"Exchange Away the Debt-Financed Tax Liability of a Leveraged Real Estate IRA"

(The Adventures of Tex Free)

More and more folks are hearing of, learning about and acting upon the emerging investment opportunities available through *Fully* Self-Directed IRA's and 401(k)'s. They are realizing that one's retirement plan investment choices are **not** limited to the conventional fare of stocks, bonds and mutual funds. Rather, they are investing IRA/401(k) dollars in real estate, private loans, private companies and a host of "alternative" opportunities while reaping the increased rewards of tax-deferred (or tax free) returns within their retirement accounts. Moreover, by accessing non-recourse loans through specialty lenders that cater to alternative asset acquisitions, investors are leveraging their IRA's and 401(k)'s into properties worth two to three times what their cash-only investments would allow.

Here's an example: A "SuccessFull Self-Director®" named Tex Free intends to purchase a $500,000.00 Four-Plex in suburban Tacoma with his IRA. Tex has $200,000.00 cash held in a *fully* self-directed account administered by RealTrust IRA Alternatives, LLC. He can go to the bank and obtain a $300,000 loan to pay the balance of purchase price. The loan must be "non-recourse". In other words, the lender cannot reach IRA assets, other than the Four-Plex pledged as collateral, to recover in the event of a default on the loan and an ultimate short fall when the bank forecloses and re-sells the Tri-Plex. Tex may not personally guarantee the loan, either, as doing so would be an extension of his personal credit for the benefit of the IRA in violation of the Prohibited Transaction rules.

In our case, the bank is willing to make the loan because there will be 40% down ($200,000 on a $500,000 purchase) and the loan-to-value (LTV) ratio is only 60% ($300,000 on a $500,000 purchase). Further, the substantial down payment and low LTV means that the rental income will more than cover the monthly installments due on the loan (including taxes and insurance). So, it seems like everything is a "go", right?

Tex wisely consults his tax advisor before obligating himself to the Four-Plex transaction. The advisor reviews the deal and raises the red-flags of UBTI (Unrelated Business Taxable Income) and UBTI's pernicious cousin, DFTI (Debt Financed Taxable Income). She explains that, because the IRA is using the bank's money to leverage into the Four-Plex (together with the IRA cash), 60% of the net profits/gains realized by the IRA will be subject to UBTI/DFTI. (In general, the tax applies to that portion of the net income realized by the IRA in a given year determined by the following ratio: the average outstanding loan amount for the past 12 months, relative to the original acquisition cost or basis of the property.) Accordingly, if the IRA sold the Four-Plex during the first year and realized a $100,000 gain, 60% of that amount, or $60,000, would be taxable. A modified trust tax rate would apply to the taxable amount and the IRA would pay the tax out of the profits realized. If the tax bill amounted to $15,000.00, the $85,000.00 net return would result in a 42.5% cash-on-cash return in less than a year ($85k ÷ $200k = 42.5%, even factoring in the tax hit), leaving the IRA with $285k cash.

Had Tex partnered his IRA with another investor who contributed $300,000 cash alongside the IRA's $200,000 to reach the $500,000 purchase price, Tex's IRA would hold only a 40% stake in the deal and realize only 40% of the profits ($40,000.00). True, there would be no UBTI/DFTI, but only $40,000 of the $100,000 profit would come back to Tex's IRA, resulting in $240k cash in the account. That boils down to a 20% cash on cash return, less than half of what the IRA would otherwise realize by keeping 100% of the deal and leveraging the IRA through a non-recourse loan.

If Tex's tax advisor was familiar with §1031 tax-deferred exchanges, she could help structure the Four-Plex re-sale transaction to be 100% tax-deferred, even with a 60% leverage/debt financing feature. By combining IRC §1031 tax-deferred exchange advantages with one's Real Estate IRA, the UBTI/DFTI problem can be transcended. Here's how:

In the example above, Tex got clipped with the tax hit when he sold the IRA's debt-financed Four-Plex for $600,000 (realizing a $100,000 capital gain). However, had Tex's IRA "exchanged" the Four-Plex for like-kind replacement property, meeting the §1031 exchange rules, the IRA would completely defer paying UBTI/DFTI on the gain. To accomplish this, Tex's IRA would retain a Qualified Intermediary, properly convert the "sale" into a §1031 tax-deferred exchange, buy suitable replacement real property of an equal or greater value ($600,000.00 or above), take on an equal or greater amount of debt against the replacement property ($300,000.00 or more) and put down the net equity toward the purchase price of the replacement property (approximately $300,000.00, less closing costs). Like any §1031 exchange, Tex has 45 days from closing to identify potential replacement properties and 180 days to purchase one or more of the targeted properties.

Under this approach, Tex keeps the entire $100,000 gain working for him on the next deal, rather than forking over the tax hit to Uncle Sam. His IRA could buy a multi-unit property worth $600,000, using $300,000 cash and a $300,000 non-recourse loan. Here's the beauty; because it's now only a 50% LTV, Tex lowered the percentage of gain that would be subject to UBTI/DFTI on the next sale from 60% to 50% ($300,000 debt = 50% of the $600,000 acquisition cost). So, if Tex's IRA made another $100,000 profit when it subsequently sold the multi-unit property for $700,000, the DFTI tax bill would be calculated on 50% of the gain, including the deferred gain. The total gain amounts to $200,000.00, so 50% equals $100,000.00. Under this scenario, if the tax hit was approximately $25,000.00, a $175,000.00 net return results, after tax. This amounts to a 58.33% cash on cash return spread-out over the number of years Tex's IRA holds the real estate investment ($175k ÷ $300k = 58.33%).

Of course, Tex's IRA could exchange again rather than "sell" the multi-unit property and continue to defer paying tax on the debt-financed portion of the gains. One of the built-in benefits of this approach is that the portion of the gains subject to UBTI/DFTI is reduced as the outstanding principal balance of the debt-financing is amortized. That's because the rule states that the percentage of gains subject to the tax is pegged to the average outstanding loan amount over the last 12 months relative to the acquisition cost or basis of the property financed.

So, let's say Tex's IRA next buys an eight-unit in Spokane for $750,000 with $400,000 down and $350,000 debt, then holds the eight-unit for the long term. Tex's IRA realizes surplus cash flow during the hold period which is used to pre-pay the loan's principal balance in part, rather than a straight amortization. Down the road, when Tex's IRA sells the eight-unit for $1,000,000.00, the outstanding loan amount has been reduced to only $150,000. Therefore, only 20% of the gains would be subject to UBTI/DFTI at the then-current tax rate. The gains would equal $450,000, 20% of which equals $90,000. Hence, $90,000 would be subject to the tax, resulting in a much diminished tax bill.

Should the debt be fully amortized for more than one year before the IRA sells the eight-plex, no UBTI/DFTI will apply because of the one year look-back rule. Hence, all gains come back into the IRA without tax! Under this strategic approach, our "SuccessFull Self-Director®" really lives up to his namesake: **Tex Free!!**