ROTH IRAS AND REAL ESTATE INVESTMENTS

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The "Roth IRA" is a form of long-term, tax-free investment that may be well-suited to those who believe that real estate assets are now priced for future appreciation.

The tax consequences of Roth IRAs different from those of regular IRAs. Contributions to a Roth IRA are not tax deductible, but all of the "qualifying distributions" received from the Roth IRA are free of tax. Thus, at the cost of not obtaining a deduction for the money placed into a Roth IRA, appreciation of the assets will escape any tax until distributed.[1] Moreover, the tax rules permit much more time to elapse before requiring a distribution from a Roth IRA than is allowed for either an accumulation in a tax-qualified plan, such as a 401(k) plan, or a regular IRA. The required minimum distribution rules do not apply to a Roth IRA during the owner's lifetime. If the surviving spouse treats a Roth IRA of the deceased spouse as his or her own, there are no required minimum distributions during the spouse's lifetime.

Except for those rules dealing with the taxation of contributions, distributions, and the period of accumulation, the income tax rules dealing with a Roth IRA are the same as those applicable to a traditional IRA. However, beginning in 2010, it is possible to convert an eligible retirement account to a Roth IRA without regard to the restriction that applied in prior years—that the taxpayer's modified adjusted gross income not exceed $100,000.[2] Thus, a taxpayer may now transfer significant amounts to a Roth IRA.[3]

The easiest way to obtain important capital to invest in real estate through a Roth IRA is to move significant assets from a traditional form of retirement savings through a Roth conversion—the transfer of an eligible retirement account to a Roth IRA. There are three ways to convert an eligible retirement account.

1. A rollover of a distribution from an eligible retirement account within 60 days.
2. A transfer by the trustee of an eligible retirement account plan to trustee of the Roth IRA.
3. Redesignating a traditional IRA as a Roth IRA.

For these purposes, an "eligible retirement account" is any of the following:

- An individual retirement account (traditional IRA).
- An individual retirement annuity (other than an endowment contract).
- A qualified retirement plan (including a profit-sharing plan, a 401(k) plan, a money purchase pension plan, or a defined benefit plan).

At the cost of not obtaining a deduction for assets placed in a Roth IRA, appreciation of the assets will escape any tax until distributed—whenever that may be.

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- A qualified annuity plan.
- An eligible deferred compensation plan of a state or local government.
- An annuity contract purchased by a tax-exempt organization or public school.

The amount of a Roth conversion in excess of any basis of the transferor (because of nondeductible contributions) is includable in gross income.[4] The 10% additional income tax for a distribution of funds prior to age 59 ½ from any such plan does not apply, but will apply if there is a distribution of the converted amount before the end of the five-tax-year period (unless an exception applies). Because the Roth conversion results in taxable income, an important factor is whether the taxpayer has the funds to pay the tax on the Roth conversion without dipping into the converted amount. For example, any traditional IRA amount withdrawn that is not reinvested, but instead used to pay the tax due on the conversion, is subject to the 10% penalty if it is an early withdrawal.

The easiest way to invest in real estate through a Roth IRA is to move assets from a traditional form of retirement savings through a Roth conversion.

An additional benefit of a Roth conversion for high-net worth taxpayers is that it will reduce their estates. Traditional IRAs are generally taxable when distributed. Since a Roth conversion is treated as a distribution, the tax is paid when the IRA is converted to a Roth. Therefore, a taxpayer's assets—and consequently the taxpayer's estate at death—are reduced by the tax paid due to the Roth conversion.

A Roth conversion made in 2010 is subject to special treatment. Any tax on a Roth conversion in 2010 is to be paid in equal amounts in 2011 and 2012, unless the owner receives a distribution from the Roth IRA before the total tax has been paid. In such a case, the tax is accelerated to the extent of the lesser of the tax on the distributed amount or the remaining unpaid tax. Like installment obligations, the taxpayer can elect out of the deferral of the tax if he or she believes that tax rates will go up after 2010. The taxpayer may be able to elect out as late as the due date for the 2010 income tax return, including extensions, which would be 4/15/11. Thus, if the value of the investment declines, the decision to incur tax on the amount converted can be reversed.

Investment restrictions on Roth IRAs

IRAs can invest in almost anything, but there are some restrictions. For example, an IRA cannot invest in a collectible (rare coins, liquors, art work, antiques, rugs, metals, gems, or stamps) or insurance (life, health, accident, or other insurance).[5] There are no investment restrictions on real estate investments, however. Accordingly, IRAs—including Roth IRAs—can invest in single-family homes, apartments, shopping centers, office buildings, hotels, and land.

To invest in real estate, however, a self-directed IRA account must be opened. A custodian to handle the account will usually be necessary, along with an advisor to locate the real estate asset and an administrator to collect the rent, pay bills, and keep records. For these and other reasons, most financial institutions do not get involved in real estate investments.

Investment regulation

In general, the employee benefit protections of ERISA do not apply to IRAs, including Roth IRAs. In effect, IRAs are not part of the definitions of "employee benefit plan" or "employee pension benefit plan." As a corollary, both ERISA and the Code also eliminate IRAs from the coverage of certain exemptions from the prohibited transaction rules.

An IRA is disqualified if it engages in a prohibited transaction.[6] The following transactions between a plan and a "disqualified person" are specifically prohibited:

- The sale, exchange, or leasing of any property between the plan and a disqualified person.
- The lending of money or the extension of credit between a plan and a disqualified person.
- The furnishing of goods, services, or facilities between a plan and a disqualified person.
- The transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan.
- The act by a disqualified person who is a fiduciary whereby he or she deals with the income or assets of a plan in his or her own interest or for his or her own account.
- The receipt of any consideration for his or her own personal account, by any disqualified per-

[1] Sections 408A, 402A.
[2] Section 408(c)(3)(B).
[3] Sections 408A(d)(3)(A)(i), (ii); Reg. 1.408A-4, Q&As-1(c), -7.
[4] For taxpayers with significant income, however, conversion may present an opportunity to lock in lower tax rates.
[5] Sections 408(a)(3), (m)(3).
[6] Section 408(e).
[7] Section 4975(c)(1).
[8] Sections 72(a), 72(t), 4937.
[9] Sections 512(a)(1), 513(c).
[10] Section 860B(a).
[11] Section 512(b)(4).

son who is a fiduciary, from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.[7]

A disqualified person includes the account owner and the fiduciary. Also included are corporations, partnerships, estates, and trusts that own 50% or more of the IRA. Some family members are also disqualified, such as spouses, ancestors, lineal decedents, and spouses of lineal decedents. Note that siblings (brothers or sisters), aunts, uncles, stepbrothers, stepsisters, and in-laws are not disqualified persons. Therefore, an IRA can buy real estate from a sibling, and a sibling can use such real estate.

If disqualified, the entire IRA is deemed to be distributed as of January 1 of that year.[8] This will probably result in income taxes, excise taxes, and other penalty taxes being due (e.g., the 10% penalty on the early withdrawal of funds if under age 59 ½). Whenever there is any doubt as to whether a transaction is prohibited or not, an exemption can be requested from the Department of Labor, and a private letter ruling can be obtained from the IRS.

A number of tax law provisions circumscribe the general rule that earnings of tax-exempt entities are exempt from tax. Although the tax law provides a broad exemption for investment type income, a tax-exempt investor—including a Roth IRA—is taxed on receipt of "unrelated business taxable income" (UBTI). The definition of UBTI is both broad and ambiguous. It includes income from any trade or business that is not substantially related (aside from the organization's need to fund its exempt function) to the exercise or performance by such organization of its exempt function.[9] Of importance in connection with investment in real estate and real estate mortgages are exceptions that permit a tax-exempt entity to invest in real estate and real estate mortgages without incurring UBTI if certain requirements are satisfied. One significant exception is that dividend and interest income is specifically excluded from UBTI. This exclusion allows a tax-exempt entity such as a Roth IRA to invest in stock of a REIT or other corporations invested in real estate and to hold real estate mortgage loans directly without generating UBTI.

Ownership of a regular interest in a REMIC is considered, for federal income tax purposes, to be ownership of a debt instrument.[10] Therefore, income earned by that investment will be subject to the interest exclusion from UBTI. However, holders of residual interests in REMICs have the potential for receipt of UBTI. As a consequence, regular interests, but not residual interests, do not involve UBTI issues.

Debt financing can cause otherwise excluded income to be subject to UBTI. For example, if the investment that generates otherwise-excluded income was acquired with the proceeds from a debt financing (for example, margin financing) that is outstanding in the tax year during which the dividend or interest is included in income, a proportionate part of the dividend or interest income is treated as UBTI.[11] The proportionate part of the income that is classified as UBTI is based on a fraction, the numerator of which is the average principal amount of the outstanding debt financing for the year in question and the denominator of which is the average adjusted tax basis of the property for the year. Similar rules apply to cause gain from the sale of such investments to be UBTI. This debt-financed property rule also applies, with certain significant modifications, to income from rental real estate and gain on sale of leveraged property, as discussed below.

The debt-financed property rules do not apply to the acquisition, without debt financing, of stock in a REIT even if the REIT uses debt to acquire interests in real estate. Thus, a REIT investment may offer a better after-tax return than real estate acquired by the Roth IRA with debt or an interest in an entity taxed as a partnership that acquires debt-financed property producing income subject to UBTI.

A taxpayer's assets—and consequently the taxpayer's estate at death—are reduced by the tax paid due to the Roth conversion.

The fact that partnership interests in real property that is subject to debt can create UBTI raises characterization issues for Roth IRAs that extend mortgage financing with "equity kickers." A loan that has an unlimited right to participate in future cash flow and appreciation in the property may be characterized by the IRS as a joint venture taxed as a partnership. The potential for such a recharacterization would be enhanced if the loan contained provisions that made the lender resemble a co-owner of the underlying property rather than a traditional lender. Any such recharacterization would not only have a negative impact on the Roth IRA, but would negatively affect the purported borrower who would lose an interest

deduction, depreciation deductions (because the purported debt is no longer considered part of the property's purchase price), and the requirement of sharing the remaining depreciation deduction with a partner. Also, property subject to UBTI is limited to straight-line depreciation.

Rental exclusion

The general rule is that rents from real property are excluded from UBTI treatment. The exemption also applies to rents from personal property leased with the real property, but only if the rents from personal property are an "incidental amount" of the total rents received or accrued under the lease.[12]

The regulations provide that rents for personal property "generally" will not be considered "incidental" if they exceed 10% of the total rent.[13] This is a more restrictive rule than the comparable rules in the REIT area, which treat rental income from personal property as being included in acceptable REIT rental income if the personal property rental does not exceed 15% of the total rent.[14] It is less than clear whether rents that exceed the 10% test but not the 15% REIT test require a disclosure in the tax return by reason of the UBTI regulation, or can escape such disclosure because of the use of the word "generally" in the UBTI regulation.

A tax-exempt investor—including a Roth IRA—is taxed on receipt of 'unrelated business taxable income.'

The determination of whether the rents attributable to personal property are incidental is made when the personal property is placed in service.[15] If more than 50% of the total rents are attributable to personal property, both the real and personal property rental income are treated as UBTI.[16]

Another UBTI issue arises if the amount of the rent "depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales)."[17] In such a case, the rents will not be considered "rents" excluded from taxation as UBIT. This test is applied on a year-by-year basis. If both the base rent and the contingent rent are figured on "income or profits," all of the rental income for the tax year is subject to UBTI. The rules for interpreting whether rental income is figured on "income or profits" are those set forth in the regulations that define that test for purposes of the REIT restrictions on the receipt of such income. Accordingly, the REIT rulings of the IRS on that requirement are directly relevant to the UBTI determination.

Debt-financed property rules

One of the significant UBTI rules is that a proportionate part of the income received from a real estate property that has been acquired or improved with "acquisition indebtedness" will constitute UBTI if that debt is still outstanding in the year in which the rent is received. "Acquisition indebtedness" is broadly defined to include indebtedness incurred (1) in acquiring or improving the property, (2) before the acquisition or improvement of the property, if the indebtedness would not have been incurred but for such acquisition or improvement, and (3) after the acquisition or improvement of the property, if the indebtedness would not have been incurred but for the acquisition or improvement and the incurrence of the indebtedness was reasonably foreseeable at the time of the acquisition or improvement. Thus, attempts to avoid UBTI by acquiring the property without debt but later subjecting it to a mortgage may fail if the later financing can be stepped together for tax purposes with the earlier acquisition.[18] Moreover, debt to which property is subject at the time it is acquired is acquisition indebtedness.[19] Also, liens for taxes or assessments that attach to property are treated as similar to a mortgage. However, certain federal mortgage financing is excepted from the acquisition indebtedness rule.

Section 514(c)(9) provides a significant liberalization of the UBTI rules for "qualified organizations" investing in real estate. However, IRAs including Roth IRAs do not qualify for these more liberal rules.

Although real estate payments may be exempt from UBTI, payments for services are

[12] Sections 512(b)(3)(A)(i), (ii).
[13] Reg. 1.512(b)-1(c)(2)(ii).
[14] Section 856(d)(1)(C).
[15] Section 512(b)(3)(A)(ii).
[16] Section 512(b)(3)(B)(i).
[17] Section 512(b)(3)(B)(ii).
[18] Section 514(c)(2)(A).
[19] Section 514(c)(2).
[20] Reg. 1.512(b)-1(c)(5).

not. Payments for the use or occupancy of rooms and other space do not constitute rents from real property "where services are also rendered to the occupant." Services are treated as rendered to the occupant "if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only."[20] Thus, operation of a hotel will generate UBTI to an IRA, including a Roth IRA.

Although sale of debt financed real estate can result in UBTI, the sale of property which is not debt financed will not. However, gain from the sale of property which is not debt financed, but which is held for sale to customers in the ordinary course of business will result in UBTI. Thus, sale of property built or converted to condominiums will normally result in UBTI.

If an IRA generates gross income from an unrelated trade or business of more than $1,000, it must file Form 990-T. A taxpayer that is an IRA owner is required to aggregate all of the taxpayer's accounts to determine if the filing threshold is satisfied. In order to file the Form 990T, the IRA must obtain an Employer Identification Number using Form SS-4.

UBTI is a difficult issue for many trustees and custodians of self-directed IRAs—the type most likely to invest in real estate assets. Often the individuals serving in those capacities do not receive the information necessary to compute the tax. Instead, the investment sponsors (usually, syndicated limited partnership offerings) send the information directly to the IRA owner. For this reason, many IRA trust and custodial agreements require that the IRA owner be responsible for filing Form 990T and for his or her own estimated taxes. This is despite the instructions to Form 990T that the fiduciary of a trust is the responsible person for the filing of the return. An IRA subject to UBTI is required to make quarterly estimated tax payments, just as corporations are.

Because of debt-financing and UBTI issues, the investment by Roth IRAs in REITs has the most predictable tax consequences. Income received from such investments should not be subject to federal income tax. Also, publicly traded REITs offer liquidity and flexibility in accommodating the size of investment. However, with respect to Roth IRAs, the long accumulation period and the potential size of the Roth IRA resulting from a Roth conversion will permit owners to accept the near-term detriment of UBTI if they expect that the real estate investment will provide a superior longer-term investment return after the repayment of the debt.

Conclusion

The new opportunity for higher-income individuals to have a Roth IRA in 2010, combined with the expectation of higher taxes in future years (including taxes related to the health care legislation in 2010 and beyond) may make 2010 a good year for a Roth conversion. For those who believe that real estate assets are well-priced for yield, appreciation, or both, a Roth IRA's exemption from the need to make lifetime distributions offers a long period of tax-free accumulation and tax-free distribution. This combination ties nicely to the requirements of a successful real estate investment. ■