Individual Retirement Accounts

How Real Estate Can Be Purchased Within an IRA

1031 Knowledge

There are many retirement plans, such as 401(k), 403(b), SEP, and others, which allow taxpayers to accumulate assets for retirement in a financially advantageous way. One of these plans is an individual retirement account, which is commonly abbreviated to IRA. Depending on the type of IRA, the income and also the capital gain taxes can be deferred or tax-free. It is possible to use an IRA to invest in real estate and, potentially, in the case of a Roth IRA, remove capital gains tax liabilities.

TRADITIONAL IRA vs. ROTH IRA

What is the difference between a traditional IRA and a Roth IRA? With a traditional IRA, subject to certain income and contribution restrictions beyond the scope of this article, a taxpayer can make contributions to a tax-deferred account with pre-tax funds (i.e. the taxpayer's income for income tax purposes is reduced by the amount of the contribution). On the other hand, with a Roth IRA, which is also subject to similar income and contribution restrictions, the contribution is made with after-tax funds. However, the advantage of a Roth IRA is that it allows for the tax-free growth of the investment account and also tax-free distributions during retirement.

To use an IRA for real estate investment, the first step is to create (or rollover, depending on the situation) an IRA and then submit the IRA to a company which provides options for a self-directed account and for real estate investment. In general, the taxpayer will want to ensure that the self-directed IRA is established set up where the company holding the funds functions as an administrator, as opposed to a custodian, and has the systems set up to accommodate real estate investments.

FINANCING ISSUES AND UBI

IRS Publication 598 states the income from debt-financed property within an IRA is considered unrelated business income (UBI). UBI is defined by the IRS as "the income from a trade or business that is regularly carried on by an exempt organization and that is not substantially related to the performance by the organization of its exempt purpose or function, except that the organization used the profits derived from this activity."

If the IRA receives more than $1,000 of UBI during a tax year, it is subject to taxation and an additional tax form must be filed (if there is less than $1,000 of UBI, no filing is required). Tax Planning Tip: Some advisors recommend using the excess UBI to make principal reductions on the mortgage each year because the income is no longer classified as UBI after the debt has been paid off.

One way to locate a company which specializes in real estate purchases within self-directed IRAs is to perform an internet search and use the phrase "self-directed IRA". This is only a brief overview of the opportunities available with an IRA purchase of real estate. Always consult with your tax and legal advisors to fully explore all relevant issues.

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HQ 800.282.1031 | NY 866.394.1031
apiexchange.com | info@apiexchange.com