

## Invest retirement in real estate

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Many people assume that tax-advantaged retirement plans—such as individual retirement accounts, Roth IRAs, simplified employee pensions and SIMPLE IRAs—have to be invested in stocks, bonds and mutual funds. The fact is, these individual retirement accounts have a vast array of permissible investment options. Using IRA money to invest in real estate makes it possible to diversify investment holdings, and perhaps to outperform the stock market. Real estate professionals may be uniquely well-suited to adding real estate assets to their retirement portfolios.

IRAs may not invest in life insurance, collectibles (e.g., artwork, antiques, metals, gems and most coins), foreign investments or S corporations. Generally speaking, IRAs can invest in anything else unless it is a prohibited transaction. If the purchase is financed, the IRA owner may not guaranty the loan. It has to be a debt solely of the IRA itself. However, not many banks are willing to do this kind of financing, so that is a potential issue. Debt service and other carrying costs must be made with liquid assets of the IRA, or with the annual contributions that the IRA owner is permitted to make. Another issue with a leveraged investment is that the IRA will have to pay "unrelated debt-financed income tax" on the portion of the profit attributable to the leverage. In evaluating an IRA investment, this additional tax needs to be considered. There are other tax consequences. An IRA may not deduct interest or take depreciation, and it does not get long term capital gain treatment of the profit—it's all ordinary income. Of course, if it's a Roth IRA, that won't matter, since all income is tax free, and a regular IRA may still defer tax on the income until proceeds are distributed.

Despite the drawbacks, many people still want to invest IRA money in real estate. A lot of people have fairly large amounts of money in retirement accounts, and they'd like to find other ways to use it.

The easiest way to use IRA money to invest in real estate is to pay cash to buy property from an unrelated third party, and not use the property for any personal use. For example, your IRA could buy a vacant lot and hold it, paying taxes with money that is already in the IRA account, or that is added as part of the allowable annual contributions. When it sells the property, all the profits go back into the IRA.

An IRA cannot directly or indirectly buy real estate from a "disqualified person." Disqualified persons are: 1) the IRA owner; 2) the IRA owner's spouse, ancestor or child; 3) the spouse of the IRA owner's child; 4) a fiduciary of the IRA or person providing services to the IRA (i.e., the trustee or custodian); 5) an entity that is at least 50 percent owned (or at least a 50 percent beneficial interest is held) by a combination of the foregoing; or 6) a 10 percent owner, officer, director or highly compensated employee of such an entity. The IRA owner may not guaranty an indebtedness of the IRA. You cannot have your IRA enable an investment for yourself or another disqualified person. If the IRA's investment is deemed essential to accomplishing a transaction in which both you and the IRA invest, then the entire transaction would be prohibited. An

additional consideration is liquidity. If the taxpayer is close to the required distribution date, he needs to make sure that there are sufficient liquid assets in the IRA to make the required distributions.

Engaging in a prohibited transaction results in the IRA becoming disqualified, generating liability for income taxes and penalties; so, it's important to structure investments carefully to avoid this result. Transactions with disqualified persons are not the only ones that can have these consequences, so be sure to hire a competent advisor before doing anything complex.

A loan secured by real estate is a straightforward real estate-related investment. This is also an option for an IRA. The IRA may lend money to unrelated persons or entities, and secure the loan with real estate collateral. Your IRA could "fix and flip" properties, perhaps providing carry-back financing for the purchases, but be sure you don't personally do any of the work—that can create income tax issues.

In order to make "nontraditional" investments with retirement funds, it is necessary to use an IRA custodian who allows this. Even if they claim to be "self-directed," most custodians just mean they'll let you buy any of the investment products that they are willing to sell you. There are several companies that specialize in being custodians for nontraditional IRA investments. Most charge a setup fee, plus a transaction fee every time you need a check written. Some are only for real estate investing, and some allow any kind of allowable IRA investment.

Some custodians advertise "checkbook control" for the IRA owner. All of the client's retirement plan funds are contributed to a limited liability company. The custodian owns all the shares of the LLC (but no other assets). The IRA owner is the manager of the LLC. The LLC can then invest in what it wants. The risks of commingling funds go up substantially in this kind of arrangement. Someday the LLC manager/IRA owner might need money, and he might take it out of the LLC's bank account. If he does, he's just made a taxable distribution to himself, and if he's not of retirement age, he'll also have to pay a penalty. Or maybe he won't have the LLC checkbook with him, and he pays an expense of the LLC. That causes an excess IRA contribution. So far, this structure is OK from a tax law standpoint, but if it begins to lead to widespread commingling of funds or other abuses, the IRS or Congress might step in to put a stop to it.

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