INVESTING IRA AND QUALIFIED RETIREMENT PLAN ASSETS IN REAL ESTATE

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I. DEFINITIONS

A. What is a prohibited transaction?

1. A "prohibited transaction" is defined in IRC §4975(c)(1) as any direct or indirect:

a. Sale or exchange, or leasing of any property between a plan and disqualified person;

b. Lending of money or other extension of credit between a plan and disqualified person;

c. Furnishing of goods, services, or facilities between a plan and disqualified person;

d. Transfer to, or use by, or for the benefit of, a disqualified person of the income or assets of a plan;

e. Act by a disqualified person who is a fiduciary, whereby he deals with the income or assets of a plan in his own interest or for his own account; or

f. Receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

2. A "plan" is defined to include an IRA and a tax-qualified plan (IRC §4975(e)(1)).

3. A “disqualified person” is defined in IRC §4975(e)(2) and includes:

   a. A fiduciary (generally the IRA owner will be a fiduciary);

   b. A person providing services to the plan;

   c. An employer, any of whose employees are covered by the plan;

   d. An employee organization, any of whose members are covered by the plan;

   e. An owner, direct or indirect, of fifty (50%) percent or more of –

      i. the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;

      ii. the capital interest or the profits interest of a partnership; or

      iii. the beneficial interest of a trust or unincorporated enterprise, which is an employer or an employee organization described in subparagraph (c) or (d) above.

   f. A member of the family (spouse, ancestor, lineal descendant and spouse of an lineal descendant) of any individual described in subparagraph (a), (b), (c) or (d) above;

   g. A corporation, partnership, or trust or estate of which (or in which) fifty (50%) percent or more of –

i. the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation;

ii. the capital interest or profits interest of such partnership; or

iii. the beneficial interest of such trust or estate is owned directly or indirectly, or held by persons described in subparagraph (a), (b), (c), (d) or (e) above.

h. An officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a ten (10%) percent or more shareholder, or a highly compensated employee (earning ten (10%) percent or more of the yearly wages of an employer) of a person described in subparagraph (c), (d), (e) or (g) above;

i. A ten (10%) percent or more (in capital or profits) partner or joint venturer of a person described in subparagraph (c), (d), (e) or (g) above; or

j. The Secretary, after consultation and coordination with the Secretary of Labor or his delegate, may by regulation prescribe a percentage lower than fifty (50%) percent for subparagraphs (e) and (g) above and lower than ten (10%) percent for subparagraphs (h) and (I) above.

4. "Plan Assets" are generally determined in accordance with DOL Reg. §2510.3-101.

a. Generally, if a plan has an equity investment in another entity, its assets include the equity interest and an undivided interest in each of the entities underlying assets.

b. Significant exceptions apply if:

i. The entity is publicly traded;

ii. Qualified plans and IRAs own less than twenty-five (25%) percent of the entity's equity; or

iii. The entity is a "real estate operating company" ("REOC"). A REOC is generally an entity of which fifty (50%) percent or more of its assets are invested in real estate in which the REOC engages directly in its operation and development.

c. Notwithstanding the above, if a plan/IRA or a plan/IRA and related parties own all of the entity's interests, the entity's assets will be plan assets regardless whether the REOC or other exceptions apply. DOL Reg. §2510.3-101(h)(3).

5. Consequences of a prohibited transaction.

a. In a qualified retirement plan, an excise tax equal to fifteen (15%) percent of the amount involved for each year will be imposed against the disqualified person. If the IRS issues a notice to correct, the excise tax increases thereafter to one hundred (100%) percent of the amount involved.

b. If an IRA or an IRA owner engages in a prohibited transaction with his/her IRA, there is a deemed distribution of all of the IRA's assets.

B. What is unrelated business taxable income ("UBTI")?

1. UBTI is generally the plan's gross income less applicable deductions derived from an unrelated trade or business.

2. An unrelated trade or business is one in which the business activity is not related to the entity's tax exempt status (i.e., producing income through the sale of a product or rendering a service).

3. Certain types of passive income are expressly exempted from treatment as UBTI, such as:

   a. Dividends and interest (IRC §512(b)(1));

   b. Royalties (IRC §512(b)(2));

   c. Rent from real property and from personal property which is incidental to the rent from real property. However, rent from real property will be UBTI if more than fifty (50%) percent of the total rent is attributable to related personal property. Real property rent will also be UBTI if its amount depends in whole or in part on any lessee's income or profits (other than an amount based on a fixed percentage of receipts or sales) (IRC §512(b)(3)). Hotel room rentals are generally treated as UBTI because they are considered to be income for services.

   d. Gains from the sale, exchange, or other disposition of property, unless the property is inventory or is held for sale to customers in the ordinary course of business.

4. If the plan is a partner of a partnership or a member of a limited liability company, the plan's share of the income will be taxed as UBTI, if the income has a UBTI character.

5. UBTI is generally taxed to the plan at trust tax rates (which may be higher than individual and corporate tax rates). See IRS Form 990-T.

C. What is Unrelated Debt-Financed Income ("UDFI")?

1. UDFI is a type of and is taxed like UBTI. UDFI is income which an IRA or qualified retirement plan has generated through "debt-financed property," even if it is a type of income which would otherwise not constitute UBTI (IRC §514(a)). Typical examples of UDFI are gains from securities acquired through the use of margin and rents, and capital gains from property acquired through debt-financing.

2. The Code and tax regulations set out complex rules for calculating the amount of UDFI.

   a. Basically, the amount of UDFI with respect to any "debt-financed property" for any year, is the income generated by the property, multiplied by a fraction, the numerator of which is the "average acquisition indebtedness" for that property for that year, and the denominator of which is the "average amount of the adjusted basis" for that property for that year (IRC §514(a)(1)).

   b. Example: An IRA has a fifty (50%) percent interest in an LLC, which purchased raw land in 2005 for $50,000, $40,000 of which was debt-financed. The land is sold in 2006 for $100,000 (resulting in gain of $50,000). Assume that the financing was through an interest-only note (so that the indebtedness remained the same from acquisition to sale), there were never any adjustments to the LLC's basis in the land, and there are no deductions with respect to the property.

The IRA's share of income upon the sale is fifty (50%) percent of $50,000, or $25,000. The fraction for determining how much of the $25,000 is UDFI is 4/5 (the $40,000 average acquisition indebtedness over the $50,000 average amount of the adjusted basis). Thus, $20,000 (i.e., 4/5 of $25,000) of the IRA's income from the sale of the land is UDFI.

3. Debt-financed real estate required by a qualified retirement plan (and not an ERA) will not generate UDFI if certain requirements of IRC §514(c)(9) are met.

   a. None of the following may occur for the exception to apply;

      i. The acquisition price must be fixed at the date of acquisition:

      ii. The amount of indebtedness, the amount payable, or the timing of payment may not be contingent on revenues or profits;

      iii. The property is leased back to the seller, an entity or entity related to the seller, or a party or entity related to the trust; or

      iv. The financing may not be provided by the seller, a party or entity related to the seller, or a party or entity related to the trust.

b. The exception generally will not apply if the trust is a partner and the partnership holds the debt financed real estate unless one of the following occurs:

i. All of the partners are qualified retirement plans or other tax qualified entities; or

ii. There are no special allocations of profits and losses.

II. ISSUES AND CONCERNS

A. Locating a custodian or trustee.

1. IRAs cannot be self trusteed by the IRA owner.

2. The custodian or trustee of an IRA must either be a bank, credit union, or a corporation, subject to the supervision of state banking laws, or a person who meets the requirements of IRC Reg. §408-2(e)(1).

a. Generally this requires the ability to show financial ability, continuity, fiduciary experience, etc.

b. I know of no individual who has ever qualified.

3. Financial institutions are generally uncomfortable holding real estate as an IRA custodian due to:

a. Environmental concerns and liability;

b. Valuation obligations;

c. Management responsibilities; and

d. Establishing systems for collecting income (if pertinent) and paying expenses.

4. Some institutions have marketed their ability to serve as a self-directed IRA custodian holding real estate. See:

    a. PenscoTrust Company at www.pensocotrust.com; and

    b. Sterling Trust Company at www.sterling-trust.com.

B. Managing improving the real estate ("Servicing the Real Estate") by the IRA owner.

    1. Servicing the real estate could be construed as a trade or business of the IRA owner, subjecting them to income taxes and self employment taxes for the value of their personal services.

    2. Providing management services, or physically improving the real estate (i.e., swinging a hammer) could be deemed a contribution and, if excessive, subject the IRA owner to the excise tax for excessive IRA contributions.

    3. Providing services to the IRA by a disqualified person is a prohibited transaction which would disqualify the IRA and cause it to be taxed to the IRA owner.

    4. The only real solution to this issue is for the real estate to be managed and improved by independent third parties.

C. Financing the acquisition and operation by an IRA.

    1. Acquisition indebtedness leads to UDFI and taxability of earnings.

    2. Loans to the IRA are difficult to obtain in any event, because the loan cannot be guaranteed. This would constitute a prohibited transaction.

3. The IRA owner or the disqualified person cannot loan IRA funds to acquire or maintain the real estate. This would constitute a prohibited transaction.

4. The IRA owner can't merely contribute more than the IRA limit. This would constitute an excessive contribution, subject to the six (6%) percent excise tax.

5. The only real solution is to be certain that the IRA holds enough cash to complete the acquisition and cover any shortfall if the income from the property is insufficient to pay operating and maintenance expenses.

D. Implication of IRS Notice 2004-8.

1. Ostensibly this Notice is limited to Roth IRAs and attempts, by taxpayers, to make disguised excessive contributions.

   a. These have been categorized as listed transactions requiring special reporting to the IRS.

   b. Principally, it covers taxpayers' attempts to artificially shift income from their own businesses to tax sheltered Roth IRAs.

2. The IRS, however, also discussed prohibited transaction implications for all IRAs (regular and Roth).

   a. The Notice contains a statement which suggests that if: (i) an entity of which any IRA is a substantial owner engages in a transaction with a "disqualified person"; (ii) the IRA can direct that transaction; and (iii) the transaction would be a prohibited transaction if engaged in directly between the IRA and the disqualified person, then the transaction would be a prohibited transaction, regardless of the nature of the business entity. For example, it would appear that transactions such as loans, sales, or payment of compensation between that business entity and the "disqualified person" would be "prohibited transactions" if the IRA or IRA owner can require the transaction to take place, regardless of the nature of the entity's business.

b. It appears, however, that such transactions are permissible if they do not require the approval of the IRA or related IRAs, the entity is not created to circumvent the prohibited transaction rules, and if the assets of the business are not treated as IRA assets under the plan asset rules. See Section I(A)(4), above.

c. On the other hand, the mere approval of the IRA or IRA owner of the payment of a dividend by an entity owned or controlled by the IRA was not a prohibited transaction.

   i. See Swanson v. Commissioner 106 T.C. 76 (1996).

   ii. The Court reasoned that receipt of the dividend by the IRA was consistent with the purpose for which the IRA was established and applies to all other similarly situated parties.

d. Here are some examples involving situations in which there may be an issue of whether a transaction between the entity and the disqualified person is prohibited:

   i. Example 1. Z's IRA owns seventy (70%) percent of an operating company, X. An independent investor, Y, owns the other thirty (30%) percent.

All company decisions are made by majority vote of its owners. X may not pay Z compensation for services, or enter into other transactions with Z, or persons or entities who are also "disqualified persons." This is because the IRA, by virtue of its ability to control the majority vote, can require X to enter into such transactions with Z and those transactions would be prohibited transactions if they were between the IRA and Z directly. It does not matter that X is an operating company.

ii. Example 2. Same facts as in Example 1, except that the compensation or other transactions with Z or related persons can occur only with the approval of Y (for example, with the approval of the independent thirty (30%) percent investor). The transactions would not be prohibited transactions, as long as they are at arm's length for legitimate purposes.

Note: The independent person should really be an independent. For example, if the "independent person" is someone who would just rubber-stamp what the IRA wants to do, the IRS probably would not treat that person as independent.

E. Joint ownership of an entity or property by an IRA and its holder.

1. Prohibited transactions include situations where a disqualified person uses plan/IRA assets for his own benefit.

2. ERISA Opinion Letter 200-10A (7/27/00) considered the issue of the joint ownership of a partnership by an IRA and an IRA holder.

3. The IRS indicated that a fiduciary (IRA owner) may not rely upon, and cannot be otherwise dependent upon, participation in an IRA in order to undertake or continue a personal benefit.

4. This opinion has been interpreted to mean that “co-investment” is permissible as long as the IRA owner is able to establish that he had sufficient other personal assets in order to “carry” the investment if IRA assets were not used.

III. <u>CASE STUDIES</u>

A. Acme Corp. (“Corporation”) maintains the Acme Corp. Profit Sharing Plan (“Plan”). Harvey Smith owns one hundred (100%) percent of the stock of Corporation and is the trustee of Plan. The Plan covers approximately 25 employee/participants. The Plan holds approximately $500,000 in assets.

Smith, who has a need to raise cash (for his daughter’s wedding), owns a piece of vacant property worth $1 million. Smith believes it will be worth at least $2 million in three (3) years and will be ready for development. Rather than selling it to a third party, Smith would rather that the Plan enjoy the future appreciation and will sell it to the Plan for a $400,000 down payment and an interest only balloon note of $600,000 maturing in three (3) years.

What issues should be considered?

1. Issues inherent to qualified retirement plans.

a. Is this a prudent investment?

b. Is there sufficient liquidity to pay interest on the note and benefits to terminating participants?

c. Plan assets must be valued annually.

d. Does the transaction violate the exclusive benefit rule of IRC §401?

2. The sale to Plan by the trustee/shareholder is a prohibited transaction.

3. What if the property was owned by and acquired from Smith's cousin Michael Jones ("Jones")?

4. What if Smith sold the property to Jones, who then sold it to the Plan?

5. If the property was sold three (3) years later for $2 million, what would be the tax consequences to the Plan?

6. What consequences or issues would arise if the Plan developed the property by financing, building and selling twenty-five (25) single family residential units?

B. Mark Green ("Green") and Green's IRA desired to acquire a small strip shopping center. The purchase price of the center is $500,000. Green contributes $80,000 and receives an undivided eighty (80%) percent interest and Green's IRA contributes $20,000 (of a total of $22,000 of the assets held by the IRA) receiving an undivided twenty (20%) percent interest in the center. The center is fully leased and provides good cash flow. It is, however, forty (40) years old and requires ongoing maintenance. Green anticipates making many of the repairs himself. A new roof may be needed next year.

Sixth Fourth Bank ("Bank") is willing to finance $400,000 as long as the loan is secured by the center and Green guarantees the loan.

What issues should be considered?

1. What are the current tax consequences if the center produces taxable income or taxable losses?

2. What are the tax consequences if the center is sold for a profit at a later date?

3. Are the following prohibited transactions?

    a. Co-investment in the center,

    b. Securing the Bank loan with the center,

    c. Green's guarantee of the Bank loan,

    d. Green's providing maintenance services to the center, and are there other issues that should also be considered with respect to Green's services?

4. Are any of the results changed if Green and Green's IRA form an LLC to acquire the center?

5. Are any of the results changed if Green and Green's IRA own ninety (90%) percent and Green's cousin owns ten (10%) percent of the LLC?