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THINGS YOU NEED TO KNOW BEFORE HOLDING REAL ESTATE IN AN IRA

Investing in real estate with a self-directed individual retirement account (an "IRA") is permissible, but an IRA owner should be aware of the potential pitfalls and strategies before doing so. Potential direct real estate investments for an IRA include land, commercial buildings, residential condominium buildings and single-family structures. An IRA may also invest in real estate indirectly, for example, by investing in a real estate investment trust (a "REIT"), or through a limited partnership (LP) or limited liability company (LLC) rather than investing directly into the real estate itself.

POTENTIAL PITFALLS WHEN INVESTING IN REAL ESTATE

Investing in Leveraged Real Estate will Trigger UBTI

An IRA generally may invest in real estate. However, holding leveraged real estate in an IRA will trigger unrelated business taxable income ("UBTI") for the IRA. The UBTI rules under the Internal Revenue Code of 1986, as amended (the "Code"), apply to income of tax-exempt entities (including an IRA) if such entity engages in activity that is unrelated to its tax-exempt purpose. Passive income that an IRA derives from property subject to "acquisition indebtedness"[1] is typically treated as UBTI. Only the income attributable to the leveraged portion of the property is taxable. Consider consulting with a tax attorney before using an IRA to invest in any leveraged real estate.

Regularly Buying and Selling Property May Trigger UBTI

An IRA generally may buy and sell real estate. However, UBTI may become an issue if an IRA is used to buy and sell multiple properties within a year. The UBTI rules under the Code apply if the IRA derives income from an unrelated trade or business that is regularly carried on. If an IRA frequently buys and sells real estate, the United States Internal Revenue Service ("IRS") could conclude that the IRA is engaged in the trade or business of buying and selling properties (especially if there is evidence that the properties were acquired for purposes of sale, rather than investment). Consider consulting with a tax attorney before using an IRA to regularly buy and sell real estate.

Investing in a REIT May Trigger UBTI

Generally, as discussed further below, holding a REIT in an IRA will not generate UBTI for the IRA. Generally, income that an IRA shareholder

[1] Acquisition indebtedness is debt incurred in connection with the purchase of the property (whether incurred before, after or at the time of the acquisition).

receives from a REIT is treated as dividend income that is typically excluded from UBTI.

However, a REIT may generate UBTI in certain circumstances. For example, if a REIT is considered a "taxable mortgage pool,"[2] distributions from that REIT to its shareholders can be partially treated as UBTI.[3] Consider consulting with a tax attorney that specializes in REIT taxation to avoid unexpected UBTI exposure.

UBTI Gives Rise to Tax Payment and Reporting Obligations

If an IRA receives gross UBTI of $1,000 or more during a taxable year, the IRA must file an IRS Form 990-T to report such UBTI and pay tax. Any UBTI that an IRA receives is taxable at trust rates up to a maximum rate of 37% (for tax years beginning in 2018 through 2025). An IRA typically must pay quarterly estimated tax on UBTI, if it expects its tax for the year to be $500 or more. When calculating the tax, certain allowable deductions can offset UBTI and mitigate tax exposure. Any such tax is paid out of the IRA funds (and may require a contribution to the IRA, if it lacks sufficient funds), rather than out of the IRA owner's personal funds.[4] An IRA must file an IRS Form 990-T by the fifteenth day of the fourth month after the end of the relevant tax year. The Form 990-T requires disclosure of the type of UBTI that the IRA received (e.g., unrelated debt-financed income, certain rent income, advertising income, etc.), as well as additional detail about such UBTI.

Beware of Double Taxation on UBTI

An IRA owner is essentially subject to double taxation to the extent that the IRA has UBTI. The UBTI is taxed upon the IRA's receipt of that income and is taxed again when distributed to the IRA owner or beneficiary. An owner is not eligible for any deduction or other tax benefit for UBTI that is paid by the IRA.

Use Caution to Avoid a Prohibited Transaction

As explained further in ["Avoiding IRA Prohibited Transactions"], an IRA may not engage in a "prohibited transaction" with a "disqualified person" (e.g., the owner or a fiduciary). Prohibited transactions include, among other things, (a) selling or leasing property to an IRA, (b) lending money to the IRA and (c) using IRA funds or assets for personal purposes. A prohibited transaction risks disqualification of the IRA, resulting in a tax event for the owner.

[2] A REIT may be a taxable mortgage pool if it invests primarily in mortgages and issues securities with different maturity dates that are based on these mortgages.

[3] In addition, if a REIT is predominately held by Code Section 401(a) pension trusts, then any such trust that owns more than 10% by value of the REIT will have a portion of its dividends from the REIT treated as UBTI. This is not typically an issue for a traditional IRA, which is not a Section 401(a) pension trust.

[4] Amounts remitted to pay tax on UBTI are not considered distributions from the IRA.

When using an IRA to invest in real estate, be aware of any personal benefits arising from such investment. An IRA's investment in real estate must be a true investment for the benefit of the IRA. For example, an IRA cannot invest in a vacation property that the IRA owner uses for his or her own vacations. However, the IRA could invest in vacation property that is rented to unrelated third parties (as long as the rental proceeds are retained by the IRA). Similarly, if an IRA sells a real estate investment, the proceeds realized from the sale must be retained by the IRA.

Expenses Associated with the Investment Must Come From the IRA

Any expenses associated with the real estate investment (including taxes, interest, improvements and insurance) must be paid by the IRA itself. The IRA owner cannot use personal funds to pay for any such expenses. Because personal funds cannot be used to pay such expenses, an IRA owner cannot deduct such expenses for tax purposes.

When using an IRA to invest in real estate, an IRA owner must ensure that an IRA has sufficient cash to pay for any and all expenses that may arise in connection with the investment. If the income from a real estate investment is insufficient to pay ongoing expenses, an IRA owner may be required to make additional contributions (subject to the annual limit on IRA contributions). Consider consulting with a tax attorney and other professionals to discuss strategy to ensure that the IRA has sufficient cash to pay expenses.

OPTIONS FOR MAXIMIZING YOUR INVESTMENT STRATEGY WHEN INVESTING IN REAL ESTATE

Hold Non-Leveraged Rental Property in an IRA

Subject to the special rules that apply to leveraged real estate (discussed above), rents generated by non-debt financed rental property are generally excluded from UBTI. Holding a vacation rental or a residential condominium building in an IRA will typically not generate UBTI exposure.

However, other activities in connection with renting real estate properties can still trigger UBTI. For example, payments that an IRA receives can generate UBTI if such payments are for services that are provided to a tenant that are not customarily rendered in connection with the rental of space for occupancy only (e.g., maid service).[5]

The UBTI rules for rental property are very fact specific. Consider consulting with a tax attorney before using an IRA to invest in any rental property.

Consider Investing in a REIT to Obtain Consistent Returns and Mitigate UBTI

An IRA is permitted to invest in a REIT. A REIT will own and manage real estate, such as an office building, a residential building or a hotel. As long as a REIT satisfies certain conditions and distributes out at least 90% of its taxable income to its shareholders, a REIT does not pay corporate level income tax. As a result, investing in a REIT can provide consistent returns for an IRA shareholder. Taxes on the REIT distributions will be deferred until the funds are withdrawn from the IRA.

In addition, investing in a REIT can generally allow an IRA to indirectly invest in real estate without risking the UBTI exposure that can arise from a direct investment in real estate. Generally, income received by an IRA from a REIT is treated as dividend income. The Code specifically excludes dividends from UBTI. Because a REIT is generally treated as a corporation for tax purposes, any borrowing at the REIT level (or below) is not imputed to its shareholders.

Recall that, as explained above, there are many potential pitfalls when investing in a REIT. An investment in a REIT can result in unexpected UBTI exposure. Consider consulting with a tax attorney that specializes in REIT taxation before using an IRA to invest in a REIT.

Consider Advantages of a Transaction, Despite UBTI Exposure

As explained above, a variety of different real estate investments may trigger UBTI exposure. An IRA owner could take certain actions to avoid generating UBTI (for example, purchasing real estate with cash or engaging in fewer real estate sale transactions in a given year).

However, even where activities trigger UBTI, there might be non-tax reasons to engage in such activities. For example, an investment in leveraged real estate can allow an IRA to diversify its portfolio and to benefit from a growing asset for a relatively small upfront investment. If the return on a taxable investment will generate a higher return for the IRA than a non-taxable investment (taking into account all expenses and tax exposure), it might make sense to engage in the taxable transaction despite the UBTI exposure. When evaluating the potential tax exposure, be sure

[5] There are certain strategies to mitigate UBTI under these circumstances, including engaging an independent contractor to provide services to tenants. Consider consulting with a tax attorney for more information.

to consider both the tax consequences at the time when the IRA receives UBTI and at the time when the UBTI is ultimately distributed to the IRA owner. Consider consulting with all relevant professionals before deciding on the appropriate investment strategy for an IRA.

Reallocate an IRA Asset to Personal Use, While Avoiding a Prohibited Transaction

Distributions from an IRA are taxable to the distributee, but can be used to allow an IRA owner to remove a real estate asset from an IRA. An IRA owner might want to distribute a real estate asset if, for example, the owner wanted to use the real estate for personal purposes (e.g., living in a vacation home). The IRA may distribute the real estate in-kind to the IRA owner. If the IRA owner receives the distribution after age 59, there is no IRS penalty on the distribution. The income tax on the distribution is calculated based on the fair market value of the real estate and is included in the distributee's gross income.

This discussion does not purport to address all federal income tax consequences that may arise with respect to transactions involving an individual IRA, IRA owner or IRA beneficiary. This discussion also is in no respect a representation that any of such transactions are appropriate for IRAs generally or any particular IRA.

For questions about investing in real estate with a self-directed IRA or clarification about the rules and processes, please contact us.

For more information, visit www.StrataTrust.com and our Self-Directed IRAs in Real Estate section.

ABOUT THE AUTHOR

Caitlin Sawyer, a Tax Associate at Hunton Andrews Kurth LLP, helps clients navigate complex federal income tax issues. She focuses on corporate mergers, acquisitions and reorganizations, fund formation, and transactions involving partnerships, limited liability companies, and other pass-through entities. Caitlin assists clients with tax issues involved in mergers, acquisitions and other complex transactions. She has significant experience regarding the tax aspects of corporate mergers, acquisitions and reorganizations (including transactions involving banks and S corporations) and drafting tax provisions in partnership and limited liability company (LLC) agreements. She also has extensive experience calculating Section 280G payments and drafting 280G shareholder vote documents in connection mergers and acquisitions. Caitlin also has experience with drafting tax provisions in a variety of disclosure documents, including proxy statements and prospectuses. She regularly advises clients regarding the Foreign Account Tax Compliance Act (FATCA) as well as the Bipartisan Budget Act of 2015 (the New Partnership Audit Rules).

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ABOUT US

STRATA
TRUST COMPANY

7901 Woodway Drive, Ste 200,
Waco, TX 76712

866.928.9394
512.637.5739

BusDev@StrataTrust.com

www.StrataTrust.com

STRATA Trust Company has quickly catapulted to become a premier national custodian for alternative assets and non-exchange traded investments in self-directed IRAs. Formerly known as Self Directed IRA Services, Inc., STRATA has been helping investors use their retirement account funds to invest since 2008. STRATA currently serves over 33,000 individuals nationwide with over $1.8 billion in assets under custody.

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