

Your Retirement  
By Ellen Hoffman

### **Hatching Property from Your Nest Egg**

Here's a way to invest in real estate through your IRA that few know about. But beware -- it takes some planning to reap the tax savings. After seeing so much wealth disappear in the stock market over the last few years, many people are looking at real estate as an investment alternative. Of course, the value can go up or down, but at least there's a solid, tangible asset, the thinking goes. A little-known option for investing in real estate is to do it through your individual retirement account (IRA).

"I personally wish I had never gotten involved in the stock market. I have taken some loss, and what's worse, I have not taken the growth," says Jim Maxwell, a Ridgefield (Wash.) "qualified intermediary" whose business is facilitating tax-favored real-estate deals. His solution: Using some of his IRA nest egg to buy a 5-acre tract of land that he's pretty confident will appreciate in value.

When he sells the land, Maxwell can keep the proceeds in his IRA -- without paying capital-gains taxes -- and invest them in the stock market or any other instrument he chooses. Maxwell has been in the real estate business for 20 years and has been doing tax-favored deals since 1990.

**LOOKING FOR OPTIONS.** Real-estate pros aren't the only ones doing this. Says Maxwell: "In our business, we're seeing a lot of people going to cash [in their IRAs]. They've sold their stocks and don't feel secure. They're casting about, wondering what to do with the cash."

For people who have been accumulating assets for years in an IRA or have rolled a 401(k) into an IRA after changing jobs or retiring, using IRA money to invest in real estate may make sense. Many people don't even realize it's an option. There's confusion because "you can't put anything but cash [directly] into an IRA," warns IRS spokesman Don Roberts. "But once you have the cash in, if the IRA trustee is willing, there's no prohibition on purchasing investment property with that cash."

Hugh Bromma is the CEO of Entrust Administration, an Oakland (Calif.) company that serves as a custodian for IRA accounts containing real estate. He says the big advantage of the property strategy is that instead of paying capital-gains taxes of up to 28% on profits of a sale outside an IRA, you can keep the

money in the account and either postpone or totally avoid paying taxes on the gains.

**TREAD CAREFULLY.** The tax is postponed if you sell the property after turning 59 1/2 and after retiring, when your income and tax bracket will probably be lower. You pay ordinary income tax on IRA withdrawals. Even better, you totally avoid the tax if you buy the real estate in a Roth IRA and hold it for at least five years. (See IRS Publication 590, Individual Retirement Arrangements, for the rules on all types of IRAs.)

This plan has potential pitfalls. First, there's no guarantee that real estate will be more profitable than any other type of investment -- or profitable at all. You'll have to make an educated judgment about the risks and potential profit. Also, if you don't plan the financial side of an IRA real estate deal carefully, you could get into expensive trouble with the IRS.

To protect yourself, you'll need to understand the how-to's and some of the major caveats. Following is some basic information that could help you decide if this is something you want to pursue.

**ATTORNEY REQUIRED.** You can use a real estate company such as IRA Resource, based in Camas, Wash., to find an investment property or locate one yourself. The property must be held in a "self-directed IRA," a special type of account that's probably not offered by your local bank or brokerage house. To find a custodian, search on "self-directed IRA" at Google or another major search engine.

As with any other real estate purchase, you'll also need an attorney to consummate it. The attorney will submit required purchase documents to your IRA custodian, which will sign and process them based on your authorized instructions.

If you buy rental property, you'll need a manager to collect the rent, make repairs, and oversee it. Rent will be paid to the IRA, and costs for repairs and maintenance will be paid by the IRA. For a demonstration of how this whole process can work, visit the Entrust Web site.

**POSSIBLE PITFALLS.** The IRS does not allow you to buy your residence in your IRA. To qualify, the purchased property may not be owned by your parents or children, or their spouses -- any immediate family. However, you could buy a house now with the intention of living in it in the future, says Debra Greenstein, president of Entrust Administration, but "buying" your property back from the IRA requires approval from the Labor Dept., which she says currently charges a

\$3,500 processing fee, and it will be treated as an IRA distribution and taxed accordingly.

If you have the property in a traditional IRA and sell it when you're 59 1/2 and older, you'll pay income tax on it. If you sell it before you're 59 1/2, you must pay a 10% penalty in addition to the income tax. Of course, just paying income tax on the full value of a house could be a steep expense, so if you can, having the property in a Roth IRA is much better for your wallet.

Another tricky issue is keeping enough cash in your IRA to pay for costs such as management, insurance, taxes, and a mortgage if you have one. If you contribute more than the annual limit -- in 2002, \$3,000 for most people and \$3,500 for people age 50 or older -- to pay the bills coming to the account, the IRS will impose a 6% penalty on your excess contribution.

And Entrust's Bromma also cautions that unless you plan the purchase and sale carefully, you could end up being hit with the "unrelated business income tax" of 39.6%.

**HIGHER FEES.** Another wrinkle can occur when you turn 70 1/2 and the IRS requires you to start withdrawing certain minimum amounts of money, known as IRA distributions. The amount of the distribution depends on your age and your IRA's total assets: cash, stock, property (the fair market value), etc. If your account lacks the cash to meet the IRS requirement, you'll have to sell the property -- even if the market happens to be down. This problem can largely be avoided with careful planning and the advice of a tax expert.

Finally, because most of the work on this type of investment must be done by other people, expect to pay more fees than you would for either a traditional real estate transaction or other investment. QUADS, a retirement-account company in Frederick, Md., charges \$25 to set up a self-directed IRA, \$250 per year for the first asset in the account, and \$125 for each additional asset.

Entrust charges \$50 to set up an account and a record-keeping fee starting at \$100 that rises to \$1,510 per year for accounts worth \$300,000 or more. You'll also pay \$100 per hour for "special services," such as working with your attorney or broker on a purchase.

**"PHENOMENAL GROWTH."** Buying a piece of land as Maxwell did, or buying other types of property investments, such as a share of a limited real estate partnership, may not require property management. But if you buy residential or commercial real estate, you'll be paying a monthly management fee -- 10% of the

rent is common for residential property -- and perhaps leasing and other fees as well.

The IRA real estate strategy is definitely not for investors who want or need to keep an IRA liquid, don't understand real estate transactions, or don't want to worry about conforming to complex tax rules. But Patrick W. Rice, president of IRA Resource Associates, says as long as the stock market continues to wobble, he expects the "phenomenal growth" of interest in IRA real estate investments that he has seen in the last couple of years to continue.

Hoffman writes Your Retirement monthly for BusinessWeek Online. She's the author of The Retirement Catch-Up Guide and you can contact her through her Web site, [retirementcatchup.com](http://retirementcatchup.com)