A Reprint from *Tierra Grande* magazine

REAL ESTATE INVESTMENTS AND IRAs

BY JERROLD J. STERN

When most people think of IRA investments, they typically envision stocks, bonds and various types of mutual funds. Relatively few seem to be aware that real estate investments can also be included in an IRA as long as the IRA is "self-directed" and IRS requirements are met. Key advantages of including real estate investments in self-directed IRAs (SDIRAs) are diversification and the deferral or elimination of taxes on annual investment income and gains from sales.

The number of SDIRAs has doubled during the past five years. The *Wall Street Journal* (April 2012) reported that the Retirement Industry Trust Association estimated that $4.6 trillion was held in IRAs in total, with 2 to 5 percent invested in SDIRAs.

In general, there are two types of IRAs (SDIRAs included) — traditional and Roth. Investments in traditional IRAs are tax deductible; tax on all earnings is deferred until the earnings are withdrawn; and all withdrawals are fully taxable at ordinary tax rates (which presently range from 10 to 39.6 percent), even if the withdrawals are associated with gains from the sale of assets. Thus, the capital gains tax rate does not apply.

Penalty-free withdrawals are *allowed* to begin at age 59½ but *must* begin at age 70½. In sharp contrast, contributions to Roth IRAs are made with after-tax dollars (that is, they are not deductible), but all withdrawals, including annual earnings and gains from sale, are tax-free. Also, withdrawals are not required.

Annual contribution limits for any type of IRA (including both traditional and Roth SDIRAs) can be as low as $5,500 but may be higher for any IRA-type plan that small businesses offer their employees. Large balances in SDIRAs may be created through annual contributions made over many years, rolling over funds from other IRAs and/or rolling over traditional/Roth 401(k) plans when employees retire or move from one employer to another.

Most IRAs are administered by large investment houses, banks, and savings and loan institutions. Investments in these IRAs are typically required to be stocks, bonds, mutual funds and similar investments.

The only way to hold income-producing real estate in an IRA-type plan is to create an SDIRA. To do so, the investor must locate an SDIRA custodian/trustee approved by the IRS who will allow the investor to invest in real estate. Such custodians may be found via the Internet and may be a local firm or a large national firm that specializes in SDIRAs. There are very few large firms, but they are easy to find online.

Various types of fee arrangements exist for SDIRAs — flat fees, fees based on fair market value, or a combination. Annual administration flat fees may range from $250 to more than $1,500 depending on fair market value (FMV). Some annual fees reflect the number of properties held in the SDIRA. Annual FMV percentage fees may range from .4 percent to 1.5 percent of FMV, according to the *Wall Street Journal* (April 2012).

Other fees may be charged for each transaction (each SDIRA contribution as well as each property acquisition or sale). Also, there may be restrictions on the number of real estate trades in a given year. In contrast, some SDIRAs are referred to as "checkbook" SDIRAs and literally enable investors to write a check to purchase SDIRA assets (see restrictions that follow). Investors need to perform due diligence and carefully compare SDIRA custodian arrangements.

Another set of critical issues pertains to the strict IRS rules governing SDIRAs. The only debt allowed to be in SDIRAs is property acquisition debt. Transactions are not allowed to take place between relatives and the SDIRA. The SDIRA owner may not sell the SDIRA assets he or she owns outside the SDIRA. Other prohibitions preclude (1) SDIRA investments in the SDIRA owner's (or a relative's) personal residence, (2) using the SDIRA as collateral for a loan and (3) receipt by the SDIRA owner of compensation associated with an SDIRA asset. As with all tax-related transactions, careful record-keeping by the SDIRA owner and/or the custodian is crucial. Running afoul of IRS requirements could bring about penalties, immediate taxation of SDIRA funds and possible termination of SDIRA tax-preferred status.

Thorough investment analyses are as important for SDIRA real estate investments as any other real estate investments. For specific advice, consultation with a tax accountant or tax attorney is recommended.

Dr. Stern (stern@indiana.edu) is a research fellow with the Real Estate Center at Texas A&M University and a professor of accounting in the Kelley School of Business at Indiana University.

THE TAKEAWAY

Self-directed IRA investments in income-producing real estate may provide significant advantages such as tax deferral, tax-free income and diversification. Tax and nontax complexities require due diligence before establishing an SDIRA.

TEXAS A&M UNIVERSITY

REAL ESTATE CENTER

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031

Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin.

About the Real Estate Center

The Real Estate Center at Texas A&M University is the nation's largest publicly funded organization devoted to real estate research. The Center was created by the Texas Legislature in 1971 to conduct research on real estate topics to meet the needs of the real estate industry, instructors and the public.

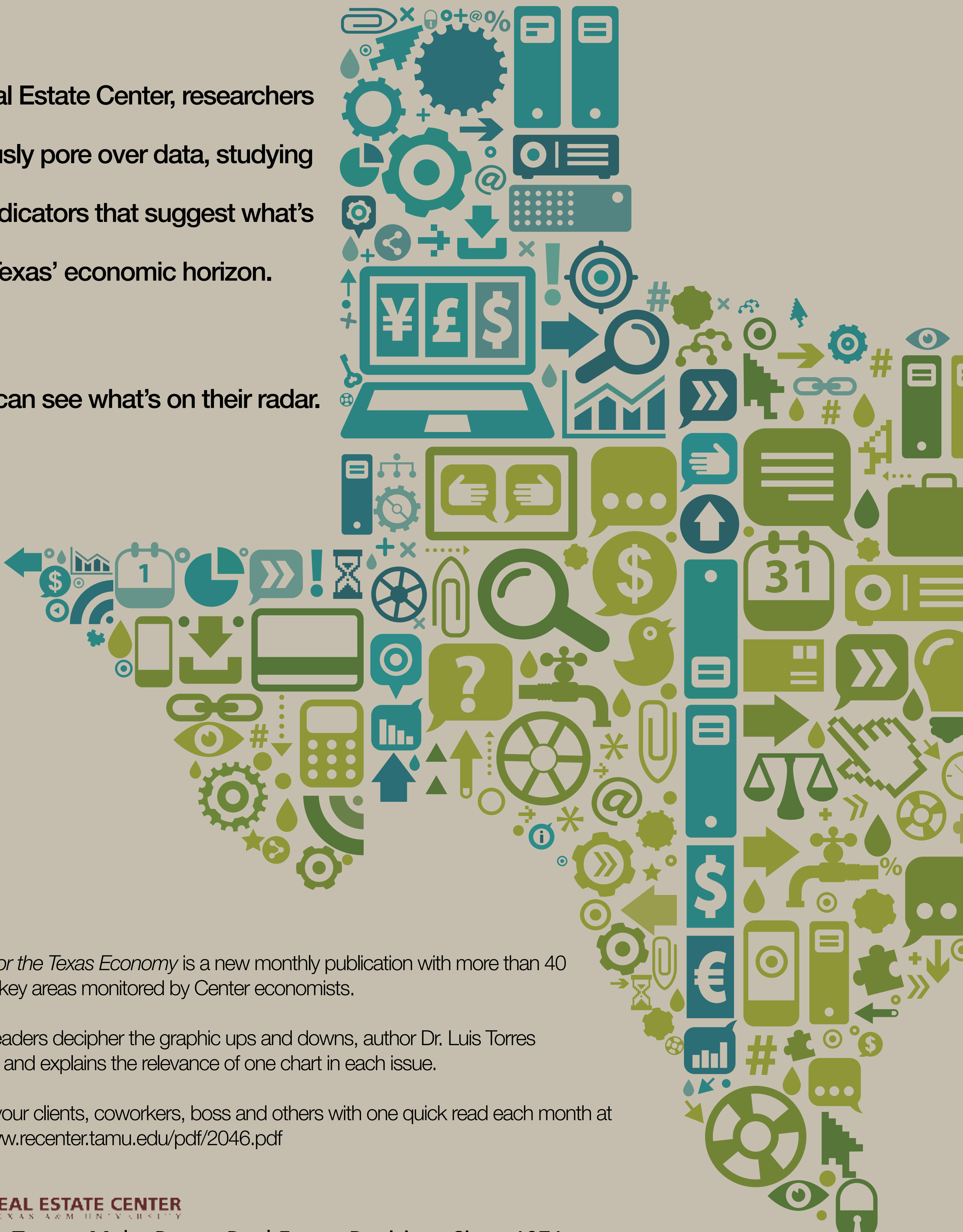
Most of the Center's funding comes from real estate license fees paid by more than 135,000 professionals. A nine-member advisory committee appointed by the governor provides research guidance and approves the budget and plan of work.

Learn more at www.recenter.tamu.edu

Charting REConomics

At the Real Estate Center, researchers continuously pore over data, studying leading indicators that suggest what's over Texas' economic horizon.

Now, you can see what's on their radar.



Outlook for the Texas Economy is a new monthly publication with more than 40 charts of key areas monitored by Center economists.

To help readers decipher the graphic ups and downs, author Dr. Luis Torres highlights and explains the relevance of one chart in each issue.

Impress your clients, coworkers, boss and others with one quick read each month at http://www.recenter.tamu.edu/pdf/2046.pdf

REAL ESTATE CENTER
TEXAS A&M UNIVERSITY
Helping Texans Make Better Real Estate Decisions Since 1971

COMMUNICATION MATTERS

You Need More Than Words To Win Hearts & Influence Minds

In the Real Estate Center's new free video series, John Krajicek, Mays Business School executive professor, reveals how important clear communication is in our business and personal lives.

It's all about succeeding. And speaking is just the beginning.

In four 20-minute videos, you will learn to cultivate your listening skills, develop a powerful presence, lead by example, and make body language convey the same message your words do.

www.recenter.tamu.edu/video

Communication Matters
Power of Presence
Communicating as a Leader
Open Up and Own the Room

ATM | REAL ESTATE CENTER
TEXAS A&M UNIVERSITY