

# **Using Your IRA to Invest in Real Estate: Be Ware of the Dangers**

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The vast majority of individual retirement accounts are invested in traditional financial investments: stocks, bonds, mutual funds, certificates of deposit, etc. Some seminars and web sites are promoting IRAs for a non-traditional investment: real estate. We will look in this article at some of the ins and outs of this form of ownership.

## **Is it Legal?**

IRAs can invest in nearly anything an individual can. There are only four things an IRA is prohibited from investing in: life insurance, collectibles, loans to the owner or a "disqualified person", and S corporation stock. Anything else is fair game. Investing your IRA in real estate is perfectly legal.

## **Is it Wise?**

That is another question. It would have been very attractive to have invested in real estate a few years ago and benefit from the rapid appreciation. The real estate could be sold for a profit while avoiding capital gain tax or held for rent with the rent income accumulating tax free. If you qualify for a Roth IRA these benefits are even greater since you will not have to pay tax on the eventual withdrawal of funds. However, real estate inside an IRA also has tax drawbacks. One cannot take depreciation deductions on real estate in an IRA. And the capital gain tax which is avoided in an IRA is turned into ordinary income when withdrawn (except for Roth IRAs). But perhaps the biggest tax drawback is if the IRA finances the acquisition of the property with debt. Any acquisition indebtedness will cause some of the income generated by the property to be taxed as "unrelated business income." That is a separate tax that tax-exempt organizations, including IRAs, are subject to.

## **How Can it Be Done?**

You cannot be the custodian of your own IRA, nor can your brother or your aunt. Only a bank or other financial institution approved by Treasury Department can serve as custodian. Most banks and financial institutions that offer IRAs will not allow investment in non-traditional assets such as real estate. So the first problem will be to find an institution which will act as custodian and allow investment in real estate. Two companies with web pages that state they will sponsor IRAs investing in real estate are Pensco (<http://www.pensco.com/>) and Entrust (<http://www.entrustadmin.com/>). Assuming you find a custodian which will accept real estate and with whom you are happy, the next question is how the investment is made. You cannot purchase the property in your own name and then transfer it to an IRA because of contribution limitations and because,

except for a rollover from another IRA or qualified plan, you can only contribute cash to an IRA. So the property must be purchased with existing IRA funds in the name of the IRA. If borrowed money is to be used, it must be the IRA that secures the loan.

### **What Can Go Wrong?**

One of the biggest dangers is commingling of funds. Suppose the property requires money, to make a repair or pay property tax. You cannot pay the bill yourself and obtain reimbursement from the IRA because that reimbursement would be a taxable distribution to you. If you do not request reimbursement, you will have made a contribution to the IRA. Both premature distributions and contributions in excess of specified limits are subject to excise tax penalties.

Another problem is day to day management. If you do this yourself, you are performing services for the IRA, which is a prohibited transaction under section 4975 of the Internal Revenue Code. That section prohibits a "disqualified person" from engaging in transactions directly with a tax-qualified plan, including an IRA. Violation of this section would disqualify the entire IRA, causing the entire balance to be considered as distributed to you. In addition, excise taxes are imposed for transactions which violate this section. For example, if you personally use the property (or allow your parents or children to do so) you will violate this section, because you (and your immediate family) are a "disqualified person" with respect to your IRA.

One idea which has been promoted at seminars to avoid the prohibited transaction problem is setting up an LLC to purchase the property and manage it. The IRA would be the sole member of the LLC. However, if you manage the property on behalf of the LLC, you might still be considered as doing so on behalf of the IRA and thus subject to the penalty tax. Anyone considering this method would be wise to first request a private ruling from the IRS that such a method would not be considered a prohibited transaction.

Because of the severe penalties associated with a prohibited transaction, it is best to have the plan custodian take care of management, probably by hiring a professional management company. The bottom line on investing your IRA in real estate is that it is possible, but very risky.