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CRAFT FINANCIAL SOLUTIONS, LLC
MONTHLY TAX TIP

REAL ESTATE IRA

Although IRS rules allow IRA funds to be invested in real estate, IRS rules do not require an IRS trustee to offer real estate as an investment option. Most trustees who offer traditional IRS investments, such as banks, don not allow an IRA owner to invest in real estate because of the extra administrative burden of real estate management. As a result, you will most likely have to convert a traditional IRA to a self-directed IRA. This type of IRA requires that you decide what investments to include. The IRS does require that the real estate property included in the self-directed IRA be for investment purposes only along with a few rules that have to be followed.

If you use all cash to purchase your IRA-investment real estate, the income produced by the property and any future gain on sale will remain in your IRA tax-deferred until you start taking distributions. But if you have to acquire a mortgage as part of your purchase of the property, you will have to pay taxes on any income or gain attributable to the financed part of the transaction. This is called Unrelated Debt Financed Income(UDFI).

For example, if an IRA purchases a piece of real estate using partial debt financing(either seller financing or bank financing), UDFI will be triggered. But keep in mind that UDFI only applies to percent of income resulting from the financed portion. This will generally result in less tax being owed. Reason being the percent of income resulting from the capital invested should result in tax-exempt income.

Let’s say a property sold for $40,000 and the property was 30% financed. Then $12,000 would be subject to tax. Let’s say that you had $5,000 of deductions against the property. So now you are down to $7,000 being subject to tax. In this case, the tax rate would be around 18%-20% resulting in tax of $1260-$1400.

Now compare this to the same real estate sale made outside of an IRA. We all know that the gain would still be $40,000 and amount taxed would be $35,000. This income would be included in your adjusted gross income and based on your taxable income and filing status, the tax bracket can be 15%-35%. So at the low end would still be a few thousand dollars more than if property was in an IRA.

So bottom line…many people are frustrated over the performance of IRA investments in stocks, bonds or mutual funds. So setting up a real estate IRA may be a desirable alternative with some tax savings along the way.