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IRA Holders Add Real Estate To Their Mix

*'Self-Directed' IRAs Give
Investors More Options,
But They Can Be Tricky*

By BRIAN J. O'CONNOR

Special to THE WALL STREET JOURNAL
Weary of being whipsawed by the stock market, a small but growing number of IRA holders are turning to some untraditional investments: They are buying real estate with their individual retirement accounts.

IRAs run by banks and financial-services firms are generally limited to the traditional stocks, bonds and mutual funds, but investors who open so-called self-directed IRAs can choose their own investments, which can include not just real estate but things such as business loans and plane leases. Certain investments are prohibited by Congress, among them alcohol, artwork and antiques. Bowling alleys and apartment buildings are fine.

For investors who feel the stock market is no place to put their nest egg right now, these options can be appealing. And as with stocks, bonds or certificates of deposit, income from the investments stays in the account tax-deferred until it is withdrawn as IRA distributions in retirement. (And it is tax-free if the account is a Roth.)

But making unusual IRA investments such as real estate can be tricky. The investment must be an "arms-length" transaction, meaning the account holder or certain family members and associates can't live in a property, or be involved in an investment, that is held by an IRA.

Other challenges include making sure the account has enough of a cash cushion to handle emergencies and cover mandatory distributions when you reach age 70½. Violating these and other rules can result in the entire IRA being declared invalid by the Internal Revenue Service, subjecting the investor to taxes and penalties.

There are ways to manage these difficulties, but only the most experienced investor should tackle unusual IRA investments such as real estate without help.

"It is not something you would recommend to someone who's not already doing it," says Richard Desich Jr. of Mid Ohio Securities Co., an IRA custodial firm. "Our clients are people who understand real estate from the get-go and understand that this is just applying it to their IRAs."

The number of IRA investors opting for real estate is still small: According to one IRA expert, out of approximately 35

Help for That 'Self-Directed' IRA

Anyone looking to invest in real estate in an individual retirement account must set up a self-directed IRA. Here are some types of firms that can provide assistance:

	HAND-HOLDING	WHAT THEY DO	FEES
Independent IRA Custodians	None	Act as trustees for an IRA account, handling the money going in and out. But you're on your own in choosing and managing the investments and doing the paperwork.	At one sample firm, set-up fees are \$50, with annual fees ranging from \$200 to \$400.
Independent IRA Administrators	Some	Handle all transactions on the account, working with their own custodians—paying bills, collecting rents and other record-keeping. But you find the properties and make the deals.	\$200 to \$500 a year, depending on the size and complexity of the account.
IRA Advisers	Plenty	Find investments and, working with IRA administrators, handle all aspects of the deals.	One sample firm charges \$1,500* for setting up an account and handling the first transaction. Annual fees to the IRA administrator are additional.

*Fee waived if adviser gets commission on sale

million U.S. households with IRAs, only 2% hold any real estate. And a big reason for that is that most people aren't aware IRAs can invest in things like real estate.

"There have been articles written where people said it was illegal," says Hubert Bromma, president of Entrust Administration of Oakland, Calif., one of about a dozen independent IRA administrators in the country, which help investors set up and handle self-directed IRAs.

But it is being done more and more, say IRA experts. Bruce Hughes, an investment adviser in Punta Gorda, Fla., has bought two waterfront properties with \$50,000 in a self-directed IRA he opened in October. "I'm in an area in Southwest Florida where building lots on the water are doubling every year just about," says Mr. Hughes.

Investors who want to build a self-directed IRA can start by finding an independent IRA administrator, who for a fee will set up the account and handle all transactions such as collecting rents and paying bills. The account can be either a traditional IRA, or a Roth if the investor has \$100,000 or less in adjusted gross income.

Other options include hiring an IRA adviser, such as IRA Resource Associates of Camas, Wash., which work with IRA administrators. The adviser will find investments and make deals. Both IRA administrators and advisers work with independent IRA custodians, which act as trustees for the account. Investors who need less hand-holding can set up an account directly with a custodian, such as Mid Ohio, based in Elyria, Ohio. But you are on your own to choose investments, manage the properties and handle paperwork.

Unprepared investors could find themselves running into headaches. For one thing, any leveraged property in an IRA can trigger the Unrelated Business Income Tax. When mortgaged investments post a profit of over \$1,000 in any year,

the gain beyond \$1,000 is taxed at anywhere from 15% to nearly 40%, depending on the amount of the investment that is leveraged. IRA investors can get around the tax by applying excess profit to the loan principal. Once the loan is paid, the Unrelated Business Tax no longer applies to any profit, and if the property is held for an additional 12 months in the IRA, eventual sale profits won't be subject to the tax, either.

Another potentially costly situation is when the investor must begin taking mandatory distributions. If there is no cash in the account to start taking withdrawals by the deadline (April 1 following the year you reach 70½), the IRS slaps the account with a 50% penalty on the amount of the minimum distribution.

Also, the account must have enough cash to not just purchase a property, but also to operate it if rental income isn't sufficient; you can't fund the property out of your own pocket. If you have reached your maximum \$3,000 contribution for the year (or \$3,500 if you are older than 50), you'll pay a 6% penalty on any additional money you put in to, say, repair a flooded basement.

There are ways to generate cash in an account to cover distributions or expenses on an investment, says Mr. Bromma. Among the simplest are to refinance a property if it is still leveraged, or roll in money from another IRA, Keogh, 401(k) or other qualified retirement plan. And, of course, the investor could sell the property.

A more critical issue is making sure that the property remains strictly an investment by avoiding any self-dealing or prohibited transactions with family members or other disqualified persons (which can include business associates).

The penalty is stiff—anywhere from 15% to 155% of the account value, says Mr. Bromma—but it still happens three or four times a year at his firm.

Inside

A Land Grab for Your IRA

Some individual retirement accounts can invest in housing—to many, an appealing alternative to stocks—but beware of rules covering tenancy and requiring a sufficient cushion of cash in the account.

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