How to Avoid UDFI Taxes When Investing in Real Estate with Your Retirement Funds

Over the past few years, we have seen a significant increase in the amount of retirement funds (IRA) being invested in real estate deals. I, myself, have also utilized my retirement money to invest in various real estate deals as well. The ability to invest in real estate using your retirement money is called self-directed investing. So why are we seeing such a dramatic increase in the amount of retirement funds being invested in real estate now? This phenomenon has often been referred to as the "Perfect Storm". Several factors that contribute to the Perfect Storm are: 1) significant decreases in value of traditional retirement investments such as stocks, bonds, and mutual funds 2) the opportunities which now exist in real estate investing as a result of depressed property values and 3) increased awareness….for the first time the public is becoming aware of this opportunity that has been available for over 30 years.

As real estate investors, we should become familiar with the opportunities now available in self-directed retirement investing as a result of this trend. As an investor, you may be able to tap into your own retirement money to invest in real estate deals.

One of the greatest benefits of investing in real estate with retirement funds is the ability to defer taxes. The income generated by an investment within the retirement account is generally either tax deferred (meaning you do not pay taxes on that money until you take the money out at retirement age) or tax free (meaning no more taxes EVER from this point forward). So the benefit of investing with money from your IRA is your ability to let money grow year after year without losing part of it to taxes. The extent to which you will benefit will depend on the number of years you have until retirement and the number of years of compounding growth that money can go through. Another great advantage of investing in real estate with retirement funds is that generally, no additional tax planning is needed. For example, since there are no taxes due currently on the monthly income, then we eliminate the need to do cost segregation studies to accelerate depreciation. Also, because of the tax preferred treatment of IRAs, there is generally no need to deal with Section 1031 exchanges on your real estate when you sell it because all the transactions within the retirement account is already tax deferred!

Having said that, there are pitfalls to watch out for when investing in real estate with retirement money. As real estate investors, we all want to maximize our ability to "leverage" our money. The great news is that you can also do it with your self-directed money! There is, however, a tax trap associated with self-directed IRA investing. Some of you may have heard of the term Unrelated Debt Financed Income Tax (UDFI). Essentially, this is a tax imposed in certain instances when you self-direct your retirement funds into real estate and use leverage at the same time. For example, if you purchase real estate using your self-directed IRA with 50% debt and earn $50,000 of income, that income is generally subject to the UDFI tax of 35% resulting in a tax bill of close to $9,000 for the year. Before you get discouraged, there is a loophole around this and it is very simple. Rather than using a self-directed IRA to invest in leveraged real estate, instead use a self-directed 401(k) to invest in real estate. One of the biggest benefits of investing in real estate with your self-directed 401(K) is that this vehicle actually allows you to use your retirement funds to invest in leveraged real estate without the taxes potentially associated with UDFI!! With leverage being one of the preferred ways to invest, real estate investors need to tap into the benefits of this loophole. To continue with the example above, if you make the same purchase under your 401(K) rather than your IRA, you can avoid the UDFI tax all together which saves close to $9,000 in taxes! This is a great benefit that the Solo 401(K) plans have above most other types of retirement plans.

Another great benefit of a self-directed 401(K) plan is in the large annual contribution limits allowed. Businesses with a spouse on the payroll can also contribute to the Solo 401k. Provided the business owner and spouse have sufficient income from the business, taxpayers may be able to contribute up to $49,000 each ($54,500 each if both are age 50+) in 2011). As you can see, a Solo K Plan may allow the taxpayers to contribute a total of up to $109,000 during the year to save close to $50,000 in taxes each year! This is significantly higher in dollar amount as compared with an IRA contribution limit of $6,000. Not only do you get a huge tax write off in the years of contribution, but the funds can then be utilized immediately to invest into real estate and receive tax deferred treatment!

As we talked about before, retirement investing is one of the most powerful tax saving tools that are available to us as taxpayers. If you think the self-directed 401(K) may be the best retirement plan for you but already have another type of plan established, consider the opportunity to roll those amounts over. Most types of retirement accounts can be converted into a self-directed 401(K) plan. Remember, retirement investing is an extremely powerful tool that allows you to pay towards your retirement rather than to the IRS. As an astute investor, retirement planning is an essential component to your tax savings plan so make sure you speak to your tax advisor to take advantage of this powerful tool to significantly reduce your tax bill!

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*We welcome suggestions for future topics that you would like to hear about tax saving strategies relating to real estate investing. So please email your suggestions to me directly at ahan@keystonecpa.com.