EXECUTIVE LEGAL & ACCOUNTING GUIDE

IRAs/REAL ESTATE

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Why not real estate in your IRA?

So how are you feeling about the performance of your IRA accounts these days? As I write this article in early June of 2008, (the Dow just fell another couple hundred points today) my sense is that many people are growing increasingly discouraged with the lackluster long-term performance of their retirement assets. This feeling is sometimes compounded by a sense of insecurity because the assets in these plans are nearly always intangible – pieces of paper representing equity or debt investments in large, far away entities. The high level of volatility present in today's stock market and the seeming randomness of its day-to-day movements make many people feel as though investing in stocks is no different from gambling. In addition, with interest rates on cash and bonds falling to near historic lows, these conventional alternatives to stocks do not seem like viable solutions for those seeking reasonable growth in their retirement nest eggs.

If you have experienced these feelings, I pose the question: How much of your retirement account value do you have invested directly in something tangible – like investment real estate? The answer for the vast majority of retirement account owners is NONE. Why is this so? If you feel that your net worth is already properly allocated between the broad asset categories (cash, stocks, bonds and real estate) then you don't need to read the rest of this article. However, if you:

1) would like to own more investment real estate as a percentage of your net worth;

2) have substantial financial assets in your retirement accounts, and;

3) have limited investable funds outside your retirement accounts, then you should read on.

The primary reason most people do not own real estate in their IRAs is that they're not even aware it's an option. Most IRA custodians are the traditional brokerage houses, insurance companies and banks, and, simply put, it has not been in their interest to encourage the investing public to buy anything other than traditional financial investments: stocks, bonds, t-bills, mutual funds, etc. In fact, most of the traditional custodians to this day (with a few notable exceptions) do not permit an IRA to purchase real estate.

The good news is that there is no law, nor any tax-related prohibition, against buying real estate within your IRA (or other retirement plans). The tax law definitively allows your IRA to invest in all types of real estate, including land, single-family homes, apartment complexes, condominiums and commercial property. If your current IRA custodian does not allow you to make these types of investments and you decide it is in your interest to do so, perhaps it's time to change your IRA custodian! You may do so at any time on a tax-free basis by doing a "trustee-to-trustee" transfer of some or all of the account. There are several experienced companies that specialize in serving as custodians for "self-directed" IRAs. One of the largest of these, PENSCO, is headquartered right here in San Francisco, and my experience with them has been positive. They do a good job of educating and guiding the new IRA owner-client through the do's and don'ts of investing through a self-directed IRA. These custodians allow you to invest in real estate and other "non-traditional" assets, including closely held businesses and notes secured against real estate.

Although tax law allows real estate in your IRA, there are certain rules and limitations of which you must be aware. There are severe penalties for "prohibited transactions" involving your IRA. Although too numerous to review them all, you should know that your IRA cannot purchase property that you (or "related parties" to you) will enjoy personally – such as a vacation home. Your IRA also cannot buy, sell, lend or borrow property or money with you directly or indirectly. Because of these and other potential pitfalls, you must consult with your professional tax advisor (and one who feels comfortable with this area of tax law specifically) before you make any "non-traditional" IRA investments.

Besides the prohibited transaction concerns, there are other issues to evaluate before acquiring real estate within your IRA. Two of the most compelling reasons to invest in real estate are tax related: 1) the lesser capital gain tax rates applied to the property's appreciation at the time of sale (which can be as much as 20% below ordinary income tax rates under present tax law) and 2) the ability to take "non-cash" depreciation deductions to help shelter the asset's net cash flow from taxation. Neither of these tax advantages is available in the tax-sheltered environment of an IRA. Appreciation from all traditional IRA assets (including real estate) will one day be taxed as ordinary income (rather than capital gains) when it is distributed out of the account. In addition, since the IRA account earnings generally are not taxed at all until they are distributed, the depreciation deduction, although allowed, is many times "wasted" since there is no taxable income to be sheltered.

The use of leverage to purchase real estate within an IRA can further complicate matters. Although your IRA account may employ leverage in its purchase of investment real estate, the loans available to the IRA will be a little more costly and cover a smaller percentage of the purchase price than those given to purchase property outside of an IRA. Moreover, the use of debt-financed real estate in an IRA can result in "UBIT" (unrelated business income tax). This is a tax imposed at the IRA level only on the income generated by the debt-financed portion of the investment – thereby negating some of the tax advantages of the IRA. Fortunately, depreciation expense can then be used to help reduce or even eliminate UBIT. As usual, there are exceptions – those of you taking advantage of the new SOLO 401K plans will be happy to learn that UBIT does not apply at all, and therefore this concern does not apply to self-directed SOLO 401Ks making leveraged real estate investments. For ROTH IRA owners the news is even better – no UBIT and no ordinary income later when the gains are distributed.

Please don't misunderstand what I am saying. If you want to own more investment real estate, and you have the capability to purchase it without using your retirement funds, you should definitely do so. It is generally better to own investment real estate in the "taxable" environment rather than within IRAs or retirement plans because the tax advantages offered by investment real estate are so significant and it is easier to utilize leverage to boost your investment returns.

However, if you have limited capacity to buy real estate with your non-retirement assets but you have significant IRA, SEP IRA, ROTH IRA and/or SOLO 401K financial assets, and you could benefit from diversifying into direct real estate ownership, then you should seriously consider transferring some of your retirement plan money to a reputable, qualified custodian for a self-trusteed retirement account. From there, you will be in a great position to direct your plan's purchases of investment real estate and perhaps make your retirement funds a little less vulnerable to stock market turmoil.

About The Author

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Steve Ghirardo is both a CPA and Real Estate Broker. He and his brother Jerry are the Principals of Ghirardo CPA (full service accounting and tax firm), Ghirardo Real Estate Group (real estate investments, brokerage and consulting) and Exchange Alliance Group (a Section 1031 Exchange Accommodator).

Steve has provided real estate consulting services from a CPA's perspective for over 20 years. The Ghirardo Real Estate Group consists of CPAs and licensed real estate and securities professionals who assist clients in all aspects of real estate investing, including: real estate portfolio evaluations, locating suitable 1031 replacement properties, evaluating and screening TIC offerings for purchase, feasibility analysis, income tax and property tax analysis, financing and sales.

Steve received a BA in History from Stanford University in 1980 and an MBA from UC Berkeley in 1982. The American Institute of CPAs recognized him for performance with high distinction for placing within the top 120 scores in the country of the 70,000 individuals taking the CPA exam in November of 1982. In 1992, Steve earned a Masters in Taxation from Golden Gate University in San Francisco, receiving the "Outstanding Graduate Award." Steve currently sits on the Board of Directors for Circle Bank and has been the Novato Rotary Endowment Treasurer since 2002.

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