

THE PROPERTY REPORT

Building Value / By Ray A. Smith

Using IRAs to Buy Mortgages Boosts Benefits

WISH YOU COULD INVEST in real estate without having to own or manage a property, while earning tax-exempt or tax-deferred income from that real estate? Well, financial planners are increasingly recommending an investment strategy that allows investors to do just that.

Buying property using an individual retirement account is a way to earn tax-exempt or tax-deferred income. And buying or creating mortgages or notes is a way an investor can invest in real estate without actually having to own and manage the property itself. Now more investors are combining the two—using traditional and Roth IRAs to buy or create mortgage notes.

One example of how the strategy works: A seller of a property would create a mortgage or note for the buyer. (Such notes or mortgages are usually created between individuals, not traditional lenders.) The borrower/buyer would make monthly payments plus interest to

the seller. The property seller would then sell that mortgage to an investor for cash upfront, often at a discounted price. The investor would buy the mortgage through his or her IRA and would earn income through the interest on the mortgage as well as the difference between the actual mortgage amount and what the investor paid—all without having to own the actual property or manage it. (See accompanying chart for details.)

The investor would normally have to pay tax on the income earned. But with an IRA, the investor would defer or wouldn't have to pay taxes on that income. Profits gained from investments aren't taxed in a traditional IRA until the money is withdrawn. And withdrawals from a Roth IRA are tax-exempt, provided the individual is age 59½ or older and has the Roth IRA open at least five years.

Using IRAs to buy notes isn't new, but financial planners and advisers are increasingly urging their clients to do it

now. One reason is that interest rates on these kinds of notes or mortgages are typically higher than the average market interest rates, which remain relatively low, says Patrick W. Rice, president of IRA Resource Associates Inc., a Canaan, Wash.-based advisory firm specializing in real-estate investing for IRAs. Other investments pegged to market interest rates aren't offering rates of return as high.

Also, in contrast with owning property outright, there are few tax advantages with owning notes. But by using an IRA to buy notes, an investor gets the tax advantages of the retirement account. IRAs are "a great vehicle to hold these instruments," says Dyches Boddiford, a real-estate investor based in Atlanta.

There are some risks, however: If the borrower stops making payments, Mr. Rice says, the IRA may end up having to foreclose on the property, a sometimes costly and lengthy process. What's more, the money to cover the expense associ-

ated with a foreclosure has to come out of the IRA and can't come from the investor's own pocket. That could erode an investor's retirement account.

Hubert Bromma, chief executive of Entrust Administration Inc., an Oakland, Calif.-based administrator of IRAs, recommends that investors conduct credit checks on borrowers. In addition, he says the IRA holder should require the borrower put up a significant equity stake, which could give the borrower more incentive to pay off the loan.

Mr. Boddiford adds that investors want to make sure that the mortgage they are buying is the so-called first lien. The first lienholder gets priority repayment treatment over other lienholders.

See the most recent **Building Value Q&A** column online at RealEstateJournal.com. If you have a real-estate question, e-mail it to BuildingValue@usj.com.

HGP Capital's Funding Philosophy is a little different than the above but the same investing methodology. For example on 12/16/04 I funded a \$95k loan to an individual that was buying a duplex in Atlanta. The purchase price was \$89k and we funded \$85k out of my SEP IRA to fund the purchase of this home for the buyer (our customer) to purchase it from Fannie Mae (Foreclosure As Is Sale) and the remaining funds needed to purchase

the duplex were provided by the buyer (We always require our buyers to have some money invested in the deal). We put \$10k in Escrow to reimburse the buyer as they progress with the renovations. HGP Capital (Loan Servicing Company) will collect 15% interest per annum on this 6 month interest only loan and my SEP IRA will be reimbursed 11% of these funds as its return on investment. My SEP IRA has the First Mortgage on this property as collateral for the loan. Basically my IRA is acting as a small little bank. In another mortgage that I funded out of my IRA (\$168k total construction loan), my IRA has received checks for \$1275 and \$1482 the last 2 months. This last month's interest of \$1482 was more than I made all year last year invested in mutual funds.

HGP Capital's Mortgage Investing Philosophy uses both IRA funds and taxable funds that are not inside of a Tax Deferred Account to invest in mortgages with real estate as the collateral. For example, last month a friend of mine was looking to invest some of the \$100k that he had accumulated in his savings/checking account over the last couple of bonus checks. We place \$50k of his funds into a 1st Mortgage. By the 9th of the next month he had earned his first 1.1% check (\$458).

Suggested Directions

Investing in real-estate mortgages with self-directed IRAs requires a little work on the part of the IRA holder. Here's some suggested guidelines for how to go about investing in real-estate mortgages with an IRA.

- **An individual with a self-directed IRA account** who wants to invest in mortgages must first conduct a transfer from his or her account with a stock broker, banker or insurance company to an independent custodian that offers real estate as an investment option.
- **Once the individual finds a mortgage** to buy or create, he or she signs a direction letter, a form that instructs the custodian to buy or create the note.
- **The IRA can't purchase a mortgage** from or create a mortgage for a related party such as a family member (ascendant, descendant or spouse thereof).
- **The lien and title** are in the custodian's name on behalf of the investor or IRA holder.
- **All the note payments**, including the interest, go to the IRA. The checks are made to the custodian for the benefit of the account.
- **The income earned from the notes** are tax deferred in a traditional IRA. The individual will have to start taking distributions at age 70 ½ years. At that point, distributions are taxed at the ordinary tax rate.
- **With a Roth IRA**, distributions are tax-free, provided the individual is 59 ½ or older and has the Roth IRA open at least five years.
- **Once the note is paid off**, the borrower owns the property free and clear of that mortgage.