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Yes, you can buy real estate with your IRA

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All your IRA money is in mutual funds and you'd like to diversify. One way is to buy raw land, a house or a building -- even your retirement home.

By Adriane G. Berg

There it is, the retirement home of your dreams. The trouble is that you're at least a dozen or more years from retirement and most of your money is tied up in your IRA. Too bad, because by the time you're ready to sell your current home that oceanfront beauty could be way out of reach. If only you could access some of that IRA money without paying a penalty. If only you could rent the space and sock away the income, tax-deferred. Until you retire and enjoy it yourself.

Maybe it's commercial space or raw land

Or how about this scenario: Your landlord has just raised the rent on your office and a little building down the block has come up for sale. What a dandy idea it would be to grab it and have a building of your own. Once again, your IRA is richer than you are. If only it could be your landlord. Or maybe: Mabel and Norman always get such good deals on raw land, but this one is the best yet. An acre of waterfront property in Nicaragua, with two sweet little cottages for $45,000. If only that IRA could be tapped without all those penalties.

All your IRA money doesn't have to be in paper

Most investors believe they cannot use IRA money to buy real estate. Developed or undeveloped. They are wrong. You can invest IRA money in a wide range of investments, including stocks, bonds, mutual funds, money market funds, saving certificates, U.S. Treasury securities, promissory notes secured by mortgages or deeds of trust, limited partnerships and … real estate. That includes houses, condos, office buildings -- even if located in another country. You cannot use IRA money to buy your own residence, or any other property in which you live. It has to be investment property. But when you retire, you can direct your IRA to turn it over to you as a distribution, at the current market value. Let's take a look at one example.

Out of the woods in Maine

Jack Wrigley found himself in a potentially disastrous position and was able to free himself using the real estate IRA. Jack took early retirement from his corporation at age 55 and rolled his company pension plan money into an IRA worth nearly $250,000. The money was invested in stocks and bonds. He then set out to find his dream retirement home in Maine. Within a few months, he found it. It was a bargain price, too, because the owner was required to sell within eight weeks. The contract Jack signed required a $25,000 down payment, to be forfeited if the closing didn't take place as scheduled. The balance of the purchase price was $150,000. The problem hit. The investment condo in Boston that Jack was going to sell to raise the $150,000 fell victim to a soft market. No buyers. Jack was in danger not only of losing the retirement home of his dreams but his $25,000 down payment as well.

The real estate IRA to the rescue

The solution was the real estate IRA. Jack quickly opened a new self-directed IRA, rolled over the entire amount of his old IRA into it, then directed his trustee to make the purchase with the IRA becoming owner. The closing took place, but that was only the beginning of Jack's IRA advantage. Since the closing, the IRA has made wonderful capital improvements in the Maine property and rented it out for a nice income, all tax-deferred. (It could even have been tax-free if the Roth IRA had been in existence at the time.) Jack eventually sold his Boston condo and pocketed that profit. Now he is looking forward to his retirement, at which time the IRA will turn the property over to him as a distribution of the then market value.

How come no one knows?

Given the real estate boom of the 1980s, and its current resurgence, it's curious that so little is understood about "the real estate IRA." Perhaps it's simply a lack of advertising. IRA accounts invested in stocks, bonds and other financial paper are very lucrative for banks, mutual funds, insurance companies and brokerage houses. These institutions will gladly act as your trustee (the middlemen in all IRAs) and sell you their wares. But they won't act as your trustee if you want to buy real estate with IRA money. Why? They're not in the real estate business. So you're pretty much on your own investing in a real estate IRA. You have to find your own property, trustee and perhaps a management company, to collect rents and maintain the property.

'House power' to the people

As a practical matter, you'll find very few professionals who can guide you through the entire process. Housepower has created a manual and audiotapes (priced around $130), but there is no one-stop shopping service you can use. Still, the do-it-yourself process is simple. Contact an independent trustee for a self-directed IRA. You must find an institution that will open a self-directed IRA and follow your "self-directed" instructions to the letter. It's not as hard as you may think. Try Mid-Ohio Securities in Elyria, Ohio, or Sterling Trust in Waco, Texas. Sign broker-to-broker papers that will transfer designated portions of your existing IRA to your self-directed IRA. Find and buy the property using a real estate attorney to create the usual documents. Remember, you most likely will have to explain IRA ownership to him. The trustee will take title at your direction.

The rules governing real estate IRAs are strict:

- The house or property must remain in the trust until distribution at retirement.
- It must be treated like any other investment.
- You cannot manage the property. But your trustee can hire a third party -- a real estate broker, or local manager -- to collect rents and maintain or improve the property.
- All rental profits must be returned to the trustee.

You can pool real estate IRAs for expensive properties

In this way, folks can get together and even buy all kinds of properties. Tenants in office buildings have pooled their IRAs to buy out their landlords. In fact, a husband and wife can consolidate their IRAs to have more cash for a purchase, or leave them separate and form a partnership. Remember, you can always get out of your investment. Just direct your trustee to sell your property or interest, and have the funds reinvested elsewhere.

Use the Roth and pay no tax at all later

Or if you are over 59½ , you may withdraw any portion of the proceeds of sale after they are deposited in the IRA. The receipts from the sale must be returned to your IRA account if you are to escape taxation and possible penalties. The Roth IRA is an ideal vehicle for those who are eligible. If the value of the real estate is expected to appreciate, it would be best to opt for a self-directed Roth IRA and pay the taxes over the next four years. In that way, so long as the real estate is not distributed for five years, it will incur no tax when the deed is transferred to you personally. Assuming you and your spouse eventually live in it before selling, $500,000 of profit is completely tax-exempt.