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Direct-Owned Real Estate in an IRA

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Assets in individual retirement accounts (IRAs) totaled $13.9 trillion at the end of 2021. As of 2020, there were over 28,000 individuals with IRA accounts exceeding $5 million. IRAs are generally invested in financial assets, including stocks, bonds, mutual funds, and exchange traded funds (ETFs). Another investment option is to hold directly owned real estate. Direct owned real estate refers to properties in which an investor (or subsidiary company) has a fee or tenancy in common (TIC) ownership of the property.

Real estate held in IRAs can also create unique planning challenges not normally associated with traditional investments. Direct owned real estate must be held in a self directed IRA as an alternative investment accepted or offered by a qualified custodian, an entity specializing in self directed accounts that may manage the investment and complete required financial and tax reporting, including IRS Form 5498, IRA Contribution Information. The real estate property must be solely for investment and not used as a vacation or second home, or as an office for a related business. These rules apply to the owner of the IRA as well as to related people deemed disqualified by the Internal Revenue Service, including the owner's spouse, parents, children, grandchildren, service providers of the IRA and any entity that owns more than 50% of the real property.

Purchasing real estate inside of an IRA is easiest when doing so with 100% cash. Financing the transaction is possible but adds a layer of complexity. Financing the property could subject any rental revenue from the property to be considered unrelated business taxable income (UBTI). UBTI is a tax on income from a trade or business that is not significantly related to charitable, educational, or other designated purposes of an exempt organization. UBTI applies when the earned income is over $1,000.

If the self directed IRA uses a non recourse loan to buy the real estate, the debt financed part of the profits is subject to UBTI. The profits generated from the non recourse loan's percentage of ownership would be taxed. This would be considered Unrelated Debt Financed Income (UDFI), or income derived from the use of "acquisition indebtedness" in the self directed IRA. "Acquisition indebtedness" is income from a property where debt is acquired during the purchase of the property.

There are certain instances where UBTI does not apply, including when investing in a subsidiary entity taxed as a C Corporation. The C Corp (or an LLC electing to be taxed as such) will pay any income tax associated with the net rental real estate income. Since the entity will have already paid any required tax before paying out any dividends to the IRA, the distribution would be tax deferred or tax free depending on the type of IRA. UBTI would not apply if, instead of the IRA investing directly into the property, it makes a loan to another real estate investor. The loan can then be secured by a lien on the property. Also, when property is not leveraged and was acquired via direct purchase, UBTI would not apply to its rental Income.

Despite the myriad rules and requirements involved with holding real estate in an IRA account, there are benefits. Real estate helps diversify a portfolio, often moving counter to financial markets. Real estate has historically appreciated over time, ideal for an IRA's long term investment horizon. Real estate can provide a steady income stream from rents, and any rental income collected grows tax free within the IRA.

The drawbacks are that a self directed IRA needs to be set up with a custodian, and deductions for property taxes, mortgage interest, depreciation and other property related expenses cannot be claimed unless a C Corp entity is used. In addition, all expenses, repairs and maintenance costs and third party management fees must be paid with IRA funds, hopefully, and a net of rents to cover.

IRA owners subject to annual required minimum distributions (RMDs) and holding direct owned real estate need to be mindful of the overall liquidity of aggregate IRA holdings. The real estate portion may not have available funds for distribution and the investor will need to draw from other IRA sources.

It is also important to emphasize that the owner of the IRA and their relatives can't live in or run a business out of the property.

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