FinancialPlanning

The dangers of IRA-owned real estate

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At the end of 2018, Americans held nearly $9 trillion in IRAs, mostly in the form of stocks, bonds, mutual funds, ETFs and annuities. But as clients have sought out new, sometimes novel investment vehicles — especially in times of market volatility — one IRA option is gaining traction.

Direct-owned real estate refers to properties in which an owner, or a company controlled by that owner, holds direct title to a property. Such investments may appear attractive on paper, but they also bundle a host of unique planning challenges not normally associated with traditional investments.

Despite this, some clients still view such a non-traditional IRA investment as their best avenue to retirement savings growth. IRAs are permitted to invest in non-traditional assets, which provides an increased level of control that may be a plus for many clients — but it can also be a double-edged sword. That's because IRAs are subject to prohibited transaction rules.

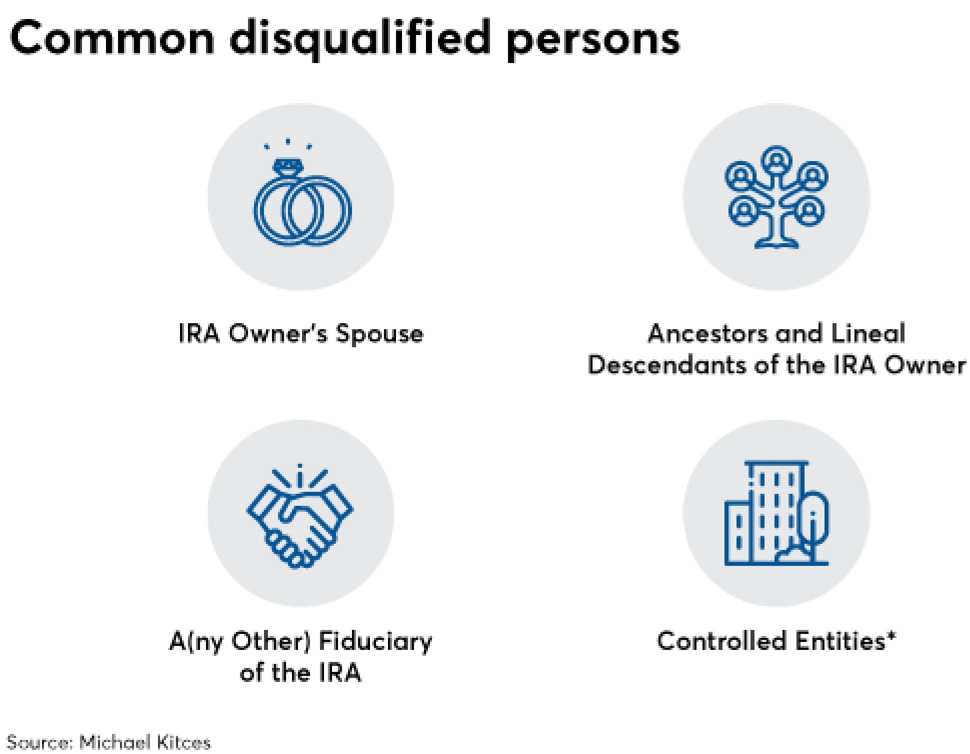
In essence these rules are designed to prevent fiduciaries of the IRA from engaging in transactions with the IRA that could run afoul of the fiduciary's obligations. In practice, the prohibited transaction rules are among the most complicated, and also the least forgiving, of all the rules that govern IRAs. This is in large part because the IRA owner themselves is always treated as a fiduciary to their own account, meaning prohibited transaction rules limit what an IRA owner can directly do with their own retirement account.

IRC Section 4975(c) details the various types of prohibited transactions that an owner may not engage in with respect to their IRA. The list, which also applies to other types of tax-favored accounts such as 401(k)s and other employer-sponsored retirement plans, as well as HSAs, includes buying or selling to/from one's IRA; lending or extending credit to one's IRA; the furnishing of goods and services between an IRA and its owner; and the use of an IRA's income or assets for the IRA owner's benefit.

In short, an IRA owner should not benefit from their IRA, other than via distributions received from the account. And the IRA itself should not benefit from its owner, other than via contributions to the account made by that owner. To do otherwise constitutes engaging in a transaction for which the IRA-owner-as-fiduciary has a potentially untenable conflict of interest with their own account.

The same prohibited transaction rules also apply to other "disqualified persons," as defined by IRC Section 4975(e)(2). Beyond the IRA owner, these persons include:

- The IRA owner's spouse
- Ancestors and lineal descendants of the IRA owner
- A fiduciary of the IRA
- Corporations in which 50% or more of profits or voting power are owned by the persons listed above, partnerships in which 50% or more of capital interests or profit interests are owned by the persons listed above, or trusts or estates in which 50% or more of the beneficiary interest is owned by the persons listed above.



In general, when a prohibited transaction occurs in an IRA, the penalty for the IRA owner/beneficiary is that their IRA/inherited IRA is deemed distributed as of January 1 of the year in which the prohibited transaction first occurred.

Consequently, the individual's entire IRA would be subject to income tax — and if applicable, the 10% early distribution penalty as well. In addition, since the tax-deferred wrapper of the IRA/inherited IRA ceases to exist as of January 1 of the year in which the prohibited transaction first occurred, all interest, dividends and capital gains earned after that time would be subject to their regular tax rates, even if on paper they occurred inside an IRA, because the prohibited transaction was not yet discovered.

Notably, a 15% initial penalty and an additional 100% penalty — if not corrected in a timely manner — apply to prohibited transactions engaged in by persons other than an IRA owner or their beneficiaries, as well as when prohibited transactions occur with other types of retirement accounts such as qualified plans.

IRC Section 4975(c)(1)(D) states that a prohibited transaction occurs when there is a "transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan." In the context of direct-owned real estate, this means that an IRA owner cannot use IRA-owned real estate for personal use, nor for that matter can any other disqualified persons, as outlined above.

And unfortunately, there is no *de minimis* exception to the personal use rule. Consequently, any personal use by an IRA owner or by other disqualified persons constitutes a prohibited transaction.

Example No. 1: Homer is a 55-year-old IRA owner. Several years ago, Homer used his IRA to purchase an apartment building in Cleveland, Ohio, which he regularly rents to travelers via online websites. Homer's daughter, Lisa, was recently accepted to Harvard, and Homer plans to drive her to campus for her first semester.

Conveniently, Cleveland is located at roughly the midway point between Homer's home in Springfield, Illinois, and the Harvard campus. With that in mind, he is considering spending the night at his IRA-owned Cleveland apartment on his way to Cambridge.

Yet the moment Homer crosses the threshold of the front door to the apartment to stay for the night, he has used the assets of his IRA for his personal benefit. As result, a prohibited transaction has occurred, and Homer's entire IRA will be deemed distributed as of January 1 of the year. (*D'oh!)*

BUYING AND SELLING

Similar to the rules that prevent use of an IRA-owned asset by an IRA owner and/or other disqualified persons, IRC Section 4975(c)(1) prevents the "sale or exchange, or leasing, of any property" between an IRA-owed asset and an IRA owner and/or other disqualified persons. This restriction is absolute and makes no distinction between sales or leases conveyed at a discount versus those at fair market value. In other words, even if the IRA owner does a transaction with their IRA at a fair market rate, it is still prohibited.

Example No. 2: Sandy is a 65-year-old IRA owner who, 15 years ago, used his IRA funds to purchase a vacation home in Key West, Florida. Via his IRA, he currently rents the house out a rate of $5,000 per month.

Sandy, however, recently retired and would like to spend more time in Key West. He loves the IRA-owned vacation home, and thinks it would make a great place to stay.

Unfortunately for Sandy, he cannot rent the vacation home from his IRA, even if he continues to pay the same $5,000 fair-market monthly rent. Furthermore, he can't even purchase the home from his IRA, even if that purchase was made as an arm's length transaction at fair market value.

In fact, there is only one way for Sandy to use the IRA-owned Key West home without running afoul of the prohibited transaction rules: He'd have to distribute the home in kind from his IRA. This, however, would result in ordinary income tax being owed on the fair market value of the home when distributed, as with any other taxable distribution.

THE CREDIT CONUNDRUM

Another concern for IRA owners investing in direct-owned real estate revolves around credit. Per IRC Section 4975(c)(1)(B), a prohibited transaction occurs whenever there is a direct or indirect "lending of money or other extension of credit between a plan and a disqualified person."

Direct extensions of credit are fairly obvious and easy to spot. Such transactions would include an IRA borrowing money from the IRA's owner or another disqualified person. However, indirect extensions of credit are generally tougher to spot. One common scenario in which an IRA and an IRA owner engage in an impermissible indirect extension of credit is when the IRA owner personally guarantees an otherwise legitimate IRA loan.

Example No. 3: Linda would like to purchase a $1 million commercial building with her IRA that will be rented to non-related persons. However, Linda only has $800,000 in her IRA, and so in order to make the purchase Linda's IRA takes out a $300,000 mortgage — which is perfectly permissible as long as the loan does not involve a disqualified person and is simply borrowed from a neutral party like a bank.

Unortunately, Linda doesn't read the terms of the loan agreement with her IRA as closely as she should. The fine print states that in the event of a default and foreclosure, the bank will first sell the IRA-owned property in an attempt to recover its debt. However, if after the sale of the home there is still an unpaid balance, the bank has the ability to collect by going after any of Linda's personally owned assets and/or income.

The ability of the bank to recoup amounts lost by attacking Linda's personal assets is a prime example of an indirect extension of credit creating a prohibited transaction. Despite Linda's best efforts to do things right, the entire value of her IRA would be deemed distributed before her signature on the loan agreement dried, because her personal guarantee of the loan means she was a prohibited part of the extension of credit to her IRA.

NO HANDYMAN SPECIALS

Oftentimes, individuals interested in direct-owned real estate seek to make a profit by purchasing properties in need of substantial improvements, making some or most of those improvements themselves and then flipping the newly renovated property for a tidy profit. That strategy of investing sweat equity to increase the property's value may work where investments made with non-qualified funds are concerned, but it will decidedly not work for investments made with IRA funds.

IRC Section 4975(c)(1)(C) prohibits the furnishing of goods, services or facilities between an IRA and a disqualified person. Simply hammering in a loose nail would be a "service" provided to the IRA, and like the other prohibited transactions discussed above, there is no *de minimis* exception for small jobs or the like.

Consequently, the performance of any work on a direct-owned piece of IRA real estate by the IRA owner would result in a prohibited transaction and the disqualification of the IRA itself. Note that the same would also be true if the IRA owner was a contractor, and instead of doing the work themselves used their IRA money to pay their employees to do the same work.

CASH CONSIDERATIONS

The example above, in which Linda needs more money in her IRA to effectively purchase and manage her desired direct real estate investment, highlights another one of the other major problems that can arise with direct-owned real estate in IRAs: cash flow issues.

This is somewhat unique to direct-owned real estate compared to other types of IRA investments due to the direct nature of managing and operating the rental real estate itself. For instance, when an individual purchases a traditional investment with IRA money, such as stock shares in Microsoft, that's generally the extent of the total cash outlay. If Microsoft has to recall one of its computers and is tight on cash flow, it has to deal with that problem at the corporate level and it wouldn't require shareholders to come up with additional funds to handle the recall.

The same is not true for direct-owned real estate held inside an IRA. When such investments require capital — say, to fix a leaky roof — the IRA itself must have, or be able to secure, the necessary cash. And because an individual must remain at arm's length from their IRA, that cash cannot come from the IRA owner themselves or another disqualified person. Using personal assets to pay for maintenance, repairs or other bills of the real estate property is strictly prohibited.

LOAN CHALLENGES

The potential cash flow issues associated with direct-owned IRA real estate can begin even before a property is purchased. Many successful real estate investments depend, at least to some degree, on debt to either make the investment feasible or make it worth it when compared to other potential investment opportunities, with the benefits of debt leverage. However, there are unique obstacles to contend with when securing financing for an IRA investment into direct-owned real estate.

As noted above, an IRA owner cannot personally guarantee any debt associated with their IRA. Thus, if an individual wishes to have their IRA secure a loan to aid in the purchase of a piece of real estate, that debt must be structured as a non-recourse loan solely to the IRA itself. A non-recourse loan is a loan in which an asset is pledged as collateral, but in the event of default the borrower is not personally liable for any additional unpaid amounts beyond the lender's ability to foreclose on the pledged asset itself. With respect to direct-owned real estate held inside an IRA, the property for which the loan is originated to help facilitate the purchase serves as the collateral.

In the event the IRA defaults on the loan, the lender can foreclose on the property serving as collateral, and sell it to repay any unpaid amounts. However, if the proceeds of the sale of the property are not sufficient to satisfy the outstanding balance of the loan, the lender cannot recover further amounts from the IRA owner, and is forced to absorb the loss.

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From a lender's perspective, this clearly makes a non-recourse loan to an IRA riskier than a loan in which it may hold the borrower personally liable for any unpaid amounts. And as a result, many lenders will not originate loans to IRAs to purchase real estate. Period.

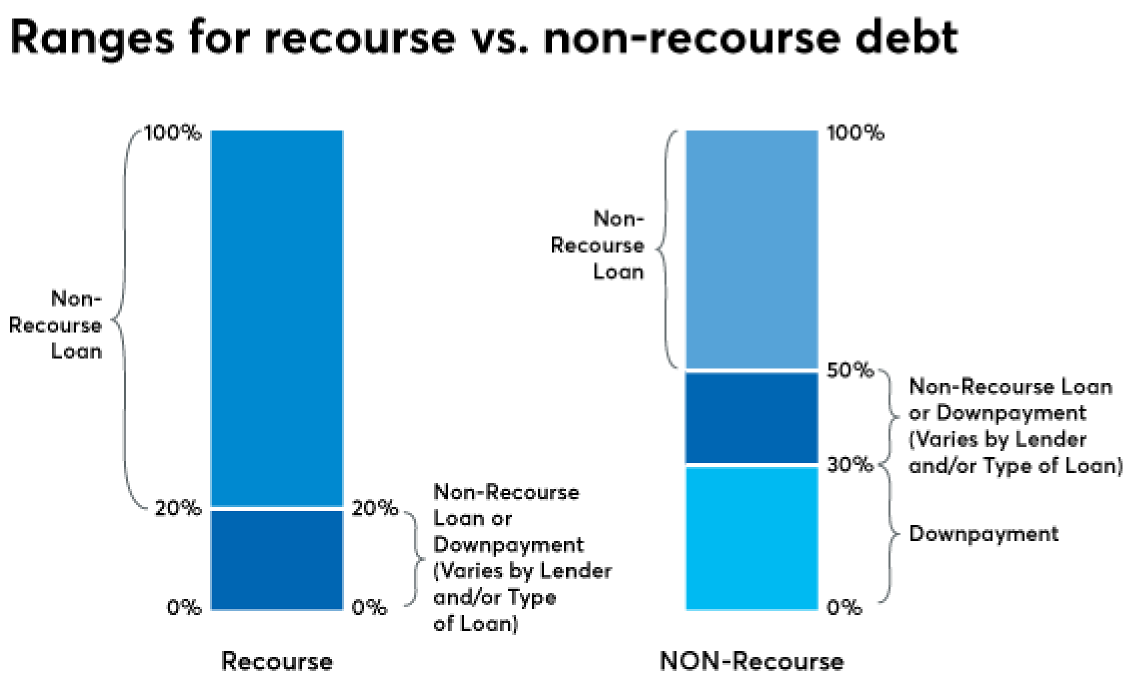
In turn, even those lenders that will originate such loans must do something to mitigate the additional risk. That typically means limiting the amount of the loan relative to the overall value of the property, at the time the loan is originated, to a greater degree than is normally the case with a recourse loan.

The amount a bank is willing to lend relative to the value of a property is known as the loan-to-value ratio. Traditionally, people have viewed 20% as a key amount to put down to obtain financing — and avoid PMI — resulting in an 80% loan-to-value ratio. The reality is that many homebuyers put down far less.

In fact, by some estimates roughly two-thirds of first-time homebuyers may put down just 6% or less, resulting in loan-to-value ratios far in excess of 90% — since the lenders know that they will have recourse back to the borrower personally if there is a default and the real estate collateral alone can't make the lender whole.

By contrast, the amount that lenders are typically willing to lend in non-recourse IRA loans is generally a much lower percentage of the property's value, leaving more initial equity in the property against which they can recover if the IRA defaults on the loan. Many IRA loan originators cap their loan-to-value ratio at or near 50%, and even the most aggressive of such lenders typically cap out at a 70% loan-to-value ratio.

Thus, an IRA must have much more cash on hand to make a purchase than would be the case if the same property were purchased outside the IRA with a recourse loan.



Source: Michael Kitces

Example No. 4: Martin is a 65-year-old IRA owner who would like to purchase a $1 million commercial building to rent. After exploring his options Martin has found a lender willing to offer him an $850,000 mortgage — representing an 85% loan-to-value ratio — if he purchases the property with a recourse loan outside his IRA. Ignoring closing costs, Martin would consequently need $150,000 in regular cash to make the purchase.

Martin has also found a lender willing to make a loan to his IRA so that it could purchase the same property. Because the IRA loan would be non-recourse debt, the lender is only willing to extend a loan up to 60% of the property's value — i.e., a 60% loan-to-value ratio. Thus, the maximum amount that Martin's IRA could borrow to acquire the property would be $600,000, meaning he'd have to have $400,000 of cash inside the IRA ready for a down payment, compared to just $150,000 to buy the same property outside the IRA.

ONGOING EXPENSES

Of course cash flow obligations for direct-owned real estate don't end once a property is purchased. Property taxes and insurance must be paid. Regular maintenance, such as gardening, must be attended to as well. And as any homeowner can attest, things break, accidents happen and unforeseen repairs are a virtual guarantee.

Critically, all of these expenses must be paid with IRA money as well. Even after a purchase an IRA owner must ensure there is enough IRA cash left over to pay ongoing expenses and to cover any repairs that may need to be made, given the expenses will be due regardless of whether or how much income the rental property is generating.

And such repairs and maintenance sometimes turn out to be more expensive than an IRA owner initially anticipates. As noted earlier, many individuals purchasing rental properties use sweat equity to help defray costs and maximize cash flow — taking care of some light maintenance such as mowing the lawn or doing basic repair work on their own. But as noted earlier, when it comes to real estate owned by an IRA, the prohibited transaction rules prevent an IRA owner from doing any work related to the property. Even changing a lightbulb would violate the prohibited transaction rules, resulting in the immediate and irrevocable distribution of the entire IRA in which the property is owned.

LACK OF LIQUIDITY

Another significant cash flow issue that can arise with respect to direct-owned IRA real estate is figuring out how to take an IRA owner's RMD. This issue only presents itself once the IRA owner turns 70 ½, but once that key age marker is reached, RMDs are required each and every year until the IRA is depleted. In addition, a beneficiary inheriting an IRA with direct-owned real estate would have to contend with RMDs beginning immediately in the year after inheritance.

Initially an IRA owner's RMDs begin at less than 4% of the prior-year-end's account value, but the percentage that must be distributed increases in each successive year. And the penalty for failing to take an RMD is a rather severe 50% of the shortfall — i.e., the amount that should have been taken, but was not. But what happens if the IRA-owned property is not generating enough cash to continue paying any debt obligations, maintain the property and allow the IRA owner to satisfy their RMD?

Unfortunately there is no exception to the RMD rules for lack of liquidity, and thus the IRA owner would be subject to the 50% penalty for any shortfall — for which completing IRS Form 5329 and requesting relief due to reasonable cause will not apply. There are, however, a number of potential solutions to this problem.

The simplest way to resolve such an RMD issue would be to take the RMD for the direct-owned-real-estate-IRA-account from another of the IRA owner's IRA accounts, which is permitted under the IRA aggregation rules for RMD purposes. Though note that it must be from an IRA, as an RMD cannot be taken from a different type of retirement account.

If there are no other IRA accounts, the IRA owner could try to refinance the IRA-owned property to pull cash out of the property, which would then be available within the IRA as cash and could be distributed to satisfy RMD obligations.

Another possible option would be to convert the property from an IRA-owned asset to a Roth IRA instead, as Roth IRAs have no RMDs during the owner's lifetime. For those IRA owners opting for this option, it is often best to ensure that the Roth IRA conversion is done in the year prior to the IRA owner turning 70 ½, since conversions done at a later date would only be able to be made after the RMD for that year was already distributed.

Though it's worth noting that even this approach comes with an expiration date: the Roth IRA owner's death (unless the account is moved into a spouse's own Roth IRA). As unlike Roth IRA owners, beneficiaries must begin taking RMDs in the year after the owner's death, which again creates the same RMD liquidity problems discussed earlier.

Alternatively the IRA owner could try to distribute at least a portion of the real estate asset of the IRA in kind to satisfy the RMD obligation, as unlike IRA contributions — which must be made in cash — distributions from an IRA can be made in cash or in kind, for RMD purposes or otherwise.

Admittedly this can be rather problematic when it comes to direct-owned real estate. Imagine for instance that an IRA owner has 1,000 shares of ABC Solutions within her IRA, each worth

$100. Furthermore, suppose she has an RMD of $4,000. Here, if the IRA owner did not have enough cash available to take a distribution, she could simply distribute 40 shares of her ABC Solutions stock.

But what if the IRA owner had the same $4,000 RMD but had an IRA consisting of a $100,000 rental home and minimal cash? How do you distribute only $4,000 worth of a single property? Do you treat the bathroom as distributed in one year, and the kitchen the next?

One potential way to resolve this problem would be to create an LLC owned by the IRA, and subsequently transfer the property into the LLC. Then, to satisfy the RMD, it may be possible to distribute a portion of the LLC interests in kind.

This can create its own share of complications. For instance, if you distribute 5% of the property in kind, the ownership of the property on the property's deed must be updated to reflect the change in ownership of the LLC. Mortgage documents may need to be updated to reflect the same. And now, whenever any expenses arise, you must ensure the IRA pays its portion and you separately pay your portion.

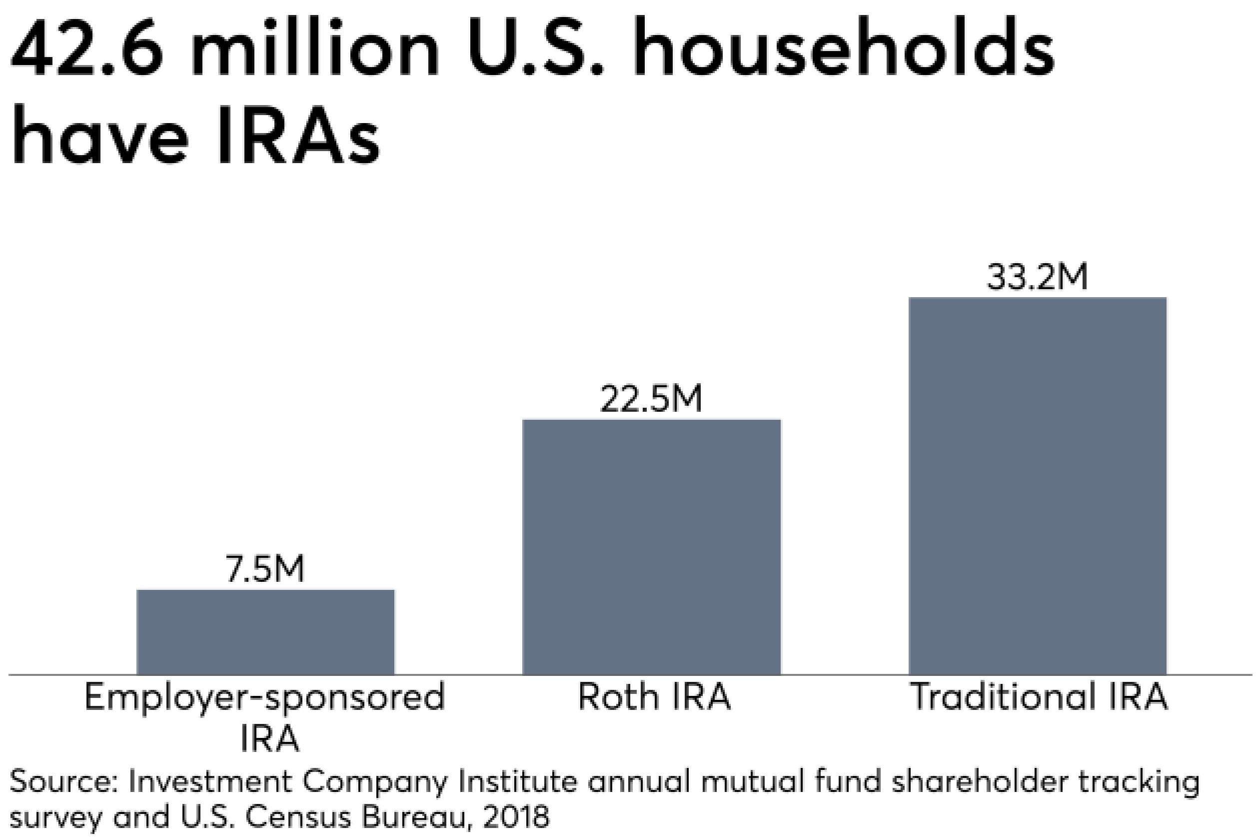
Good luck keeping that all straight and not running afoul of the prohibited transaction rules.

VALUATION ISSUES

When an IRA consists of traditional investments such as stocks, bonds, mutual funds, ETFs and annuities, determining the fair market value of the investments is generally straightforward. The prices of such investments are readily available and are essentially tracked automatically by an IRA custodian. Valuing non-traditional assets such as direct-owned real estate, however, can be more complicated, leading to even more headaches for IRA owners with direct-owned real estate.

One common misconception is that the value of an IRA owner's account only matters once they turn 70 ½, when the account balance needs to be determined to calculate the required minimum distribution itself. The reality is that the IRS requires that the fair market value of an IRA be reported each year on IRS Form 5498. Clearly there's no way to know what the fair market value of the account as a whole, unless you know the fair market value of the investments within the IRA.

Additionally, since 2015 the IRS has required more reporting for hard-to-value assets, which includes direct-owned real estate. In addition to reporting the fair market value of the account as a whole, custodians must also separately report the fair market value of hard-to-value assets (Box 15a of IRS Form 5498) and the type(s) of hard-to-value assets found within the account (Box 15b of IRS Form 5498). Thus, an IRA custodian must know the value of such assets each year.



But how does an IRA custodian determine the value of a piece of direct-owned real estate? This comes down to knowing a custodian's procedures and policies.

Admittedly, unless an IRA owner distributes all or a portion of their hard-to-value IRA asset(s), including via a Roth conversion, the value of the asset(s) — while required to be reported to the IRS — doesn't really matter all that much. In other words there are no income tax repercussions from having an inaccurate valuation.

Many self-directed IRA custodians will consequently allow IRA owners to self-report such valuations prior to turning 70 ½, or to provide the custodian with an estimate from an online source such as a Zillow, Realtor.com or Redfin, which the custodian will then use to complete

IRS Form 5498. However, some custodians will require more formal valuations even at this point, which can create an additional ongoing expense for the IRA that must be planned for and considered.

There's an important caveat. RMDs are calculated in part using the prior-year-end's fair market value. Thus, once an IRA owner turns 70 ½ the value of the IRA — and as such, the value of the assets within the IRA — really matter. Undervaluing an asset would result in an artificially low RMD calculation, effectively depriving the government of some of its long-awaited tax revenue, and creating the risk that the IRS audits, adjusts the valuation, determines that the prior RMD was insufficient and applies the draconian 50% penalty for the failed amount of the RMD that would have been due with a proper valuation.

Given the heightened importance of fairly valuing assets inside an IRA once RMDs are required, many self-directed IRA custodians no longer accept an IRA owner's estimation, or less formal valuations such as those from online sources. Instead formal appraisals are often required, and if RMDs are due on an annual basis, so too are formal appraisals. These are likely to cost $300 or more for single-family residences, but can easily cost $1,000 or more for larger multi-family buildings and/or commercial properties.

In addition to the requirement to regularly obtain a formal appraisal once RMDs begin, custodians often require similar valuations to be obtained at younger ages if the IRA owner either distributes all or a portion of the direct-owned real estate or if a Roth IRA conversion is made. In either case the IRA/Roth IRA owner's reported income — and subsequent tax liability — would be based on the fair market value of the assets distributed/converted, and thus an accurate valuation is of critical importance.

Notably any costs associated with obtaining a valuation for IRA purposes are an expense of the IRA itself, as part of the costs associated with the direct-owned real estate investment. Thus, an IRA owner must be sure to pay for any and all such appraisals with IRA funds, and not with personal assets. The use of personal funds for such an expense, even if by accident, would yet again be a prohibited transaction, resulting in the total distribution of the IRA.

IRAs are incredible tools for helping create and preserve wealth. This helps remove the so-called tax drag associated with investments made with taxable dollars. But the tax-deferred wrapper both giveth and taketh away.

THE DEPRECIATION DOWNER

For many real estate s, one of the most attractive parts of owning real estate is the ability to depreciate the property. The basic idea behind depreciation is that over time, assets often lose value, and therefore the owner should be able to deduct that lost value in some way, and in turn reduce their taxable income. Indeed, this loss of value over time holds true with most assets, from automobiles (notwithstanding collectibles) to office furniture.

By contrast real estate not only typically holds its value over time, but tends to actually appreciate as well. Nevertheless, real estate purchased with taxable dollars can be depreciated over 27.5 years for residential, or 39 years for commercial, giving investors a paper loss tax benefit while their investment actually appreciates. In so doing, much of the benefit of an IRA's tax-deferral wrapper is replicated, since real estate income is often mostly or fully offset by depreciation deductions, at least in the early years.

But depreciation is not available when direct-owned real estate is held inside an IRA. The IRA has no income in the first place, so there is no income against which the depreciation deductions can be applied. Withdrawals from an IRA result in income, but that is still income to the IRA owner, not of the IRA, so depreciation deductions still do not apply. Thus, one of the most valuable tax benefits typically associated with real estate investing is lost.

It's also worth noting that the tax-deferred nature of the IRA is often underused when the IRA invests in direct-owned real estate. For starters, real estate investments are generally longer-term holds, and as long as the property is held, any appreciation in its price is tax-deferred anyway, regardless of the fact that it is held inside an IRA.

OTHER DEDUCTION LOSSES

As part of the tax law changes passed in 2017, Congress created a new tax deduction for small business owners called the 199A, or qualified business income (QBI), deduction. This is worth up to 20% of profits, and is often applicable to the income generated by real estate investments made with taxable dollars.

Since real estate income is tax-deferred when earned inside an IRA, the QBI deduction offers no additional tax benefit unless the IRA is subject to the unrelated business income tax, or UBIT. (More on this later.) The QBI deduction available outside of IRAs effectively reduces the relative value of the tax deferral offered by the IRA as well. Simply put, the higher the effective tax rate of an investment, the greater the value of tax deferral. For investments made with taxable dollars, the QBI deduction can lower the effective tax rate of rental income by up to 20%, and the value of the tax deferral offered by an IRA is reduced proportionately too.

If you think about it, there's something not quite fair about an IRA securing debt. That debt provides leverage and can essentially act as an extra contribution to the IRA that could produce extra earnings capable of tax-deferred growth, if there wasn't some rule to prevent that.

That is why, since 1950, Congress has had a way of leveling the playing field. The mechanism by which this is accomplished is the aforementioned unrelated business income tax, or UBIT. Under UBIT rules, the first $1,000 of unrelated business taxable income (UBTI) generated by a tax-exempt entity, including an IRA, is subject to the tax. And since an IRA is considered a trust, it must pay tax on any UBTI in excess of a small $1,000 exemption at trust tax rates — i.e., the worst rates around.

Of critical importance to investors using non-recourse loans to purchase direct-owned real estate within their IRA is the concept of unrelated debt-financed income (UDFI), a type of UBTI that is subject to the UBIT. More specifically, UDFI is equal to the ratio of the average acquisition indebtedness of a property, over the average adjusted basis of the property, multiplied by the gross income from the debt-financed property.

In other words, whatever percentage of the property is debt-financed, so too is that percentage of the rental income deemed UBTI, causing the IRA to pay income taxes on that amount.

Example No. 5: On January 1, 2019, Sheila purchased a $1 million rental property inside her IRA, using a combination of IRA cash and a non-recourse loan made to her IRA. As of December 31, 2019, the average outstanding balance of the non-recourse loan for the year is $550,000, and the property has generated $20,000 of gross income.

Under UDFI rules, ($550,000 / $1 million) x $20,000 = $11,000 will be considered UBTI, subject to the unrelated business income tax. Thus, the $11,000 amount will be reduced by the IRA's $1,000 exemption amount, with the remaining $10,000 of UDFI/UBTI will be taxable at trust tax rates.

Finally, the UBIT serves as yet another reminder of the barrier that must be placed and kept between an IRA owner and their IRA. In the event an IRA is subject to the UBIT, the IRA itself must pay the tax, and not the IRA owner. This is done by the IRA filing an IRS 990-T Tax Return, which is often prepared by the IRA custodian for a fee, which would be yet another cost of the IRA.

Consequently, it's especially important for IRA owners utilizing self-directed real estate as an investment in their IRA to be aware of the prohibited transaction rules. The onus is still on the IRA owner to ensure the IRA is properly maintained, and that the prohibited transaction rules are complied with.

To hold direct-owned real estate within an IRA, an investor must generally custody their assets with a self-directed IRA custodian who has the systems in place to handle such non-traditional retirement account assets. And because of the various complications discussed above that such custodians must contend with, the fees they charge for maintenance and other items are generally far in excess of the fees charged by traditional custodians.

However, it's crucial to recognize that one thing self-directed IRA custodians do not necessarily do is make sure that their IRA owners do not violate the aforementioned prohibited transaction rules. While custodians will generally provide education about such matters and may let IRA owners know if they spot obvious potential problems, self-directed IRA custodians rarely, if ever, take responsibility for ensuring an IRA owner complies with the rules.

When investors get excited about a real estate deal that seems too good to be true, cooler heads will say, "Buyer beware." That counsel should also be dispensed to anyone who may be considering non-traditional investments such as direct-owned real estate within an IRA.

Jeffrey Levine