Taft/

DID YOU KNOW?

____

Did you know investing in real estate through your self-directed IRA could result in taxable income?

The tremendous appreciation in real estate values and rents over the last five years or so has made real estate investments much more popular to the general investing public. Promoters of real estate investment partnerships often advise potential investors that they can make such investments through their self-directed IRAs. While this allows individuals to tap these financial resources, it is important to be aware that such investments could give rise to taxable income to the IRA.

IRAs, which are generally not taxed, are subject to income tax known as UBIT (unrelated business income tax) on certain types of income from real estate investments. The tax is imposed at the highest marginal rate (37%) on income in excess of $14,450. The IRA will be required to file a tax return (IRS Form 990-T). Responsibility to file the return each year is on the IRA account owner not the investment sponsor or the IRA custodian.

Real estate investment income that is subject to UBIT is i) income from an active (rather than passive) business, and ii) income that is debt-financed, even if it is passive. Most investments offered to investors through self-directed IRAs are partnerships structured to obtain passive income such as rental income while the property is held and capital gain income when the property is sold. Real estate investments that are active and that will trigger UBIT on income include fixing and flipping properties, new construction for sale, and short-term rentals. (See prior Did You Know discussing short-term rentals.)

Even when the investment is passive, it will give rise to UBIT to the extent that it is leveraged with debt. For example, if the investment partnership acquired property with 25% equity and 75% debt, 75% of the net rental income and capital gain would be subject to UBIT. (Note: Unlike self-directed, IRAs, solo 401Ks are not subject to UBIT on debt-financed income from real estate investments).

Bottom Line: The fact that UBIT may apply to income from an investment in real estate does not make it a bad investment for a self-directed IRA, but investors should be aware of the potential tax cost and tax return filing requirements in making their investment decision.

"Be nice to nerds. You may end up working for them. We all could." – Charles J. Sykes.

James E. Duffy / (612) 977-8626 / JDuffy@Taftlaw.com