Are Self-Directed IRAs for Real Estate a Good Idea? Maybe Not (Part 2)

Part 1 of this article explained how the self-directed IRA works with real estate.

As you know from that article, the self-directed IRA for real estate faces a wall of regulations. And from a practical standpoint, putting real estate in an IRA for the do-it-yourself individual does not work well.

Part 1 covered several drawbacks that arise when you place real estate in a self-directed IRA. Here we explain three more potential problem areas that you need to consider if you want to put real estate in a self-directed IRA:

1. Debt financing
2. Unrelated business income tax
3. Problems with RMDs

Debt Financing

One of the great advantages of owning real estate is leverage: you ordinarily can borrow a substantial portion of the purchase price.

Your self-directed IRAs also can borrow money to purchase real estate, but it is more difficult than a normal real estate transaction.

Neither the self-directed IRA owner nor any other disqualified person may lend money to the self-directed IRA or personally guarantee a real estate loan (or any other loan) taken out by a self-directed IRA. As a result, any loan used to purchase real estate in a self-directed IRA must be a non-recourse loan in the name of the self-directed IRA (or self-directed IRA/LLC, if applicable).

With a non-recourse loan, the lender's sole recourse in the event of default is to foreclose on the property. The lender has no additional legal rights against the self-directed IRA or self-directed IRA owner.

Such a non-recourse self-directed IRA loan is more difficult to obtain than a regular loan. Typically, lenders who furnish such loans will charge a higher interest rate and will require that the self-directed IRA furnish a 30 percent to 50 percent down payment.

In addition, the self-directed IRA must use funds in the IRA to pay all the fees and expenses for the purchase. The self-directed IRA owner cannot pay the fees and expenses from his or her personal funds.

Unrelated Business Income Tax

Ordinarily, the money or property in an IRA grows tax-free.

But the non-traditional investments in a self-directed IRA may result in the IRA subjecting itself to the unrelated business income tax. This is a tax imposed on tax-exempt entities, including IRAs, that earn money from businesses unrelated to their tax-exempt purposes.

If an IRA generates more than $1,000 in gross income from an unrelated business, it must file Form 990-T. Tax is paid on such income at the same rate as for trusts. The top rate is 37 percent, the same as for personal income tax. But there are only four brackets, and the self-directed IRA reaches the top bracket (37 percent) at taxable income over $13,050.

If the self-directed IRA incurs the unrelated business income tax, it must pay the tax from its funds (the IRA owner may not pay).

Great escape. Fortunately, the tax code exempts passive investments from the unrelated business income tax, including real estate rental income, interest income, capital gains income, dividend income, and royalty income.

Key point. If your self-directed IRA purchases real estate with all cash, it has no unrelated business income tax due on any rental income it earns or on any gains when it sells the property.

The dagger—debt. Things are very different when a self-directed IRA uses debt financing to acquire or improve property. With debt financing, the self-directed IRA becomes subject to a form of unrelated business income tax called "unrelated debt-financed income tax." This tax is paid at unrelated business income tax rates on the profits that are returned to the self-directed IRA as a result of the debt.

Unrelated debt-financed income is equal to your leverage ratio—that is, the percentage of the property that is debt-financed. For example, if your self-directed IRA buys a rental property worth $500,000 with $250,000 of non-recourse financing, 50 percent of the rental income from the property is subject to the unrelated debt-financed income tax. If the income is $30,000, then $15,000 (50 percent) is subject to the unrelated debt-financed income tax.

To determine your unrelated debt-financed income tax, you deduct from the unrelated debt-financed income amount the property's operating expenses, interest expense, property tax, and depreciation in proportion to the leverage ratio. For example, if your self-directed IRA borrowed 50 percent of the property's cost, you may deduct 50 percent of these expenses from unrelated debt-financed income. As a result, in the normal course of events, often no unrelated debt-financed income tax is due or the tax is quite small.

Example 1. Your self-directed IRA used 50 percent debt financing to purchase a $500,000 rental home. The home earns $36,000 in annual rental income, so $18,000 is unrelated debt-financed income.

The annual deductible expenses for the property, including depreciation, amount to $60,000, so $30,000 (50 percent) are unrelated debt-financed expenses.

After these deductions, no unrelated debt-financed income is left on which tax need be paid.

The unrelated debt-financed income tax most often poses a problem when the self-directed IRA sells debt-financed real property. Unrelated debt-financed income tax on any profit earned must be paid at capital gains rates. If the property has substantially increased in value, the tax could be large.

The unrelated debt-financed income at the time of sale is calculated by taking the prior 12-month average debt to determine the leverage ratio.

Example 2. Your self-directed IRA purchased property with 50 percent debt financing several years ago. Its adjusted basis is $200,000 and it sells for $500,000.

The remaining average debt was $100,000. Your leverage ratio is $100,000 debt/$200,000 basis = 50 percent.

Fifty percent of your $300,000 gain from the sale—$150,000—is unrelated debt-financed income. You may subtract from this amount your deductions for annual expenses and depreciation—say, $20,000.

This leaves $130,000 in unrelated debt-financed income subject to the 20 percent long-term capital gains rate, for a total tax of $26,000.

Key point. Your self-directed IRA can avoid paying unrelated debt-financed income tax on property sales if the debt on the property is paid off more than 12 months before the sale. Remember, unrelated debt-financed income tax at the time of sale is calculated by taking the prior 12-month average debt to determine the leverage ratio. If there is no debt over this period, the leverage ratio is zero and there will be no unrelated debt-financed income.

Be alert. Many self-directed IRA custodians don't want to deal with unrelated business income tax. Instead, they place the responsibility for filing Form 990-T and making quarterly tax payments on the IRA owner. A self-directed IRA subject to unrelated business income tax must make quarterly estimated tax payments.

Key point. When a traditional self-directed IRA owned by you has to pay unrelated business income tax, you end up getting double-taxed. First, the self-directed IRA pays tax on its profits at trust rates, and then when you take money out of the self-directed IRA, you'll be taxed again at ordinary income rates.

RMDs

If you're at or near 72 years of age, you need to consider how holding real estate in a traditional IRA will impact the requirement that you take annual required minimum distributions (RMDs). (No RMDs are required for Roth IRAs.)

Once you hit the RMD age (currently 72), you must distribute a percentage of your IRA's value to yourself each year or face an enormous 50 percent penalty. The annual RMD amount is based on your life expectancy and goes up each year.

If all or most of the assets in your traditional IRA consist of real estate, the property may not generate enough cash to pay your RMD. This is not an unsolvable problem, but it is a problem.

One possible solution that would result in sufficient cash to pay your RMD is to refinance the property to pull out enough cash to pay the required amount. It is also possible to pay your RMD in kind—that is, to distribute property instead of cash. But this can get complicated with real estate.

By the way, be aware that the fair market value of an IRA as a whole must be reported to the IRS each year on IRS Form 5498. In addition, IRS custodians must separately report the fair market value of hard-to-value assets such as real estate.

Many custodians permit estimates from the IRA owner or valuations based on online sources such as Zillow or Redfin.

But once you reach RMD age, things get more serious because your RMD amount is based on these valuations.

Thus, many custodians require a formal real property appraisal when the IRA owner has reached RMD age. This will cost at least $300 for a single-family home and can easily cost $1,000 or more for larger multi-family rental properties or commercial properties. The appraisal fee must be paid by the self-directed IRA, not by the IRA owner.

Takeaways

Here are five things to know from this article:

1. Debt financing for real estate held in a self-directed IRA may consist only of non-recourse loans in the self-directed IRA's name. Such loans are harder to obtain than ordinary real estate loans, and the IRA is usually required to provide a 30 percent to 50 percent cash down payment.

2. When debt financing is used for real estate in a self-directed IRA, the IRA may become subject to the unrelated debt-financed income tax on any annual profits.

3. The unrelated debt-financed income tax can be especially large if the self-directed IRA sells property at a substantial profit.

4. Your self-directed IRA can avoid the unrelated debt-financed income tax if it pays off the debt 12months before it sells the property.

5. Self-directed IRA account owners must take required minimum distributions after they reach age 72. If the IRA lacks enough cash to make the RMDs, this can prove troublesome.