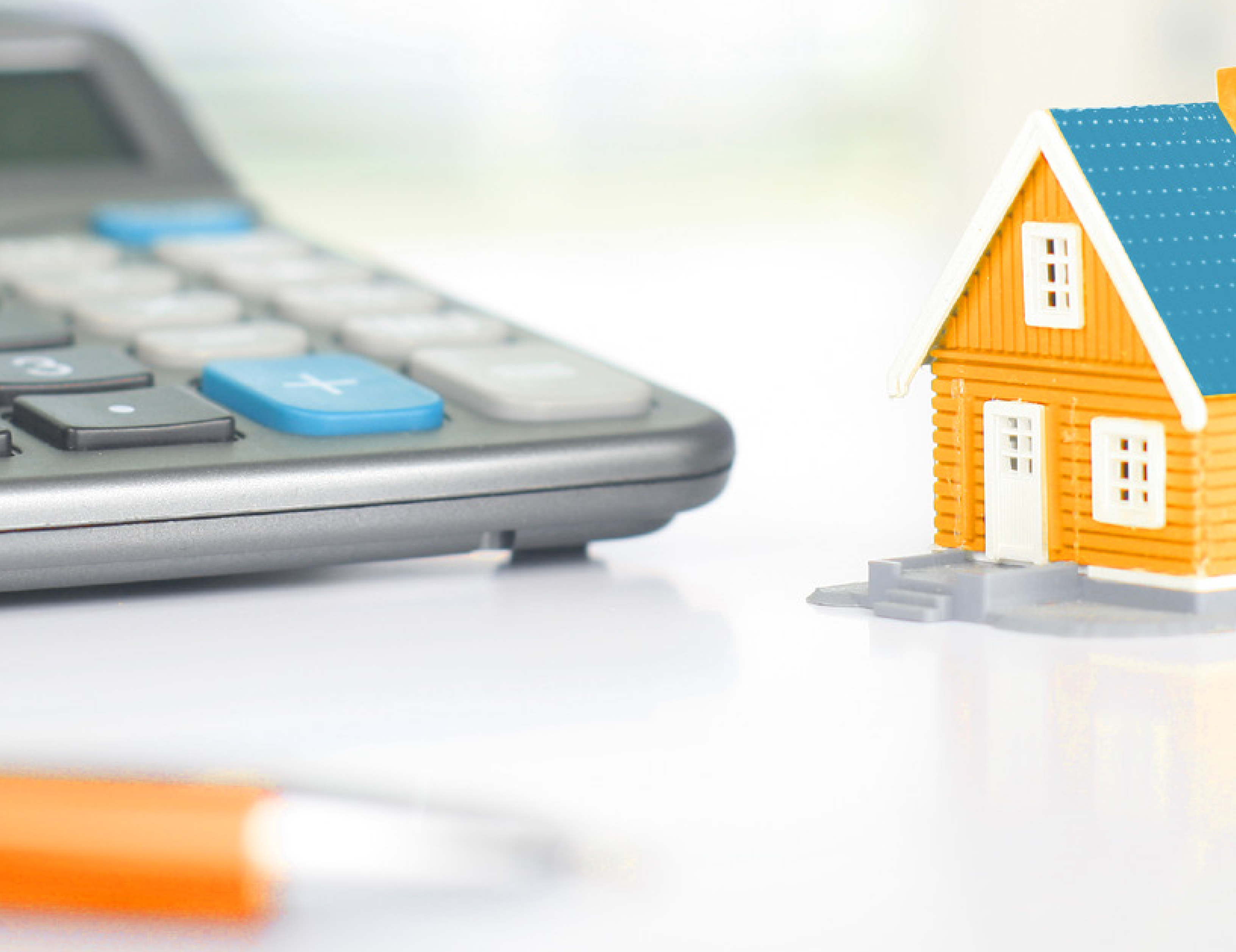
Real Estate Investing

HOW TO HOLD REAL ESTATE IN A SELF-DIRECTED IRA OR QUALIFIED PLAN



synergy
FINANCIAL
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This article is meant to be an introduction to the topic and not an exhaustive guide. The topic is complicated, and I recommend that anyone interested in pursuing this type of investing seek the advice from the appropriate professionals so you may be advised on the particulars of your individual situation.

This article is written in two parts. Part I covers basic information on real estate, and Part II explains how to use retirement plans to buy, sell and hold real estate.

The strategies discussed can be used in many types of retirement plans such as an IRA, 401(k), SIMPLE, SEP, or other retirement plan. I will use the term IRA or retirement plan generically to reference these types of accounts.

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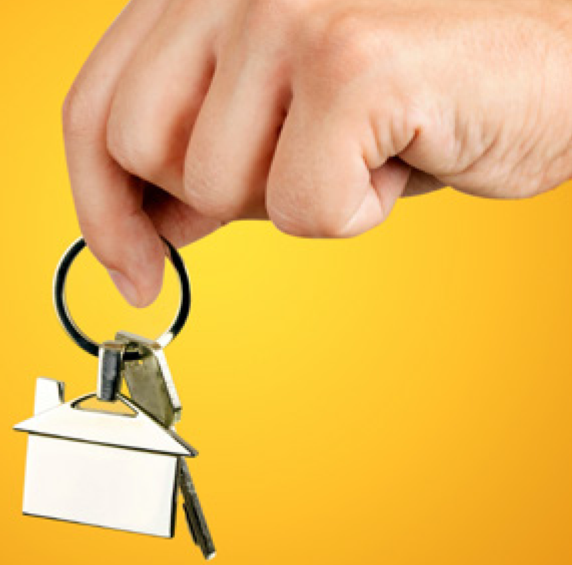


Part I: Real Estate Basics

Modern portfolio theory suggests that real estate is an important part of an investment portfolio's asset allocation. From asset allocation we get diversification, which means an overall reduction in risk.

Real estate investments can be made through an indirect purchase of real estate such as in Real Estate Investment Trusts (REITs) or through a direct purchase of property. It is the direct ownership of real estate that we will focus on because of its particularly appealing favorable risk-return tradeoffs that result from its uniqueness and the relatively inefficient markets in which real estate trades.

Some people follow the theory that the securities markets are efficient, and others do not. However, I do not know anyone who believes that the real estate markets are efficient. What this means is that skillfully conducted real estate analysis can really pay off.

The reason why real estate markets differ from securities markets is that there is no good system for complete and accurate information exchange among buyers and sellers. There is no central marketplace like there are in the securities markets, such as the New York Stock Exchange or other exchanges. Instead, real estate is traded in generally illiquid markets that are regional or local in nature and where transactions are made to achieve investors' often-unique investment objectives.

Before we discuss how to buy, sell, and hold real estate in self-directed IRAs or qualified plans, let's briefly discuss investor objectives, constraints and analysis of important features of real estate that apply whether you are investing in or out of your retirement plans. Please remember that just because you can use your retirement plans does not necessarily mean you should use your retirement plans for real estate investing.

Just as a mutual fund manager is responsible for managing securities for its shareholders, you must realize that managerial decisions about real estate greatly affect the returns earned from investing in it, and that you are the manager. Thus, you must ask yourself some tough questions.

Are you going to invest in income-producing property, such as residential rentals and multifamily properties like apartments; or, maybe, commercial properties like office buildings and shopping centers?

You may be a real risk taker and prefer speculative property like raw land and real estate investment properties that are expected to provide returns primarily from appreciation in value due to location, scarcity, and so forth, rather than from periodic rental income. If you decided on income producing property, you may want to ask questions like:

- What rents should be charged?
- How much should be spent on maintenance and repairs?
- What appurtenances will be transferred with the property?
- Are there any looming adverse environmental issues?

Along with market forces, answers to such questions determine whether you will earn the desired return on a real estate investment. Remember, like other investment markets, the real estate market changes over time and you need to stay abreast of the macro and micro issues that might affect your real estate portfolio. Investing in real estate means more than just "buying right" or "selling right". It also means choosing the right properties for your investment needs and managing them well.

Managing your properties well will be easier if you have clearly identified your investment objectives and constraints. As we discussed earlier, do you want income producing property or speculative property? To select wisely, you need to consider the available types of properties, and to which type you are better suited.

When setting your objectives, you also need to set both financial and non-financial constraints and goals. Often this financial goal is stated in terms of discounted cash flows (net present value) or an internal rate of return (IRR). The risk-return relationship you find acceptable will be determined by:

- How much money do you want to allocate to the real estate portion of your portfolio?
- Will you use debt financing?
- Do you require positive cash flow?
- How much down payment will you make or how much down payment is required to achieve your return goals?

You also need to consider how your technical skills, temperament, repair skills, and managerial talents fit a potential investment.

- Do you want a building with curb appeal and that is trouble free?
- Or would you prefer a fixer-upper?

There are four ***general features*** related to real estate investments on which to base your analysis.

PHYSICAL PROPERTY

PROPERTY RIGHTS

HOLDING PERIOD

LOCATION

PHYSICAL PROPERTY

Through proper inspection of the site and its building(s), you can make sure you are buying what you think you are buying. Problems can arise if you fail to obtain a site survey, an accurate square-footage measurement, or an inspection of the building(s). Be sure to confirm that the purchase and sale agreement accurately identifies the real estate via its legal description and that it lists all items of personal property you expect to receive (such as a refrigerator).

PROPERTY RIGHTS

When you buy real estate, what you are really buying is a bundle of legal rights that fall under concepts in law such as deeds, titles, easements, liens, and encumbrances. Just like you do a physical inspection, you want to do a legal inspection. Real estate and lease agreements should not be the work of amateurs, and you should seek the advice of a qualified attorney when necessary.

HOLDING PERIOD

When you are evaluating your holding period or time horizon, you need to remember that the real estate market goes through cycles just like other markets do, and you need to identify where you are in the cycle. Prices go up and down, slowly and quickly, so before judging whether prices will appreciate or depreciate, decide what time period is relevant for your situation and the property in which you are investing.

LOCATION

Location, location, location! You have heard it before, and, yes, it really is that important. For some properties, the area of greatest concern consists of a few blocks. For others, an area of hundreds of square miles serves as the relevant market area. Understand the boundaries that are important for your investment so you can properly analyze supply and demand.

The last issue I will mention before moving on is determinants of value. In the analysis of real estate investments, as with all investments, valuation is a key concern. This subject matter could go on for pages; but I will keep my comments brief, because I feel you should be working with a qualified professional who can help you with valuation issues.

There are four main ***determinants of value*** that will help you evaluate your real estate investment.

DEMAND

SUPPLY

THE PROPERTY

PROPERTY TRANSFER PROCESS

DEMAND

Demand is the measurement of people's desire to buy or rent a given property at a given time and stems from a market area's economic base. Property values follow an upward path when employment is increasing, and values typically fall when employers begin to lay off workers. Population demographics and people's emotional dispositions called psychographics are also key elements to demand.

SUPPLY

How many other similar properties (competitors) are available in your targeted area? Size up the competition. The more properties on the market for a given number of buyers or sellers, the lower the value becomes. The fewer properties on the market, the higher the value becomes. One other concept to evaluate is the principle of substitution. Are there other properties that can fill the same need? If so, then there is more supply.

THE PROPERTY

The property itself is a key ingredient. Look for a property's unique selling advantage. What makes it different? What is its competitive edge? Investors should consider five factors:

1. **RESTRICTIONS ON THE USE OF THE PROPERTY**
2. **THE LOCATION**
3. **THE SIZE AND QUALITY OF THE SITE**
4. **IMPROVEMENTS MADE**
5. **THE EFFICIENCY OF MANAGEMENT**

PROPERTY TRANSFER PROCESS

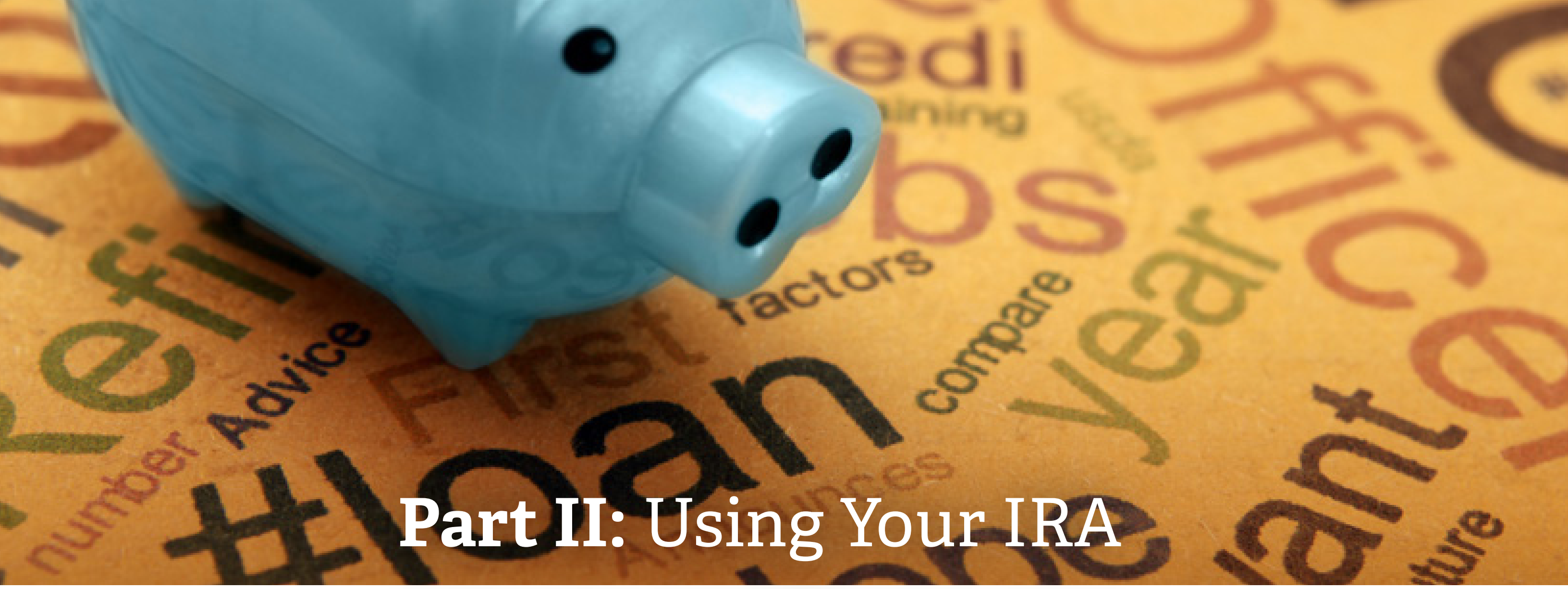
This is the process of promotion and negotiation of the property, which can significantly influence the cash flows a property will provide. Here we are trying to bring efficiency to an inefficient market. You may want to think of this as creative or efficient marketing.

Once you have gathered all of the pertinent valuation determinants, you can then perform the valuation and investment analysis, interpret your results, and make a portfolio decision.

TO SUMMARIZE THE PROCESS

- Set objectives, goals, and constraints
- Analyze important features of the property
- Gather determinants of value
- Perform analysis
- Implement your decision

Please find an example of what one evaluation might look like as an exhibit at the conclusion of this writing.



Part II: Using Your IRA

For many years now, people have been using non-directly owned real estate in their IRAs and other retirement plans. These intangibles are investments like REITs and real estate mutual funds. Most people didn't know they could use their retirement plans to purchase directly owned real estate such as raw land, commercial buildings, condos, residential properties, empty lots, trust deeds, or real estate contracts.

In general, the internal revenue code (IRC) section 408 does not prohibit the holding of real estate in an IRA, provided the transaction is not prohibited under IRC Section 4975.

Code section 4975 covers what transactions are prohibited between an IRA or retirement plan and a "disqualified person". Generally, "disqualified persons" are defined to be the accountholder, other fiduciaries, certain family members, and businesses under the accountholder's control. In essence, the prohibited transaction rules prohibit an IRA or qualified retirement plan from owning a piece of property which will be purchased from or used personally by the accountholder, family members, or businesses under the accountholder's control. Simply put, the property must be used for investment purposes only and cannot be used personally while maintained in the IRA. In addition, properties that are individually owned outside of the IRA cannot be transferred or purchased by one's individual IRA.

Remember, the IRS will not let you use your IRA to purchase your home or a vacation home. Nor will they let your business lease property from your IRA. You cannot have personal use or benefit from the property. If you did, it could cost you plenty in taxes and penalties.

However, it may make sense to take the property out of the IRA as a distribution and live in it during retirement.

Make sure not to move in until the distribution is complete. The distribution would need to be at the current market value as of the date of distribution and taxes would be due unless your account was a ROTH IRA. This may be a good reason to convert your IRA to a ROTH. Further, if you were under the age 59½, a 10% penalty may also apply.

EXAMPLE Convert your IRA to a ROTH IRA and pay the income taxes now. Once the conversion is complete, use your new ROTH IRA to purchase a residential rental property in a location in which you may want to retire. Rent the property until retirement. When you are ready to retire, take the property out of the ROTH IRA as a tax-free distribution, assuming you follow the rules, and then you may live in the property.

For those of you who stopped reading and immediately called your basic IRA provider so you could get started investing in real estate right away, you probably were told that you were not allowed to do so and now think I'm crazy. So, now that you're back, let's find out how you go about doing this.

The first key step to investing tax-deferred or tax-exempt in real estate is to open a self-directed IRA with any one of the dozen or so independent IRA custodians that allow real estate investments. Remember, just because it may be okay with the IRS does not mean that your local bank, stockbroker, or insurance company will provide this service.

A self-directed IRA is simply an IRA where you are in control of your investment options and are not limited to just stocks, bonds, mutual funds, and other traditional securities.

In a self-directed IRA, you have access to all of these traditional investments plus real estate and even other alternative asset classes.

Because fees and other services may vary, it is a good idea to check out a few of the independent IRA custodians to find the one that fits best with your needs.

Now that you know how to open an account, let's discuss how to fund the account. In 2016, the IRA and ROTH contribution limits are $5,500 or $6,500 for an individual over the age of 50 and making catch up contributions. We all know that five or six thousand dollars is not enough to buy a rental house, so how else can we fund the IRA?

One very popular way, if eligible, is to roll over your 401(k) plan into a new self-directed IRA or use a self-directed 410(k) that is allowable by both the IRS and the IRA custodian.

In many scenarios, the IRA holder will have sufficient funds to cover the real estate purchase, but what if you find a great investment property for your IRA, something really valuable, and your retirement account simply doesn't have adequate funds? Luckily, there are a number of ways in which you can make the purchase and still keep the transaction both legal and profitable.

We will review three ways in which you may want to pursue real estate investing with your IRA.

LOANS

TENANCY-IN-COMMON (TIC)

LIMITED LIABILITY COMPANIES

LOANS

Yes, you can use debt financing to purchase real estate in a self directed IRA. However, to do so legally, you must use the IRA-purchased property, not the IRA itself, as security for the loan. This type of permitted borrowing is called non-recourse lending. A non-recourse loan is not like the loan on your personal residence. In fact, it is very different. Here, unlike your home loan, if the loan isn't paid back as promised, the lender may take the IRA-owned property used to secure the debt, but may not take recourse against any of your other assets. Because of its unique nature, not very many banks or lending institution offer these types of loans, but they do exist, and your self-directed IRA custodian may be able to point you in the right direction.

Like other loans, non-recourse loans do have a monthly payment and some type of amortization schedule which will need to be followed. Therefore, your IRA property will need to be able to make the loan payments from its cash flow, its annual IRA contributions (within the 2016 limits – $5,500 or $6,500 if 50 or over), or some combination of the two. Simply put, you need to have more money coming into your IRA than is going out. This also means you need to have sufficient liquidity in your IRA for other real estate related expenses like property taxes, insurance, and other repairs and maintenance. Remember, the IRA itself must pay all expenses.

Let's look at a simple example:

PRESENT VALUE OF LOAN **$100K**

Term (amortization period)	30-year fixed
Annual Interest Rate	7%
Monthly Payment	$665.30
Annual Payment	$7,983.62
Annual Property Tax	$1,500
Annual Insurance Premium	$400
Annual Repairs	$150
TOTAL ANNUAL COSTS=	**$10,033.62**

The amount of $10,033.62 is the amount of money going out each year, and so your property would need to have more than this amount coming in each year. So, for a person under the age of 50, you could subtract the $5,500 annual IRA contribution from the $10,033.62 annual expenses and you would need ($10,033.62 - $5,500 = $4,533.62) $4,533.62 of cash flow from the property.

In addition to annual operating expense, in accordance with Section 511 of the Internal Revenue Code, if your IRA property has debt, or if a mortgage was incurred with its acquisition, you must pay annual taxes on any income produced. This special tax is called Unrelated Business Taxable Income (UBTI). Please note that this tax does not apply to every property purchased with an IRA but only to those that have related debt. Here is an example of how it works. Please be advised that I am not a CPA and that the following calculations are for illustrative purposes only. I advise you seek tax advice from your own CPA when it applies to your individual situation.

First, your income is taxed only after deductions are made for expenses and for other items that are deductible. Then, the first $1,000 of your net income from the property is not subject to tax.

Using our previous example you will remember that we had a loan of $100,000. Let's also say that you put down $100,000 so that the total purchase price was $200,000. Finally, let's say you found some good renters and your net income after expenses is $1,500.

The first $1,000 is not subject to tax, so only **$500** **NET INCOME WILL BE USED IN THE UBTI CALCULATION**

The tax is based on the relationship between the average amount of debt on the property during the preceding twelve months and the property's average tax basis. Here tax basis is the purchase price, increased by improvements or decreased by depreciation, during the same period.

In our example our ratio looks like this:

Debt	$100,000
Basis (purchase price)	$200,000
Ratio equals	$100,000 / $200,000 = **50%**
We then apply the ratio to the income that is subject to the UBTI tax.	
$500 (net income) x **50%**	= **$250** (and is then taxed at the current rate for trusts)
The trust tax rates, like other tax rates, are a moving number. Here we will use a trust tax rate of **37.5%**	
$250 x **37.5%**	$93.75
SO YOUR TAX LIABILITY IS **$93.57**	

You should notice that as the debt is reduced, the UBTI tax is decreased proportionately.

TENANCY-IN-COMMON (TIC)

For people who identify an attractive property that costs more money than they have in their IRA or more than they can (or are comfortable) borrowing, tenancy-in-common may be a solution.

Tenancy-in-common is a form of concurrent ownership in which two or more persons each have an undivided interest in the entire property, but no right of survivorship. Because each person's interest, or share, is undivided, each can sell his share at any time without the consent or agreement of the others. So, how does this help you? Let's go through an example:

Let's say you and two of your friends find a good property in which to invest, and the purchase price is $100,000. With a tenancy-in-common arrangement, you can buy the property together, with each person putting in the amount of money he or she has available. Each will own a certain percentage of the property, the income generated from its operation, and, eventually, a percentage of the profits when the property is sold.

OWNERS	CONTRIBUTION AMOUNT	% OWNERSHIP
You	$60,000	60%
Tom	$20,000	20%
Rob	$20,000	20%
Total	**$100,000**	**100%**

A tenancy-in-common arrangement also allows use of both IRA funds and non-IRA discretionary funds to buy a single investment. It is not a requirement that each of the owners use the same type of funds as the others. Here is what I mean:

OWNERS	CONTRIBUTION AMOUNT	CONTRIBUTION TYPE
You	$60,000	50% IRA money / 50% cash
Tom	$20,000	100% IRA money
Rob	$20,000	100% cash
Total	**$100,000**	**100%**

Your IRA has a current balance of $40,000 but you do not want to use the entire $40,000, so you use $30,000 from your IRA and $30,000 from your bank account. Your total contribution amount is $60,000, and you're a 60% owner of the property.

Tom's IRA has a current balance of $20,000. He is comfortable using the entire amount, and he will fund future property expense inside the IRA with his annual IRA contributions.

Finally, Rob does not own an IRA, so he will use some of his savings account to contribute his $20,000.

The possibilities are endless.

LIMITED LIABILITY COMPANIES (LLC)

The limited liability company is another flexible option if your IRA does not provide sufficient funds for the purchase, and neither loans nor tenancy-in-common ownership provides a solution for which you are looking.

I am going to skip the long version of what an LLC is and leave that to your attorney, but, briefly defined, an LLC is a form of business entity that offers both limited liability for its owners and certain tax benefits.

When using LLCs, it is similar to investing in a real estate investment trust (REIT) in that your IRA may be invested in limited interests which is kind of like investing in shares of stock. The difference here is that LLCs are private, and there are usually only a few investors that are limited members and a developer that is the managing member.

HERE IS ONE WAY AN LLC MAY BE USED

You know a developer who is getting ready to start a new project in your local area. He has used $1,000,000 of his own money to purchase the land and now is trying to raise capital to develop the property. Once the project is finished and the condos are sold, he expects to realize a large profit. He is willing to give up some of his profit in exchange for the needed capital.

The name of his company is ABC Construction Company, LLC. After your attorney has reviewed the proper agreements and you have done your due diligence, you may instruct your self-directed IRA custodian to purchase the units of ABC Construction Company, LLC that have been agreed upon with the developer.

This is a simple version, and there are many more detailed points to be considered and understood when using LLCs, but I hope this provides some food for thought.

Now we are ready to talk about how to actually purchase the property. When using your IRA to purchase property, the steps in buying real estate are really no different than if you were not using your IRA. There are a few things to be aware of, and we will review them now.

THE BASIC STEPS ARE

1. The Purchase and Sales Agreement (the offer)
2. The Acceptance
3. The Inspection
4. The Closing

The purchase and sales agreement is where it all starts and is probably the most important. Each self-directed IRA custodian will have their own set of rules and procedures, so you need to review their real estate processing checklist well in advance of actually making an offer.

You need to make sure that the purchase is made by your IRA custodian and not you, personally. This means that you will need to set up your self-directed IRA prior to making an offer. If you are under the gun and did not have time to open your IRA, and if the person making the offer is not a disqualified person, you may make the offer in the following way: “John Doe and or assigns”. Adding the phrase “and or assigns” will allow you to assign the contract to the IRA custodian once the account opened.

In addition, if you put up earnest money with your personal funds, you will need to make sure you include that amount in the total due so that the title company can reimburse you upon closing.

Some IRA custodians will require that they hold the original recorded title to the property in safekeeping. The title should reflect the name of your IRA custodian for your benefit, such as, XYZ Trust Company, Custodian FBO John Smith IRA.

In conclusion, I hope you now realize that there are some interesting and creative ways to invest in real estate and that this can be done in your IRA or other types of retirement plans. This topic is very complex and by no means have all the elements of this opportunity been covered in the article, but I hope it was a good start for you.

Please remember that this type of investing is best utilized when using a team of professionals that can help you navigate the potential hazards. Please seek the advice from the following professionals as needed: an Attorney, CPA, IRA Custodian, CFP, Real Estate professional, Mortgage Broker, Registered Investment Advisor or other competent Financial Advisor.

Of course, I am more than happy to discuss your individual situation and can be contacted at my office in Seattle at Synergy Financial Management, 701 Fifth Avenue, Columbia Center, Suite 3520, (206) 386-5455.

Thank you for taking the time to read this article, and happy investing!