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How to Invest in Commercial Real Estate with Self-directed IRA Funds

By David V. Tran

Sunny Doe has been working as an Engineer in the Bay Area for more than 15 years. Over the years, he contributed to his company's 401K plan and has accumulated over $350K in his IRA rollover account. While it is very convenient to invest in the stock market, he notices that the returns on the mutual funds in his IRA account are under-performing. As he grows older, Sunny faces the reality that his gray hair is not his asset but could be a liability in the high-tech field. He is also concerned about the volatility of the stock market. On a day the market is doing well, Sunny enjoys checking the balance of his account several times. On a bad day, he feels discouraged and questions the investment choices made. In addition, Sunny also wants to diversify his investments as most of it has been placed in the stock market.

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After learning that he can use money from a self-directed IRA to invest in real estate, he is motivated since he has been successful in real estate investments where he has more comfort and control. Learning that 44% of net worth per capita in the US is in real estate, he knows he is in the right direction. Upon further research, he discovers that money from a self-directed IRA account can be used as a down payment.

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What is a self-directed IRA?

In 1974, Congress enacted The Employee Retirement Income Security Act (ERISA) which established IRA's to give us the freedom to make our own Individual Retirement Arrangement or IRA. ERISA allows you to open an IRA account and control the investment of your money. It did not state that you have to invest in stocks, bonds, or mutual funds. Most IRA companies choose to focus on stocks and mutual funds because it makes good business sense for them. It's like McDonald's focuses on fast foods and does not serve prime rib. So if you want to have more investment choices besides stocks and mutual funds, you have to use a service of a self-directed IRA company. Once you open a self-directed IRA account, you can use the money to invest in stocks, bonds, mutual funds, real estate, mortgage notes, businesses, precious metals and other assets.

Self-directed IRA Companies

Below are some of the companies that offer self-directed IRA accounts. The author does not endorse any companies.

Equity Trust Company, (440) 323-5491, www.trustetc.com.
IRA Trust Services, (650) 593-2221, www.iraservices.com.
Pensco Trust, (866) 818-4472, www.penscotrust.com.

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When you contact these companies for information about their fees, they normally provide a service menu and associated fees. Some are based on the size of the assets and/or the number of assets, some are based on the services you need.

There are 3 kinds of self-directed IRA companies. You need to know this to understand how they operate.

1. Custodian: this company holds the assets on your behalf and executes your instructions. It is normally a bank or entity approved by the IRS to hold

the self-directed IRA assets.

2. **Trustee**: this company just holds the self-directed IRA assets. It's normally a bank.

3. **Administrator**: this company just does the paper work. It normally works with a trustee or a division of a bank.

What are some prohibited transactions or restrictions of a self-directed IRA?

1. You are not permitted to buy or sell a property between your IRA account and yourself, or your spouse, or your direct ascendants or descendant.

2. An IRA owner is not permitted to commingle self-directed IRA funds with his personal funds. However, the IRS allows an IRA owner to use personal funds to pay for incidental fees, e.g. closing costs.

3. The IRS precludes any personal guarantee for the loan and treats the violation the same as a withdraw from IRA account. Most commercial loans require personal guaranty. And so financing is the major challenge. Non-recourse commercial loans in which the property itself is the only collateral do not require this personal guarantee. However, it is difficult to apply for a non-recourse loan. In addition, most non-recourse commercial lenders are not familiar with loaning money to a self-directed IRA account as the borrowing entity. So they are somewhat hesitant in lending money especially when the self-directed IRA account is the only borrowing entity of the property. The so-called self-directed IRA and hard-money lenders that do not require the personal guarantees literally charge "an arm and a leg", e.g. 8% to 12% interest for the loan. So, getting financing at a low rate seems to be the trickiest part.

Financing for Properties with self-directed IRA Funds

Sunny has several financing options:

1. **Buy in cash**: This is the easiest and most straight-forward way to invest with fund from a self-directed IRA. However, this puts a major restriction on size of his investment properties. Besides, Sunny loves the idea of using someone else's money to make money.

2. **Get seller to finance**: This may work out. However, most sellers prefer to get cash for their properties. The seller who agrees to provide financing probably had a problem selling the property. If so, there may be something wrong with the property.

3. **Borrow money from a "self-directed IRA" or hard-money lender**: These lenders charge very high interest rates, 8% to 12%. Sunny has a major problem with this kind of interest rate. The banks will end up keeping all of the profits!

4. **Invest together with other investors**: Sunny buys a commercial retail property together with other investors. All the co-owners apply for one loan. As long as he owns less than 20% of the property (this limit is set by individual lender), the lender does not require him to provide loan application and sign any guarantee. This will satisfy the IRS restriction on personal guarantees. Sunny pays the lowest interest rate and can maximize leverage in the best properties. This is the best option for self-directed IRA investors as they co-own a better property at the lowest interest rate.

5. **Apply for a non-recourse loan**: It's fairly hard to qualify for a non-recourse loan as lenders tend to have very strict guidelines, for example:

- The borrower must be an experienced commercial real estate investor with high net worth and stellar credit history. And so Sunny wants to work with a local lender who knows him well.
- The property has to have long term lease with a national tenant, e.g. Walgreens.
- The property is in good condition and at a good location.
- The loan amount has be large, e.g. at least $1MM.

Income Tax: Assuming Sunny deposits 30% and borrows 70% of the money to buy the property, then 30% of the income will be taxed deferred. This cash flow will go back to his self-directed IRA account. The other 70% of the income attributable to the debt is subject to income tax called Unrelated Business Income Tax or UBIT tax at the trust rate. All of the rental expenses and depreciation are deductible from income. In addition, the first $1,000 of income is exempt from UBIT tax. When the property is sold, the IRA may avoid UBIT and capital gains tax if the debt had been paid off by principal payment at least one year before the sale.

Title to the property

His self-directed IRA account, not Sunny Doe, must be on title to the property. For example if he has a self-directed IRA account with Pensco Trust, he must take title as "Pensco Trust FBO (For the Benefit Of) Sunny Doe's IRA Account". Pensco Trust will sign all the real estate and loan documents on Sunny's behalf as trustee of his account at close of escrow. Sunny applies for a tax ID from the IRS website for this entity after close of escrow for income taxes filing.

Possible Investment Scenario

Sunny invests with his brother in a $2M single-tenant dialysis center on a 10 years NNN lease with a net operating income of $150,000 (cap rate of 7.5%). They form a Limited Liability Company (LLC) to take title to the property. The LLC operating agreement specifies that his brother owns 80% and Pensco Trust FBO Sunny Doe's IRA Account owns 20% of the property. With this arrangement, they apply for $1.4M (70% LTV) loan with a national lender and use a total of $600,000 for a down payment. $120,000 of this $600,000 comes from Sunny's IRA account since it owns 20%. Since Sunny's share is 20% initially, only Sunny's brother has to apply for the loan and provides lender with financial documents. The bank also requires Sunny's brother to sign a personal guaranty; hence Sunny is not obligated to sign a personal guaranty which in turn complies with IRS requirements.