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An IRA to invest in real estate? Beware, penalties are harsh

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Over the past 5 years the real estate market has declined substantially making prices attractive to investors. Even investors unfamiliar with real estate have been diving into the market. At the same time the banks have tightened lending requirements. So how can an investor obtain funds to purchase such properties? Some have turned to their individual retirement accounts as an investor, but beware: the rules are complicated and the penalties for a misstep are severe.

Individual retirement accounts (IRAs) can be "self-directed", that is the owner can decide the underlying assets in which the IRA invests. Most brokerage houses limit the investments to traditional stocks, bonds, mutual funds, etc. to avoid complication. However, there are many more investments available, real estate being one. The basic concept is: an IRA invests in real estate, pays expenses, earns a rate of return and grows the value of the account tax-free. It sounds too good to be true and it might be.

The biggest obstacle to a self-directed IRA is the "self-dealing" rules. Simply stated the IRA cannot have direct transactions with the IRA owner nor can the owner have indirect benefits from the property owned. A self-directed IRA cannot purchase or sell properties from the IRA owners. But the complexity arises in what constitutes an indirect benefit. The more obvious indirect benefits include an IRA investing in a property in which the owner uses as a vacation property (even once). Some other examples of unacceptable transactions include: renting the property to a disqualified person (even if at fair value); borrowing money from the IRA; personally guaranteeing loans acquired by the IRA or paying the owner (or related company) for services performed. The "disqualified person" definition is convoluted but is intended to encompass relatives (ancestor and lineal), spouses, business partners and co-owners.

The penalties are harsh. §408(e)(2) states that if an IRA owner or its beneficiary engages in a §4975 prohibited transaction during the tax year, the IRA is disqualified as of the first day of that tax year, and the IRA owner is treated as having received a taxable distribution equal to the fair market value of all of the assets in the account as of the first day of the year. In a recent case, the Tax Court held that the owners of self-directed IRAs engaged in a prohibited transaction when they guaranteed a loan of the IRA as an indirect extension of credit to the IRA. The result was the IRA ceased to be an IRA as of the date of the prohibited transaction. The owners were taxed on the value of the IRA on that date as a distribution and were subject to early withdrawal penalties. In addition, when the property was sold later, the gain was fully included in the taxpayers income (Peek and Fleck, 140 TC No. 12, 5/9/13). A disqualified person does not need to be the account owner or beneficiary and if someone other than the owner or beneficiary engages in a prohibited transaction, that person may be liable for certain taxes. In general, there is a 15% tax on the account of the prohibited transaction and a 100% additional tax if the transaction is not corrected. In yet another tax court case during the year, a taxpayer engaged in a prohibited transaction when he caused compensation to himself through an LLC in which his IRA invested. The transaction resulted in over $300,000 of taxable income to the owner along with a 10% early withdrawal penalty and a 20% accuracy related penalty (Ellis, TCM 2013-245).

If a self-directed IRA generates unrelated business taxable income (UBIT) an additional set of rules may apply. Generally, UBIT applies if all of the following are true: income is derived from a trade or business, business activity is not substantially related to the exempt status and, business is regularly carried on. Most passive income (interest, dividends, royalties, rent, etc.) is exempt from UBIT. However, using debt financing to generate such income may make it subject to the tax. Hence, if one is using debt financing on real estate in an IRA, proceed with caution.

The Internal Revenue Service has been lax in enforcement of IRA rules in the past. In a 2013 letter from Peggy Bogadi (Commission of Wage and Investment Division) to congressman Steve Israel of New York, the IRS admitted to failing to analyze information on Forms 5498 (IRA contribution information). The letter continued to state that the IRS "will begin a careful and data driven approach" for ensuring IRA compliance. In 2014, the IRS plans to change Form 5498 to include a box for self-directed IRAs. New codes will be added to categorize the types of investments in the IRA including: ownership in a LLC; real estate; ownership of contracts not available on an established market. Clearly more focus will be placed on these accounts.

In conclusion, the IRS is changing some of its enforcement polices surrounding individual retirement accounts. In doing so, they may be taking a closer look at self-directed IRAs which have gained popularity recently as vehicles to invest in real estate. An owner of a self-directed IRA, especially one investing in real estate, should take extreme care to follow the complex rules for these investments.

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