MB Capital Group

Diversification is key to a healthy retirement account, and for many investors, real estate is a promising asset that offers stability and high growth potential.

Real estate is a great self-directed IRA investment that often boasts better returns when compared to more traditional assets, like mutual funds or stocks. Best of all, real estate can create a passive income that allows for consistent growth.

If you're ready to add real estate to your retirement portfolio, you'll need to set up a real estate self-directed IRA before you can make your first investment. So here's everything you need to know about a real estate self-directed IRA.

How to Invest in Real Estate with an IRA

If real estate investment is part of your retirement fund strategy, a regular IRA won't suffice. Instead, you'll need to open a self-directed IRA (SDIRA). It allows account holders to invest in alternative assets like real estate, including precious metals, cryptocurrency, promissory notes, etc., via a qualified custodian.

SDIRAs are available in several forms, including traditional IRAs and Roth IRAs. That means you can still leverage the tax benefits enjoyed by either but enjoy the investor freedom an SDIRA provides.

SDIRAs also carry the same IRS rules and regulations applied to other individual retirement accounts, including contribution limits.

The Pros and Cons of Buying Real Estate with an IRA

Pros

Tax Benefits

SDIRAs enjoy the same tax benefits as normal IRAs. If you choose a traditional SDIRA, you can purchase real estate using pre-taxed dollars, and your investment will grow tax-deferred, with taxes applied only upon distribution.

If you choose a Roth SDIRA, you invest with pre-taxed funds, but you will not need to pay taxes on distributions. This can provide a tax shelter for individuals who believe they will be in a higher income bracket upon retirement.

Enhanced investment control

When you use an SDIRA to purchase real estate, or any alternative asset, for that matter, you gain direct control over how your funds are invested. When applied to real estate investment, this benefit gives you the control to add various types of property to your portfolio, including commercial or residential rental properties.

You also maintain the ability to sell or flip the property and return any earnings to your IRA to grow your account or to purchase other properties.

Potential for Increased Returns

Real Estate ROIs can be realized in two primary ways: income earned from rental properties or equity earned when you sell your property. Depending on your real estate market knowledge, SDIRA real estate investments can yield significantly higher returns than more traditional assets, like mutual or index funds.

Asset Protection

While other assets may be vulnerable if you claim bankruptcy, your IRA is typically safe. Under the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), assets held in IRAs, including traditional, Roth, and SDIRAs are protected by up to $1 million in the event of bankruptcy.

Cons

Additional Rules and Regulations

When you use your SDIRA to invest in real estate, there are specific rules that dictate how you can use and engage with your property. One of the primary rules is that the property you purchase with your IRA must be used only as an investment. You cannot live in or use the property for work purposes, such as office space.

In addition, any earnings you make off the property, including rental income, must be returned directly to your IRA account.

The same rules apply to disqualified persons, which include your parent, spouse, children, grandchildren, grandparents, or the spouse of a decedent (e.g., a child's spouse would be considered a disqualified person).

If you fail to follow real estate investment rules, you run the risk of engaging in a prohibited transaction, which carries tax penalties.

Additional Paperwork and Fees

SDIRAs and related transactions tend to come with more paperwork and fees than a regular IRA account. That's why it's important to thoroughly vet and compare custodians (the entity in charge of holding funds and overseeing transactions). The right custodian offers fee transparency and is well-versed in the paperwork and forms required for the alternative asset you're interested in–real estate, in this case.

Increased Vetting & Responsibility Required

When you invest in real estate through your IRA, you must perform due diligence and determine what is (or isn't) a good investment. This won't be much of a drawback if you're well-versed in the real estate market and related issues.

On the other hand, if you're new to the game, it's important to remember that your SDIRA custodian only acts as an administrative third party regarding investment advice. They won't provide any insights into the stability or risks involved with a specific investment.

Potential UBTI Obligations

In most cases, you only need to worry about taxes when you take a distribution (traditional IRAs) before you contribute (Roth IRAs) or when you take non-qualified withdrawals from your account. However, in some cases, earning from your real estate investment may be considered unrelated business taxable income (UBTI), and you'll be on the hook for taxes.

If you're investing in real estate, discuss the tax implications with a tax advisor or qualified custodian who can help you determine if you'll be on the hook for UBTI obligations.

Types of Real Estate You Can Invest In with an IRA

In general, you can use your IRA to purchase most types of real estate, including residential property, such as single- or multi-family dwellings and apartments, as well as commercial properties, including hotels, retail shops, office space, and commercial properties. You can also use IRA funds to purchase lots and raw land.

Real Estate Self-Directed IRA Rules and Limitations

If you purchase real estate with an IRA, there are certain rules and limitations to keep in mind.

- You cannot use an IRA to purchase a property you intend to permanently or temporarily live in.
- You cannot use IRA funds to purchase a lot to build a structure, residential or dwelling, in which you plan to live or use as a place of business.
- If purchasing a home or other structure to "flip," you must hire an outside contractor to complete the work. You (or any disqualified person) cannot complete renovations or other work required.
- Any income you receive from the property, including rental income or equity from a property sale, must go back to the IRA account–you cannot live off of earned income from the property.
- You cannot pay yourself or your property manager with funds from your IRA or those earned from your IRA-purchased property.
- If using IRA funds to invest in real estate, you cannot purchase property from a disqualified individual, such as a family member.

Before you use your IRA to invest in property, familiarize yourself with all IRS rules and regulations so you can avoid engaging in prohibited transactions, which will result in penalties and jeopardize your retirement savings.

How to Purchase a Property with an IRA

Find an SDIRA Custodian

If you want to purchase property with an IRA, the first thing you have to do is open a self-directed IRA account with a certified real estate IRA custodian. Banks often offer IRAs and other retirement products, but they don't always offer self-directed IRAs.

Finding the right custodian is one of the most important steps to ensure that you can execute your retirement strategy as you wish.

Find and Plan for a Property Purchase

Once you open your SDIRA account with a qualified custodian, you can begin your hunt for real estate. As specified above, IRA funds can be used to purchase various types of commercial and residential property as well as lots and raw land.

Keep in mind that you cannot purchase property from a disqualified person, and you cannot complete any work or renovations yourself. You'll need to hire someone to do the work for you. As such, it's important to be aware of these limitations when looking for the right property, especially if your goal is to flip the property and make a profit.

Fund Your Purchase

You can fund your IRA real estate purchase using one of four methods:

- Cash purchase. If you have enough money in your IRA account, you can use it to purchase the property outright. This is the best option, as you will not need to worry about a mortgage or unnecessary taxes.
- Partner with another investor. If you don't have enough funds in your SDIRA, you can partner with another SDIRA account holder, like a spouse, friend, or business partner, to combine funds and purchase the property. Under this arrangement, you would own a percentage of the property. Property expenses and earnings would then be divided per the ownership agreement.
- Finance your purchase. If you want to purchase a real estate property but don't have the funds required, you can borrow against your IRA to complete the purchase. Under this arrangement, the mortgage is extended to your IRA, not you, and the property is used as collateral.

This route is typically only accessible for individuals purchasing an income-earning property, like a rental property, as the IRA is responsible for repaying the debt, and lenders favor applicants that can show a track towards repayment.

Financing will also typically require a significant down payment (40% to 50%) and result in UBIT obligations.

- Form an SDIRA LLC. If you have enough funds in your account, you can form an LLC and direct your custodian to move funds from the investment account to the LLC. Commonly referred to as checkbook control, this type of arrangement increases control and allows you to purchase and pay related expenses directly through the LLC, with limited dependence on the custodian.

Managing and Selling a Property in Your IRA

Once you purchase your property, the next thing to decide is how you will manage the property.

Management of your IRA-purchased property is held to similar rules and limitations that apply to the purchase and use of the property. The account holder cannot manage rental expenses or income.

The same is true for disqualified persons. For instance, if you are collecting rent, the rent must be paid directly to the IRA, not deposited to your bank account, and then deposited to the IRA.

The most common management structure is through an LLC. Under this arrangement, money flows in and out of the LLC checking account. For instance, the account owner can cover related expenses using the LLC checking account, and rent is paid to the LLC and distributed back to the IRA.

Another option is to hire a property manager through the IRA. In this situation, the property manager is responsible for renting or leasing the property and managing related expenses. The property manager will then remit income to the IRA, minus fees or other expenses.

The third option is management through the IRA. In this scenario. In this scenario, the custodian receives funds and pays expenses directly from the IRA.

If you choose to sell the property, you must work directly with the custodian and a real estate agent to complete the sale. The IRA acts as the "seller" in the real estate transaction. All earnings from the sale must be deposited directly to the IRA.

Property sales are held to the same rules and regulations, particularly regarding disqualified individuals. In this case, you cannot sell the property to a disqualified individual, such as a spouse or family member.

Real Estate IRA Alternatives

Using your IRA to purchase real estate can lead to lucrative gains, but if you're not ready or interested in leveraging property in this manner, there are other ways you can incorporate real estate into your retirement portfolio

Real estate investment trusts (REITs) refer to an entity that purchases and invests in commercial properties, including shopping hubs and hotels. When you invest in a REIT, you earn money through dividends based on the REIT's income. REITs provide a great option for diversifying your portfolio and typically deliver a stronger ROI than traditional stocks and bonds.

Mortgage notes allow you to invest in real estate without actually purchasing a property. In this case, you can purchase the mortgage note associated with a specific property. As the property owner repays the debt, you earn the agreed-upon interest. Like REITs, mortgage notes can provide a strong ROI, provided the borrower repays the debt.

Investing in real estate can be a great way to diversify your portfolio. It can also be a great way to add a stream of passive income to your retirement account, allowing you to bolster your earnings for years to come.

If you're considering adding real estate to your IRA strategy, the first step is opening a self-directed IRA with a qualified custodian. They can help with the management and administration of your IRA property. Contact Horizon Trust today to learn more about real estate's role in your retirement and how we can help you realize your financial goals.

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