Investing in Real Estate Syndications with a Self-Directed IRA

Safeguard Advisors
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Smart investors look for smart investments. It sounds simple and in a certain sense, it is.

When it comes to long term wealth building in a tax-sheltered retirement portfolio, a few key metrics come to mind:

- Where can I generate solid, consistent returns over time?
- How can I minimize risk?
- How can I minimize the amount of effort I need to put into identifying and managing investments?

Participating in commercial real estate syndications, when done right, can be just that kind of smart, optimal investment to build wealth in your tax-sheltered IRA or Solo 401(k).

How Syndications Work

Syndications are the aggregation of capital from many investors to fund a larger project. Most investors cannot fund the purchase of a $10 million apartment complex. Bringing together a few dozen partners at $50,000 to $300,000 each makes such deals possible.

A general partner sponsors the project, which includes finding the deal, rounding up capital, and executing the project. The sponsor will usually invest in the deal alongside limited partners.

A partnership entity such as a LLC is often used. Investors will be limited partners. They act simply as participants providing funding and are not actively involved in running the project.

Income from the project can be split in many ways. Most sponsors will have fees for putting the deal together and acting as the asset manager. A preferred return, commonly in the range of 7-8% will be paid to limited partners before the sponsor starts receiving a share of income. The eventual sale of the property is split between the investors and the sponsor on set terms with sponsor often taking 25-30%.

A common project might look like this:

- Acquire a 30-year-old class B apartment complex with 150 units for $10 million.
- $2.5 million of investor capital as down payment and a $7.5 million loan.
- Upgrade the property over time and improve property management. This results in higher occupancy rates and higher rents.
- Hold the property for 5-7 years, then sell at a value of $14 million.

A limited partner placing $100,000 into such an opportunity might see $41,000 in net cash flow over 5 years and a $43,000 gain at sale. This would equate to a 15% overall return on investment.

A Growing Opportunity

The concept of pooling investors to purchase a large property isn't new. Until recently access to these opportunities was limited to well-networked accredited investors, however.

The passage of the JOBS act in 2012 and resulting SEC rules implemented in 2015 allowed investment sponsors to raise capital for these types of much more easily. As a result, such opportunities are now broadly available to a wider range of investors.

Benefits of Syndications

Participating as a limited partner in a professionally run real estate project that is larger in scale provides a lot of benefits. For busy professionals looking to put retirement money to work in a hands-off manner that provides a good mix of principal security and solid return potential, real estate syndications are hard to beat.

Access to Larger Opportunities

Commercial and large multi-family real estate has always been one of the highest performing asset classes. Operating at scale mitigates certain risks and produces consistent income.

Diversification

Multi-tenant properties are a great way to achieve diversification for individual investors.

If your IRA owns a $100,000 single-family home and there is a vacancy, you have no income from the property until it's rented again.

If your IRA places that same $100,000 into fractional ownership of a 50-unit apartment complex and 5 units are vacant, there's still rent coming in from 45 units. That means 90% of potential rents are still being collected.

Rather than putting $200,000 into one single-family investment, you can place that same amount in 2-4 syndications in different markets.

Professional Asset Management

Leveraging the expertise of a professional sponsorship team has many advantages. Experienced and well-networked project leads will be able to source quality deals and put together all the necessary resources to manage the project successfully.

Truly Passive & Arm's Length

One of the primary IRS rules that applies to investing with a self-directed IRA or Solo 401(k) is keeping your investments at arm's length and avoiding too much personal interaction with the plan.

Acting as a limited partner in a syndicated real estate deal is one of the most hand's off ways to approach real estate investing and is therefore very well suited to retirement plans.

The Benefits of Leverage

Most syndicated real estate transactions use a mix of investor capital and debt-financing. As a result, the project produces leveraged returns that can outperform any all-cash deal.

Because the general partner is obtaining the financing, there's no need for a personal guarantee on behalf of your limited partner investment. This meets the IRS criteria that any loan obtained by a retirement plan must be non-recourse.

Limited Liability Risk

As a limited partner in a LLC or LLP syndicate, your IRA or Solo 401(k) has no direct exposure to liability risk or debt obligations. The entity structure will shield your plan from liability that may stem from the actions of the managing partner, hired vendors, or other operational aspects of the project.

Solid & Predictable Returns

Syndicated opportunities typically produce 8-10% annual return via cash flow. With reasonable appreciation of property value and a gain at sale, the overall annualized return can easily run in the 12-16% range.

Qualification Requirements

Some level of qualification may be required in order to participate in a syndication deal.

As investor offerings considered to be securities most syndications operate under one of two classes of SEC regulation D exemptions.

Rule 506(b) allows for up to 35 investors to be “sophisticated”. This is a broad distinction, generally meaning someone has sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of an opportunity. Any number of accredited investors may also participate in such deals.

506(b) opportunities may not be generally solicited or advertised, so you must develop a relationship with an investment sponsor in advance. This can be done via networking and referrals or researching providers online. A higher threshold of disclosures is required for Rule 506(b) securities.

Rule 506(c) offerings may be generally marketed but are only available to accredited investors. To be accredited, an investor must have income exceeding $200,000 (or $300,000 together with a spouse) in each of the last two years and be likely to continue producing such levels of income. Alternately, a net worth over $1 million excluding the value of a primary residence will qualify. Your self-directed IRA or Solo 401(k) inherits your accreditation status.

For more visit www.ira123.com

Diligence Considerations

When evaluating a potential investment into a real estate syndication it is important to perform the necessary research to ensure the opportunity is a safe place to put your retirement savings. There are three main areas to focus on; the management team, the property, and the financial projections.

Many different skills go into being a successful real estate syndicator. You will want to be sure the team leading any project you are considering investing with has the necessary background and experience to master those skills, or masterfully mange any outsourced services. From property acquisition to unit upgrades to property management, expertise matters.

Most syndicators will be vetting a property acquisition and including their own capital in the deal, so you can assume a certain amount of diligence into the property, local market, and available renter demographic has been done. The project sponsor will usually present some of this information in their investor marketing. You should still do your own independent review to verify key assumptions.

Making sure you fully understand the financial projections for an opportunity is also a critical step. Just because the sponsor hired a CPA firm to draw up a pro-forma analysis does not necessarily make it so. All such documents are just projections, and the reality of a deal can end up being different. Be sure you review what assumptions are being made to base projections of key metrics like increased occupancy and higher rental rates may be, and if they seem reasonable. You should also be sure you understand how income flows through the deal; and how investors get paid both if things go well and if the performance is less than expected.

Lastly, it is important to understand your rights as a limited partner. You really want to hope the team running the deal does so successfully, but if they do not, you'll want to know what recourse to you have to make decisions about when to sell a property, bring in new management, etc.?

UDFI Tax Implications for IRA Investors

Most syndication deals use a combination of investor capital and mortgage debt to acquire properties. This use of debt-financing produces exposure to tax on Unrelated Debt-Financed Income (UDFI) for an IRA investor.

When an IRA is using debt-financing, it is bringing non-IRA money into the picture to increase the performance of the IRA's investment. Section 514 of the tax code designates a tax on this Unrelated Debt-Financed Income. Such taxation first became applicable in 1969 and is a means to prevent certain types of abusive transactions via tax-exempt structures.

UDFI is the portion of the income that an IRA receives based on the use of the borrowed funds. In a property with a 65% LTV loan, that would mean 65% of the gross income produced by the property is considered UDFI. The IRA can apply the same 65% ratio of normal deductions such as depreciation, interest on the note, and operating expenses to offset the taxable income. The net taxable amount left after deductions is used to determine the tax owed by the IRA.

Taxation on UDFI applies to rental income produced by a debt-financed property. The gain on sale of a property that still has debt-financing in place is also considered to be UDFI and taxable.

At the end of the day, the IRA pays what is usually a nominal amount of tax in order to benefit from the higher cash-on-cash returns that leverage produces. The benefits of leverage will still very much be realized, just with a small amount of friction.

The Solo 401(k) Exemption

As a qualified employer retirement plan, a Solo 401(k) is exempted from UDFI when the debt-financing is used for the acquisition of real property.

In most syndicated real estate partnerships where income and losses are attributed to all limited partners equally, this exemption will still apply even though the real estate is indirectly held and financed.

For those investors who are eligible for a Solo 401(k), that platform provides an advantage in terms of simplicity and higher profitability when investing in leveraged multi-family syndications.

A Sample Multi-Family Syndication

Let's examine a typical multi-family syndication and how UDFI taxation applies.

Project Summary

- 216-unit apartment
- Purchase price of $25M
- Acquisition cost total of $26.25M with commissions, closing costs, property upgrades, etc.
- $10M down, consisting of $1M from the general partner and $9M from investors as limited partners
- 10-year hold, with the goal of improving performance and thereby raising both rents and occupancy rates
- Sales price after 10 years projected at $34.5M

An IRA investor bringing $100K to this project will have a 1% equity stake as a limited partner in the LLC that will hold and operate the property.

When the investor is looking at their income and applicable taxation, everything is fractionalized to their IRA's 1% level of ownership. So instead of this being a $25M project with $10M of investor capital down, it essentially becomes a $250K project with the IRA investor's $100K down.

The promoter's pro-forma projections for cash flow indicate that a 1% limited partner can expect a distribution from the LLC annually. The following amounts exhibit the increase over time as property performance increases.

- **Year 1: $7,119**
- **Year 5: $10,769**
- **Year 10: $11,395**

At the end of the 10-year hold when the property sells, the investor should receive their capital back, plus their percentage of the gain on sale. Our $100K investor with 1% participation could expect around $92K in proceeds from the future sale if the $34.5M goal is met.

How UDFI is Calculated

When examining UDFI, there are 3 key values used:

Average Acquisition Indebtedness

Average Acquisition Indebtedness - is the average monthly balance on the loan during that portion of a given tax year during which a property is held.

Average Adjusted Basis

Average Adjusted Basis - is the average cost basis of the property over the period during a given tax year when the property is held. The initial cost basis starts with the price paid for the property, as well as closing costs and the cost of any property improvements completed at acquisition or reasonably foreseen as necessary at the time of purchase. The average adjusted basis is reduced each year by the full amount of straight-line depreciation on the property.

Debt Financing Ratio

Debt Financing Ratio - is the result of dividing the average acquisition indebtedness by the average adjusted basis. This ratio is then applied to gross income produced by the property to determine the amount of UDFI. Likewise, the same ratio is used to determine deductions for applicable expenses like interest, depreciation, and operating expenses such as property taxes, management, etc.

A $1,000 exemption against UDFI applies per taxpayer.

The net income deemed to be UDFI after the exemption and deductions is then run through the trust tax table to determine the taxable amount. An IRA is a form of trust, thus the use of the trust table.

2019 trust tax rate brackets range from 10% on amounts below $2,550 to 37% on amounts over $12,500.

The potential of some income being taxed at a 37% rate is intimidating, and a big reason why many folks become deterred from debt-financed investments. **As we continue, you'll see that only a fraction of real income is subject to taxation, and the effective tax rate an IRA will pay is generally quite low.**

UDFI Calculations - Rental Income

For sake of brevity, we'll skip over the details of the math for determining our average adjusted basis and average acquisition indebtedness. When we run the numbers on this deal we end up with a debt-financing ratio after the first year of .63. This means that 63% of the gross income is considered taxable as UDFI.

The property will generate $2.43M in rents, so our 1% shareholder IRA will be allocated $24,326. 63% of that value is $15,309 which is our gross UDFI income amount.

The allowable deductions include mortgage interest, depreciation, property taxes, property management, etc. The 63% allocation of these write-offs equals $15,376.

> **Wait, that is higher than our debt-financed income!**

Due to the lower performance of the property in the initial years, we'll have more allowable expenses than income. There will be no UDFI tax in year one even though the IRA received $7,119 of net income. Likewise, in year two, the IRA will take home $8,719 and have no tax obligation.

The tax losses are negligible, and therefore not worth doing a return in order to carry losses forward to offset taxes in future years. This would be a viable strategy with larger tax losses.

Each year the values shift a bit and that changes the tax implications. With an interest-only loan such as this project uses, cash flow is boosted in the early years.

The trade-off with respect to UDFI is that the average acquisition indebtedness is not reduced each year by principal payments on the loan. The average adjusted basis does become lower each year as the full amount of depreciation on the property is applied. This causes the debt-financing ratio to increase over time, making more of the income taxable. By year 10, the debt-financing ratio is .81.

In a loan normally amortized on a principal plus interest basis, the debt-financing ratio will trend consistently near the initial value until dropping in the last few years of the loan.

Following are the top line numbers for a few landmark years of the project.

- Year 3 is the first year with tax liability.
- Year 5 is the last year of the interest-only loan.
- Year 7 reflects increased mortgage payments once the interest-only period expires.

All values reflect the 1% share our IRA investor has in the larger deal.

	Year 3	Year 5	Year 7	Year 10
Gross Income	$28,394.00	$30,415.00	$32,268.00	$35,260.00
Operating Expenses	$(12,151.00)	$(12,624.00)	$(13,136.00)	$(13,774.00)
Lender Reserves	$(432.00)	$(432.00)	$(432.00)	$(432.00)
Sponsor Fees	$(902.00)	$(902.00)	$(902.00)	$(902.00)
Debt Service	$(5,687.52)	$(5,687.52)	$(8,756.40)	$(8,756.40)
Net Cash to Partners	$9,221.48	$10,769.48	$9,041.60	$11,395.60
Pre-Tax ROI	9.22%	10.77%	9.04%	11.40%
Debt-Financing Ratio	0.67	0.73	0.76	0.81
UDFI Tax Amount	$33.80	$156.37	$324.82	$917.67
Effective Tax Rate	0.37%	1.45%	3.59%	8.05%
Tax Preparation	$350.00	$350.00	$350.00	$350.00
Net Tax Cost	$(383.80)	$(506.38)	$(674.85)	$(1,267.75)
Post-Tax Return Amt	$8,837.68	$10,263.10	$8,366.75	$10,127.85
Post-Tax ROI	8.84%	10.26%	8.37%	10.13%
UDFI Return Reduction	0.38%	0.51%	0.67%	1.27%

The impact of UDFI on the overall returns for this project is negligible.

Over the 10-year period covered in the sponsor's projections, the IRA's $100K investment would produce $89,313 of net, after-tax cash flow. That is an annualized ROI of 8.93%.

Taxation on UDFI plus the cost of tax preparation would only reduce the overall return by an average of .58% per year.

When UDFI Applies to a Property Sale

If mortgage debt is still in place when a property is sold, then the gain on sale is treated as debt-financed and subject to UDFI.

The UDFI calculation uses the highest acquisition indebtedness value during the 12 months prior to the sale. If a property is fully paid off a full 12 months prior to sale, there is no UDFI implication.

In most syndicated deals, the property is sold long before retiring the debt, so there is likely going to be a taxable gain for the IRA investor.

How UDFI is Applied to the Property Sale

All tax calculations for UDFI hinge on the debt-financing ratio as discussed earlier.

The debt-financing ratio results from dividing acquisition indebtedness by the adjusted cost basis of the property.

At the disposition of property, the highest amount of acquisition indebtedness in the 12 months prior to the sale is used. This is a different formula than the average debt balance over the course of the year we used when dealing with operating income.

The formula for average adjusted basis is the same as that used for operating income. The beginning and ending values for adjusted costs basis during the portion of the year the property was held are averaged. Each year, the full value of straight-line depreciation on the building is applied to reduce the beginning-of-year basis.

At the time of sale, the debt-financing ratio is determined by dividing the highest acquisition indebtedness over the last 12 months by the average adjusted basis during the period the property is held during the final tax year.

The debt-financing ratio is applied to the capital gain. Capital gains are calculated using the same logic as in a non-qualified property sale, including the recapture of depreciation.

The Property Sale

Let's assume the property sells as projected for $34.5M. That means our 1% IRA investor's stake will represent $345K.

Sales costs of 4% are typical in these types of deals, allowing for broker commissions and transactional fees. This means a $13,800 cost of sales and a net sales price of $331,200.

The outstanding share of debt is $145,757.60.

After a return of originally invested capital, the net gain from the sale is $85,442.40.

Because there is still outstanding debt, UDFI will apply to the gain.

UDFI Calculation

The actual cash gain of $85K is not used for UDFI calculations. Rather, the normal rules for determining capital gains apply.

Here is how that works out using the 1% values of our IRA investor:

A	**Sales Price**	**$345,000**
B	**Sales Costs**	**$13,800**
C	**Net Sales Price (A-B)**	**$331,200**
D	**Initial Cost Basis**	**$262,500**
E	**Accumulated Depreciation**	**$85,695**
F	**Adjusted Basis at Sale (D-E)**	**$176,805**
G	**Capital Gain (C-F)**	**$168,195**
H	**Highest Debt Balance in Prior 12 Months**	**$149,344**
I	**Average Adjusted Basis**	**$181,090**
J	**Debt Financing Ratio (H/I)**	**0.82**
K	**Gain subject to UDFI (GxJ)**	**$138,7409**
L	**UDFI Capital Gain Tax (Kx.20)**	**$27,742**
M	**Actual Cash Distribution**	**$85,442**
N	**Post-UDFI Cash to IRA (M-L)**	**$57,701**

Project Performance Review

This project looks to have the potential to be a good investment for the IRA. It may generate better than average returns in an investment backed by the security of real property.

The fact that tax on UDFI will apply to the gains does not diminish the overall positive results. The use of leverage in the transaction boosts the return, and the IRA certainly sees a benefit.

When comparing this opportunity to other investments the IRA may take part in, it will be difficult to find something that is as secure and predictable, with a 14% return.

Here are the top-line numbers after allowing for UDFI taxation:

Initial Investment	**$100,000**
10-Year Cash Flow	**$89,313**
Gain at Sale	**$57,701**
Total Gain	**$147,014**
Project ROI	**$147.01%**
Annualized ROI	**14.7%**

Supercharging the Opportunity

As we have seen, an IRA can expect solid returns from participation in a well-executed multi-family real estate partnership. In fact, the returns are considerably better than most folks regularly achieve with their IRA.

But what if we were to make the same investment using a Solo 401(k), with immunity to UDFI taxation?

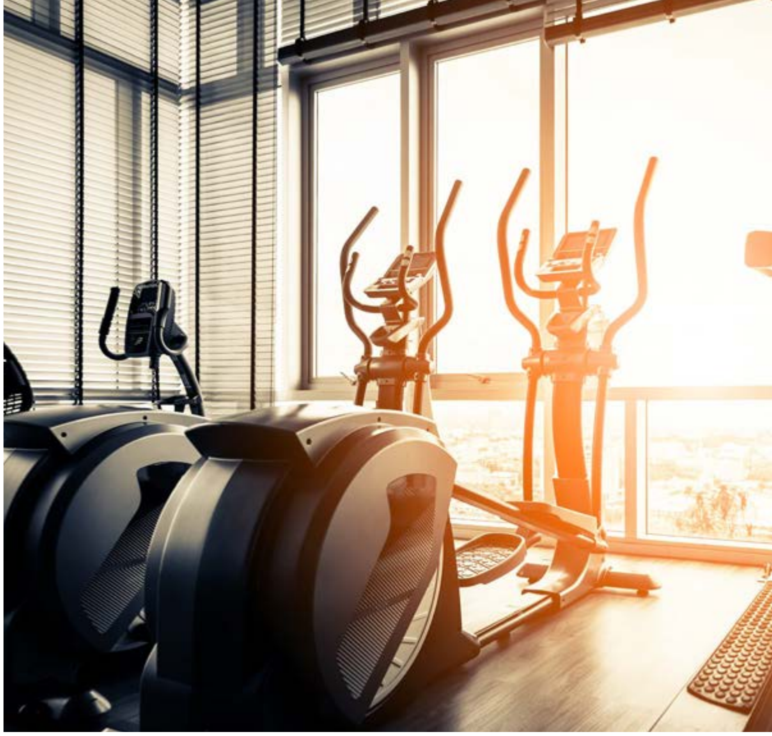
Most anyone can establish a self-directed IRA and have the opportunity to invest in a more diversified fashion.

Investors who are self-employed and have no-full time employees may be eligible for a Solo 401(k).

As a qualified employer retirement plan, a 401(k) is exempted from taxation on UDFI in specific cases per IRC Section 514(c)(9).

- Only debt-financed income produced when the debt is associated with the acquisition of real property is exempted.
- When investing in real estate indirectly via a partnership, the income and costs of the partnership must be allocated equally, meaning that depreciation cannot be shifted only to partners not using retirement funds for example.

So, what would this deal look like for an investor with a Solo 401(k)?



Here are the top-line numbers without the impact of UDFI taxation:

Initial Investment	**$100,000**
10-Year Cash Flow	**$95,063**
Gain at Sale	**$85,442**
Total Gain	**$180,505**
Project ROI	**180.51%**
Annualized ROI	**18.05%**

An investor with a Solo 401(k) would make an extra $33,491 on this very same opportunity.

Not everyone qualifies for a Solo 401(k), and we caution about trying to force qualification, but when there is a good fit for the Solo 401(k), it is clearly a better tool for the job.

In Summary

Not many investments available to an IRA or 401(k) investor have the potential to produce 14% returns consistently over a 10-year period. Of course, there is also the real difference between the pro-forma projections of an investment sponsor and the real outcome of a project. Like all investments, one must do their homework and diligence to create the best possible pathway to success.

The fact that an IRA investor will be subjected to tax on a debt-financed real estate partnership is neither here nor there at the end of the day. A good investment is a good investment, and the overall mix of risk and reward is what really matters. In our experience, most investors will take a 14% return on a leveraged investment with exposure to UDFI instead of a 9% return on a non-leveraged investment.

Call 877-229-9763

4845 Pearl East Circle
Suite 101
Boulder, CO 80301
www.ira123.com

Disclaimer: *The examples provided in this document are for education purposes only and should not be construed as tax guidance. Several assumptions have been taken for simplicity of illustration such as full tax-year holdings of the property in the initial and final years. Each opportunity is unique, and many factors such as the design of a partnership can impact a participant using retirement plan funds. You should always seek qualified, licensed tax counsel when evaluating an investment using debt-financing.*