Real Estate in an IRA

Since this issue always seems to come up, let's address the possibility of using real estate as an IRA investment. Most investors will opt for a real estate fund—a Real Estate Investment Trust (can be public or privately traded) or a limited partnership. These are "paper" investments that typically do not give rise to the same problems that investments in physical property can generate. Be careful however—make sure that the real estate fund is all cash and does not use any financing, as anything financed in your IRA may give rise to your IRA having to pay Unrelated Business Tax.

How It Works

Since every IRA must be held by an IRA custodian, you must first find a custodian that will permit this type of investment. Most banks and securities firm custodians will not permit it. Usually, a financial advisor can help you locate an independent IRA custodian that allows real estate investments and work with that company to set up an IRA account. But 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 IRAs, including a traditional IRA, a Roth IRA, and a Simplified Employee Pension plan, or SEP-IRA.

Purchasing the Property

Most IRA custodians that hold real estate will usually allow you to purchase raw or vacant land, residential properties, or commercial buildings for your portfolio. In addition, some custodians may permit foreign property or leveraged property. Since buying a property may require more funds than you currently have available in your IRA, you also can have your IRA purchase an interest in the property in conjunction with other individuals, such as a spouse, business associate, or friend. Also keep in mind that if the property is leveraged, the debt must be a nonrecourse promissory note.

Unfortunately, Internal Revenue Service regulations will not let you use the real estate owned by your IRA as your residence or vacation home. Nor can your business lease space in your IRA-held property. The underlying premise for any real estate investment purchased with IRA funds is that you can't have any personal use or benefit of the property. To do so may cost you plenty in taxes and penalties.

There are a few other IRS limitations as well. You cannot place a real estate property that you already own into your IRA. Your spouse, your parents, or your children also couldn't have owned the property before it was purchased by your IRA. Property owned by siblings may be allowed, since the Internal Revenue Code (section 4975) specifies that only "lineal descendents" be disqualified.

Once you've chosen a property, your IRA custodian—not you personally—must actually purchase it. The title will reflect the name of your IRA custodian for your benefit (such as Silver

Trust Co., Custodian FBO John Doe IRA). In addition, if you put up earnest money with your personal funds, you'll need to make sure you include that amount in the total due so that the title company can reimburse you upon closing.

Operating an IRA-Held Property

Because all property expenses, including taxes, insurance, and repairs, must be paid from funds in your IRA, you'll need liquid funds available in your account. Of course, all income generated from the property will be deposited in your IRA account so you can use that money to cover your costs. But be very careful. If a storm blows the roof off the property and you need an instant $20,000, you cannot write out a check. The money must come from the IRA, so you must always have significant liquidity in an IRA that holds real property.

It's also possible to sell properties while they are held by your IRA, so long as the purchaser is not a family member. Once a deal closes, your IRA account now holds the cash proceeds—ready for you to make your next investment. An alternative is to sell an IRA-held property with seller financing so that all payments made by the buyers are paid to the IRA.

Note the disadvantages:

You can't deduct property taxes or mortgage interest, and you can't use your depreciation deduction. Also, when you sell the property, a traditional IRA turns profit into ordinary income rather than capital gains that you would incur if you owned the property as an individual