MarketWatch

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Using IRAs to buy real estate

Six reasons to tap retirement funds now to buy rental property

By Chris Pummer

SAN FRANCISCO (MarketWatch) -- One of today's soundest investments is never touted in financial-services ads. The reason: Wall Street wouldn't make any money off it.

Since 1974, Americans have had the ability to use IRA assets to buy investment property. Yet the means to do that -- called a self-directed IRA -- remains one of the least known and unheralded investment vehicles in the vast financial marketplace.

Finding a bottom for home prices

David Berson, chief economist of PMI Group, talks to MarketWatch's Stacey Delo about how the housing market will rebound before jobs do, and why he expects home prices to bottom for most of the U.S. in early 2010. (April 1)

With foreclosed homes selling at dimes on the dollar, residential real estate is a bargain for investors holding cash. And if they can put 30% down, IRA investors will find specialty lenders eager to help them leverage their retirement savings with mortgages on rental properties.

The U.S. housing market may not yet have hit bottom, but the winds appear to be shifting. Existing-home sales are on the mend in hardest-hit markets and foreclosure-avoidance programs are expected to stem the rising inventory of bank repossessions, meaning the window to buy at rock-bottom prices could close before the year is out.

Bear in mind homes purchased with IRA funds can't be used for personal purposes. Doing so risks the IRS declaring the assets withdrawn and demanding immediate payment of income taxes and penalties on the entire account value.

Still, as an investment readily understood by anyone who's been through the home buying and selling process, purchasing a steeply discounted property that can produce annual income of 10% and more is a low-risk strategy for uncertain times -- especially for retirees whose fixed-income investments are paying paltry yields right now. Read more on setting up a managing a self-directed IRA.

Here are six reasons why buying real estate with an IRA is a potentially lucrative and wise move today:

1. A solid alternative to stocks

When economies teeter, investors often run to hard assets such as gold -- humankind's historic "store of value." Yet gold's value is measured not only in ounces but also in the intangible fear that surrounds its price spikes.

When it comes to hard assets, there's perhaps no greater shared sense of value from Mongolia to Montana than for land and a dwelling. And in U.S. history, there's never been such a fire sale on our housing stock.

The Great Depression exacted a heavy toll on home values, but there was nowhere near the inventory flooding the housing market as in the past year. The reason: A collapse in home prices, not stocks, triggered this meltdown.

Of course, some would say foreclosed-home buyers capitalize on others' misfortune. But the sooner we clear the massive, nationwide inventory of unsold homes -- which many economists argue is a key to recovery -- the better off we'll all be.

2. An investment well-suited for long-term investors

Even in the best of times, the stock market looks out six months to a year. Right now, even seasoned pros can't feel the bottom of the muck we're in.

Many retirement savers are uncomfortable with their nest egg tied up largely in stocks. That's just the direction where the system of IRAs and 401(k)s -- which also advances Wall Street's interests -- shepherds them.

Real-estate cycles generally run in decade-or-so swings and this one may not yet have neared its bottom. Housing values could drop another 10% to 20%, but the stock market also could drop further and take a decade to well surpass its previous highs.

Especially for those in or near retirement, buying a property that produces rental income that's likely to increase with inflation is as sound a long-term investment as any TV commentator or investing guru might offer.

3. Purchasing a significantly undervalued asset

For investors willing to hang on to a property for five years or more, residential real estate today presents a tremendous opportunity to do just what investors ideally do -- buy low and sell high.

In some of the hardest-hit regional markets nationwide, homes are selling for as little as 20% of their value in 2006. In the San Francisco Bay Area, for instance, a 3,400-square-foot, five-bedroom, three-bath house built in 2000 recently listed for $257,000 -- after last selling for $795,000 just three years ago.

More importantly, at a cost of just $75 per-square-foot, that's about a third of the new construction cost for a well-outfitted, single-family home in that region. An IRA buyer in that case would get a relatively new house that would require little maintenance -- and a 7,000-square-foot lot essentially thrown in for free.

While that may be an extreme example, countless thousands of existing homes nationwide are selling for 50% of today's construction and land costs. Putting aside previous overinflated values, that statistic illustrates how inexpensive home prices have become -- and how much upside they offer in terms of appreciation when the real-estate market finally recovers.

4. A steady income generator

At a time when companies are slashing stock dividends at record rates, retirees can't be assured of that income source. And with government bonds paying a pittance in terms of yield, that fixed-income stream is running mighty shallow.

Income from a rental property bought with a self-directed IRA flows back into the retirement account. The IRA holds title to the property and the income it produces can be directed into all manner of investments typically held within an IRA, be it stocks, bonds, mutual funds or money market accounts.

On a percentage basis, that income can be two to three times higher than today's fixed-income offerings even after paying expenses such as property taxes and insurance. Meanwhile, the accountholder can eventually reap the potential appreciation of the underlying asset -- the property -- that the IRA owns.

For retirement savers needing to fund a child's college costs, a rental property held in an IRA also can be a valuable source of funds. While money taken out of a traditional IRA is subject to income taxes, it doesn't face early-withdrawal penalties if used for higher-education costs. And while financial advisers caution against using retirement funds to pay for college costs, the IRA owner still has upside potential on the property to count on and the income in years ahead.

5. A safer means to play the stock market

For those who don't want to abandon potential stock-market returns, a rental home owned in an IRA still affords them the ability to invest in stocks.

Rental income funneled into stocks or stock mutual funds today will be buying shares at sharply reduced prices. Directing the proceeds of each monthly rent check into stocks or mutual-fund shares accomplishes the same "dollar-cost averaging" strategy that occurs when employees steer a fixed amount of every paycheck into their 401(k).

Over a 10- to 20-year period, the return that the rental income produces if plowed into stocks is rich icing on the cake, coming on top of the return provided by the rental income itself.

6. The ability to flip real estate with no tax bite

Proceeds from selling an IRA-owned home roll back into the IRA without facing capital-gains taxes. To the contrary, an investor who buys and resells a property within a year with nonretirement funds faces a capital-gains levy.

Many foreclosed homes today are "distressed," vandalized by angry departing owners who may have deferred maintenance due to tough times. They often ransack anything and everything not nailed down and many things that are, from lighting fixtures and kitchen appliances to furnaces and central-air conditioners, toilets and bathroom vanities.

Such properties -- which can be found at most all price points -- are among the cheapest on the market on a per-square-foot basis because the Federal Housing Administration (FHA) and most private mortgage lenders won't loan on homes deemed "uninhabitable." That drastically reduces the potential buyer pool to just cash purchasers -- and reduces the property values as a result.

Even homes needing only cosmetic fixes sell at a discount today because there are countless others available in move-in condition. If an IRA home buyer has enough in the account post-purchase to refit a home's interior -- whether it's laying carpet and laminate flooring or upgrading a kitchen or bathroom -- going the minor-rehab route can be a rewarding approach.

Buyers might choose to fix up the cheapest, distressed property in a solid neighborhood so it qualifies for a mortgage and then resell it. They also could improve upon it over several years with the rental income. Either way, it's a potentially enriching value-add strategy.

The ultimate choice

The bottom line with buying rental properties with an IRA is that the investor retains a level of control over a tangible asset that he or she could never remotely attain in owning shares of a company or a mutual fund.

The question that bears asking: What will yield a better return in the next five to 10 years -- shares of Microsoft, General Electric or Citigroup, or a modest rental home in a decent school district -- selling for 30 cents on the dollar -- whose value may soon be juiced by record-low mortgage rates and unprecedented tax breaks?

Thursday: Choosing a self-directed IRA custodian and managing your properties.

Chris Pummer is a former senior editor for MarketWatch and Bloomberg News and a reporter for such papers as the Los Angeles Times and San Jose Mercury News.