The Basics

Ground your retirement fund with real estate

Yes, you can tuck property into your retirement account. But you have to be careful. A single mistake can turn into a tax disaster. Here's what you need to do.

By Jeff Schnepper

Over the last few years, stocks have cratered. Despite their recent rebound, millions of retired and almost-retired have been forced to extend their working years just to maintain a minimum standard of living.

But one asset has skyrocketed in value during that period -- real estate.

And while your 401(k) plan may not offer real estate in any form, the fact is, you *can* own real estate in your retirement plans. Retirement plans are by nature long-term investments. And, you can't get much more long term than real estate. But you must keep in mind that you'll be able to invest only for income and appreciation. You can't deduct depreciation, as you can in a taxable investment. And you have to be very careful how you do it. A single bad move can create a major tax disaster.

Know the rules

The law allows your qualified plan or IRA to own just about any kind of real estate. You can invest directly in property: single family and multi-unit homes, co-ops, condos, apartment buildings, even improved or unimproved land. You can invest indirectly in real estate investment trusts, but I'm not wild about these for retirement because their overheads are too high.

If you buy a property for your IRA, the income and appreciation normally builds up tax-free until you start to take withdrawals.

Careful now: I said normally tax-free. That's because there's a special tax on debt-financed income in retirement plans called the unrelated business income tax (UBIT). If the real estate is mortgaged, then you must file Form 990-T with the IRS. It allocates the income earned between debt and non-debt financing, and the tax due. So, let's say you want to buy a $100,000 duplex for your retirement account. You put in $70,000 and borrow the remaining $30,000. On a simplified calculation with the UBIT, you'd be able to shelter only 70% of the income. The rest of the income from the property is subject to ordinary income tax rates.

That's why an all-cash transaction is probably the easiest. If you don't have sufficient cash, your retirement plan can purchase a partial interest in a property. That's known as a tenant in common interest.

Or, you can borrow the money to finance the property and pay the UBIT. Depending on aggravation level, costs, tax rates and rates of return, the leverage may be worth the tax cost.

The advantages of real estate in a retirement plan are its potential high rate of return, added diversification and its lower risk over the long run.

This can be a pain to set up

Disadvantages only begin with the hoops you have to jump through. First you have to get your dollars from your retirement custodian (probably your broker) to an independent custodian that offers real estate as an investment option. These include Sterling Trust, of Waco, Texas, Lincoln Trust of Denver and Pensco of San Francisco. (You'll find links at left under Related Sites.)

You sign a direction letter to the custodian to purchase the property. The rents go into the retirement account and all expenses are paid from the account.

You can use a Roth individual retirement account, a traditional IRA or even a single-participant 401(k) to purchase real estate. All you need is a custodian that allows real estate investments. Check out Entrust Administration for single-participant 401(k)s and self-directed retirement plans. (You'll find a link at left under Related Sites.)

Watch out for other traps. You can't transfer property you already own into a retirement account. You also can't buy a vacation house and rent it out to yourself. That's called "self-dealing" and is a prohibited transaction. It covers your family members as well.

Perhaps the biggest drawback to investing in real estate for a retirement account is the loss of the depreciation deduction. It's useless inside a retirement account. However, many argue that the cash flow and appreciation benefits outweigh the loss of the depreciation deduction. That does work for REIT investors.

The Roth IRA: great potential but tax complications

My favorite retirement vehicle for real estate investment is the Roth IRA. Profits earned under the Roth umbrella, including rents and all the gain on any sale of the property, normally escape taxation. Your contributions aren't deductible. But, if you had the dollars in the Roth for at least five years and are either 59½, disabled or dead (distribution is to your beneficiary), or to the extent you're a qualified first-time homebuyer, all of the dollars come out tax-free!

If your Roth now has lots of cash, or stock that can be sold for cash, you can pay cash for the real estate. That, of course, gets you around the UBIT problem.

If it doesn't, you might consider rolling over traditional IRA dollars into the Roth. If that doesn't provide sufficient cash (or if you don't already have a traditional IRA), consider rolling your 401(k) or pension dollars into a new IRA, with a second rollover into the Roth.

Make direct transfers rather than taking the cash in hand and rolling it over into a new account. Unless it's a direct transfer, the IRS requires withholding, normally at a 20% rate. The IRS requires 20% withholdings on all rollovers of qualified plans. That means you'd have to come up with the withheld dollars to roll over within the 60-day tax-free window or face tax and penalty. Withholding is not required with an IRA. But many financial institutions will withhold anyway.

In any case, you're going to be hit with tax on the earnings built up in the retirement account when you roll over to the Roth. That should be a major consideration in your decision process. As a general rule, the younger you are, the more advantageous the Roth becomes compared to other retirement alternatives. But, because of the tax, less money will be reinvested.

It's a complicated decision. And it's based on multiyear projections. And those are based on guesses as to current and future tax rates and rates of return. So you obviously must have a good assessment of the health of your local real estate market.

Here's another strategy

There is a strategy you can use if you want. You don't have to convert *all* your traditional IRA dollars to a Roth in a single year. You can convert a portion of the account each year, depending on your needs.

If you don't have sufficient cash, again, your retirement plan can buy a partial interest in a property as a tenant in common. And, of course, you can borrow the money to finance the property and pay the UBIT. Depending on aggravation level, costs, tax rates and rates of return you can expect in your market, the leverage may be worth the tax cost.

Your adjusted gross income may also limit your ability to convert. You can't convert if your adjusted gross income is more than $100,000, or if you're married filing separately. Amounts converted don't count toward the $100,000 limit.

While real estate isn't appropriate for everyone's retirement account, it should at least be looked at as another arrow in your quiver of retirement investment alternatives.

Jeff Schnepper is the author of the best-selling "How to Pay Zero Taxes," which is in its 15th edition. He has written several other books on finance and taxation including "TurboTax Deluxe," "How Much is it Worth? Asset and Business Valuation," "The New Bankruptcy Law: A Professional Handbook," and "Inside the IRS, How it Works (You Over)." A former professor of taxation, accounting and finance, Schnepper has argued before the U.S. Supreme Court and has appeared on numerous national and local television programs. He lives in New Jersey.