-IRA.

SIMPLE IRA FOR SMALL BUSINESSES

A SIMPLE IRA (Savings Incentive Match Plan for Employees) is an employer-provided IRA that permits employees to set aside money and invest it on a tax-deferred basis. These plans are less popular than the SEP-IRA or the 401(k) because the contribution limits are lower. SIMPLE IRA contribution limits for 2019 are $13,000 for those under 50 and a $3,000 catch-up contribution permitted for those employees age 50 or older for a total contribution of $16,000.

TRADITIONAL IRA FOR INDIVIDUALS

Traditional IRAs, originally called Regular IRAs, were created in 1975. The only criterion for being eligible to contribute is for an individual to have enough earned income to make the contribution. These contributions are tax deductible for the tax year in which the contribution was made, however, when qualified withdrawals are made, the income is taxed at ordinary income tax rates. During the life of a Traditional IRA, all income earned permitted to grow tax-deferred until the time of withdrawals.

For 2019, the total annual contribution is $6,000 for individuals under age 50 and, for those age 50 or older, the annual contribution is increased to $7,000, which includes a $1,000 catch-up contribution. There is no income limitation to contribute to a Traditional IRA. If you are covered by a retirement plan at work, your Traditional IRA contribution is only fully deductible if you have Modified Adjusted Gross Income (MAGI) of $64,000 or less or, if you are married filing jointly, your MAGI is $103,000 or less. There are partial deductions available if your MAGI is $74,000 or less for singles and $123,000 or less for married couple.

ROTH IRA FOR INDIVIDUALS

A Roth IRA is a special type of individual retirement account that is not taxed, provided certain conditions are met. Roth IRAs were originally called American Dream Savings Accounts, but were later renamed after their chief advocate, Senator William Roth of Delaware.
The principal difference between a Roth IRA and a Traditional IRA is that the contributions are not tax deductible. The benefit to a Roth IRA is that, when the earnings are withdrawn, they are tax free, if they meet certain qualifications.

Jim Dahle, a recognized personal finance and investing expert, made the following statement about the Roth IRA, "The Roth IRA is perhaps the greatest gift ever given to the American investor….Because of these very favorable rules, a Roth IRA should be one of the first places you put money for retirement and one of the last places you withdraw if from….When you combine the magic of compounding with tax-free growth and a healthy disinclination to spend, truly amazing things are possible." (Jim Dahle, *Bogleheads' Guide to Retirement Planning,* p. 51).

The 2019 contribution limits for a Roth IRA are the same as for a Traditional IRA, i.e., $6,000 under age 50 and $7,000 age 50 or older. There are also income limits to be eligible to contribute to a Roth IRA. If you are single, you must have a Modified Adjusted Gross Income (MAGI) under $137,000 and contributions are reduced starting at $122,000. If you are married filing jointly, your MAGI must be less than $203,000, with phaseout starting at $193,000.

If you are ineligible to contribute to a Roth IRA due to your income level, there is a workaround. Some call it a Backdoor Roth. You can contribute to a Traditional IRA, for which there is no income limit preventing contributions, and then covert that IRA to a Roth by paying the required ordinary income taxes at the conversion. To do the conversion, you must be able to deduct the IRA contribution from your taxable income or you have no other Traditional IRAs.

Only a Roth IRA is not subject to Required Minimum Distributions (RMDs) at age 70 ½. All other retirement accounts are subject to RMDs which requires the account owner to begin liquidating his/her retirement accounts and paying taxes on the withdrawals.

Five Year Holding Period for Roth IRA Withdrawals

An investor can withdraw his or her contributions to a Roth IRA at any time without tax or penalty, but there is a restriction of when the earnings on the Roth IRA can be withdrawn without paying a tax or a penalty for early withdrawal.

To withdraw your earnings from your Roth IRA without pay any taxes or penalties, not only must you be over 59 ½ years old, but your initial contributions must have been held for a period of five years before the date from which your withdrawals start otherwise your withdrawals will not be considered qualified distributions. This is called the Five-Year Rule.

The year period for your Roth IRA earnings starts on January 1st of the year you make your first contribution. Since Roth IRA contributions can be made up to April 15 of the year following its initial set up, technically the qualifying period could be shorter than five years.

For instance, if you made your first Roth IRA contribution on March 15, 2019 and designated it for the 2018 tax year, you would only have to wait until January 1, 2013 to withdraw your Roth IRA earnings tax free, assuming you are at least 59 ½ years old. If you withdraw your earnings prior to the five-year time frame, it would trigger a 10 percent penalty for an early withdrawal, just as it would if you had withdrawn the money prior to turning age 59 ½.

REQUIRED MINIMUM DISTRIBUTIONS

You can begin taking withdrawals from your retirement plan when you turn age 59 ½. If you take withdrawals before that age, the withdrawals are taxed as ordinary income plus there is a 10% penalty fee for early withdrawal.

For Roth IRAs, there is no penalty for early withdrawal of the contributions, but there is a penalty for early withdrawal of the earnings. That's because the taxes have already been paid on Roth IRA contributions.

When you reach age 70 ½, you are required to withdraw a certain amount of money from your retirement accounts each year. The withdrawals are called Required Minimum Distributions (RMDs). The IRS has a table showing the RMDs. The rule applies to the following tax-deferred retirement accounts: Traditional IRAs, SIMPLE IRAs, SEP IRAs, and most 401(k) and 403(b) plans, however, there is no RMD requirement for Roth IRAs. IRS Publication 590-B deals with *Distributions from Individual Retirement Arrangements (IRAs).*

ROLLOVERS AND CONVERSIONS

It is possible to have more than one IRA or more than one 401(k) or both. An IRA rollover is a transfer of funds from a retirement account into a Traditional IRA or a Roth IRA via direct transfer or by check. IRA rollovers can occur from retirement account such as a 401(k) or 403(b) into an IRA or as an IRA-to-IRA transfer.

A direct conversion occurs when a Traditional IRA, SEP IRA, SIMPLE IRA, or qualified plan such as a 401(k), 403(b) or 457(b) is converted to a Roth IRA. Under a direct conversion, the assets are made payable to the Roth IRA custodian for the benefit of (FBO) the Roth IRA owner. The direct conversion can be made between accounts at the same financial institution or between accounts held at different financial institutions. Effective January 1, 2008, Roth conversions can occur from qualified plans to Roth IRAs.

RULES GOVERNING SELF-DIRECTED RETIREMENT ACCOUNTS

All IRAs and 401(k)s or other qualified plans are subject to the following rules. Most retirement plan holders are unaware of these rules because, when your money is placed with a stock brokerage firm, insurance company or financial institution, they manage your money and prohibit you from investing in anything that would disqualify your plan.

When you self-direct your own retirement plan, you are the person responsible, along with your Third-Party Administrator and Custodian, to insure your plan is not being used to purchase prohibited investments or with people to whom you have a self-dealing relationship. Compliance with these rules is very important, otherwise you could disqualify your retirement account. Below are the most important rules that must be considered.

Prohibited Investment Rules

The IRS prohibits you from acquiring the following types of investments with your retirement plan:

Life Insurance. While annuities are permitted, whole life, universal life and variable universal life insurance policies are not permitted. There is an exception for a small amount of coverage if it complies with the Incidental Benefit rule.

Certain Types of Derivative Trading. Derivatives include options and futures contracts on securities or commodities. Any type of trade or position that has unlimited or undefined risk, such as selling naked calls, is prohibited by the IRS.

Collectibles and Antiques. Furniture, wine or other alcoholic beverages, fine art, stamps, precious stones, porcelain and pottery, rugs, silver and dinnerware, jewelry, comic books, baseball cards, priceless family heirlooms and other collectibles cannot be owned in the name of your retirement plan.

Certain Types of Coins. In general, you cannot hold any type of coin made from gold, platinum or other precious metal, inside your retirement plan. The IRS does have a list of exceptions, including:

- American Eagle coins that have never been circulated;
- Proofs of American Eagle coins;
- American buffalo coins;
- Canadian Maple Leaf coins; and
- Australian Gold Philharmonic coins.

To be allowed in a retirement plan, the coin's actual currency value must exceed its value as a collector's item.

Your Personal Residence. You cannot hold any property that you personally use inside your retirement plan. This goes for real and personal property. For instance, your primary residence, a second home or a vacation home that you own or use on a personal basis is prohibited. The Secretary of the Treasury has the right to define what types of tangible personal property may or may not be held in your retirement account.

Prohibited Transaction Rules

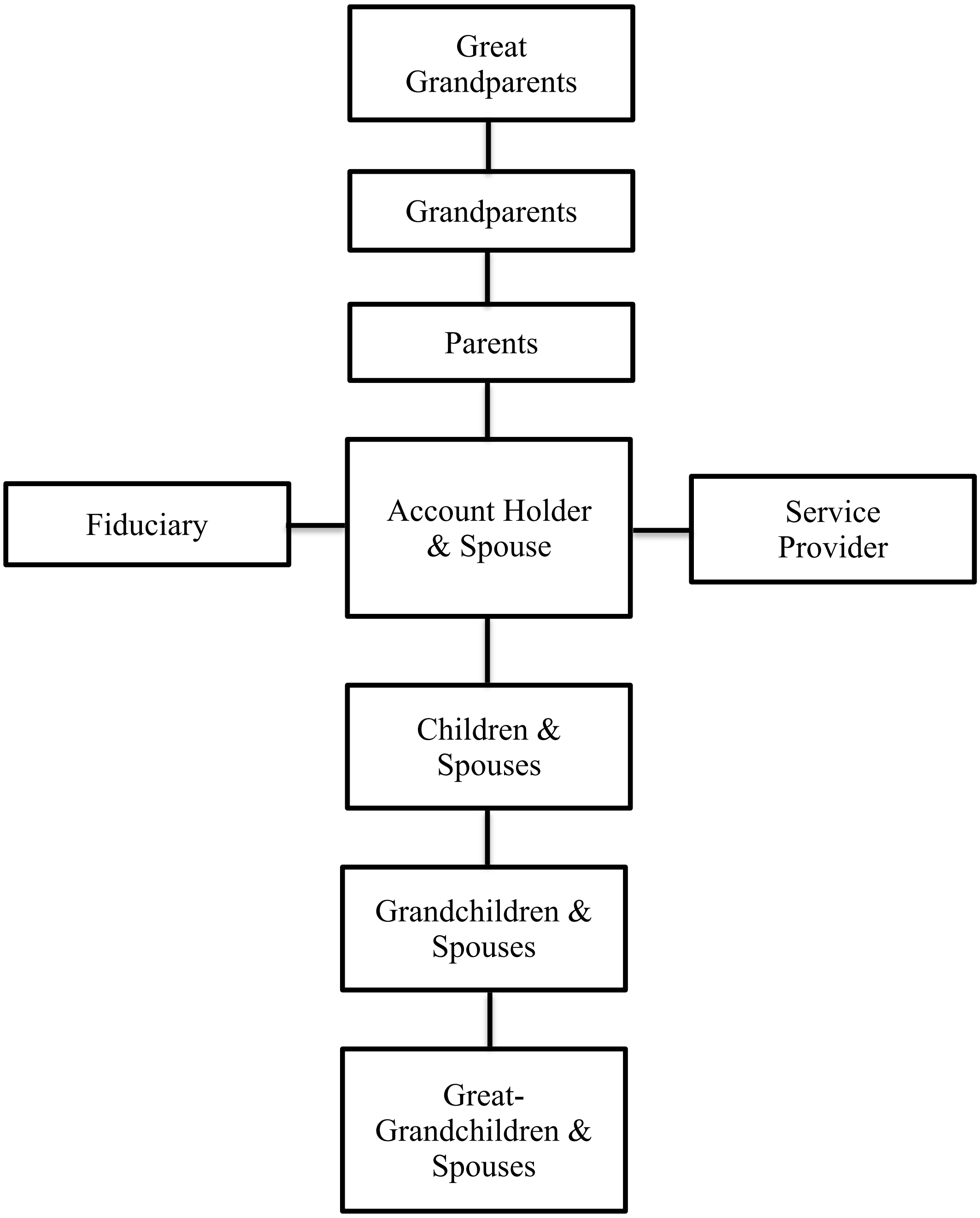
Prohibited transaction rules do not specify in what assets your retirement account may invest but, rather, they restrict with whom your retirement account may do a transaction. A prohibited transaction is any improper transaction between your retirement account and a disqualified person, as defined in IRS Publication 590. There are different types of prohibited transactions under the rules, all of which could cause your retirement account to be disqualified which would result in immediate disillusion of the account and immediate payment of income taxes and penalties.

Per Se Prohibited Transactions

A per se prohibited transaction occurs when a self-directed retirement plan engages in a transaction with a disqualified person. The word "per se" means by, of, or in itself; intrinsically. A per se prohibited transaction occurs when a retirement account engages in a transaction with a disqualified person regardless of whether or not any benefit is received.

Your retirement account may not do a transaction with a disqualified person. Disqualified persons include the retirement account owner and certain family members. A disqualified person to your retirement account includes the owner of the retirement account and the lineal ascendants and descendants of the account owner, such as: the account owner, the account owner's spouse, parents, grandparents, children, and spouses of children.

DIAGRAM OF "SELF-DEALING" RELATIONSHIPS



Why would you be considered a disqualified person to your own retirement account? The primary reason is that you are a fiduciary to your self-directed retirement account and make decisions on behalf of that account which gives you the ability to enter into transactions with the intent to avoid or unfairly minimize taxes (*IRC §4975(e)(2)(A)).* For instance, you could not use your IRA to buy real estate that you already own in your personal name.

Note that all family members are not disqualified persons. Brothers, sisters, cousins, aunts, uncles, nieces and nephews are not disqualified persons nor are friends, co-workers, neighbors or other third parties.

Disqualified persons also include companies in which the retirement account owner or other disqualified person has more than 50% control. The 50% controlling interest rule includes:

- 50 percent or more of the voting authority of all classes of stock, or
- 50 percent or more of the capital interests or profits of the entity, or
- 50 percent or more of the beneficial interest of a trust or unincorporated business. (*IRC §4975(e)(2)(G)).*

These rules are in place so that no corporation, partnership, LLC, trust or estate owning more than 50 percent can wield undue influence over the retirement account.

Self-Dealing Prohibited Transactions

The prohibited transaction rules are designed by Congress to prevent you from attempting to use your retirement account for personal gain, other than earning interest or receiving normal returns on an investment. The rules stop you from self-dealing while using your retirement account. Essentially, you can't take a tax deduction for a contribution and then get an additional benefit by using the contribution for personal gain outside the retirement account.

Credit Extension Prohibited Transactions

Another type of prohibited transaction with a disqualified person is when a disqualified person extends credit to the retirement account. Below are some examples extension of credit prohibited transactions:

- Lending money between an IRA and a disqualified person;
- Using IRA assets as collateral for a loan;
- Using IRA assets to benefit a fiduciary to an IRA.

Any of the above examples of extending credit to your self-directed retirement by a disqualified person could disqualify your retirement account.

Consequences of a Prohibited Transaction

The consequences of a prohibited transaction differ depending on whether the disqualified person is the plan owner or another party. The most common type of prohibited transaction is between an IRA owner and his/her IRA.

If the retirement account owner engages in a prohibited transaction with his/her own retirement account, the entire plan is disqualified which results in the distribution of the entire account, based on the fair market value of all assets in the account as of January 1 of the year in which the prohibited transaction occurred [IRC §4975 (c)(3), IRC §408 (e)(2)(A)].

Distribution of the retirement account results in possible taxes on the amount distributed plus early withdrawal penalties if the person is under 59 ½ years of age, and revocation of the favorable tax treatment for the retirement account for any investments that occurred after the prohibited transaction.

A Disqualified Person Can Purchase Real Estate with Their Self-Directed Retirement Account

If a self-directed retirement account is purchasing real estate, it can partner with the owner of the retirement account. That statement seems contradictory to the information stated above, but it is based on when an asset is purchased, not the purchase of the asset itself.

For example, if a retirement account and its account owner, purchases a real estate property together, with no intervening time in between, the transaction is permissible. If the account owner purchases the property then tries to sell it to the retirement account, the transaction is deemed prohibited. The key is the simultaneous acquisition of a new asset.

BUYING REAL ESTATE WITH SELF-DIRECTED RETIREMENT ACCOUNTS

Real estate is the most common investment made by self-directed retirement plan investors. Self-directed IRAs and 401(k)s may invest in all types of real estate including, residential (both single family and multifamily units) and commercial properties. These retirement accounts can acquire existing real estate properties, or they can invest in new development and construction projects. They can also invest directly in land, water rights and mineral rights.

When purchasing real estate investment property with a self-directed retirement account, you must consider the following key points:

- Real estate owned by a retirement plan must always be held for investment. That means disqualified persons cannot live in or benefit from the property.
- All income derived from the property should be paid directly to the retirement account for its benefit and all expenses relating to the property should be paid from the retirement account.
- When purchasing real estate, the retirement account must be listed on the real estate purchase contract or purchase and sale agreement. For example, the buyer to the contract should read, "Equity Trust Company FBO Sally Jones 401(k)." Usually the Administrator/Custodian is listed first followed by FBO, which stands for "For the Benefit Of" and lastly the name of the self-directed retirement account. Sometimes, the title also includes a retirement account number.
- Remember, the retirement account is purchasing the property not the retirement account owner. If the retirement account owner inadvertently puts his/her name on the contract, then the contract should be rewritten. The purchase contract cannot be assigned from a disqualified person to the retirement account.
- All funds due to the seller must be paid by the retirement account. This would include the earnest money deposit and any due diligence costs or closing costs. Remember, the retirement account owner cannot make the earnest money deposit from funds other than the retirement account nor can they pay other expenses associated with the property with personal funds.
- If the contract is written in the retirement account owner's personal name and cannot be undone, then an addendum to the contract should be added to clarify who the actual buyer is.
- A retirement account can obtain a loan to purchase real estate, but the loan must not result in an extension of credit prohibited transaction under IRC §4975 (c)(1)(B). Also, any loan obtained must be non-recourse. It cannot be personally guaranteed by the account owner.
- If the retirement account is going to be on title with other multiple parties, the form of ownership must be as tenants in common. Other forms of ownership, such as joint tenancy, should not be used because they transfer ownership to the other parties upon the death of one of the owners.
- When managing a retirement account investment, the account owner should limit his/her activities to administrative and investment oversight rather than handling property management tasks. This is to avoid the appearance of self-dealing. See the chart below to determine which activities are permissible and which are prohibited.

Permissible and Prohibited Management Activities by Disqualified Persons	
Permissible	**Prohibited**
Making decisions as to the property manager or tenants. Making all decisions for the property, such as when to buy or sell and at what price, etc.	Taking title or entering into contracts in the retirement account owner's personal name rather than the retirement account's name.
Setting terms for the lease or other legal agreements. When the property is owned directly by the retirement account, any contract must be signed by the custodian.	Receiving rental income in the retirement account owner's personal account of paying operating expenses from the personal account of the retirement account owner.
Visiting the property and overseeing repairs and maintenance. Hiring contractors to do the repairs and maintenance.	Physically working on the property. Work on the property by the retirement account owner or other disqualified person is prohibited.

CHECKLIST FOR RETIREMENT ACCOUNT OWNERSHIP OF REAL ESTATE

- Is the contract and title in the retirement account's name?
- Did the custodian (Trustee) sign the contract and legal documents?
- If a loan was used to acquire the property, was it nonrecourse?
- Is the retirement account receiving the rental income and paying the operating expenses?
- Does the retirement account have sufficient capital to cover unexpected property expenses?
- Is the retirement account holding the property for investment purposes?
- Is the retirement account owner avoiding personal use or benefitting property the property?
- Did the retirement account owner refrain from personally benefiting from the acquisition?
- Is the property subject to Unrelated Debt Financed Income or Unrelated Business Income Tax?

SPECIAL CONSIDERATIONS WHEN BUYING REAL ESTATE

Typically, a self-directed retirement account cannot borrow money to finance part of the purchase of the property unless the financing is nonrecourse, which means neither the self-directed retirement account nor its owner or spouse can personally guarantee the loan.

Should a default occur, the lender must look solely to real estate asset or some other guarantor for repayment of the loan. It is permissible for the self-directed retirement account to provide the equity capital and have some other guarantor personally guarantee the debt on the real estate, as long as the guarantor is not a disqualified person.

For self-directed IRAs, if there is no debt financing on the property, depreciation would not be applicable, nor would there be any recognition of gain on the sale of the asset. In a Traditional IRA, the recognition of income is deferred until withdrawals begin, at which time, all income is taxed at ordinary income tax rates.

In a Roth IRA, all withdrawals are tax-free, so there is never any recognition of income. With regard to a self-directed Traditional or Roth 401(k), the same principles apply.

UNRELATED BUSINESS INCOME TAX (UBIT)

If a self-directed IRA acquires a business and uses nonrecourse debt as part of the acquisition, a portion of the income and gain on the sale is subject to Unrelated Business Income Tax (UBIT). Unrelated Business Income exists when a tax-exempt entity engages in a business purpose that is unrelated to its primary tax-exempt purpose.

There are two types of Unrelated Business Taxable Income (UBTI): (1) Income arising from the conduct of an unrelated trade or business that is regularly carried on; and (2) Debt-financed income, which is usually income in the form of rent, interest or royalties arising from financed property. A trade of business is any activity carried on which produces income from the sale of goods or the performance of services in the same manner as a for-profit business.

Deductions, both direct and indirect, which are proximate and primary to the generation of taxable income, can be used to offset UBTI. These would include salaries, interest payments, maintenance expenses, and depreciation. UBTI can be mitigated, to some extent, by depreciating the assets using cost segregation, which segregates the cost of each construction component and depreciates it over its useful life.

UBIT is a tax imposed on the unrelated business income generated by a tax-exempt entity, of which a self-directed retirement account is one. UBIT is calculated by using the tax rates for estates and trusts, which is very high. For 2019, the income tax rates for estates starts at 10% of taxable income and grows to 37% for taxable income in excess of $12,750.

AND UNRELATED DEBT FINANCED INCOME (UDFI)

If an IRA uses debt financing to acquire real estate, the acquisition is subject to the payment of a tax on that portion of the income attributable to the debt financing. The income derived from the debt financed portion is called Unrelated Debt Financed Income (UDFI). UDFI is a subset of UBTI.

Investment income that would otherwise be excluded from an exempt organization's unrelated business taxable income must be included to the extent that it is derived from debt-financed property. The amount of income included is proportionate to the debt on the property.

In general, the term "debt-financed property" means any property held to produce income (including gain from its disposition) for which there is an acquisition indebtedness at any time during the tax year (or during the 12-month period before the date of the property's disposal, if it was disposed of during the tax year).

UBIT and UDFI applies to IRA accounts but does not apply to 401(k) accounts. Acquisition indebtedness (*IRS Publication 598*), therefore, since a 401(k) is a qualified retirement plan, it has been exempted from the UBIT and UDFI rules, which makes 401(k) plans more ideal for acquiring real estate with debt financing.

REAL ESTATE INVESTMENT ALTERNATIVES

Self-directed retirement accounts can purchase both residential and commercial real estate. Residential real estate is defined as four units or less while commercial real estate is defined as residential real estate with more than four units and any other type of property used primarily for commerce.

In addition to residential and commercial real estate, self-directed retirement accounts can purchase real estate options, promissory notes, tax deeds and tax liens, and real estate investment trusts (REITs). Self-directed retirement accounts can also lend money to others unless they are a disqualified person.

A real estate option is a legal document that gives the holder the exclusive right to buy or not to buy a property. While the option is valid, no one else can buy or sell the property during the option term. Options work best in markets where the value of real estate is appreciating rapidly.

Self-directed retirement accounts can lend money or they can purchase discounted promissory notes. Lending money is a simple transaction usually handled with the assistance of a title company. The borrower executes a promissory note on behalf of the lender, which is the self-directed retirement account, and the title company records a trust deed on the property, when real estate is involved.

A discounted promissory note is a note payable held by a lender or beneficiary who has decided that they would rather receive a lump sum of money rather than hold the note to maturity. Since the promissory note specifies certain payment terms over time, the purchaser of a note payable can calculate with certainly how much they will receive over time then purchase that stream of payments at some discounted rate to yield a higher return.

When a property owner fails to pay the required property tax assessed on real property, the property may be auctioned and sold at a real property tax sale. Some states engage in the sale of deeds to real property to recoup losses from delinquent property taxes. Other states engage in the sale of liens against real property to recoup the losses. These deeds and liens for nonpayment of real property taxes are called Tax Deeds and Tax Liens.

Depending on the state, a self-directed retirement account can purchase these tax deeds and tax liens. In tax deed states, the winning bidder at a tax sale purchases ownership to a property as specified by the tax deed. In some tax deed states, the previous property owner is given an opportunity to redee3m the property from the newly established owner upon the payment of all delinquent taxes plus other costs and fees assessed against the property.

In tax lien states, a tax lien certificate is issued as evidence of indebtedness against the real estate. when tax lien certificates are sold, the parcel of real estate serves as collateral to secure the purchase of the tax lien certificate. Most tax deed states hold periodic delinquent property tax sales while most tax lien states, hold annual property tax sales. Some investors find this form of investing very lucrative.

A Real Estate Investment Trust (REIT) is a company that raises money through its stockholders to acquire and operate income-producing commercial real estate. Some REITs also engage in financing real estate. There are both publicly-traded REITs and non-traded private REITs. Both can be purchased by self-directed retirement accounts.

CONCLUSION

In conclusion, both IRAs and 401(k)s can be self-directed. IRAs and 401(k)s can be either Traditional or Roth. A Traditional retirement accounts permit the owner to receive a tax deduction when the payment is made, but is required to pay ordinary income tax on any withdrawals that are taken while Roth retirement accounts do not receive a tax deduction with the contribution is made but are required to pay no tax on the withdrawal of contributions and earned income, if the account is held for a period of five years. Depending on the income level, a retirement account owner can have both a 401(k) and an IRA.

Self-directed retirement accounts are similar to any other retirement account with the exception that the owner of the account has the opportunity to self-direct what assets are purchased. The IRS permits all IRA and 401(k) accounts to be self-directed, but stockbrokers and financial planners limit the account owners by permitting them to invest only is assets they offer through their brokerage relationships.

When setting up a self-directed retirement account, it is wise to use a Third-Party Administrator and Custodian to manage the account, but not the assets acquired. They handle administrative and reporting functions. Most TPAs and Custodians handle both self-directed IRAs and One Participant 401(k)s. A One Participant 401(k) is ideal for most sales professionals if they have no employees.

The benefit of having a One Participant 401(k) is that the contributions amounts are much greater and they are not subject to Unrelated Business Income Tax (UBIT) and Unrelated Debt Financed Income (UDFI) tax.

Although almost any income-producing real estate investment is preferable to dealing with the volatility of the stock market and will likely yield higher returns, it is preferable to invest IRAs in unleveraged assets and to invest 401(k)s in leveraged assets, as long as the account owner is not personally guaranteeing the loan.

Finally, the ideal scenario is to have both a Roth IRA and a Roth 401(k) and, eventually, at age 70 ½, transfer all the money into the Roth IRA. That is because Roth IRAs are not subject to Required Minimum Distributions (RMDs) while all other types of retirement accounts, including a Roth 401(k) is subject to RMDs.