Checkbook IRA is the Best Way to Hold Real Estate

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Abstract

A Checkbook IRA is a power tool for building wealth, but by knowing the facts that by growing your future funds through investment can be confusing and even scary. The Checkbook IRA empowers you to take control of your retirement funds and unlock a world of investment opportunities by building retirement wealth through traditional and alternative asset investments, such as real estate. A Checkbook IRA [also known as the self-directed IRA LLC (Limited Liability Company) or IRA LLC] is a cost effective and time efficient investment vehicle available to self-direct IRA investors. In short, the Checkbook IRA will help you: (1) Take control of your future, (2) invest in what you know, i.e. {buy investment properties such foreclosures, multi-families, and undeveloped lands}, and (3) eliminate excessive custodian fees. Since the early 2000s, the number of self-directed IRA LLC "Checkbook Control" has more than doubled! These plans give individuals the ability to invest into assets that they understand and can control such as real estate. Investors who have knowledge and expertise in a particular investment can purchase them in a tax-free or tax-deferred environment. Self-directed IRA LLC "checkbook control" are qualified retirement plans in which the account holder is the sole investment decision maker. According to IRS regulations, a qualified custodian (bank or trust company) holds the assets of an IRA on behalf of the account holder. The IRA custodian maintains the assets and all transaction records of the account, files required IRS reports, and perform other administrative duties on behalf of the account holders. The purpose of this paper is to explain (a) why the IRA should be invested in real estate, (b) the steps involved in in establishing a sound Self-Directed IRA LLC with Checkbook IRA, (c) the restrictions (prohibited transaction) in a real estate IRA and the tax and penalty consequences of incorrect investment in a real estate IRA.

Introduction

According to IRS Publication 590 "An Individual Retirement Account (IRA) is a trust or custodial account set up in the United States and the law passed by Congress in 1974 for the exclusive benefit of you or your beneficiaries. The account is created by a written document. The document must show that the account meets all of the following requirements. The trustee or custodian must be a bank, a federally insured credit union, a savings and loan association, or an entity approved by the Internal Revenue Service (IRS) to act as trustee or custodian". Most people mistakenly believe that their IRA must be invested in bank CDs, the stock market, or mutual funds. Few investors realize that the IRS has always permitted real estate to be held inside IRA retirement accounts.

Investments in real estate with a truly Self-Directed IRA, a limited liability company ("LLC") are fully permissible under **the Employee Retirement Income Security Act of1974(ERISA)**.**A self- directed IRA LLC is also commonly referred to as a Checkbook IRA, Real Estate IRA or a Self – Directed IRA LLC with Checkbook Control**. IRS rules permit you to engage in almost any type of real estate investment, aside generally from any investment involving a disqualified person. As per the Internal Revenue Code (IRC 4975(e)(2), a "disqualified person" is generally defined as the IRA holder and any of his or her descendants or any entity controlled by such person(s).Allowable investments according to IRS Code Sec.401 IRC 408(a) (3) are: Real estate(raw land, residential homes, commercial property, apartments, Duplexes, Condos/townhomes); Secured and Unsecured Notes; Tax Liens& Deeds; precious Metals; Private Company Stock.

In general, there are **three categories of self-directed IRA structures** distinguishable by the level of control the custodian exercises over your **IRA** investments.

1. Financial Institution Self-Directed IRA

With a financial institution self-directed IRA, you are able to direct your IRA investments, however, you are generally limited to investing in the financial products such as stocks, mutual funds, and bonds offered by the financial institution usually with high transaction and custodian fees, but you will not be permitted to make non-traditional investments such as real estate, precious metals, private business investments, foreign currency, options, etc.

2. Custodian Controlled Self-Directed IRA without "Checkbook Control"

With a custodian controlled Self-Directed IRA without "Checkbook Control", many types of nontraditional investments, such as real estate, are generally permitted, however, custodian consent is required in order to enter into and execute the transaction. This typically results in long delays and high custodian fees associated with the transaction. To make an IRA investment, you will be required to receive the consent of the custodian. Furthermore, you will be required to provide the custodian with the transaction documents for review as a part of their transaction review process. The Common characteristics of using **custodian controlled Self-Directed IRA without "Checkbook Control" is time delays and high custodian fees.**

3. Custodian Controlled Self-Directed IRA LLC with "Checkbook Control"

With a truly Self- Directed IRA, you will have total control over your IRA funds and you will no longer have to get each investment approved by the custodian of your account. Instead, all decisions are truly yours.
A Checkbook IRA is a cost effective and time efficient investment vehicle available to truly Self- Directed IRA investors. This investment vehicle is a popular choice for gaining "Checkbook Control" of an IRA.
Here's how the process goes:

A: Open a self-directed account with an IRS approved custodian.
B: Rollover funds from your exiting IRA or 401K.
C: A special purpose Limited Liability Company (LLC) is created, which is owned by the IRA or 401K. You will act as the **manager of this LLC**.
D: You direct the custodian to purchase 100% of the LLC units. The LLC is the funded and ready for investments.
E: Once the plan (checkbook IRA) is in place, you are 100% in control.

- You will choose the bank or brokerage that holds the funds.
- You will make investment decisions, negotiate, and execute contracts on behalf of the plan.
- You can initiate an investment or pay expenses simply by writing a
- Check, using a debit card, or wiring funds.
- Income from investments is deposited directly to the LLC account.
- There is no requirement for third party review of paperwork.
- There are no transaction fees or processing delays when making or maintain investments.

As a result, you get a legal structure allowing you (the account holder) to make transactions using your IRA funds at the LLC level without custodian involvement. The Checkbook IRA method is used to eliminate "red tape" and transaction delays associated with the custodian giving you "checkbook control" over your retirement account and it also eliminated all transaction and asset-based fees charged by the custodian.

The Self-Directed IRA LLC "Checkbook Control" structure has been in use for over 30 years. The notion of using an entity owned by an IRA to make an investment was first reviewed by the **Tax Court in Swanson V. Commissioner 106 T.C. 76(1996).** In Swanson, the Tax Court, in holding against the IRS, ruled that the capitalization of a new entity by an IRA for making related investments was permitted transaction and not prohibited pursuant to Code Section 4975. The Swanson Case was later affirmed by the IRS in Field Service Advice Memorandum (FSA) 200128011 for IRS field agents to guide them in the conduct of tax audits. With a Self-Directed IRA LLC with "Checkbook Control", when you find an investment that you want to make with your IRA funds, simply write a check or wire the funds straight from your Self-Directed IRA LLC bank account to make the investment.

Advantages of using a Self-Directed IRA LLC with "Checkbook IRA" to purchase real estate are: gains are tax free; positive cash flow is tax free; no time limit for holding property; IRA can borrow money- leverage your investment with non-recourse financing; and potential to earn a larger rate of return on invested capital.

Prohibited Transactions

Self-Directed IRAs are generally permitted to engage in most types of investments. However, if Self-Directed IRA LLC engages in certain types of "prohibited transactions" or invests in life insurance or collectibles you may jeopardized the tax-deferred status of your IRA. This could lead to the disqualifications of the IRA and severe tax consequences. The IRS publication 590 defines a prohibited transaction as follows:

"Generally a prohibited transaction is any improper use of your IRA account or annuity by you, your beneficiary, or any disqualified person. Disqualified persons include your fiduciary and members of your family (spouse, ancestor, lineal descendant, and any spouse of lineal descendant." Therefore, it is important that you familiarize yourself with the IRS rules. Here are some of the IRS rules and guidelines:

Internal Revenue Code Section 408
IRC provision prohibiting IRAs from investing in life insurance contracts.

Internal Revenue Code Section 4975
IRC provision referencing tax on prohibited transactions.

Internal Revenue Code Section 408(e)(2)
IRC provision describing an IRA's loss of tax -exempt status upon engaging in a prohibited.

Internal Revenue Code Section 408(e) (4)
IRC provision describing effect of pledging an IRA or any IRA assets as security for a loan.

Internal Revenue Code Section 408(m)
IRC provision describing impermissible investment in collectibles.

Internal Revenue Code Section 512
IRC provision describing unrelated business taxable income(UBTI)

Internal Revenue Code Section 511
IRC provision imposing tax on (UBTI)

Internal Revenue Code Section 513
IRC provision describing an unrelated trade or business

IRS publication 590----Individual Retirement Arrangements (IRAs)

IRS topic 451—Individual Retirement Arrangements (IRAs)

Swanson v. Commissioner, 106 T.C. 76(1996)

Real estate investing through IRA provides good investment opportunities for individuals who are knowledgeable about real estate investing or work with knowledgeable advisors and/or real estate brokers. Investing in real estate for retirement could serve as a means to diversify a retirement portfolio and to hedge against the cyclical changes in the economy and stock market. It should be emphasized at this point that in making real estate investment decisions, the most important factor for success is real estate location. For a successful investment, make sure that you work closely with trustworthy real estate broker in your area and consult with your CPA accountant and/or attorney.

When you use self-directed IRA LLC with "Checkbook Control," you are required to follow these ground rules:

A: You can sell a house and purchase another one, and you can buy more than one property at a time. But Property purchased by your IRA is owned by your IRA is owned by your IRA LLC, not you individually.
B: You can invest in raw land, real estate contracts, or the trust deeds that back Mortgages. In addition, if you don't have enough money to invest on your own, you Pool your resources with others in the same Boat.
C: Any money used to buy a property with your IRA LLC has to come directly from Your IRA LLC, not you personally, and you can't be reimbursed by your IRA.
D: You cannot do business with family members, including spouses, parents, Children, grand-parents, Grand-children and great- grand-children.

Summary and Conclusion

With today's economic uncertainty and low interest rate, more people are turning to alternative investments such as real estate, which could provide more protection and better potential return than traditional stocks and mutual funds. By investing in IRA accumulated funds in real estate, one could gain potential appreciation, more income, and avoidance of capital gains tax on the sale of property. The suggested steps for this type of investment are: (a) creation of a Self-Directed IRA LLC "Checkbook Control" account,(b) transfer funds from IRA and 401(k) funds to Self-Directed IRA LLC "Checkbook Control" account, if possible,(c) deposit of the maximum annual allowable amount in the Self-Directed IRA LLC "Checkbook Control" account, (d) better understanding of Internal Revenue Codes(IRC) that governs IRAs, and (e) consummation of all the purchase transactions through a Self-Directed IRA LLC "Checkbook Control" account and the escrow account which is opened in the name of the Self-Directed IRA LLC "Checkbook Control" account and **not in the name of the beneficial owner.**

To invest successfully IRA funds in real estate without unfavorable tax and legal consequences, the property must be for investment purposes and not personal use. It should not belong to the owner of an IRA account before the purchase by the IRA plan. It cannot be used or leased as a residence or for other purposes by you, your family members (other than siblings), or your business (Corporation, Partnership, or LLC) while it is in your plan. Finally, your IRA plan cannot be an investor in Sub Chapter S Corporations, and all income generated from all rental profits and the sale of a property owned by your IRA must return directly to the IRA. Violations of the IRS codes 511(b), and 512(a) could cause harsh penalties and taxes against the real estate IRA. The unrelated business income tax (UBIT) is another tax that could be triggered if investment property acquired by an IRA funds has mortgage and generates income in excess of $1,000.

In short, if the process of investing in IRA funds in real estate is done properly, it could become a very successful project. It is, indeed, were suited for those high bracket professionals like physicians, attorneys, executives who have accumulated a sizable amount in their retirement accounts.

Endnotes

Internal Revenue Code (IRC), Section 4975 (e) (2)
IRS Publication 590 and IRS topic 451, Individual Retirement Arrangements (IRAs) which provides detailed information on IRAs, including guidelines for making withdrawals.
IRS code Section 401, IRC (408) (a) (3)
IRC Sections: 408 (e) (2), 408(e) (4), 408 (m)
IRC Sections: 511(b), 512 (a)