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Can I use my IRA to Buy Real Estate?

By Bruce Ferry



A common question from clients, or often times from people at dinner parties, is “Can I use my IRA money to buy real estate?” The easy answer is “yes,” the rules for IRAs allow for a myriad of investing opportunities beyond stocks and bonds and do include real estate. However, there are a number of traps for the uninformed, including several reasons why owning real estate within an IRA is not as advantageous as it may seem.

Traps for the Uninformed: Prohibited Transactions

There is a long list of prohibited transactions which an IRA and IRA owner cannot enter into. One of these is the “self-dealing” prohibition which bars the owner, or relatives of the owner, from occupying or working on the property. Many people put “sweat equity” (meaning that they have worked on the property themselves) into a property. This is prohibited if the IRA owns the property.

Another prohibition is that all expenses of the property must be paid for by money in the IRA. So if the property needs a new roof, the IRA must pay for it, not the IRA owner. “Well”, you say, “I’ll just consider that a loan to the IRA, and the IRA can pay me back at some point.” Unfortunately, the IRS thought of that also and prohibited loans between the IRA owner and the IRA. Also, if you plan on renting the property, forget about managing it yourself – that’s “self-dealing”. You will need to hire a property manager. The penalty for disregarding any of the above rules is stiff, a violation of any of the prohibited transaction rules will result in immediate loss of tax-deferred status of the IRA, and the value of all assets of the IRA are considered taxable income. If you are under 59 ½, there is an additional 10% penalty.



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The tax benefits aren't as great as you think they are

In most cases, IRAs are exempt from tax (we'll discuss how they might be taxed later). Thus, income that the IRA makes (such as capital gains) are not taxable. Unfortunately, most people focus on that and stop there. The opposite is also true – losses from the sale of real estate are not deductible. In fact, owning property in an IRA negates all of the familiar tax benefits of owning investment real estate:

- Rental losses are never deductible; they stay trapped inside the IRA
- Gains are not taxed; however, at 70 ½, you have to start taking Required Minimum Distributions (RMDs) which are taxed at your ordinary tax rates. Effectively you've converted capital gains (taxed at preferentially low rates) to ordinary income (taxed at standard rates).
- Non-cash deductions like depreciation and amortization become mute; they are part of your rental losses.

What, no mortgage?!

Most lenders will not lend on real estate held inside an IRA. If you can get a mortgage, you will likely get it at unfavorable terms, which means a higher interest rate, a lower debt to equity ratio and more fees. In addition, mortgaged real estate inside an IRA triggers an obscure tax on IRAs. Known as the Tax on Unrelated Business Taxable Income (UBTI) effectively the IRA must file an income tax return and calculate and pay tax on the income from the rental property (if any) and also on the gain from the sale of the property.

So, expect to pay cash for the property, which negates the use of leverage.

Don't Do It

In summary, the only advantage to holding real estate in an IRA is to defer the income tax on the eventual sale. However, that can also be accomplished by doing a tax-deferred exchange. The many disadvantages include:

- Can't use leverage (e.g. mortgage)
- Negates tax advantages of real estate
- High cost (property management fees, IRA custodial fees)
- Penalty for Failure is high – loss of tax-deferred status and potentially massive income tax hit
- Convert capital gains (taxed at preferentially low rates) to ordinary income (taxed at standard rates)

A well-diversified IRA portfolio is the key to retirement success. If you want to include real estate as an asset class in your IRA, invest in a publicly traded REIT (Real Estate Investment Trust). There are many available to choose from that focus on certain real estate sectors (commercial, office, residential, retail) and are managed by professionals.

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