AN INVESTOR'S GUIDE:

Tax-Advantaged Real Estate Investing

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Tax-Advantaged Real Estate Investing

Holding real estate in a qualified retirement account offers tax advantages not found with traditional property purchases. This guide is aimed at helping investors learn how an Individual Retirement Account (IRA) can hold real estate investments, including:

- Prohibited transactions that can result in a loss of tax advantages
- Types of property investments and purchase methods that are permitted
- What investors should expect from the account's custodian

The Rise of Self-Directed IRAs

In 1974, Congress enacted the Employee Retirement Income Security Act (ERISA) to shift the responsibility of retirement savings away from the employer and put employees in greater control of how their funds were invested. Individual Retirement Accounts (IRAs) were created the following year, ushering in a new era of retirement planning. In the intervening decades, IRAs have become one of the most popular investment instruments because of their tax advantages for investors in nearly every income bracket.

The ability to invest IRA funds in stocks, bonds and mutual funds is well understood by most investors. What's less well known is that the Internal Revenue Service (IRS) allows IRA funds to be invested in alternative assets, including real estate, private stock, LLCs, precious metals, mineral rights and more.

Most large financial institutions that act as IRA custodians limit the investments they offer to those traded on the exchanges, which may explain the lack of knowledge surrounding alternative asset accounts. Custodianship of retirement accounts that hold non-traditional assets is a more complicated process that generally involves significantly more paperwork and administration. For this reason, alternative asset custodianship has always been limited to a smaller number of specialized entities willing to take on the extra responsibilities of self-directed IRAs.

After years of market instability, self-directed IRAs are attracting greater attention as investors search for additional ways to manage risk and meet return objectives with their retirement funds. No longer limited to the very wealthy, these accounts have accumulated significant funds, a portion of which may be invested in an alternative asset such as real estate.

$130 Billion

Estimated amount of funds in self-directed IRAs*

*Estimate based on 2% of the total IRA balances of $6.5 trillion as of 12/31/13

Freedom to Invest in Your Passions

Self-directed Individual Retirement Accounts (IRAs) allow investors to use their retirement funds to invest in assets that are not traded on the exchanges. Just like traditional IRAs, they are sanctioned by the Internal Revenue Service (IRS) and differ only in that the custodian or trustee permits investments in a broader class of assets than what is allowed by most custodians.

As the name implies, investment decisions are initiated and made by the IRA account owner. This carries the freedom to invest in a wider array of assets and exert far greater control over the investments than what is offered by a third-party manager. However, self-directed IRA investors must assume the risk of investments that have less regulatory oversight and pose potentially greater risk.

Self-directed IRAs offer the same tax advantages as traditional IRAs. Contributions are tax-deductible* and the taxes on any transactions within the account — interest, dividends, income and capital gains — are deferred until the funds are withdrawn. Or, if held in a Roth account, investment growth is tax-free. Plus, any returns on the investment may be reinvested on a tax-deferred or tax- free basis. Self-directed accounts may incur additional taxes depending on the investments held in the account.

In addition to tax advantages, self-directed IRAs present investors with the opportunity to use their retirement funds for investments that are not subject to the same market forces as assets that are traded on the exchanges. Investors learned in market downturns in 2000 and 2008 that a mix of stocks and bonds is often not enough to protect retirement savings from extreme losses – especially when markets and asset classes around the globe move in sync. Because alternative assets are often not readily tradeable on exchanges, their values are more likely to change at different times and to different degrees than conventional investments, helping to stabilize your portfolio.

Real estate, which offers the possibility of yielding significant long-term gains, can be particularly attractive to investors looking for alternative assets to hold in their retirement accounts. Many investors have prior experience and a higher level of comfort with real estate, which makes it a natural investment choice. There are, however, significant differences in how real estate transactions work within a self-directed IRA that investors should understand before investing.

*May 2014. Visit http://www.irs.gov for more information.

What is a Self-Directed IRA?

Where the custodian of these accounts allows investments in a broader class of assets — like real estate.

Exchange Traded vs. Non-Exchange Traded Assets

	Exchange Traded	Non-Exchange Traded
Asset types	Stocks, bonds, mutual funds, cash instruments traded on public exchanges	Virtually unlimited with the exception of insurance and collectibles
Liquidity	High	Low
Investment Decision Control	Portfolio manager designated by the plan sponsor or fund operator	Individual investor (often in conjunction with their advisors)
Management	Third-party, typically a portfolio manager	Self-directed custodian; or the account owner with certain types of accounts

Understanding IRS Rules to Make The Most of Your IRA

It's vital for investors to understand what the IRS refers to as "prohibited transactions," which can jeopardize the tax protection offered by self-directed IRAs. Engaging in a prohibited transaction, even unintentionally, could trigger immediate distribution of the asset and lead to significant taxes and penalties.

The primary restriction of self-directed IRAs is that they cannot hold any assets that are used for the owner's personal benefit or the benefit of any disqualified person, even indirectly, while the asset is held in the IRA. In addition to the account owner, disqualified persons include his or her spouse, lineal family (parents, children, grandparents and grandchildren) and their spouses, and fiduciaries. The account owner's business and other businesses that they may own are also excluded from benefiting from a self-directed IRA investment. This prohibition is known as self-dealing.

For this reason, no personal use of the real estate held in a self-directed IRA is allowed. The account owner and disqualified persons cannot live or work in the property, or benefit from it in any way while it remains in the IRA.

The account owner and disqualified persons also cannot provide any services to the property, including maintenance and repairs. To remain in compliance, some custodians require that income-producing properties have a third-party property manager who is in no way affiliated with the account owner (a non-disqualified person) to pay bills, arrange for improvements or remodels and provide property oversight. The funds to pay the property manager must also come from the IRA.

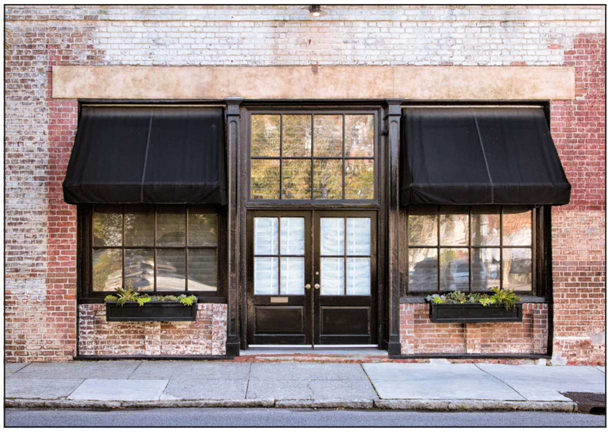
Another IRS stipulation is that investors cannot mix IRA and non-retirement funds in the same account. For this reason, all financial transactions must flow through the IRA first to be eligible for tax advantages. This means that all expenses related to the property from the down payment and mortgage payments (if any) to property taxes, insurance and repair expenses must be paid by the IRA itself. And all revenue generated from the property, including income and capital gains, must be paid to the IRA before distributions can be taken by the investor.

What is Self-dealing?

When the IRA account owner or disqualified party personally benefit from the investment held in the IRA.

Building Your Portfolio Brick by Brick

Investors can invest in the entire gamut of real estate instruments - limited only by the funds they have available. Property can be purchased for long-term appreciation, rental income or a flip (purchased at a discount, possible renovation, and then a quick resale for profit). Investors can also benefit from real estate without owning the property itself by using their IRA funds to purchase mortgage notes and trust deeds secured by real estate.



IRS rules allow investment in both domestic and foreign real estate. However, the value and viability of foreign property can be more difficult to assess, so many custodians do not permit international investments or impose greater restrictions and charge higher fees. What's more, some countries do not recognize IRAs as a legal entity that's qualified to hold a legal title to real estate. Investors considering a foreign property for their self-directed IRA should be extremely meticulous about conducting due diligence for these investments.

What Kind of Real Estate Can My IRA Buy?

- Long-term residential properties including:
  - Condominiums
  - Single-family homes
  - Multi-family homes
  - Apartment Buildings
- Short-term residential properties (Flips)
- Trust deed notes, mortgages and tax liens
- Raw land and lots
- Commercial properties including:
  - Retail and wholesale buildings
  - Hotels and motels
  - Office complexes
  - Service businesses
- Additional types of property such as farm land and boat slips

Can I be a lender?

Self-directed IRAs permit investments in both real property AND notes that are backed by real estate.

Purchasing and Maintaining Real Estate in a Self-directed IRA

A range of options is accessible, contingent upon the retirement funds the investor has available. Regardless of the purchase method, the investment must be purchased with funds held in the self-directed IRA and the title needs to be vested in the name of the IRA custodian for the account.

Common ways to invest in real estate for a self-directed IRA include:

- Direct purchases where the IRA buys the entire property outright using funds in the account
- Partnerships or Tenants-in-Common purchases, which combine the investor's IRA funds with other people's IRAs or use them in conjunction with the account owner's personal, non-IRA funds. The investment's income and expenses are handled proportionate to each entity's ownership amount
- Mortgage-backed purchases that can lower the amount of IRA funds needed to buy the property. Important caveats here are that neither the IRA, nor the account owner, can have any personal liability in the mortgage (investors can't back their own loans). Also, a non-recourse loan must be used so that the lender can only seize the actual property and not the rest of the IRA's assets if the borrower defaults on the loan. Non-recourse loans typically have lower loan-to-value ratios and may have higher interest rates because of the greater liability
- Limited Liability Corporation interests where the property title is held in the name of the LLC. In this case, the IRA holds an interest in the LLC rather than title to the investment

Who is on the title?

The self-directed IRA is the actual buyer of the investment and should be listed as such on the title and all paperwork.

Purchasing and maintaining real estate in retirement accounts differs from traditional property investments in a few important ways:

- The property's buyer is the IRA, not the investor. That's why paperwork must flow through an IRA custodian like PENSCO
- All expenses and revenue must go through the IRA. Expenses must be paid by the IRA and any revenue must remain in the IRA
- You cannot use the property for personal reasons. The property must be treated as an investment, not for the immediate benefit of you, your business, or your family
- Maintenance and repairs must be done by a third party. If the IRA owner provides any "sweat equity" activities – even something as minor as changing a light bulb — there could be significant penalties

Understanding the Role of a Custodian

All IRA accounts are held for investors by a custodian or trustee, which may be a bank, trust company or other entity approved by the IRS to act in this capacity. Custodians of self-directed IRAs differ only in that they allow investments in a broader range of asset classes. Since these generally require less disclosure and oversight than traditional assets held in IRAs, it's important for investors to understand what is and isn't required to custody assets in a self-directed IRA.

To begin with, the custodian or trustee has limited duties when it comes to evaluating the investment, so investors or their advisors must determine the merits of the real estate transaction on their own. Custodians may choose to - but are NOT required to — investigate the validity of the investment itself, the background of any promoter or the accuracy of any financial information provided.

Self-directed IRA custodians are responsible only for holding and administering the assets in the account. They see to the extensive recordkeeping required by the IRS and handle the reporting of all investment activity within the account including quarterly reports, processing of annual asset valuations and other documentation. Custodians must make certain that the property is properly administered while it is held in the account, which includes seeing that all expenses are paid with IRA funds* and that all income and gains flow through the account.

With a self-directed IRA, investors can use their retirement funds for real estate purchases and receive tax-deferrals on the property's income and capital gains, or tax-free growth if it's held in a Roth account. These tax advantages and the greater diversification provided for retirement account holdings give investors alternative ways to meet their risk and return objectives.

A self-directed IRA custodian:

- Offer a possibility of broader range of investments
- Does not evaluate the merits of an investment beyond it's ability to be held within an IRA
- Provides extensive record keeping
- Will monitor for prohibited transactions and ensure IRS compliance
- Assumes responsibility for the administration process and documentation required to buy, hold and sell alternative assets while in an IRA

PENSCO Makes It Possible

PENSCO Trust Company has been helping investors use their retirement account funds to invest in real estate, private equity and other non-exchange traded assets since 1989.

As the trusted custodian of over $10 billion in assets on behalf of more than 50,000 clients, PENSCO works with asset sponsors, financial institutions, and financial advisors, as well as self-directed investors who typically have a point of view about alternative investment opportunities based on their own knowledge or expertise.

To learn more about PENSCO services and investing in non-traded alternative assets, please visit http://learn.pensco.com or call 1-866-818-4472.

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* Note that the account owner is responsible for making sure the custodian receives all tax bills and statements for other expenses that need to be paid by the IRA.

PENSCO Trust Company performs the duties of an independent retirement custodian, and, as such, does not provide investment advice, sell investments or offer any tax or legal advice. Potential clients are advised to perform their own due diligence in choosing an attorney, tax advisor, or any investment opportunity.

Alternative investments are not FDIC insured and are subject to risk, including loss of principal.