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### Self-directed IRAs allow for real estate investment

NORTH PALM BEACH, Fla. – April 26, 2007 – If you're tired of being limited to the typical lineup of stocks, mutual funds, bonds and CDs that most brokerages allow you to buy in your IRA, you might consider creating a self-directed IRA that enables you to invest in real estate.

The addition of real estate can diversify a portfolio and, to be sure, buying actual property to be held in your IRA is just one way to do it. The process is not terribly complicated, but as with any retirement account, you must follow the letter of the law or face penalties from the IRS. Additionally, unlike the run-of-the-mill self-directed IRAs that allow you to invest in the aforementioned stocks and bonds, a self-directed account that holds real estate arguably requires considerably more work on your part. It is also a much higher-risk investment.

In his book, "The No-Nonsense Real Estate Investor's Kit," Thomas Lucier writes, "... the real estate investment business is full of four-letter words such as: hard, work, risk and loss."

If you don't know much about real estate, if you're not willing to do a lot of so-called "due diligence," and if you're not financially or emotionally prepared to handle significant risk, don't attempt this. Sure, you can make painful mistakes in the stock market, but, generally speaking, your investments are liquid and you can cut your losses quickly if you feel it's necessary. The real estate market is not as forgiving.

#### What an IRA custodian does

But if you're determined, start by opening a self-directed IRA or self-directed Roth IRA with a custodian or administrator. Although this article focuses on real estate, a self-directed IRA can hold trust deeds, secured and unsecured notes, limited partnerships, private stock and other nontraditional investments. An Internet search will probably turn up a couple dozen companies that will handle these types of investments.

However, don't expect them to advise you on what properties to buy. A custodian is a neutral third party and it is not allowed by law to give that type of advice.

"We act only as the IRA custodian," says Kelli Click, vice president at Sterling Trust Company in Waco, Texas. "This is a simple illustration of what takes place, but an individual comes to us, sets up an IRA and tells us they want to purchase the property at 100 Main Street. They find the title company, get everything in place, tell us to wire the funds to the title company and tell us the closing date. We purchase the property and make sure it's in the name of the IRA account. We hold the property and provide the account holder with a quarterly statement, and we provide any IRS reporting for the IRA account."

Fees for custodian services vary, so be sure to get a complete list of fees before hiring someone.

You can use your self-directed IRA to buy your future retirement home, but you can't live in the home until you retire. You also cannot put a piece of property that you currently own into your IRA.

#### Due diligence essential

Most people use their IRAs to buy income-producing investment properties, and that takes a lot of homework, says Thomas Musil, Ph.D., director of the Shenehon Center for Real Estate at St. Thomas University in Minneapolis.

"The astute investor knows if the market fundamentals are there, the rental demand is there, the condition of the property warrants the investment, the terms and the price are right. There's a great deal of due diligence that the investor has to perform on a piece of property to put in a self-directed IRA."

Far and away, Musil says, the biggest mistake people make is failure to understand the market and competitive forces.

"You buy a four-unit building in a market that has a great deal of new construction taking place after you acquired the building, and the newly constructed properties are very competitive and rent for what you're charging."

#### Outside assistance and financing

If you want someone to find properties and do all the homework, there are companies that can assist you.

Patrick Rice, owner of one such company, IRA Resource Associates, and author of "IRA Wealth: Revolutionary IRA Strategies for Real Estate Investment," says his company manages between \$50 million and \$60 million in IRA assets, up from approximately \$2 million in 2000.

Most people open a self-directed IRA using funds from a 401(k) that they amassed while working for a previous employer. But while brokerages may require \$3,000 or less to buy a mutual fund, property usually costs considerably more, so be sure you have enough money in the account to fund a real estate purchase and other associated expenses.

Nevertheless, Rice says there are ways to buy property that don't require a large sum of money.

"Let's say I'm interested in a \$250,000 vacant office building; I can use my IRA to option the property. I take \$10,000 out of my IRA and say, 'I'll give you \$10,000 for an option to buy this property for \$250,000 within the

next year.' Now, the reason I did this is because I know Joe Blow down the street needs an office building. So I say to Joe Blow, 'I'll sell this to you for \$350,000.' I have only \$10,000 wrapped up in the deal, but I'm making \$90,000."

#### **Additional expenses to consider**

Obviously, complications can arise and a potential deal might not go so smoothly, but it's something to think about. If you do need financing, you'll have to get a non-recourse loan. If something goes wrong, you're not personally liable; lenders can only look at the asset when trying to recover their money. By the same token, you can't personally guarantee the loan. Be prepared for a down payment of at least 30 percent.

Another major consideration is having enough money for taxes, maintenance and management fees. Just as all income from the property must go into the IRA; all expenditures – down payments, taxes, management fees, maintenance costs and the like must come from funds that are in the IRA. So, keep appropriate amounts of cash in the account to pay bills and keep your head above water should you have a problem renting the property 100 percent of the time.

Hugh Bromma, CEO of The Entrust Group, an administrator of self-directed IRAs, knows from his own experience how important it is to maintain adequate reserves.

"I have two Florida houses in my IRA and I was getting \$1,300 a month on each of the properties; I had a slight positive cash flow," he says. "But then both tenants moved out, and in Florida the real estate tax rates almost doubled, so I got a double whammy. My slight positive went negative because, when the tenants moved out, I still had to pay the mortgages. Fortunately, I had \$10,000 extra in each account to pay for that eventuality which came to pass."

While Bromma is prepared for the downside of real estate investing, he cautions that many people aren't, and they should think twice about risking their retirement fund.

"A lot of people have gotten into real estate and thought they couldn't lose because the real estate market will go up forever. They bought property thinking it would appreciate, and a year later it's upside down and they have a real problem. It's not like buying a stock and thinking it will go up. You probably have more confidence in publicly traded assets and having an adviser who can say this company has a good track record, here's its performance, etc."

Not everyone thinks self-directed IRAs are a great venue for buying real estate. "I tell people to not use third parties in any real estate transaction," says real estate expert Lucier, who is firmly opposed to the concept. "You're going to get your best deal dealing directly with sellers and buyers without a middleman. (The custodian and property manager) are unnecessary layers that are stripping away money that should be coming to you. It's going to kill any positive cash flow in a lot of cases."

#### **High-risk investment**

As with any investment, consumers should know how much risk they're willing to tolerate and whether they have the financial wherewithal to withstand any market downturns and the possible loss of their money. This may be especially critical when using a retirement fund. Some people may be better off limiting their real estate purchases to real estate investment trusts, or REITs, or mutual funds that specialize in real estate.

Even if you plan to use someone to help you find properties, it's best to educate yourself about the various real estate markets that interest you. You should also speak with an IRA custodian to understand which types of transactions are allowed and which are prohibited.

If you're going it alone, Rice advises that in addition to a custodian, you should have a financial planner who will help you set goals; a real estate broker who will find properties; an attorney who will draw up leases, purchase contracts and the like; an accountant who can review all the numbers, and a title company.

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