News

How to set up your IRA to own and manage real estate

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Second of three parts

SAN FRANCISCO (MarketWatch) -- Buying rental property with IRA funds can be a rewarding investment for both income and capital gains. It just comes with its own set of rules.

When buying real estate within a self-directed IRA, investors must choose a "custodial" firm and weigh the fees it charges. The custodian holds title to a property in accountholders' names and can steer rental income into mutual funds or stocks of their choosing.

The accountholder also must choose a means to manage the property -- whether at her or his own direction, through a property manager or the formation of a limited-liability corporation (LLC). Each has pros and cons.

The critical concern is avoiding "prohibited transactions" that could lead the IRS to strip the tax-advantaged status of an account and demand immediate payment of taxes on its value and penalties.

"For real-estate investors using IRA funds, it's a great time to buy low and sell high since they're in it for the long term," says Tom Anderson, chief executive of San Francisco-based Pensco Trust, a leading self-directed IRA custodian. **Read six reasons now is a good time to buy real estate in your IRA.**

"The housing market will certainly rebound eventually and you can generate substantial income in the meantime," Anderson says. "But you have to abide by the rules or you could have hell to pay."

Choosing a custodian

Before shopping for a property to buy with IRA funds, set up an account with a custodian and transfer assets from brokerage firms holding existing IRA funds and 401(k)s still maintained with former employers. That way, you can jump on attractive buys that present themselves in current beaten-down housing markets.

Custodians handle the paperwork with title companies, and the deed will read in the custodian's name "for the benefit of" the accountholder. "If any company is going to put title in their name, run the other way, because that means you're not on the title," Anderson warns.

A custodian firm's costs can range from almost negligible to about 1% a year -- but still run less than most actively managed mutual funds that retirement savers hold in IRAs and 401(k)s.

Lower-cost custodians make up some of the discounted cost with small transaction fees for cutting expense checks or transferring rental income periodically into mutual fund and stock investments. Higher-cost custodians may provide such services at no added cost.

One of the lowest-cost providers is San Carlos, Calif.-based IRA Services Trust, used for that reason by advisory firms that set up LLCs for self-directed IRA investors.

IRA Services charges $60 a year for the account, a $60 annual fee for each property held and $10 for cutting checks for expenses and IRA transfers. "Most companies that provide this service charge a percentage of the portfolio value, usually in addition to a base fee," IRA Services Trust Officer Michael McNair says.

At the other end of the cost spectrum is long-established Pensco, whose fees run from several hundred dollars to a maximum $2,500 for the largest accounts. Its Web site allows online access to account records and has a wealth of educational information.

"We're looking for large accounts because smaller accounts cost us more in time and education," Anderson says. "We know our fees are not a big problem for those who have large accounts."

Other custodians include Equity Trust, Fiserv Trust, Millenium Trust and Sterling Trust.

Worth noting: Custodians typically keep rental-income proceeds in very low-yielding bank savings or money-market accounts. Accountholders would be wise to move forwarded rental payments monthly or quarterly into an outside IRA brokerage account, which accomplishes "dollar-cost averaging" into stocks, mutual funds or higher-yielding, fixed-income investments.

Prohibited transactions

The IRS's prohibited-transaction rules are designed to prevent stealthily pulling money out of the IRA without paying taxes. For instance, a parent who buys a condo in a college town for a child to live in rent-free for four years would in essence be withdrawing tax-free the market rent they'd have received and funneled back as required into the IRA.

"I advise clients that they should get an index card and write down their name and the names of their spouse, parents and grandparents, children and grandchildren and their spouses, and any entity be it a family business, corporation, trust or LLC 50% or more owned by any one of those people," says Steven Sheppherd, founder of Checkbook IRA, which forms LLCs for

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managing IRA-owned properties.

"If someone on that card is involved, you can't do any transaction with them, end of discussion," Sheppherd says.

Still, that does not preclude all relatives, notes Patrick Rice in his book "IRA Wealth: Revolutionary IRA Strategies for Real Estate Investment." Accountholders can rent to their brothers and sisters, spouse's brothers and sisters, their spouse's parents and their stepchildren, aunts, uncles and cousins -- and even hire them to act as property manager.

Rice says accountholders can justifiably rent to those relatives at a discount of up to 25% from market rents because of their "tenant qualifications," namely, their dependability and the fact they'll assist in the property's upkeep.

Property-management choices

The most cost-effective approach to managing an IRA-owned rental property is to handle it yourself. This method must be handled with some caution.

An accountholder who goes this route should be sure to get a low-cost umbrella-insurance policy of $1 million or $2 million on top of homeowner's coverage to limit exposure of personal assets to claims arising out of ownership of the property.

If the property is bought with a mortgage, confer with an accountant about paying unrelated business income tax as well as depreciation allowances and mortgage-interest and property-tax deductions. If not, accounting is straightforward -- tracking income and expenses -- because there's no such tax breaks on IRA-owned real estate bought with cash.

Accountholders can screen and select tenants and collect rent checks, but they must be made out to the deed-holder, i.e. "XYZ Custodian Firm FBO Josie Smith." To minimize transaction fees, custodians can cut checks for recurring costs -- such for trash collection -- to cover three to six months of payments.

Accountholders also can arrange for work to be done on the property, but payment for labor and materials should be issued by check from the custodian directly to contractors and suppliers.

Because prohibited-transaction rules were written primarily to cover pension funds and employer-sponsored retirement plans, what remains somewhat unclear is the degree to which a self-directed IRA accountholder can do minor work on a property themselves. Spokespersons for the IRS and the Department of Labor, which governs pension funds, refused to answer specific questions about allowable work.

Pensco's Anderson advises accountholders to not perform any work on a property, but self-directed IRA experts who've spoken with DOL lawyers say they were told accountholders can perform any maintenance work that does not increase the property's value.

The reason: Accountholders have a fiduciary responsibility to themselves to maintain their investment's value, just as would a money manager hired to invest assets in traditional investments. As long as the work performed doesn't add value -- which in essence would amount to an undeclared and perhaps excessive in-kind IRA contribution -- several self-directed IRA experts say it would fall within the spirit of the rules.

Such work might include maintaining the landscape, fixing or subbing out a leaky faucet, doing shingle repair on a leaky roof or painting a few rooms between tenants. On the other hand, an accountholder capable of remodeling a kitchen or bathroom or replacing an entire roof, such as a contractor or skilled tradesperson looking to flip properties, would be adding value to the property and risk IRS action.

The property-manager route

A second option is to hire a property-management firm to handle everything from securing tenants, collecting rents and overseeing maintenance and repairs. That puts management beyond arm's length, but it also comes at a cost that reduces annual returns.

Property managers may charge 10% to 15% of monthly rental income for their services, along with a month's rent or more each time they screen and sign up a new tenant. McNair says it also can be difficult in many areas to find a property manager who will handle a single property.

The third option is for accountholders to create a limited liability company that will give them "checkbook control" as the manager of the self-directed IRA account. This option, which also protects the accountholder from personal liability for any claims or lawsuits, tends to only be cost-effective for IRAs holding multiple properties.

Advisory firms like Checkbook IRA and Guidant Financial will handle all paperwork and filings required to set up an LLC for fees ranging from about $2,500 to $5,000. Additional costs include annual state fees for LLCs, which can run up to $800, and accounting services required because the LLC, like a property manager, must provide bookkeeping records to the custodian one or more times annually to ensure rents are coming in and the legitimacy of expenses.

"We do suggest to people that they may want to get a property manager or form an LLC for asset protection," McNair says. "But as long as you operate within the rules, and we can provide some guidance there, you can easily manage a property yourself."

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