

Using IRAs and 401(k)s to Purchase Your Next Investments

Building wealth in your retirement account with real estate

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With the turmoil in today's U.S. financial markets, you have probably watched the balance in your retirement account march steadily in the wrong direction. Ever wish you could use your retirement account to build wealth, tax-deferred or even tax-free, by investing in real estate? Enter the self-directed retirement account.

Thought this couldn't be done? It can and it's quickly becoming a popular tool among today's savvy real-estate investors. You can use your IRA or solo 401(k) to purchase raw land, commercial buildings, condos, residential properties, empty lots, trust deeds, or real-estate contracts. The IRS only prohibits an IRA from investing in life-insurance policies and collectibles such as art work, gemstones, rugs, and the like (see IRS Publication 590). Other investments are, for the most part, wide open.

It takes a self-directed retirement account

The trick is that you can't buy real estate with your basic IRA or retirement plan at a bank or brokerage firm. You need to open a self-directed IRA—one with an independent IRA custodian that allows real-estate investments. Or, for sole proprietors, open a self-directed solo 401(k). There are a handful of retirement custodians across the United States that will let you invest in real estate through a self-directed IRA or solo 401(k).

A self-directed IRA or solo 401(k) is simply a retirement account for which the account owner calls the shots. Unlike most banks or brokerage firms, an independent IRA custodian doesn't limit your investment options to just bank CDs, stocks, mutual funds, annuities, and other common IRA investments.

And while banks and brokerage firms typically don't allow you to invest your retirement account in real estate, a self-directed IRA or solo 401(k) usually allows you to hold not only real estate but a full array of traditional investments, including stocks, mutual funds, and other investments, in the same account.

Shopping for a custodian

You should thoroughly check out and compare several retirement custodians. As when dealing with banks or financial institutions, you will want to know whether uninvested funds are insured and whether the custodian is regulated by a state or federal regulatory agency. You also want to inquire about the custodian's experience and abilities. Just as important, you should compare costs and know the rules set forth by each custodian.

If you already have an IRA or two, you're a step ahead.

Fees can vary widely from one custodian to the next; so does the flexibility each custodian provides for account holders. Some custodians may permit debt-financed (leveraged) or foreign real-estate properties; others may not. Likewise, some custodians may provide property services such as filing of the deed or collection of rental income. Other custodians may require you to contract with a third party to provide these types of services. Do your homework and understand what you're getting into.

Determine your needs

If you already have an IRA or two, you're a step ahead. You simply instruct your IRA custodian that you wish to transfer your IRA funds to the custodian you have chosen to hold your real-estate IRA. Or, if you have left a previous employer and have 401(k) funds to roll over, you can instruct the plan administrator to roll over the funds to your chosen custodian.

It's always best to make an informed decision and talk with a tax professional to determine which type of retirement account best fits your needs.

If you don't already have an IRA, don't despair. Today's increased retirement contribution limits make it easier than ever to start from scratch. One thing to consider before setting up an account is deciding which type of retirement account will work best for you. For an individual, a traditional or Roth IRA may be the answer. But if you are self-employed, a SEP-IRA may let you sock away as much as \$46,000 each year! And if you are a sole proprietor, a solo 401(k) lets you contribute up to \$46,000 annually as well.

With a traditional IRA, annual contributions may be tax-deductible, but taxes are paid once you start withdrawing from it. Better yet, if you qualify for a Roth IRA, you can avoid paying taxes and capital gains altogether, even though annual contributions are not tax-deductible. A Roth IRA might be extremely attractive—especially if you anticipate the value of your real-estate investments will appreciate significantly.

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Retirement Plan Contribution Limits for 2008

Annual Contribution Limit	For Individuals Under Age 50	For Individuals Age 50 & Over
Traditional and Roth IRA	\$5,000	\$6,000
SIMPLE IRA	\$10,500	\$13,000
SEP IRA	\$46,000	\$47,000
Solo 401(k)	\$46,000	\$51,000

The chart above shows the different annual IRA and solo 401(k) retirement plan contribution limits, including catch-up contributions that may be made by people 50 and older.

A solo 401(k) offers another resource for real estate

Another little-known secret is that some IRA custodians that permit real estate in self-directed IRAs also offer self-directed solo 401(k)s. A solo 401(k) enables owner-only sole proprietors, partnerships, and corporations with no employees to establish a 401(k) and contribute up to \$46,000 each year. Couple this with the ability to purchase real estate, and an owner-only business can have a powerful resource for directing its retirement destiny.

Funding your retirement account

Once you choose your custodian and determine the type of account you need, you will need to establish your self-directed IRA or 401(k). Though an IRA or 401(k) may be opened by making an annual contribution as mentioned above, it could take a couple or more years to accumulate a sufficient amount to be able to buy a real-estate property. Another option, and the one used most often, is to transfer or roll over part or all of your assets from your existing IRA to your new self-directed IRA. Further, if you have changed jobs or quit working, you may also roll over assets from your former employer's qualified retirement plan.

Purchasing the property

Retirement-account custodians that hold real estate will usually allow any form of real estate: raw land, residential, commercial, or rental property. Though a few custodians may require that the property have no debt, some will allow you to debt-finance the property with a non-recourse promissory note. There are several lenders in the United States that will provide this type of financing. Another option would be for your IRA to purchase an interest in the property in conjunction with other purchasers. You might even consider forming a limited partnership or limited-liability company to purchase the property.

Most importantly, make sure that the purchase is made by your retirement account custodian—not you personally.

Most importantly, make sure that the purchase is made by your retirement account custodian—not you personally. In addition, any earnest money put up must be paid directly out of your retirement account by your custodian.

In general, your retirement-account custodian will require that it hold the original recorded title to the property



in safekeeping. The property should be titled in the name of your custodian for your benefit (such as ABC Trust Company, Custodian FBO John Doe IRA).

The IRS will not let you use the real estate owned by your retirement account as your residence or vacation home.

Keep in mind that your retirement account should have some liquid funds available to pay for expenses such as taxes, insurance, payments if debt-financed, and any improvement costs, since these expenses must be paid out of your retirement account. If your account doesn't have sufficient funds for these costs, you will have to make annual contributions within the federal guidelines or else withdraw the property from your retirement account and pay taxes and possible penalties.

One other caveat that, being a real-estate investor, you probably already know: Real estate is generally not considered a liquid investment. If you are approaching retirement or anticipate that you will need to draw upon your retirement funds soon, real estate may not be the right choice for you.

Don't let it get personal

You may be thinking of limitless possibilities—having your self-directed IRA purchase your residence, maybe even your office building. Not so fast—there are some important limitations to keep in mind. The IRS will not let you use the real estate owned by your retirement account as your residence or vacation home. Nor can your business lease it as office space. The underlying premise for any real-estate investment purchased within a retirement account is that you cannot have any personal use or benefit of the property. To do so may cost you plenty in taxes and penalties.

There are a few other restrictions as well. You cannot place a real-estate property that you already own into your retirement account. This means

that you, your spouse, or your family members (unless it's a sibling) cannot have owned the property before it's purchased by your retirement account.

After you retire, however, you can take a property out of your retirement account as an in-kind distribution (at the current market value and pay any taxes if your retirement account is not a Roth IRA) and then move in. However, the premise of any real-estate property owned by a retirement account is that it be purchased for investment reasons.

Other things to consider before taking the plunge

Investing in real estate through a self-directed retirement account may sound like a phenomenal opportunity, and it can be. However, as with anything, there can be a downside. When real estate is held in a retirement account, you must forego the depreciation on your annual tax return. Also, if the property is debt-financed, it may generate unrelated business taxable income, and any tax would need to be paid from your retirement account.

Whether or not you choose to invest in real estate, a self-directed retirement account can certainly open up more options when building wealth for retirement. ♦

