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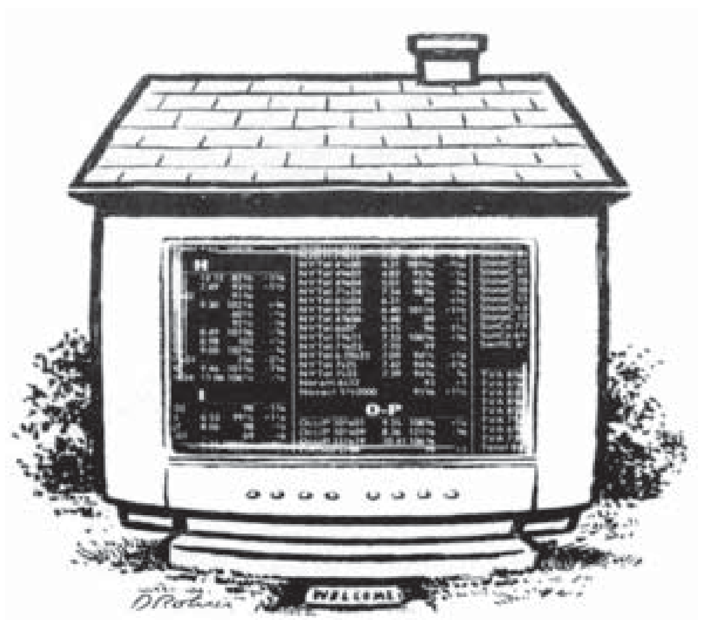
Investing IRA Money in Real Estate

BY HARRY VELDKAMP



Many individuals have opted to invest their Individual Retirement Account money in a bank — for example, CDs and money market accounts — or in mutual funds, stocks and bonds. However, there is growing interest and awareness that IRA money can be used for nontraditional investments, including the booming real estate market.

In many cases, IRA investments in real estate have far outpaced those in traditional investments. Before delving into any investment opportunity, it is critical to scrutinize each one closely and weigh all of the variables before investing.

Why Real Estate?

Real estate-related investments, particularly in California with the recent boom in values, have become increasingly popular. Many individuals, and perhaps many of your clients, perceive the stock market as too unpredictable and look at real estate as a good alternative or as a supplement to stocks or mutual funds.

With an IRA, money accumulates on a tax-deferred basis. You will pay income tax as you take distributions from the IRA, but the concept is that the compounding effect of the tax-deferred income coupled with the expectation that an individual's tax rate at retirement will be lower than the current rate makes an IRA very attractive.

The introduction of the Roth IRA several years ago added another dimension. If money is left in a Roth IRA for at least five years, there is no tax due when money is taken out. The catch is that the money going into the Roth IRA is after-tax money, but if you have a number of years to go until you will start taking distributions or if your return on investment is high, a Roth IRA might be the best choice

We have an aging population, and many people have accumulated sizable sums in their IRAs. IRA account balances can be built up by annual contributions or by rollovers from company retirement plans. A lot of these IRA holders are looking at real estate as a good alternative to stocks or mutual funds, or they consider real estate investments an additional way to diversify their IRA assets.

Fees — Don't Be Stumped

Consider the impact of all fees on the total investment return in any IRA. The annual fees for a self-directed IRA will be more than what a bank, mutual fund company or brokerage firm charges, but recognize that, although these institutions typically charge a lower annual administrative fee, they also collect commissions or investment fees on the investments they offer.

A company derives income from a person's self-directed IRA solely from administrative fees. So at first glance, their annual fees seem higher. There should be a "Buyer Beware" notice for consumers so they are not misled. Savvy investors look beyond a comparison of administration fees; they understand that the total return is what's important.

Most banks, mutual fund companies and brokerage houses do not allow nontraditional assets in the IRAs they sponsor because it is not cost-effective.

Large institutions want to offer investments that have a broad appeal and generate large deposits or investment dollars. They usually derive their income from a commission or fee that is calculated as a percentage of the total assets. The more money that is invested in a particular investment, the more income the bank or brokerage firm generates.

Nontraditional assets are usually established for a small number of IRA investors, many times as few as one, and these types of investments don't fit the profile of a large institution.

Which Type of Real Estate Investment Is Best for You?

Trust deeds, limited-liability corporations, limited partnerships, mortgage pools and direct ownership are all options in a self-directed IRA. There are pros and cons to each, and much depends on the sophistication and knowledge base of the investor.

Trust deeds are probably the most commonplace investments, and most are initiated by a mortgage company or real estate professional. Some IRA holders set up their trust-deed investments completely on their own by finding a borrower and doing all the paperwork themselves, but this requires the know-how that many people do not have.

In addition, many IRA holders prefer to rely on a professional to select the borrower, service the loan and take any required action in the event of a default. Several IRAs can invest in the same trust deed through a participation arrangement in which each IRA has a percentage of the total note. Many mortgage professionals use this approach to pool money for larger loans or to diversify their clients into several deals to reduce investment risk.

Mortgage pools, a collection of trust deeds funded by many investors, are another way to reduce risk. They are similar to a mutual fund. An investor enjoys the diversification of owning pieces of several trust deeds that they wouldn't be able to purchase on their own, and they have a professional managing the mortgage pool. Mortgage pools are especially attractive to IRA holders who are investing in real estate for the first time or have smaller amounts of money.

Limited-liability corporations and limited partnerships are ways to own real estate directly in an IRA or a number of IRAs. An unrelated third party must manage the limited-liability corporation or partnership, and the IRA investors will be passive members or limited partners. Limited-liability corporations, or partnerships, are nothing new in the real estate world, but using IRA money might be an additional source of funds for some professionals.

Red Flags — Be Alert

Using IRA money to invest in real estate has many benefits, but you must be aware of the pitfalls. You should not engage in a prohibited transaction, which generally means investments with a "party in-interest," such as a close relative or your own business.

Use common sense. Using IRA money is better for less-risky investments than you might consider with non-IRA money.

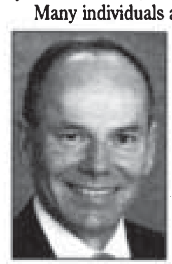
For example, if something goes wrong with a trust-deed investment, you might have to advance money for payments or fees. If the IRA has insufficient cash, the account holder will be forced to sell the investment to a third party or take a taxable distribution of the asset.

In a limited-liability corporation or limited partnership, an IRA might be subject to unrelated business taxable income, which typically comes into play when part of an investment is leveraged.

If unrelated business taxable income is present, a separate income tax filing, Form 990T, is required, and part of the income will be taxable each year.

Scrutinize the self-directed IRA fee schedules — some administration companies charge a fee that is a percentage of your total assets, and it can turn out to be a very large figure.

Many individuals and real estate professionals have been very successful using IRA money in real estate investments. As always, consult your investment and tax advisers before investing IRA money. Every situation is unique, and there is no substitute for expert advice and guidance.



__Harry Veldkamp__ is co-owner and chief executive officer of Polycomp, a California-based consulting firm providing customized retirement plans and benefit administration.