

Real Estate

Is It True That You Can “Buy Real Estate With Your IRA and Use It NOW!?”



You have seen this on the Internet and wonder, “Is it possible to use your IRA to purchase real estate that you can actually live in?” The answer to that question is NOT a simple “yes.”

There are two ways to buy real estate with your IRA:

#1 Purchasing as personal property but paid for with your account

The advertising that states you can buy real estate with your IRA and live in it is not actually referring to the purchase of real estate within the IRA. What it is talking about is a little known rule for IRAs whereby you can take distributions from your Plan before reaching the age of 59 ½ years without penalty. This type of transaction is called a 72(t) Distribution.

In IRS Publication 590, included in the list of allowed distributions without penalty is one in which you establish an agreement with the IRS for you to take equal payments from your IRA account. The IRS states:

Annuity. You can receive distributions from your traditional IRA that are part of a series of substantially equal payments over your life (or your life expectancy), or over the lives (or the joint life expectancies) of you and your beneficiary, without having to pay the 10% additional tax, even if you receive such distributions before you are age 59 ½. You must use an IRS-approved distribution method and you must take at least one distribution annually for this exception to apply.

The payments under this exception must generally continue until at least 5 years after the date of the first payment, or until you reach age 59 ½, whichever is later. If a change from an approved distribution method is made before the end of the appropriate period, any payments you receive before you reach age 59 ½ will be subject to the 10% additional tax.

Those who sell annuities primarily market the 72(t) Distribution concept. The IRA is actually investing in an annuity that guarantees a series of payments which are taken as distributions. This is how it is used for real estate purchases:

-Sellers of annuity contracts will have the individual transfer their annuity based IRA into a self-directed IRA, which in turn will purchase an annuity contract that guarantees a fixed payment in order to meet the required payment agreed upon with the IRS

-The individual will find a piece of real estate and buy it using a mortgage guaranteed by their personal assets with payments from the annuity used to pay the mortgage on the property.

How is this different from real estate held in your IRA? The substantial differences are:

1. You must have enough wealth to guarantee the mortgage on the property to begin with.
2. This is not an IRA investment. The real estate is outside of your IRA. Sale of the property, unless it is your primary residence, will follow all the rules of any investment sale.
3. The IRA is being liquidated to make the distribution payment. You may not put those funds back into the IRA after taking them out.
4. There is generally little flexibility on the



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rate of return or how you invest the IRA after the annuity is purchased and the 72(t) Distribution election is made.

5. You will be taxed on the distributions at your current tax rate rather than at your tax rate at retirement.

6. You have a mortgage on your credit rating as well as the need to come up with a down payment.

#2 Purchasing real estate as an investment within your self-directed account Using a self-directed custodian, you may, if you choose, buy and sell real estate within your IRA. The proceeds of each sale go back into your account, taxfree, to be used for the next purchase. There is no time limit on how long real estate is held nor is there any requirement for “like kind” purchases with the proceeds as there is in a Section 1031 Exchange. Taxes occur when you take distributions from the IRA at age 59 ½ or later, at which time they are taxed at your income tax rate at that time. With this type of investment, however, there is a requirement that this be an investment and that the IRA owner cannot use it personally while it is still in the IRA.

Which method or real estate purchase is right for you?

If your intent is to use your IRA now for the purchase of a second home to use now, for example, the 72(t) option could be for you. If your attraction to real estate is for building wealth within a tax-deferred account by buying and selling for a profit and growing your IRA, then a 72(t) is probably not what you want. The taxdeferred status of IRAs is specifically designed for the purpose of tax-free growth. You lose this status when the real estate is purchased outside the IRA and funded with taxable distributions from an annuity.

Are there other options available?

Must you purchase an annuity contract in order to take a 72(t) Distribution? The answer is no. It is possible to do a 72(t) Distribution from any IRA, regardless of the assets held. For ease of distribution, the investments in the IRA should have sufficient liquidity available to make the mandatory distributions. You, or your advisor, need only to be able to make the calculation of the required annual distribution amount. It is a relatively simple calculation, and most tax advisors can advise you. Your self-directed custodian can hold any investment of your choosing for the purposes of the 72 (t) Distribution-purchasing mortgages, income property or any cash-producing asset, for example. Consider that the purchase of an appreciating asset that also produces cash flow sufficient for your distributions may allow the account to grow for your future retirement needs while still funding the 72(t) Distribution. Making your investments inside a self-directed account allows you to keep maximum flexibility rather than locking you into the purchase of annuity contract. As an example, consider the following for your IRA:

- Purchase a condo for cash within your IRA for \$150,000
- Your IRA rents the condo for \$800 per month, which nets \$700 per month cash flow into the IRA.
- You determine that the required monthly distribution for a 72(t) will involve taking \$700 per month from your IRA account.
- You use the \$700 to make payments on your “second home” mortgage.

•The condo appreciates at a rate of 5% per year, making your IRA worth \$190,000 in five years even while paying out the required distributions.

•Your IRA is going up in value because it contains real estate.

You have your second home to use now.

Conclusion

Choosing the right option is important, especially when one of the choices is electing a 72(t) Distribution which involves a commitment to the IRS to take mandatory distributions. Seek input from your tax and financial advisors before embarking on investments either inside or outside of your IRA in order to quantify the tax consequences of the various options. For information on self-directed IRAs and the IRS rules applicable to those types of investments contact your local self-directed IRA administrator.