

Put Some Real Estate In Your IRA

Take charge of your nest egg by investing in real estate through a self-directed IRA.

By Ward Lowe

Which do you know more about: stocks or real estate? If you answered real estate, then consider using your expertise to boost your retirement funds. You can set up an individual retirement account to purchase raw land, single-family homes, apartments, commercial buildings, and other properties.

Investing in real estate through a self-directed IRA enables you to diversify your portfolio and benefit from your knowledge of real estate—all while enjoying the tax benefits of an IRA. You might even promote this option to clients, positioning yourself as an investment-savvy REALTOR®.

Decisions, decisions

First, you must open a self-directed IRA. Your local savings and loan can't help with this step. You need to contact an IRA custodian. Before you search for someone to set up your IRA, though, decide what type of real estate you're likely to invest in and how much, if any, additional services you'll need.

IRA custodians typically charge about \$200 a year in fees just to set up the self-directed IRA and hold your money. Depending on the custodian, you may face additional charges every time you want to authorize a check, for example, to pay an electrician who worked on the property. You can also hire an IRA adviser who'll set up your self-directed IRA through a custodian, offer advice and attorney consultations, and give you more freedom to write checks from your IRA. Their fees vary.

If you're buying an empty lot and sitting on it for 10 years, a custodian will likely suit you fine. You won't pay much in fees, you won't need much guidance, and you probably won't have cause to authorize many checks from the account other than those to pay your property taxes. However, if you're planning on leveraging your IRA to purchase a fixer-upper or performing a

similarly complicated transaction, do your homework. Compare the fees from several custodians, talk to an IRA adviser, and consult a tax attorney. How much money do I need?

You can roll all or part of your current retirement funds into a self-directed IRA. Some financial experts recommend having at least \$50,000 in the new IRA, while others think it should have at least \$200,000. Again, it depends on what you want to purchase with the account and how you intend to pay for the real estate. Purchasing property outright is the simplest way, but your IRA can invest in real estate through a down payment and subsequent loan.

You cannot personally guarantee a loan through your IRA, and some custodians may not permit debt-financed (leveraged) properties. However, you can set up an IRA LLC (limited liability corporation) that makes you a partner with your self-directed IRA and can facilitate getting a loan. This is where an IRA adviser can come in handy.

Dan Cordoba, certified estate adviser and founder of Asset Exchange Strategies in Leander, is such an adviser. His company charges \$1,900 to \$3,000 to set up an IRA LLC through a custodian and offers consultations with tax attorneys to clients, among other services.

“An LLC is appropriate if you have a lot of transactions like with a fixer-upper,” he says. “You’ll need a checkbook, and you retain more control through an LLC—as a partner—than having to clear everything through a custodian.”

The checkbook, however, must draw from the IRA—not one of your accounts. In fact, all closing costs and other up-front outlays must be paid from the IRA. Keep this fact in mind when deciding how much money to put in the IRA and what real estate to invest in. You need to have sufficient funds not just to purchase the property, but also maintain it.

Also, leveraging your IRA can result in your IRA owing tax on unrelated debt-financed income (UDFI), which is the income attributable to the leveraged portion. This is another expense that must be covered by the IRA. It’s wise to discuss this and any other tax ramifications with your attorney.

No sale

Before you envision purchasing your primary residence or a vacation home through your self-directed IRA, there are some restrictions you should know about. The IRS won't allow you, your spouse, your parents, or your children and their spouses to live in or use any property owned by your self-directed IRA. Your IRA can't purchase real estate from any of these people either. Also, your business can't own or lease space in the property. It must be investment property.

What these rules boil down to, according to Cordoba, is that you cannot perform transactions that benefit any entity other than the IRA. These "prohibited transactions" and "disqualified people" are aspects of self-directed IRAs where you must pay close attention or risk hefty fines and penalties that could erase your retirement gains. If you don't feel up to navigating the IRS code, consider hiring an adviser or consulting your tax attorney before any transaction.

Remember that the IRA—not you—must be listed as the buyer and must pay for all expenses. If you need a property manager, the custodian will hire one paid for by the IRA. If you need a plumber, the custodian will hire one paid for by the IRA.

Risk vs. reward

The biggest risk you encounter when investing in real estate with your IRA is the same thing any real estate investor risks: fluctuating property values.

"It differs from typical real estate investments because you don't get the depreciation benefits, and if the IRA buys the property you don't get the tax write offs," explains Cordoba.

So, why do a self-directed IRA? "Because you're not making enough money in the stock market, so you might as well diversify and try something else to enhance your portfolio," he says. Plus, you probably know more about what makes a good real estate investment than what stock will be hot next month.

While self-directed IRAs and 1031 exchanges offer different advantages to an investor, self-directed IRAs provide more flexibility. "You can decide to buy a property and change your mind—without tax implications—and there are no timing problems—no 45-day identification period or 180-day closing period," Cordoba says.

Investing your IRA in real estate can better protect against loss of your principal while generating attractive return rates. Any income from non-leveraged property proceeds from its sales, or capital gains on it return tax-deferred to the IRA.

People of any age can benefit from self-directed IRAs. If you purchase a beach house outright later in life, you can let it generate rental income for five or 10 years, only incurring costs when you need to make up for lost revenue from vacancies. When you reach the age to take disbursements from your IRA, have the house turned over to you as a distribution. If you're younger, leverage your IRA and pad your retirement fund with years of rental income from a multifamily dwelling. If set up properly, the debt likely will be paid off long before you retire.

Looking good

Knowing about self-directed IRAs also can enhance your image in the eyes of clients. Ask current and past clients if they've heard about this retirement option. "Agents who suggest this will be viewed as a much more sophisticated professional," says Cordoba. "It's easy to demonstrate the advantages of self-directed IRAs in real estate to people."

And who can help them find the right property to invest in? You, of course. All you need to do is help them understand the process, then leave it to them to find a custodian or adviser to perform the transactions.

Plan for your retirement and better position your business simply by employing your hard-earned knowledge of the real estate market. Talk to your tax attorney about altering your investment strategy to include your area of expertise.