

***1031FEC* IRA Real Estate Investing**

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The Basics

The rules governing allowable investments in IRAs preclude an IRA's investment in life insurance, collectibles (e.g., artwork, antiques, metals, gems, and most coins) and S corporations.

All other types of investments are permitted, and thus the range of possible investment choices is nearly unlimited. Consequently, any form of real estate can be purchased by an IRA.

Real estate investing through an IRA opens up a huge range of alternative investments for individuals who are knowledgeable about real estate investing or who work with knowledgeable advisors, sponsors, or brokers. Investing in real estate for your retirement may serve as a means to diversify your retirement portfolio to hedge against the cyclical changes in the stock market, economy and bank and government-based investments.

For many who are experienced with real estate investing, real estate investments hold the potential to protect against the loss of principal while generating better than market rate returns through income production and capital gains. When real estate investments are not leveraged, both income and capital gains can flow back to IRAs tax-deferred (or tax-free if the IRA is a Roth IRA).

Conclusion

To summarize the following discussion documents, the tax laws (1) require that the investments in an IRA not benefit the IRA owner and (2) prevent "self-dealing" between the IRA and the IRA owner or other disqualified persons. However, by properly structuring an IRA investment in real estate, an IRA can obtain the benefits of real estate investment in a manner that complies with applicable tax laws.

(This document is a general discussion. It is not intended, and should not be relied upon, as an opinion or advice on any legal, tax or investment aspects of IRAs. An IRA owner considering an IRA investment in real property should consult with one's own legal, tax and investment advisors.)

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Important Considerations

Easy

If you have your IRA purchase real estate from an unrelated party and pay cash for it, and you do not use the real estate for personal reasons while it is in your IRA (i.e., you treat it strictly as an investment), there are no special issues.

More difficult

If your IRA invests in real estate through a down payment and leveraging, there are some significant issues:

1. You cannot personally guarantee a loan for your IRA;
2. Some custodians will limit the amount of debt the IRA can carry (PENSCO's limit is 50%);
3. It may be difficult to get a bank to allow an IRA to be the debtor without a personal guarantee;
4. Your IRA will pay tax on UDFI (unrelated debt financed income), which is the income and/or capital gains attributable to the leveraged portion. (UDFI is taxed at the trust tax rate because an IRA is a trust.)

As a consequence, although it is PERFECTLY LEGAL, it may not be desirable to have an IRA carry debt in a real estate investment transaction.

What you can't do in an IRA with real estate

1. You cannot directly or indirectly buy real estate from a "disqualified person". Who is a disqualified person?
 - o The IRA owner;
 - o the IRA owner's spouse, descendant (e.g., son), or ascendant (e.g., mother);
 - o spouse of a descendant of the IRA holder;
 - o a fiduciary of the IRA or person providing services to the IRA (e.g., the trustee or custodian);
 - o an entity at least 50% of which is owned (or at least 50% of the beneficial interests are held) by a combination of the above (e.g., if you and your spouse own 50% of an LLC, that LLC is a disqualified person with respect to your IRA); or
 - o a 10% owner, officer, or director or highly compensated employee of such an entity.
2. You cannot have your IRA enable an investment for yourself or another disqualified person. In other words, if the IRA's investment is deemed essential to accomplishing a transaction in which both you and your IRA invest, then the transaction would be considered a prohibited transaction.
3. Your IRA cannot purchase a real estate asset and then have a disqualified person use it while it is in the IRA. For example, you cannot buy a vacation home and use it partly for personal use, even though you might rent it to unrelated persons the rest of the year.

What you can do in an IRA with real estate

Buying real estate from an unrelated party (i.e., one who is not a disqualified person) with cash is the simplest way of investing in real estate with your IRA. Your IRA can buy raw land, commercial property, residential (e.g., rental) property, real estate options, as well as extend loans (e.g., first and second mortgages), secured by real estate with your IRA, to unrelated parties. As discussed above, your IRA can also buy property through leveraging, provided the loan is not guaranteed by the IRA owner (or any other disqualified person) and that the IRA has enough liquidity to support the mortgage and expenses. Generally, most custodians will have limits on the amount of leverage they will permit. Also, as previously mentioned, leveraging can result in income taxes on UDFI that must be paid by the IRA. Generally, these taxes are higher than would be paid on income generated from a property that you buy and finance personally. In addition, the UDFI taxes must be paid from funds from the IRA and, therefore, there has to be enough liquidity in the IRA to cover these taxes. See IRS Form 990T and its accompanying instructions for details.

There are a variety of ways, however, that an IRA can participate in a real estate investment without a full cash capital

investment. For example, your IRA can co-invest with other parties. You could also have your IRA, and other parties participate in real estate investing by becoming members of an LLC that buys and sells property.

Examples of real estate investments that can be made using IRA funds

Example I

John's IRA has purchased a single family home from an unrelated seller. John now wishes to have the IRA sell it to his sister with a first mortgage that his IRA will hold.

The purchase of a single family home from an unrelated party is not a problem. John pays \$300,000 cash and his IRA holds the grant deed from the sale to his IRA by the third party. John's IRA later sells his sister the property and takes back a first mortgage and a down payment in exchange. His IRA gives her a market rate loan for 15 years and receives a 10% down payment. Since this is a \$280,000 debt owed to the IRA and not by the IRA, PENSCO is not concerned about the potential liability to the IRA. John's IRA has a fixed income investment and is protected because it holds the trust deed in the event his sister defaults on the loan. The transaction may also have the incidental benefit of allowing John's sister to purchase the home more easily than she could have on the open market.

Example II

Allison is a real estate developer who wants to form a real estate development company in the form of a limited liability company and then manage the company. She wants to make her IRA the primary investor and she intends to be compensated by the LLC to manage it. She expects to have other investors in the LLC.

Allison's IRA can participate in the formation of the LLC provided Allison has not already established the LLC personally as a 50% or more owner. If she is just starting the LLC, then the IRA can own something less than 100% (e.g., 95%) and she can still be compensated for managing it. The LLC is considered a real estate operating company and, therefore, the assets are not considered plan assets unless there is 100% ownership by the IRA. If the company's assets are deemed plan assets, then a transaction (e.g., being paid for service) between the company and the IRA owner is considered a transaction between the IRA and a disqualified person (the IRA owner) and is therefore a prohibited transaction.

If the LLC was not a real estate operating company or other type of operating company (for example, if it was a hedge fund), then the aggregate ownership of all IRAs and employee benefit plans would have to be less than 25% in order for the LLC's assets not to be considered IRA assets. (The interest owned by the IRA owner is disregarded for purposes of calculating the relevant percentage.)

Example III

Howard wants to have his IRA purchase a \$400,000 rental property with a 50% down payment. Is this possible and are there any special considerations?

Yes, it is possible, but there are special considerations such as:

-Disqualified persons (such as the IRA owner and his or her spouse) cannot personally guarantee the loan for the IRA.

The loan must be supported by the property itself or some other property that the IRA owns;

-The IRA will be subject to tax (UDFI) on any income attributable to the leveraged portion (around 50%) on the investment;

-Most custodians and banks will not finance a property purchase with less than 50% down when an IRA is the borrower.

It should be noted, as an alternative, that the IRA can purchase the property with other parties, all of whom pay cash.

When this is done, there is no UDFI and there are no issues associated with the financing.