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Using Real Estate to Build Your Retirement Portfolio

By Marla Brill - From MarketWatch

Four years ago, Vincent McCord was approached by a developer about investing in the construction of a Las Vegas shopping center. He liked the project and wanted to diversify his portfolio beyond stocks, bonds, and mutual funds. But the bulk of his investment assets were in an individual retirement account at a firm that, like most custodians, does not permit real estate other than publicly-traded real estate investment trusts or mutual funds that invest in them. At his accountant's suggestion McCord contacted a custodial firm that specializes in establishing and administering "self-directed" IRAs that typically allow real estate and other non-traditional investments. Since then, the 60-year-old technology company chief financial officer has earmarked IRA money for three other real estate development projects and is scouting out a fourth. "It's a great way to diversify and go beyond what a traditional IRA allows," McCord said.

By law, IRAs cannot hold certain assets including life insurance and collectibles such as art, antiques, gems, coins, and most precious metals. Because there is no approved list of investments for IRAs, many view the rest of the investment universe as fair game. Stories of people using IRA money to purchase everything from thoroughbred horses to football season tickets have long circulated in financial-services industry circles, although more typical self-directed IRA fare might include interest in private equity partnerships or commodity pools.

For many people, real estate is the alternative investment of choice, according to Tom Anderson, president of PENSCO Trust, a custodial firm specializing in self-directed IRAs. "The slowdown in the real estate market really hasn't affected our business because we're talking about investment properties versus personal residences, and people are taking advantage of down market opportunities," he said.

New accounts come mainly through referrals from existing account holders, as well as financial advisers whose clients are demanding broader diversification. The investment may take a number of forms, including land, commercial property, or a rental condominium. It may also involve a debt-related transaction, such as a short-term secured loan to a developer in need of cash.

Laying a foundation

Anderson and other experts caution that while investing in real estate is permitted in an IRA, such transactions involve complex Internal Revenue Service rules and violating them could lead to substantial taxes and penalties.

Chief among them: an IRA cannot do business with a disqualified person, such as the individual IRA owner, a spouse, parent, children, or grandchildren. The entire venture, including management of the property, must run as an arms-length transaction. Because an IRA cannot purchase real estate and then have a disqualified person use it while it is in the account, residences and vacation homes the owner or his family occupies are off the table. Even if a vacation home is rented out most of the time, the investment could be considered a prohibited transaction if the owner uses it even occasionally while it's in the IRA.

Watch out for other rules and pitfalls. You can't invest in property you already own. Rental income must flow back into the IRA, and the IRA must pay for all expenses associated with the property. The IRA will pay tax on unrelated debt financed income (UDFI), which is the income and/or capital gains attributable to the leveraged portion. For that reason, Anderson says, carrying debt in a real estate investment transaction is a bad idea if there's any significant risk that the IRA will be unable to pay the mortgage payments.

Open door

The safest route for IRA owners is to act as passive investors in projects run by third parties. The investment deals that McCord has participated in, for example, were organized by developers in need of cash.

Charles Kissee, president of Securus Financial Services in Eagle, Idaho, says some of his clients invest in rental property they eventually use themselves after they remove it from the IRA at retirement. Their IRA may also act as a lender in real-estate secured loans to builders and other borrowers.

"I think there is a lack of understanding about these kinds of transactions," Kissee said. "It's really a question of digging in and understanding them."

Accountant Ed Slott, founder of the IRAhelp.com Web site, says a hands-off approach is critical to avoid even the appearance of self-dealing.

"The kinds of people attracted to these transactions are often contractors and do-it-yourselfers," he said. "The problem is that if they perform any of the labor themselves for a property purchased with IRA money it constitutes a prohibited transaction. They need to hire outside third parties to do the work."

Slott offers several suggestions to those considering using IRA money for real estate:

1. Set up a separate IRA for real estate investments. Even if only a small portion of the IRA is used for real estate, he noted, the IRS could penalize the entire balance in a prohibited transaction.

2. Check the investment scenario with custodians and other professionals who have experience in these transactions and can spot red flags.

3. Use money outside an IRA if it's available, since tax benefits such as depreciation and the ability to deduct losses are lost in an IRA environment.

4. If you must use an IRA, a Roth IRA is preferable. The money in the Roth has already been taxed and any distributions, including capital gains on the property, are generally tax-free.