REAL MONEY

AN IRA IS A POOR SHELTER FOR REAL ESTATE

YOU CAN BUY HOUSES WITH RETIREMENT MONEY, BUT YOU'LL LOSE THE TAX BREAKS YOU'RE COUNTING ON TO MAKE A PROFIT. BY JOHN MILEY

OUR READERS

WHO: PAUL AND DEBRA SATTERTHWAITE

WHERE: INDIANAPOLIS

QUESTION: SHOULD WE USE AN IRA TO BUY REAL ESTATE IF WE FIND GOOD PROPERTIES AT DISTRESSED PRICES?

PAUL, WHO WORKS IN telecommunications, has bought and fixed up investment houses on and off for 25 years. He's sold some and kept a few. Now, Paul, 56, sees properties selling—or not selling—for $100,000 less than the asking prices of a year ago, and he's thinking about dusting off his real estate experience to prepare for retirement for himself and his wife, Debra. Paul says he's tired of the stock market after ten years of just breaking even. Real estate sparks his enthusiasm. "I see an extreme opportunity. We believe the real estate market where we live in Indianapolis is at or near bottom," Paul says. So he's thinking of using his IRA to buy homes in the $150,000 range, then rehabbing them to rent or sell.

The rules for IRAs allow for a myriad of investing opportunities beyond stocks and bonds, and real estate is a hot pick. Since 2008, Equity Trust, an Ohio-based custodian of self-directed IRAs that specializes in real estate, has seen an 82% increase nationwide in IRA realty purchases, says CEO Jeffrey Desich. But investing in real estate inside an IRA comes with strict rules. Complication number one: Owning property in an IRA negates all the familiar tax benefits of owning investment real estate, says James Lange, a CPA and financial planner in Pittsburgh. You can't deduct property taxes or mortgage interest or take advantage of depreciation.

Aggravation number two: There's a long list of prohibited transactions. You and your relatives are barred from occupying or working on the property, so forget free rent or "sweat equity." The IRA, not you, owns the place, so if you're considering a rental property, you'll need a property manager to find tenants. Every dollar you invest in the property, plus expenses such as roof and furnace repairs, must come out of the IRA. Flout any rule and it's a catastrophe: The tax-deferred status of your entire IRA is ruined, and you'll owe income taxes on the full value of the IRA's assets, plus a 10% penalty if you're younger than 59½.

RYAN KURTZ

Annoyance number three: It's difficult to get a mortgage to finance real estate inside an IRA. So expect to pay cash—which means you can't do the leverage thing and put down just $6,000 to buy a $60,000 home with the expectation that you'll profit fivefold or sixfold if you make modest improvements and sell the place. On the other hand, securing a mortgage can be a mixed blessing because when you sell a property financed with borrowed money, it can trigger an arcane tax on unrelated business income.

For most people, purchasing distressed property works much better outside a retirement account. You can borrow at a low interest rate, enjoy the interest and depreciation deductions, and benefit from capital-gains rates when you sell. "Most of my clients who dabble in real estate actually don't make money," Lange says. Paul might be the exception (he intends to be discriminating in the properties he would consider), but his chances of making a killing would be better without the constraints of the IRA rules. ■