Tax-Sheltered Real Estate Investing in a Self-Directed Retirement Plan

SAFEGUARD ADVISORS

UNLOCK YOUR RETIREMENT PLAN

Introduction

With a self-directed IRA or Solo 401(k) retirement plan, you can break free of limited investment options and pursue a truly diversified path to wealth building.

Holding real estate as an investment in your tax-sheltered retirement plan can be a great way to secure your retirement future. Real estate has long been one of the most reliable forms of wealth creation. By combining this stable asset class with the power of compounded tax sheltering in a retirement plan, you can create tremendous potential.

If you're ready to unlock your retirement plan and invest in what you know, our team at Safeguard Advisors is here to help you understand what's possible.

In this guide, we'll help you understand some of the basic concepts and benefits of utilizing a self-directed IRA to invest in real estate, including:

- The benefits of holding real estate in an IRA
- Types of real estate that can be held in an IRA
- Which plan types are available to facilitate real estate investing
- IRS rules surrounding real estate investing in an IRA
- Leveraging your IRA dollars with mortgage financing

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The Benefits of Real Estate in your IRA

Real estate is an excellent investment asset for many reasons. As a real asset, there isn't the same exposure to total loss that's possible in paper assets. Real estate is generally less volatile than other market classes, and therefore a lot more stable and predictable. Not insignificantly, real estate value cycles are largely decoupled from stock market cycles, making real estate an excellent diversification play.

Real estate provides several avenues for income, including:

- The ability to purchase at a discount in some cases
- The ability to add value through updates, repairs, or additions
- Predictable cash flow from rental income
- Potential for appreciation of the asset

Many investors find comfort in the fact that real estate is an asset they can understand and control more directly. Your expertise can be put to work in selecting the right projects and markets, as well as managing the lifecycle of an investment from purchase to eventual sale.

When you own real estate in your retirement plan, the income accrues to the plan in the same tax-sheltered way as any conventional IRA. You can take advantage of tax-deferral in a traditional IRA or 401(k) to reinvest the non-taxed proceeds from your real estate investments, and compound growth over time. Gains from real estate in a Roth IRA or 401(k) will be tax free.

What Kind of Real Estate Can be Held in an IRA?

An IRA or 401(k) retirement plan can invest in real estate in a variety of ways. In fact, IRS rules don't restrict the type of real estate that may be held by an IRA.

Following are some of the common types of real estate investments available to IRA investors:

- Residential rental properties
- Commercial properties & apartments
- Industrial or storage properties
- Raw land, farm land, ranches & timber land
- Real estate development projects
- Property flipping
- Real estate partnerships, joint ventures, or syndicated investments
- Real estate crowd funds
- Real estate finance such as mortgage notes

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Self-Directed IRA and 401(k) Plans that Allow for Real Estate Investing

Retirement plans offered by mainstream financial institutions are limited to investments in publicly traded assets like stocks, bonds and mutual funds. The only way this type of IRA can invest in real estate is indirectly via a Real Estate Investment Trust (REIT).

IRS rules allow for a much broader array of investment choices, including real estate, mortgage notes, private equity, and other alternatives. Processing these investments within an IRA is more complex, which is why most firms don't offer the ability to invest in real estate.

In order to invest in real estate and other non-traditional assets, a self-directed IRA or 401(k) is required.

These plans are identical to more common IRA and 401(k) offerings in all ways relative to the tax code. Rules for contributions, age thresholds for distribution, designation of account beneficiaries, and annual reporting are the same. These accounts are also federally regulated in the same way as conventional offerings.

What makes a self-directed plan different is simply the specialized services that support investing in anything the IRS rules allow for – including real estate.

Several self-directed plan options are available, and most any kind of existing retirement savings can be converted to a self-directed format with no tax implications, including:

- Traditional IRA
- Roth IRA
- SEP IRA
- SIMPLE IRA
- Inherited IRA
- 401(k), 403(b) and 457 employer sponsored plans from prior employment
- Pensions and defined benefit plans

A current employer plan such as a 401(k) may not be eligible for transfer. These plans can only be moved to one of your choice if you terminate employment or continue working past age 59½.

Checkbook Control

The Right Tool for the Job

When it comes to investing in real estate with a self-directed IRA or 401(k), plans that offer "checkbook control" provide many significant advantages.

There are self-directed IRA plans held by specialty custodians that have the capacity to invest in real estate and other alternative assets, but such accounts can be cumbersome and expensive to use.

In this arrangement, the custodian acts as a passive processing agency at your direction. They hold the funds, sign every document, issue funds for expenses associated with the investments you choose, and receive the income produced by those investments. When you factor in the 3-5 day processing queue and combination of per-transaction and per-asset fees such custodians typically charge, this can be a less than efficient means to invest.

Safeguard Advisors specializes in plans that offer you direct control over all investment activities, and the ability to hold plan funds in a local bank account of your choosing for which you will have signing authority.

Rather than rely on 3rd party processing for your critical and time-sensitive investment activities, you can simply sign a contract and write a check.

Checkbook control is simply more effective and efficient than a custodian-held account, and will save you both time and money.

Checkbook IRA

A Checkbook IRA LLC provides the maximum amount of flexibility and control for IRA investors. A unique design featuring two layers is used to create this program:

1. A self-directed IRA account held by a registered trust company as custodian
2. A specially crafted Limited Liability Company (LLC) wholly owned by the IRA

All IRA accounts require a custodian by rule. In this structure, the custodian serves the necessary compliance and reporting role, but is otherwise in the background. All investment transactions take place within the LLC.

You will only interact with the IRA account for purposes of adding or removing IRA capital in the future. This could include making contributions, taking distributions, or rolling over funds between this and another IRA plan.

The LLC functions as your own personal IRA asset-holding company. The IRA is the 100% owner of the LLC. The IRA cash is invested into the LLC and remains under the umbrella of the IRA for reasons of tax treatment. You can serve as the manager of the LLC and will have signing authority on behalf of the entity. This allows you to direct the capital of the IRA-owned LLC into the investments you choose.

It's similar to having a more conventional IRA invested into a mutual fund - but you get to be the fund manager.

Checkbook Solo 401(k)

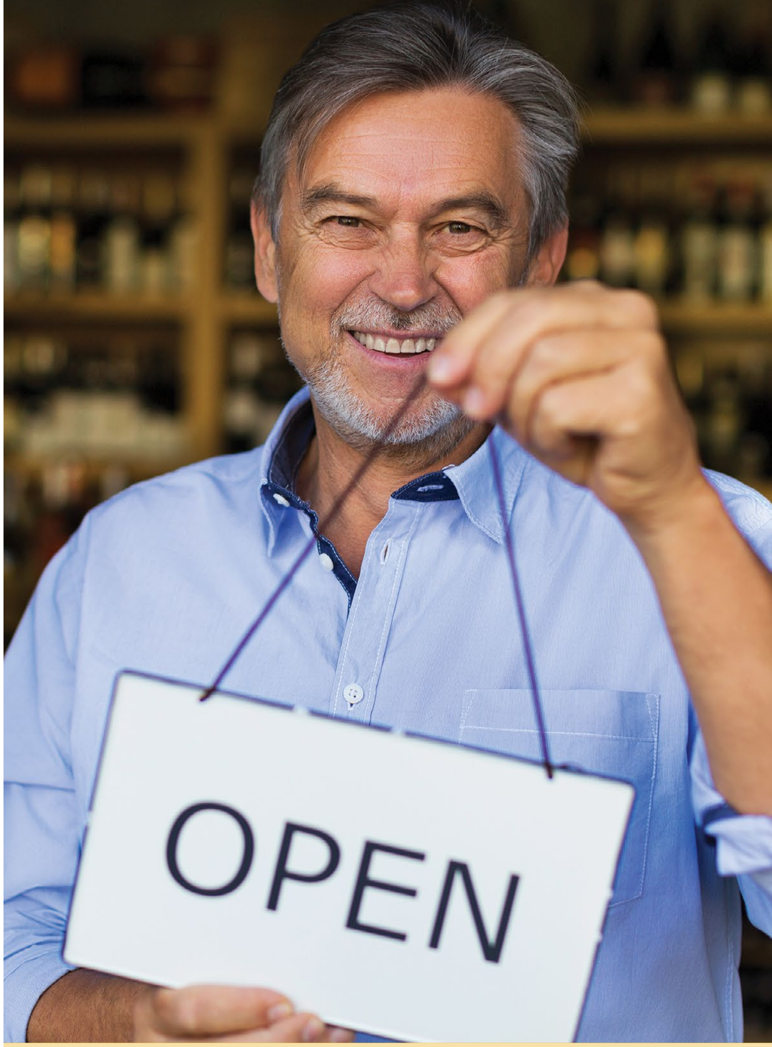
For investors who qualify by being self-employed and having no full-time employees, the Solo 401(k) is the preferred plan format.

Our Solo 401(k) plan offers the same kind of checkbook control as the IRA LLC, with the additional benefit of being a more powerful retirement plan designed for self-employed individuals.

With the Solo 401(k), no 3rd party custodian is required. The plan itself is a trust, and you as the self-employed business person act as the trustee. This gives you direct control over plan transactions, which you will fund from a bank account of your choosing held in the name of the 401(k) trust.

401(k) plans offer very generous contributions up to $55,000 for those under age 50 and $61,000 for those age 50 and older (2018 limits). You can also make Roth contributions of up to $18,500 per year without any income limits.

Solo 401(k) plans also allow you to borrow personally from the plan up to $50,000. That can come in handy in an emergency of if you need capital for a personal venture outside of the plan.



With the Solo 401(k), no 3rd party custodian is required.

The Solo 401(k) is popular with independent contractors, real estate agents, professionals like attorneys and CPAs, and other self-employed individuals. Many types of business formats qualify, including sole proprietorships, LLCs and corporations. You can even have qualifying self-employment to sponsor a Solo 401(k) while also working for a separate employer.

IRS Rules & Guidelines

The key benefit of IRA and 401(k) retirement plans is the tax-sheltered income they provide. This sheltering allows you to grow your savings over time by reinvesting and compounding investment gains, rather than seeing gains eroded by taxation.

To maintain tax-sheltered status when investing your IRA in real estate, there are certain rules that need to be followed.

The number one thing to keep in mind is that all investment activities must be executed at arm's length and exclusively for the benefit of the plan.

You or those considered disqualified parties to your IRA may not personally benefit from the use of IRA funds. Disqualified parties include:

- You as the IRA account holder
- Your spouse if you are married
- Lineal antecedents such as parents and grandparents
- Lineal descendants such as children and grandchildren
- The spouse of a descendant
- An entity such as a business or trust where one or more of the above have controlling interest
- Fiduciaries to your IRA or 401(k) plan

Keeping things at arm's length means you should avoid transacting with disqualified parties. This includes having your IRA purchase a property from you or a lineal family member. Your Solo 401(k) shouldn't purchase a property you intend to have a family member live in or rent, nor should your plan lend money to a disqualified party. It's also disallowed for your self-directed IRA to hire a disqualified party to perform services.

The prohibition against self-dealing applies in both directions. While you may administer the investment activities of your self-directed IRA, you may not add value to the IRA through the provision of goods or services. Providing your time and energy to the IRA would be the equivalent of making non-documented contributions to the IRA, and is therefore prohibited. This means you shouldn't perform work on an IRA-owned property, or use personally owned furniture to decorate an IRA owned rental.

A good way to approach this concept is to realize that a self-directed IRA is simply a means to diversify the investments of the IRA. These plans are not a way for you to access funds to make investments you wish, or to achieve some personal financial goal today. Instead, they're a way to provide a better investment option for the retirement plan... and for your future, retired self.

A Rental Property Investment

Let's take a look at using a self-directed IRA LLC to purchase a rental property to put these concepts in context.

The first step is to have your self-directed plan in place before writing an offer on a property. The IRA-owned LLC will be the purchaser of the property, and LLC funds must be used for any earnest money deposit or other pre-purchase expenses such as property inspections. It can take 3-4 weeks to have a plan setup, funded and ready to issue a check, so planning ahead is crucial.

Once you have your plan in place and have identified a good investment property, you as the LLC manager can negotiate with the seller, finalize a contract, and issue funds from the LLC bank account to provide an earnest money deposit.

The deed will be prepared in the name of the LLC. When it comes time to close on the property, you will sign the necessary documents and provide funds for the purchase from the LLC account.

If the property needs any repairs, maintenance or cleanup before it can be marketed to potential tenants, you can hire vendors to perform the repairs and pay them from the LLC.

Be sure to establish a commercial / landlord insurance policy where the LLC is the named insured.

You can hire a property manager to list and rent the property or choose to select and screen tenants yourself. Any pre-rental fees such as application fees or credit checks should be paid to the LLC or 3rd party property manager.

As the LLC manager, you can sign a lease with the tenant. The LLC is the landlord.

Monthly rents will be paid by the tenant to the LLC. This can be via check, direct-deposit to the LLC bank, or other means. The mechanics of funding aren't important — just that the LLC is the recipient of the rental income.

Any expenses including property taxes, insurance, repairs, etc. are paid from the LLC account.

If you're using a property manager, they can receive the rents, pay the expenses and send the LLC the net income. Or, they can send the full rent to the LLC and you can then pay the expenses from the LLC.

Any difference between the expenses and income is tax-sheltered growth for your IRA... similar to if your IRA received dividends on a stock investment.

In the future when your IRA sells the property, there are no taxes on any gain in value. You are essentially just reallocating the IRA from real estate back to cash, and can then reinvest in the next opportunity.

Pro Tip:

An IRA LLC may be funded with a smaller amount in order to place a property under contract. Once a subject property is identified and a specific funding need determined, you can transfer more funds as needed.

The Power of Leverage in your IRA

When purchasing a property with an IRA, it's possible to use mortgage financing instead of paying all cash. This approach allows you to extend the purchasing power of your IRA, and to bring the benefits of leverage to your IRA.

While using margin to invest in volatile assets like stocks can be a risky proposition, debt-financed real estate is a much more secure option for the use of leverage.

Because of the rules against self-dealing, any debt instrument the IRA utilizes must be non-recourse in nature. This means there is no personal guarantee from you. As a disqualified party, you may not provide the IRA the benefit of pledging your personal assets for the IRA's debt.

Only a handful of lenders offer such non-recourse mortgages for IRA and 401(k) investment properties. An IRA may also obtain private financing from other investors who are not disqualified to your IRA, or obtain seller-financing.

The terms offered by bank lenders tend to be slightly more conservative than a personally backed loan. Non-recourse mortgages will have higher down payment requirements and slightly higher interest rates, and will typically mandate a set amount of liquid reserves in the IRA.

When a self-directed IRA uses debt-financing to acquire property, there is a small tax on the Unrelated Debt-Financed Income (UDFI) that the IRA receives as a result of utilizing non-IRA money. The overall cost of this tax is far less than the benefits the IRA will receive through the use of leverage. Your IRA should see an increased cash-on-cash return for each dollar deployed when using mortgage financing.

A Solo 401(k) is exempted from UDFI taxation on debt-financed real estate. For investors who qualify for this plan format, that exemption eliminates paperwork and tax cost, making your leveraged investments simpler and more profitable.

The strategy of using debt-financing to acquire IRA owned property is more advanced, but can provide a significant boost to your investment returns.

When purchasing a property with an IRA, it's possible to use mortgage financing instead of paying all cash.

Passive vs Active Income and UBTI Taxation

While most any kind of real estate investment is allowed so long as one avoids self-dealing, choosing the right deal structures is important to ensure the full benefits of tax-sheltering.

Passive income such as from rentals, private mortgage lending, or the sale of a passively held asset are going to be fully tax-sheltered to an IRA or Solo 401(k) plan.

However, when a tax-exempt entity engages in a trade or business on a regular or repeated basis, the entity becomes subject to tax on Unrelated Business Taxable Income (UBTI). This tax is designed to protect tax-paying businesses from unfair competition by tax-exempt entities.

Flipping, wholesaling, and new construction for sale are types of real estate transactions that can create such tax exposure if they are a focused activity of your self-directed retirement plan.

An occasional flip will be viewed as an investment opportunity and non-taxed. A concerted strategy of buy-fix-sell-repeat may not be beneficial in the IRA space, however, as the tax on UBTI would degrade the returns.

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Frequently Asked Questions

Is it legal to invest IRA funds in real estate?

Yes, since IRA and 401(k) plans were created in 1974, a wide variety of investments have always been allowed.

Are my funds safe?

At the structural level, your funds are entirely safe.

Safeguard Advisors never holds client funds.

IRA plans utilize a licensed and registered self-directed IRA custodian operating under the exact same rules as any other bank or brokerage, and funds in cash are FDIC insured to $250K. Funds move through the custodian to a LLC account of your choosing and under your control.

In a Solo 401(k), no 3rd party ever holds your funds. A rollover to the plan will land directly in a trust account with a bank of your choosing, also insured by FDIC to $250K while in cash.

Once you invest, then there is risk of loss due to poor performance of an investment, or potential fraud by a 3rd party investment providers if such are used.

Are there taxes for converting to a self-directed IRA or 401(k)?

No. These self-directed plans are still qualified, tax-sheltered vehicles. They just provide a different model of investing

Why haven't I heard about this before?

The business model and financial self-interest of commission-based investment firms are centered on publicly traded assets. The mainstream financial services industry is simply not designed to provide access to real estate investments, and cannot easily profit thereby, so real estate is not on the menu.

Expert Guidance is Your Key to Success

Establishing your self-directed plan is only the first step.

How you use the plan is what really matters when it comes to building your retirement savings safely and successfully.

Quality education and guidance is the real value that comes bundled with each and every Safeguard provided retirement plan.

At Safeguard Advisors, our team of investment, real estate, and legal professionals is uniquely capable of providing the full range of ongoing consulting services you need to invest with confidence.

As a client of Safeguard Advisors, you have ongoing, unlimited access to our team so long as you are using the plan – at no additional cost.

You'll have a dedicated consultant who is a seasoned investor to help guide you as you take control of your retirement portfolio. If you want to understand the IRS guidelines surrounding a particular transaction strategy, learn how to use the power of leverage within your IRA, or just want help making your annual IRA contribution, we've got you covered.

Since 2005, we've implemented thousands of self-directed IRA plans for investors in all 50 states. Through dedication to excellent service for each and every investor we work with, we've earned an A+ rating with the BBB.

A+ RATING
BBB
ACCREDITED BUSINESS

With an A+ rating from the BBB, thousands of clients in all 50 states attest to our integrity and our competency.

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Serving clients nationwide since 2005

The first step on your path to success is a conversation.

If you are ready to explore your options and learn more about a self-directed retirement plan for investing in real estate, give us a call. One of our expert advisors will be happy to evaluate your specific situation and investment goals and recommend a personalized strategy for success.

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As with any investment, there is risk associated with investing in real estate. Before investing, you should ensure you have the financial ability and experience to gauge and understand the risks, perform the necessary diligence, and properly administer such investments in compliance with both local real estate laws and the federal tax code relating to IRA and 401(k) retirement plans.

Safeguard Advisors, LLC is not an investment advisor or provider, and does not recommend any specific investment. We provide properly structured self-directed retirement plan platforms that provide you as the investor with full control over investment decisions. The information above is informational in nature, and is not intended to be, nor should it be construed as providing tax, legal or investment advice.

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