Commercial Mortgage Insight®

Reprinted with permission from the October 2003 issue

Use Little-Known Retirement Accounts As A Source For Private Investor Capital

The self-directed IRA can be a tool to attract investors to mortgages and mortgage pools, as well as real estate.

BY MICHAEL P. SCOTT

As everyone knows, the rule of thumb is to diversify your retirement investment portfolio to spread out the risk, but how can you wisely diversify your portfolio when almost every publicly traded investment has suffered losses?

Despite recent stock market uncertainties, a declining economy and an equally murky economic future, at the end of 2002 most of the nearly $3 trillion in IRA assets in the United States were invested in publicly traded stocks, bonds and mutual funds. However, a little-known Internal Revenue Code regulation allows individuals to invest their IRA or 401(k) funds rolled into a self-directed IRA into a wide variety of nontraditional assets, which often have a higher rate of return than traditional investments.

Michael P. Scott

You may be asking yourself, "what has this got to do with me?" The answer is simple: private investor capital. As a mortgage banker, broker or hard-money lender, you know how important it is to raise private investor capital to fund your mortgages and mortgage pools. Private investor capital is the key to maximizing profitability on a deal, since it usually can be secured at a lower cost than traditional institutional funding sources.

As the stock market continues to struggle and the economy continues to sputter, more and more Americans are pulling out of traditional investments such as stocks and bank CDs, and are aggressively seeking alternative investments to get their retirement savings back on track. These IRS-permitted alternative assets include mortgages and trust deeds, mortgage pools, as well as real property, including vacation rental properties, multifamily units, commercial property and even raw land.

Retirement funds can also be invested in shares of limited partnerships and limited liability corporations. Rolling current retirement funds from an existing IRA or 401(k) account into a self-directed IRA to do this type of investing is penalty-free. Additionally, the taxes due on the growth of the investments are deferred until distribution begins at retirement. If a self-directed Roth IRA is involved, the principal and earnings are *tax-free* when distributed at retirement.

Are you still wondering how all of this affects you and your mortgage company? Here is an example of how investing self-directed IRA funds in a mortgage pool benefits both the IRA owner and the mortgage company.

The tool in practice

Bob has an old 401(k) from a previous employer and an IRA account that are each invested in publicly traded stocks and mutual funds. Over the past couple years, he has seen his once healthy retirement nest egg dwindle down to less than half of its original value. Bob is too close to retirement age to be able to wait for the next market upswing.

He finds out from his CPA that there is a wide variety of nontraditional assets in which he can invest his IRA funds. One that piques Bob's interest is mortgages and mortgage pools. Bob's best friend Marty owns a mortgage company that is always looking to raise private investor capital to fund its mortgages.

Bob contacts Marty and tells him what he's learned about alternative asset investing. This interests Marty, as lately his company has had difficulty finding new sources of private investor capital. Marty contacts a self-directed IRA custodian and learns that his mortgage pool is a qualified IRA investment. Marty's company then begins a mass marketing campaign to let both current and potential investors know that they can invest their IRA funds in his mortgage pool, penalty-free and tax-deferred. His mortgage pool will pay a guaranteed return, which is considerably better than what most investors are receiving in the stock and bond markets.

Shortly after the marketing cam-

Michael P. Scott is vice president of East Coast Operations for PENSCO Trust Company, a licensed self-directed IRA administrator. He can be reached at (866) 818-4472 on the East Coast or at penscotrust@mindspring.com.

paign kicks off, Marty's company starts getting calls from interested individuals who want to get their retirement savings back on track. It's a win-win situation for everyone involved. Marty's company has a new revenue stream - retirement funds that individuals are investing in his mortgage pool within self-directed IRAs. His investors, including his old friend Bob, are thrilled with the rate of return they will be earning on their retirement investments.

The process of investing in private notes like mortgages is a simple one. You identify your investors, both current and potential, explain the opportunity to invest retirement funds in your mortgages and mortgage pools. Interested investors contact a qualified self-directed IRA custodian to receive an application. The investor opens a self-directed IRA and instructs their current IRA or 401(k) custodian to roll their retirement funds into their new self-directed IRA.

In the meantime, you will probably be asked by the self-directed IRA custodian to submit paperwork on your private mortgages or mortgage pool to them for review and acceptance. You should consult with a legal or financial professional for guidance in setting up the investment vehicle. Also, as securities laws vary from state to state, you should consult with your state's securities regulators on the legality of your investment offering.

Once your investment is reviewed and accepted by the self-directed IRA custodian, it is available for IRA investments. Your investors can then direct the custodian to invest their self-directed IRA funds in your mortgage notes or mortgage pools.

A little-known vehicle

If it's so easy and potentially lucrative, why aren't the vast majority of Americans and their financial advisors aware of the use of self-directed IRAs? The reason is due primarily to the lack of knowledge on the subject as there are, literally, only a handful of financial service firms in the nation willing and able to provide the required custodial and administrative services.

Typically, institutions licensed to administer IRA accounts, such as banks, credit unions, trust companies or savings and loan institutions, are not willing to undertake the extensive paperwork, manual processing and IRS-reporting required to administer nontraditional assets within IRA accounts.

Others, however, such as broker-dealers and mutual fund companies, have to be separately licensed by the Employee Plans Division of the IRS and restrict their IRA clients to a limited set of investments.

They do so for several reasons. First, if they offer investment advice, sell

investment product, or have discretion over the management of investment assets, they will be concerned about the liability associated with the purchase and/or administration of any nontraditional investment.

Second, their specific structure or license may restrict them from certain types of investments.

Third, they may not be organized to profit from any investment other than their own proprietary investments (e.g., mutual fund companies). Consequently, the vast majority of institutions offering IRA servicing do not promote the fact that clients can legally choose from a variety of investment options for their IRAs.

Since most financial providers don't allow their clients to diversify their IRA holdings, how can a potential investor take advantage of the regulations? It's simple - they must establish a truly self-directed IRA with an institution that offers them, *and* which does not restrict the choice of investment.

For example, many large discount brokerage firms claim to offer clients "self-directed" IRAs. But in fact, they are only self-directed in the sense that clients make the investment decisions and choices independently, in other words, without advice or discretion from the provider. All of these institutions still restrict the "type" of investment to publicly traded investments.

True self-directed IRA custodians allow clients to select from virtually any type of investment. Investments such as private notes, real estate, annuities, structured settlements, car paper and commercial leases, are possible choices for clients of firms that are truly self-directed. While clients can still include traditional investments such as stocks and mutual funds within their self-directed IRA, they also have the freedom to diversify their portfolio by adding a nontraditional asset like a mortgage or piece of real estate.

Such institutions serve as a vital source of funds to those managing investment pools by assisting individuals, including "angel" investors, who diversify their portfolios by investing some of their retirement funds in these types of assets. In many cases, these investors have large sums of money accumulated in their retirement accounts, which they can now put to work in nontraditional investments through the services of a qualified self-directed IRA institution.

Now that you know that individuals can legally invest in mortgages and real estate of all types through their IRAs, you may be looking for the "catch." Of course, there are a few prohibitions surrounding specific transactions.

Some limitations

For example, if an individual buys property for investment, he can't make personal use of it until it is distributed from his IRA upon retirement, and individuals can't lend money on a trust deed to a lineal ascendant or descendant and certain other disqualified parties. But, in general, if IRA owners treat real estate and mortgages strictly as an investment, they have no trouble with the IRS.

Since you know real estate and mortgages are acceptable within an IRA, you can include IRAs as an element in marketing programs soliciting individual investors. If your mortgage company is seeking to raise additional private investor capital, you'll be in a position to tap the more than $3 trillion in available IRA funds. You may be surprised at how many people will be interested, especially in these troubled times. ●