

Q&A with Natalie Choate: Buying Real Estate from a Self-Directed IRA

Natalie Choate | 06-09-06

Natalie Choate is the author of "The 100 Best and Worst Planning Ideas for Your Client's Retirement Benefits," in which she analyzes over 140 ideas gathered from planners, web sites, clients, seminars, and her own book. To order this collection of great, not-so-great, and truly terrible planning ideas, or for more information, visit www.ataxplan.com.

I received dozens of great questions during my recent Morningstar Advisor Web seminar. I couldn't answer them all during the session, so in I'm tackling the leftovers in this column. Last month, I covered questions about [designated Roth accounts](#). This month, I'll answer the questions on self-directed IRA investing.

Q. How do you purchase real estate inside an IRA?

Natalie: There are four steps to purchase real estate in an IRA.

Step 1: Transfer your IRA to an IRA custodian that specializes in holding real estate. Regardless of what your IRA invests in, generally only a bank can be custodian of an IRA. (There is a procedure whereby another substantial financial institution that is not a bank could get IRS approval to serve as an IRA custodian.)

Step 2: The bank-custodian purchases the real estate investment inside your IRA. You cannot buy the real estate first, outside the IRA, then transfer it to the IRA, because only cash can be contributed to an IRA. You cannot buy the real estate outside the IRA then sell it to the IRA, because that would be a prohibited transaction. So the IRA itself buys the real estate, just as more typical IRAs would buy stocks or mutual funds.

Step 3: This step is not legally required but is highly recommended. Hire a professional real estate management company to manage the property. The management company runs the property, collects the rents, pays the bills, and sends a net check to your IRA custodian every month. If the real estate investment does not require active management (for example, property subject to a triple net lease, or vacant land), then you can dispense with this step.

If you manage the property yourself, you run a much greater risk of problems caused by commingling your IRA assets and other assets. For example, Joe owned a three-family house inside his IRA. When the rent checks were late, he paid some repair and utility bills for the house from his personal funds; that was considered an "excess IRA contribution" (6% penalty tax). Another time, the IRA paid a bill for some landscaping work that covered Joe's residence in addition to the IRA property; that was a taxable distribution from the IRA. Avoid these problems by hiring professional management.

Step 4: Do not have the IRA transact with yourself or with anyone you have a relationship with outside the IRA. Don't rent an apartment to your stepson. Don't hire your brother to mow the lawn. Don't spend your vacation in the IRA-owned resort condo. If you follow this step, you will have no risk of "prohibited transactions" that could disqualify your IRA.

Q. If a client's IRA owns a parcel of real estate as its only investment, and the client is over 70½, how does the client take minimum required distributions (MRDs) from the account?

Natalie: This can be an extremely difficult problem. The IRA does not have liquid funds, so obviously the IRA can't distribute the MRD in cash.

The IRA can distribute undivided interests in the IRA-owned real estate; for example, suppose the IRA's only asset is a parcel of undeveloped land and the required distribution for the year is 1/25.6th of the account. The IRA can deed a 1/25.6th undivided interest in the real-estate parcel to the IRA owner. However, it's not clear that a 1/25.6th undivided interest is worth 1/25.6th of the total value of the property.

An annual appraisal may be required both to determine the amount of the MRD (based on the appraised value of the IRA's total assets) and to determine the value of the undivided interest distributed to the participant (to make sure it's worth at least the MRD amount). Also distributing undivided interests in the real estate requires lawyers, deeds, and recording fees.

When MRDs are required, it would be more convenient to have the real estate owned by a pass-through entity such as an LLC, with the IRA owning the LLC shares or units. That way, the IRA can simply distribute shares of the LLC to fulfill the MRDs. It may still be necessary to obtain annual appraisals.

After the MRD, there's another problem: Now the property is owned partly by the IRA and partly by the participant. That substantially increases the risk of commingling of personal and IRA funds and the risk of a prohibited transaction since the two property owners will have to deal with each other.

Q. Do IRA real-estate investments incur UBTI tax if there is no debt involved?

Natalie: An IRA can become subject to the tax on unrelated business taxable income (UBTI) in either of two ways.

One way is if the IRA borrows money (such as by using a margin account for purchase of securities or by owning real estate that is subject to a mortgage); this generates income from debt-financed property, which is a form of UBTI.

The other way an IRA can have UBTI is by actually operating a business (see the next question).

The issue of whether real estate is an "investment" or a "business" is an age-old source of disagreement between the IRS and taxpayers--but usually the IRS is the one arguing that real estate ownership is not a business. For example, when a decedent's survivors want to claim the real estate is a business so they can qualify for deferred estate-tax payments, the IRS is likely to say it's merely an investment.

Real estate management typically requires more time and physical activity than does

management of more "passive" types of investments such as stocks and bonds. A person managing a stock portfolio just has to stare at a computer screen. A person managing real estate has to interview tenants and hire plumbers and pay bills and update the insurance policies; but all of those activities are still just management of the property.

If the IRA owns real estate but does not owe any debt, it will not have UBTI unless the IRA "crosses the line" from "managing the investment" to running a business. No one knows exactly where that line is with real estate, but if all you do is interview tenants, hire people to keep up the property, collect the rents, and pay the bills, you probably do not have a "business."

Q. Can an IRA buy an airplane and lease it out to unrelated parties, using the IRA's cash funds to pay maintenance costs? Can the IRA owner pilot the plane?

Natalie: If the IRA operates an airplane flight business, it has unrelated business taxable income and must pay income tax on it, just like any other business. So operating a business is not illegal, but it is taxable.

However, if the IRA owner is personally working for this business that his IRA is running that's a whole new flight plan. The IRS would shoot down that airplane! The IRS can reallocate income and deductions among taxpayers; so they could allocate the IRA's business income to the IRA-owner/pilot's personal return Schedule C, meaning he would owe income and self-employment taxes on it (plus penalties for failure to report the income and pay the taxes). Then, the IRS would say he was deemed to have contributed that income to the IRA; that's an excess IRA contribution. Or the IRS could just say the whole thing is a prohibited transaction and the IRA is disqualified.

So, yes, theoretically, an IRA can run a business inside the IRA, if the IRA pays the proper tax on the resulting UBTI. But the IRA cannot do business with related parties and having the IRA owner perform any services for the IRA's business (beyond investment management) is strictly a no-fly zone. G'day!

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Natalie Choate practices law in Boston, specializing in estate planning for retirement benefits. Her book, [Life and Death Planning for Retirement Benefits](#), is fast becoming the leading resource for professionals in this field.

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