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Rethinking stocks: Put land in a real-estate IRA for retirement

By Curtis Seltzer

BLUE GRASS, Va.—I'm sure there are three people in America who figured the stock market just right this year and are swimming in money like Donald's Uncle Scrooge. I am not among them. And neither are millions of others who didn't duck out.

The value of the stocks in my Roth IRA is where it was about 15 years ago. I am tail-gating 63. This is not good.

An Individual Retirement Account (IRA) is a retirement-savings plan that's funded by smiling, hopeful nitwits like me. Officially, we are called, beneficiaries.

About 47 million U.S. families have at least one IRA. In 2007, IRAs totaled about $4.2 trillion. I'd guess it's less than $2.5 trillion today.

Several types of IRAs are available. The most used is the **traditional IRA**, which a taxpayer funds with a tax-deductible contribution of pre-tax income. The tax hit falls on all dollars withdrawn, both those contributed originally and those earned from investment.

With a **Roth IRA**, the contribution is taxed going in, but withdrawals, including gains, are not. The Roth should be a better deal, except, of course, when your account loses over time.

When deciding between a Roth and a traditional IRA, we nitwits must project future tax rates for the time we plan on withdrawing money. If we bet that future rates will be high and current rates are low, then Roth is the way to go. But if current rates are high and we think that future rates will be low, then the traditional IRA has more appeal. The federal government could eliminate this crystal-ball aspect of retirement planning by establishing a future tax rate that applies to IRAs.

Federal rules govern each IRA type. "The taxpayer must follow every rule to the letter--in setting up these accounts, administering them and making contributions and withdrawals," said Thomas D. Arbogast, tax expert at the Pittsburgh law firm of Schnader Harrison Segal Lewis, LLP. "Otherwise, taxes and even the loss of the IRA account can be imposed."

You cannot, for example, contribute to a Roth IRA if your adjusted gross income exceeds $110,000 for an individual and $160,000 for a married couple, filing jointly. The maximum annual contribution is $5,000 for those under 50 and $6,000 for those over.

The good news is that this restriction ends in 2010 and the account holder will be able to move from a traditional IRA to a Roth regardless of income while spreading the tax hit over two years.

IRAs mostly help middle-income taxpayers who can squeeze out an annual contribution and get their account started early in life. Rich folks don't need IRAs, and poor folks can't fund them.

IRA plans use custodians to administer the accounts. Most IRAs are parked with custodians like banks, stock brokers and funds. It follows that most IRA money is invested in stocks, funds, bonds and interest-earning paper.

I've had an IRA invested in stocks for 30 years. I've watched its value go up, down and end up not far from where it started.

Enough! I would have done better putting my retirement money into land held through a **real-estate Roth IRA**.

A real-estate IRA can buy land, houses, commercial property, mortgage notes and rental units, among other investments.

The IRA can also finance a purchase through a nonrecourse loan (security limited to the IRA-purchased property) or a private loan. The IRA itself cannot collateralize a purchase.

Money in the IRA from contributions, interest and earnings needs to cover a property's carrying costs—property taxes, repairs, insurance and improvements.

The IRA owner can't use the IRA-owned property as a personal residence or place of business. But the IRA can buy its owner-beneficiary a retirement home that's rented until the owner retires, takes a distribution of the asset and moves in. Rental income goes into the IRA, not the owner's pocket.

The IRA owner can direct real-estate investments but is prohibited from managing IRA properties. The IRA account holder can hire a property manager to take care of IRA properties, paid from IRA monies.

Rural land -- and particularly, timberland -- lends itself to a retirement investment. Woodland is an easy IRA keeper. It requires little management almost all of the time.

It appreciates long-term and generates timber-sale income every so often. Risk of loss is low. Timber sales can be arranged by a consulting forester and timed to catch a rising market. Small IRA accounts can afford 10 to 15 acres, which is a good investment for young adults.

If the IRA property has no mortgage, the IRA account need not pay taxes on income the property produces. If the IRA property carries a mortgage, the IRA account must pay the **Unrelated Business Income Tax (UBIT)**, which is levied on income left after property expenses are deducted. If an IRA buys $100,000 of real estate with a $40,000 mortgage, the UBIT would only fall on 40 percent of the rental income. The first $1,000 of net income is spared the UBIT.

When an IRA property is sold, the gain is subject to the UBIT tax if it's mortgaged. If it's not mortgaged, the taxable gain is either deferred under a traditional IRA or exempt under a Roth IRA.

The UBIT applies to any trade or business carried on by the IRA. Other types of income are free of it, including dividends, interest, royalties, annuities, most real-estate rents and gains from sales other than trade-or-business property.

The real-estate IRA can also be used to originate mortgage money to borrowers and purchase existing mortgage-based promissory notes. And less obvious investments are also allowed, such as options on real estate, tax-sale certificates and foreclosures.

Certain types of transactions are prohibited. Your IRA cannot work investments with a **"disqualified person,"** including your immediate family, your IRA custodian and those providing services to your IRA, such as a broker. Your IRA can, however, invest with your siblings, in-laws, aunts, uncles and cousins. It cannot lend money to business entities when 50 percent or more of the stock is owned by you or a disqualified person,

An IRA cannot be used to buy life insurance and most collectibles, such as art, antiques, rugs, metals (with the exception of certain U.S.-minted bullion coins), gems, stamps and alcoholic beverages.

A very useful primer is Patrick W. Rice's, IRA Wealth: Revolutionary IRA Strategies for Real Estate Investment, 2nd ed. (Square One, 2007, $17.95). Rice helps clients find investments and matches them with custodians. (www.iraresource.com.)

Real-estate IRA custodians can be found through an Internet search. Custodians review the investments, do the paperwork and hold the IRA money and property titles. Investments can be found through the taxpayer's own network, consultants and real-estate brokers.

In light of the unpleasant fact that most Americans are not able to fund their own retirements under the current system, the federal government might consider expanding the definition of assets that can be contributed, raising the cap on annual contributions and making it easier tax-wise for more Americans to help their own retirements.

If I was in my 30s or 40s, I'd set up a real-estate Roth IRA and buy timberland. But readers should be warned: I was the guy who bought Pan American World Airways stock just before it flew into that dark night from which nothing good emerges.

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