

Ira's and Investment Properties

Sometimes the best way to show how something can work is in practice...



Some time ago, Mike, a long time client left me a message. He was upset and at the end of his rope. Mike went to Mass Maritime Academy, graduated as an engineer, and has sailed ever since. He's in a union, put in his high 3, and plans on continuing to sail until he's 59 or so. He's married with two kids. His son is about to graduate from college and his daughter is a sophomore at a university in Boston. His

wife Stacy is a nurse at one of the Boston area hospitals. They're a great couple, whom I consider good friends before clients. They've done all the right things. They bought a house, paid their taxes, saved for retirement, and put their family first.

Mike had met Stacy at a friends' house on Moosehead Lake in Maine many years ago. The two made sure to take a couple weeks every year, rent a house, and vacation on the lake that had brought them together. They had decided that when they retired, they would build a house on the lake, get a bass boat, and grow old gracefully.

As the years passed, the two began to look at property on the lake more seriously. Last year they found it. It was a waterfront lot in a great area, priced right at \$56,000. They could buy the lot and sit on it until they were ready to build.

This is when I received a call. It turned out that Mike and Stacy were stretched thin. They made too much for the kids to qualify for financial aid and too little that it didn't affect their finances. They were stuck smack dab in the middle class experiencing the full force of the marriage penalty. They had already taken out equity on their house to put the kids through school, and there was more to come as their daughter had several years to go. Barring some very pricey financing, they couldn't buy the property.

Mike called and asked me what the tax effect would be to pull \$56,000 out of retirement to buy this property. Turned out in Mike's case, a \$56,000 early distribution would result in about \$26,000 in taxes between the IRS and the State! Mike was angry. He explained how this property is perfect, it won't be around for ever, and they just want to sit on it to lock in zoning regulations so they can build down the road. Mike said, "It doesn't make sense that we've put all this money away for retirement, but we can't use it for that reason." "Why don't you buy the property with the IRA?" I asked. Silence.

The Self Directed IRA-

Mike thought I was pulling his leg. “How can you do that? I’ve never heard of that before.” He said. “Well, it isn’t for everyone, and most IRA custodians don’t deal with individual real estate transactions, so they wouldn’t benefit from advertising or promoting these transactions. It’s a little tricky, but if you follow the rules, it’s doable.”

The bottom line is Mike’s Roth IRA is now the owner of the investment property he and Stacy had wanted. The IRA holds and manages the property through Mike’s self-directed IRA. They plan on taking the property as a distribution when Mike reaches retirement age. The distribution will be tax free. That’s tax planning!

The Process -

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 IRA’s. Other investments include franchises, private equity, boat slips, racehorses, fishing rights, agriculture, etc... One type of investment that is becoming more popular using an IRA is making home loans. The Wall Street Journal Online published an interesting article on this topic http://online.wsj.com/article/SB118946839813823189.html?mod=googlenews_wsj Some people are taking advantage of foreclosures by having their IRA effectively be the bank. There are always risks involved, but for some this is an appealing option.

What’s the catch? Several. First, you and your linear decedents (at a minimum) can not have active participation in these transactions. If you think your IRA is going to buy a property that you’ll personally fix up and flip, it isn’t happening. You cannot commit sweat labor or personal funds into your IRA assets. If you purchased a rental property, your IRA would be making repairs and receiving rent. You cannot personally be involved. In order to use the property, you have to distribute it out of your IRA. And no, you can’t sell it out of the IRA to yourself. Also remember that IRA’s are subject to required minimum distributions RMD’s, meaning at a certain age you are required to distribute a portion of your IRA. This can be tricky if your money is tied up in property.

Properties expected to appreciate would most likely be better off in a Roth venue. Putting an appreciating property into a Standard IRA will trigger a taxable event if it is distributed.

What if you think this is for you? First, you need to find an established IRA custodian who allows self-directed IRA’s and the investments you’re considering. Second, understand all of the restrictions and rules involved. This article is an intro and in no way explains the whole process. There are pitfalls associated with these transactions that should be weighed carefully before proceeding.

Just remember, it is sometimes a tax planning option...