

REALTOR[®]

MAGAZINE ONLINE

This article was published on: 09/01/2003

Retirement Planning

Buy Real Estate in Your IRA

A little-known IRS provision lets you extend your real estate purchasing with tax-deferred dollars.

BY KELLI L. CLICK

Are stock market woes preventing you from building wealth in your retirement account? If so, you might be interested in a small, but growing, trend among individual retirement account owners—investing their retirement funds in real estate.

How It Works

If the option of using tax-deferred funds to purchase property sounds appealing, you'll need to locate an independent IRA custodian that allows real estate investments and work with that company to set up an IRA account. Most banks and brokerage companies—the most common IRA account options—limit your choices to certificates of deposit, stocks, mutual funds, annuities, and similar financial instruments. But Section 408 of the Internal Revenue Code permits individuals to purchase land, commercial property, condominiums, residential property, trust deeds, or real estate contracts with funds held in many common forms of IRAs, including a [traditional IRA](#), a [Roth IRA](#), and a Simplified Employee Pension plan, or [SEP-IRA](#).

To find a custodian that specializes in real estate, search under terms such as “real estate IRA” or “self-directed IRA.” This latter term was coined by the financial industry in the 1980s to distinguish the self-directed IRA from other IRAs that focus on stocks and bonds. The IRA account holder can't serve as the custodian of his or her own account. However, it's important to select a custodian knowledgeable about the types of investment you're interested in, because the custodian holds title to the real estate. Do your homework, and understand what you're getting into.

Fees can vary widely among custodians, as can the flexibility of the services provided for account holders. If the custodian holds real estate on your behalf, but does not service it (collect the rent, etc.), you may have to contract with other providers. However, be sure that all rents are paid into the IRA and that all taxes are paid by the IRA.

Purchasing the Property

Most IRA custodians that hold real estate will usually allow you to purchase raw or vacant land, residential properties, or commercial buildings for your portfolio. In addition, some custodians may permit foreign property or leveraged property.

Since buying a property may require more funds than you currently have available in your IRA, you also can have your IRA purchase an interest in the property in conjunction with other individuals, such as a spouse, business associate, or friend. Also keep in mind that if the property is leveraged, the debt must be a non-recourse promissory note.

Unfortunately, Internal Revenue Service regulations will not let you use the real estate owned by your IRA as your residence or vacation home. Nor can your business lease space in your IRA-held property. The underlying premise for any real estate investment purchased with IRA funds is that you can't 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 IRS limitations as well. You cannot place a real estate property that you already own into your IRA. Your spouse, your parents, or your children also couldn't have owned the property before it was purchased by your IRA. Property owned by siblings may be allowed, since the Internal Revenue Code (section 4975) specifies that only "lineal descendants" be disqualified.

Once you've chosen a property, your IRA custodian—not you personally—must actually purchase it. The title will reflect the name of your IRA custodian for your benefit (such as Silver Trust Co., Custodian FBO John Doe IRA). In addition, if you put up earnest money with your personal funds, you'll need to make sure you include that amount in the total due so that the title company can reimburse you upon closing.

Operating an IRA-held Property

Because all property expenses, including taxes, insurance, and repairs, must be paid from funds in your IRA, you'll need liquid funds available in your account. Of course, all income generated from the property will be deposited in your IRA account so you can use that money to cover your costs. You also can make annual contributions within federal guidelines.

Currently, you can contribute \$3,000 annually to a traditional or Roth IRA (\$3,500 if you're age 50 or older) and as much as 15 percent of your annual compensation, up to \$40,000, if you're a self-employed individual with a SEP-IRA. If your account doesn't have funds to cover property expenses, you will have to withdraw the property from your IRA and pay taxes on the value of the property, as well as possible penalties for early withdrawal.

It's also possible to sell properties while they are held by your IRA, so long as the purchaser is not a family member. Once a deal closes, your IRA account now holds the cash proceeds—ready for you to make your next investment. An alternative is to sell an IRA-held property with seller financing so that all payments made by the buyers are paid to the IRA.

Distributing Your Property

You can withdraw real estate from your IRA and use it as a residence or second home when you reach

retirement age (age 59½ or older for a penalty-free withdrawal). At that time, you can elect either to have the IRA sell the property or take an in-kind distribution of the property. Under that arrangement, your IRA custodian assigns the title to the property to you. You will then have to pay income taxes on the current value of the property if it's been held in a traditional IRA. If the property was held in a Roth IRA, you won't owe taxes at distribution. This makes a Roth IRA extremely attractive if you anticipate that your real estate investments will appreciate over time.

Whether your retirement strategy is to hold properties or buy and sell for gain, real estate investing through your IRA can yield extraordinary returns toward your future retirement.

IRA Options

While any form of IRA allows for real estate investment, there are other pluses and minuses to consider when choosing the account type that's best for you:

- A **traditional IRA** lets you deduct annual contributions (currently set at \$3,000, or \$3,500 if you're age 50 or older) from your income. However, once you begin withdrawing money, those funds will be taxed as regular income.
- A **Roth IRA** gives you no deduction on your current contributions (again \$3,000), but does allow you to withdraw funds tax-free. If you expect to buy a real estate investment in an IRA and hold it for a long period, this is probably your best option, particularly if the property increases in value over that period.
- A **SEP-IRA** is designed for self-employed individuals and small companies. You can contribute up to 25 percent of your compensation, or \$40,000, whichever is less. However, keep in mind that if you have employees, you must make contributions for them as well. This option is a great alternative for real estate practitioners who can make the higher contributions because they can build up funds more rapidly to purchase properties. Withdrawals from a SEP-IRA are treated like those of a traditional IRA for tax purposes.

Kelli L. Click is vice president of sales and marketing at Sterling Trust Co., a self-directed IRA and 401(k) custodian, in Waco, Texas. She can be reached at 800/955-3434, ext. 250.



[Make REALTOR® Magazine Online Your Homepage](#)

[Bookmark This Page](#)

[Home](#) [About Us](#) [Contact Us](#) [Privacy Policy](#) [Advertise With Us](#)

[REALTOR.org Home](#)

© Copyright, 2006, by the NATIONAL ASSOCIATION OF REALTORS®