Real Estate IN YOUR IRA

Jennifer Heiman
CNB Custody
CNBCustody.com
MAREI Business Associate

What is a Self-Directed IRA?

A Self-Directed IRA is really just a regular IRA as far as the IRS regulations are concerned, but they typically allow a wider variety of investment types than other IRAs and can be directed by you, the IRA owner. Traditional, Roth and SEP IRAs can all be set up as Self-Directed. By having funds in a Self-Directed IRA, you can diversify your investments into a wider mix of products than the standard publicly traded stocks, bonds, or mutual funds. A Self-Directed IRA can hold alternative investments, such as real estate, which can be held direct, under the umbrella of an LLC, or in the form of a real estate investment trust (REIT). Other types of alternative investments that can be held are limited partnerships, notes, and precious metals to name a few.

Why would I want to purchase real estate inside an IRA?

There can be several benefits to using an IRA to purchase real estate investments. Any income, such as rent, that the property produces is held within the IRA and grows tax deferred. For traditional IRAs, these proceeds would not be taxed until withdrawn from the IRA, and in Roth IRAs it may be possible to never pay tax on this income. Along these same lines, capital gains taxes do not apply when real estate is purchased and sold inside an IRA.

Another benefit is having an additional funding source. If you have an investment property you would like to purchase but do not have cash available and do not want to take out a loan, you can look to your existing IRAs or retirement plans. Money in a 401(k), 403(b), pension, or other retirement account can be rolled into a Self-Directed IRA to create funding for your purchase.

E**xamples of Real Estate You Can Hold**

- ·Single or Multi-Family Homes
- ·Farms
- ·Commercial Real Estate
- ·Raw Land

You can also buy Notes & Mortgages and Lend Money.

Real-Life Example

You may be wondering how your IRA might grow once you invest in real estate. Following is an example of how an investor used his IRA.

Greg purchased a residential property that had a three-bedroom, two-bathroom home with a two-car garage for $200,000 with his IRA. Within his market, he was able to rent the home to Tom and Jane for $2,000 per month.

Tom and Jane pay their monthly rent of $2,000 to Greg's IRA, rather than to him personally. Assuming all rent is paid monthly, and the tenants stay for an entire year, the IRA would have the potential to gain $24,000 per year. The income will grow tax deferred inside of the IRA until a distribution is requested.

At that point, taxability will depend on your account type, your age, and which IRS exceptions you may qualify for at the time. Distributions from a Traditional or SEP IRA would be taxable as you request the funds. Roth IRAs grow tax-deferred and may potentially be tax free upon distribution if the IRS distribution qualifications are met.

According to the IRS, just as all income is deposited to the Self-Directed IRA, all expenses to maintain the property must be paid by Greg's IRA and not from his personal funds. For example, Greg decided to put a fresh coat of paint on the inside of the home before Tom and Jane moved in .According to Internal Revenue Code 4975, Greg is not allowed to paint the home himself, so he hired John's remodeling company to do the work for him. Greg chose the paint colors and John purchased the supplies and painted the home. John's company sent Greg an invoice or labor and supplies. Greg submitted the invoice and his payment authorization to his IRA custodian so John's company could be paid. The invoice was for $5,000, thus annual earnings after this expense would be $19,000, assuming no other expenses.

Many other expenses to maintain Greg's property may apply over time, such as property taxes, insurance, utilities, etc. All expenses must be paid by the IRA. Budgeting was important to Greg to ensure that the income would cover the expenses as they occur. Otherwise, additional funds may have to be transferred from another IRA, or he may contribute to the IRA to cover expenses if he is eligible to do so.

Another important consideration for Greg was that the expenses for the IRA property are not deductible on his personal tax return, like they might be if he owned the rental property in his personal portfolio. Since income is tax-deferred, the IRS doesn't allow a personal tax deduction for expenses. After considering this, Greg determined that the benefits of deferred taxes outweighed not being able to take the potential deductions.

Greg held this property inside his IRA for 5 years and was fortunate to have had excellent tenants. He ended up with $120,000 in rental income over those five years and had expenses that totaled $25,000 during that time. His net income was $95,000 over the five-year time frame that he owned the property, which is now held as cash inside his IRA along with the rental home.

Since the market was very favorable after his initial five years, and he was nearing retirement, he thought it would be a good idea to sell the property to create some liquidity.Greg was able to sell the property for $235,000, which was deposited to his IRA. Now, he has $95,000 in earnings as well as the $235,000 from the sale in his Self-Directed IRA, which he can use to invest into other types of investments or purchase another property. Five years ago, he started with $200,000 and turned it into $330,000, all tax deferred and with a nice return.

Getting Started

Set Up a Self-Directed IRA

Before making an offer on property, do your research and locate a Self-Directed IRA custodian that will service an account which holds real estate. It is a good idea to establish your account and fund it prior to making an offer so the earnest money, if required, is available to send by contract deadlines.

Funding your account may include several options. You may transfer funds from another IRA that you have. If you are eligible, rolling funds over from a qualified plan such as a 401k or defined benefit plan to an IRA is another way to fund your account. Annual contributions may also be made according to the IRS contribution limits.

Once your account is open and funded, you can make an offer on a property that is a good fit for your financial goals. Check with your custodian on the paperwork they require prior to submitting an offer to avoid any delays. Your offer must be made in the name of your custodian for your benefit. To comply with the IRS regulations, do NOT make an offer personally or pay any earnest money out of personal funds. The offer must be signed and submitted by your custodian and earnest money must be sent from your IRA to avoid any prohibited transactions.

What if my IRA doesn't have enough money to purchase a property?

A couple of options you might visit with your legal and/or tax advisor on is either partnering your IRA with other funds or applying for a non-recourse loan. Your IRA may "partner" with personal funds of your own, another IRA of your own (i.e. Traditional and Roth funds together) or with another person's funds, whether they are personal or retirement funds.

Let's continue our story about Greg.... Once Greg sold his property and had $330,000 available in his IRA, he decided to invest a portion of the proceeds back into another property but wanted to keep some of it in assets that were easily redeemable in case he needed the funds for his upcoming retirement.

He decided to invest $100,000 back into another property but realized he would need more than that to purchase the type of property he had in mind. He was discussing his idea with his long-time friend, Jack, who also owned a few properties. Jack said he had $150,000 available he wanted to invest, so they decided to partner their funds to purchase a property together.

In this scenario, with a $250,000 property purchase Greg's IRA would be 40% owner and Jack would be 60% owner. Meticulous records would need to be kept with a partnership, since 40% of the income would go to Greg's IRA and 60% would go to Jack. Expenses would also have to be paid according to the 40%/60% ownership established upon investment. When Greg and Jack sell the property, the proceeds would also be split in this manner.

Once the property is purchased, the ownership percentage must not be changed, thus it is important to have a good understanding of the cash flow of your chosen partner(s). If Greg or Jack's funds run low and one of them is not able to cover their share of expenses, the IRS doesn't allow the other partner to cover them. If Greg's IRA started paying all the expenses for a couple of months until Jack was able to pay his 60% share, the IRS may consider this a prohibited transaction.

What would the deed to the property look like if I partnered my IRA funds with other funds?

When Greg and Jack put their funds together, their agent recorded the deed to the property as follows:

"**IRA Custodian" FBO: Greg Brown IRA,** an undivided 40% interest and
Jack Jones, and undivided 60% interest as Tenants in Common(Jack used personal funds)

If you don't have an opportunity to partner your IRA funds with other funds, another idea to research is applying for a non-recourse loan for your IRA. These types of loans may have a fixed or variable rate. The collateral for the loan is the property held in the IRA. Your remaining assets not held inside the IRA would not be tied to the non-recourse loan in the event of default. Usually, the non-recourse lender will require a higher down payment for a loan of this nature, but please visit with your lender to see what would be required for the property you have in mind.

It is important to discuss potential unrelated debt financed income (UDFI) before taking out a non-recourse loan with your tax advisor. UDFI is taxable income attributable to borrowing funds within an IRA, and if due, must be paid by your IRA.

A Self-Directed IRA can be a powerful tool for investors looking to diversify retirement funds into different types of investments. Many scenarios can be used for purchasing real estate inside of an IRA, especially with the option of partnering with other funds of your own, or with another trusted individual with the same goals in mind. Income received from the property can grow tax deferred in a Traditional, Roth, and SEP IRA and may even be tax-free with a Roth IRA. Imagine all the possibilities! As always, please consult with a tax advisor as well as with an attorney that is well-versed in Internal Revenue Code 4975 before investing in real estate inside of your IRA. With a good understanding of the rules, combined with property that fits your portfolio, your IRA can gain substantial wealth to help you reach your financial goals.