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By Phoebe Chongchua

How IRAs buy real estate

A small but growing number of people are using their retirement funds to invest in commercial real estate in hopes of turning a bigger profit.

While many are becoming aware of using IRAs to invest in residential real estate, investing in commercial properties seems to be utilized by a select few. And many more only think of an IRA as being associated with stocks, bonds and mutual funds.

Investing in everything from single family homes to raw land to commercial buildings is permitted with certain IRAs, provided that the real estate is not being used for your own personal use such as a vacation home or an office for your business.

But getting started in this process can seem a bit overwhelming.

Larry Dalton, 44, recently consolidated his 401(k) and various IRAs to what's known as a self-directed IRA. Using a company called Asset Exchange Strategies LLC Dalton created a limited liability corporation.

According to Daniel Cordoba, principal of Asset Exchange Strategies and a certified estate advisor in Texas, there are four basic benefits to doing this.

“First we give them transaction control. That means that they don't have to go ask a custodian to write a check for them every time they need some funds. Second, they don't have to ask the custodian for permission to buy a particular asset, as long as it's not a prohibited transaction,” Cordoba explained. “The third thing that the LLC provides for them is litigation protection,” he said.

“The fourth item ... is that we have built relationships with these custodians and offer the lowest custodial fees available.”

Cordoba said the custodial fee is typically less than \$190 per year to hold the asset. However, there is a one-time cost ranging from \$1,900 to \$3,000 to set up the LLC. The costs can be paid for with your IRA funds.

“So you don't really want to do this unless you have a good amount of money to invest,” Dalton said.

“If you don’t have that much to invest, I would say it’s really too expensive to do that because obviously you have the up-front costs. My advice would be to have \$50,000 or more to invest and once you have that amount of money, these costs, going long term, can be more than made up with the additional returns you get from investing directly in real estate.”

If you’re considering this option for your IRA, here are a few questions and answers that you should be aware of before beginning. For more details, visit www.myrealestateira.com.

Is financing real estate inside an IRA more complex?

“It’s a myth that it makes it more complex. If you use the IRA LLC, it makes it no different from any other transaction. The steps are the same. The property is titled in the IRA LLC. However, there are more things to think about if you need to also get a loan,” Cordoba said.

“You go about getting the loan, but you can’t use the credit of the individual. You can only use the credit of the IRA and that gives rise to some unfavorable tax situations (unrelated business tax). If there is income, you may have to pay taxes on the part of the income that is financed by debt,” said Bill Leighton, an attorney who is board certified in tax law and estate planning in Texas.

“It is always best if you can buy the property outright with the IRA. If you get a loan, you should get a nonrecourse loan (that is the next best situation). There is the chance of incurring unrelated business tax. [People] need to determine, with their tax advisor, if this is the appropriate structure to debt finance,” Cordoba said.

Can you write off interest and depreciation on your real estate investment?

“You cannot write off interest and depreciation. Instead, you are getting your tax break up front,” Cordoba said. “Basically, the LLC and the IRA is a tax-exempt entity, and so there is no depreciation deduction,” Leighton explained.

Can you invest with several people to purchase a property?

“Yes. We’ll create two entities. We’ll create what we call a purchasing entity,” Cordoba said. “And then we’ll have several IRA LLCs underneath that purchasing entity.”