Potts Financial Services

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Using IRAs/401(k)s to Purchase Real Estate: A Look at Different Forms of Risk
By Alan N Potts

This article provides financial information that will assist real estate investors who are owners of IRAs and 401(k) rollover accounts and want to purchase more real estate. Retirement accounts and real estate both have different forms of financial, demographic, expense and distribution risk. These risks should be considered from each investor's personal perspective, taking into account what will best serve his or her personal and retirement objectives.

This article will discuss retirement accounts versus real estate and explain how four different forms of risk affect returns. Because we all want financial success, we must understand these risks and how they will affect our long-term returns.

Investment Risk

IRAs and 401(k) Rollover Accounts

Many people have decided or been convinced by their investment advisor that mutual funds and/or stocks are the best investment choice for their retirement accounts. Investors have discovered that mutual fund and stock investment risk is very broad and has many forms. People have learned how corporate assets can be used not for corporate growth, but for an executive's benefit and gain. Even when executives do a poor job, the board of directors usually votes to buy out the executive's contract and give him or her a golden financial parachute. This buyout can be millions of dollars and generally comes from corporate assets (stockholder equity). This reduces the stockholders' gain.

In today's financial environment, unlike in the past, most corporations do not pay dividends. By keeping dividend returns within the corporation, and not in the hands of the investor, the investor assumes greater investment risk. The consumer relies on the good faith of corporate officers and the board of directors to maintain prudent management practices.

Real Estate

Real estate investors have discovered that property ownership is another way to save money. Like always, a property's return is determined by location, location, location! Since an investor selects location, investing provides a sense of control that formal retirement plans do not offer.

Different types of properties involve different risks. Commercial properties generally do not have residential risks. Business properties are subject to business cycle risk. The cost of commercial property management is generally lower (per dollar per square foot) because the property is not used for residential purposes. Residential properties have a bigger pool of users, but management expenses may be higher.

However, the assumption of rental risk provides the investor a return that retirement plans cannot offer during the accumulation period. The investor receives rental income today and also growth on the property's fair market value. The investor has two forms of return: Growth and income. This reduces investment risk since rental income and growth, which are used to calculate total return, are independent of each other. The return on real

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estate can be multi-dimensional, whereas the returns on retirement accounts are onedimensional.

Demographic Risk

We all want financial success. To use certain retirement accounts or real estate as ways to accumulate wealth, an investor should understand how our aging society could affect longterm returns.

IRAs/401(k) Rollover Accounts
Have you ever heard of the baby boomer generation? Boomers were born between 1946 and 1964. The oldest will become 65 years old in 2011, and the youngest in 2029. Today, Boomers have a very large pool of investment dollars, consisting of new savings, accumulated savings and assets that have been inherited from their parents. Boomers are currently in the accumulation phase of their financial lives, but that will change in the very near future. As they retire, they will change from the accumulation phase to the distribution phase of retirement planning.

Some economists say that because succeeding generations are smaller, when boomers sell this will put downward pressure on stock and bond prices. One thing is for certain: There will be more sellers than buyers, and the U.S. retirement systems will have a net outflow for the first time ever. Some pessimistic economists have said that this conversion has the capacity not only to depress, but also to crash our financial market.

"Baby boomers have affected the economy all through their lives. When they went to school they put great strains on the school system: When they entered the workforce, wages went up very slowly," said John Shoven, professor of economics at Stanford University."It would be naïve to think that their retirement will go smoothly."

Real Estate
The long-term real estate market, which exists on a basis of supply and demand, depends to a large degree on the demographics of our population. Based on the most recent data, the baby boomer population is entering its peak earning years. Boomers will create an even larger demand for primary residences, second homes and possibly rental income properties.

Realtors have acknowledged that at least 40 percent of their clients have purchased their second homes. The motivation behind these purchases is either to acquire an investment property, or to purchase a place to spend their leisure time. As in the past, the security of land and property ownership seems more secure and tangible for baby boomers. These types of trends are projected to continue for the next 10 years. These trends, combined with lower interest rates and property appreciation, make real estate an attractive alternative to stock market risk.

Expense Risk

IRAs and 401(k) Rollover Accounts
Many investment firms offer mutual funds as an investment alternative. When an investor purchases mutual

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funds, the mutual fund company's overhead becomes an additional investor expense. Because of these additional fees, mutual funds should not be used as a long-term investment strategy. Instead, mutual funds should be considered a short-term accumulation of capital savings tool. After a short period of time, mutual funds should be sold and the investor should invest in stocks, therefore eliminating longterm mutual fund expenses.These actions do not assure financial success, but they will increase the chances for gain in corporate America.

Another form of mutual fund expense risk is institutional management. In December of 2004, several reporting services stated that the State of California filed a lawsuit against a major brokerage firm, accusing them of accepting $300 million in improper payments in order to push its clients toward certain mutual funds. This occurred the same day the brokerage house agreed to a $75 million settlement with federal prosecutors in the State of Missouri over allegations related to their mutual fund sales practices. California Attorney General Bill Locyer said the brokerage house failed to tell investors about payments it received from seven "preferred" mutual fund groups in order to promote and sell their funds.

Real Estate

Real estate expenses vary by property type. The expenses can include property taxes, maintenance costs, property management fees, and mortgage interest. Some costs can be reduced if the investor chooses to become more active and/or assumes the role of property manager. Many investors have children whose own businesses or skills are employed to help maintain the property. The investor can offer his or her children an opportunity to earn additional income and teach them life lessons.

Another cost is private mortgage insurance (PMI). PMI protects the lender if he or she defaults on the loan. If the first mortgage exceeds 80 percent loan-to-value, lending institutions generally require this added protection, however by coordinating the first mortgage (80 percent loan-to-value or less) with an equity line of credit for any excess borrowed amounts, this dilemma is solved. The additional loan will have minimum closing costs since most of the underwriting costs are incurred when the first mortgage is closed.

If the investor purchases a rental property, the rental income stream is an additional source of capital. The income stream can be used to offset these costs, which include mortgage reduction. In addition, these expenses may be tax deductible.

Distribution Risk

IRAs / 401(k) Rollover Accounts

There are two stages when making any investment. The first is accumulation and the second is distribution. Many investors are aware of the accumulation stage, which is made up of deductions and tax deferral. Some of the distribution rules and costs are income taxes, cost basis, and minimum/ mandatory distributions.

Most people have not been told that their retirement accounts will generally have a zero cost basis. This is because the government loans the retirement account holder a tax deduction for making a retirement plan contri-

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bution. Since the investor's account is taxdeferred, one day this tax deduction loan must be paid back to the government. When people receive income from their retirement accounts, the accounts generally have a zero cost basis, and the IRA holder is taxed in his or her highest tax bracket. If the last dollar of the distribution goes into the highest bracket, all of these distributable monies will be taxed at the IRA holder's highest marginal tax rate.

Generally at age 65, the IRA holder is told not to take a distribution because he or she will have to pay the income taxes. This is where minimum/mandatory distribution rules are used to defer the income taxes again. The IRA holder can defer using his or her money until age 70. At age 70, the government requires distributions to begin and they must continue every year. Life expectancy tables (single or joint if spouse is alive) are used, so at the specified date, all deferred income taxes are paid back. The IRA is now depleted, and if the IRA holder or his or her spouse outlives life expectancy, he or she must rely on Social Security or other assets.

The rules of law and taxation for real estate are more consumer friendly. If a property is held for 12 months or longer and then sold, the property qualifies for longterm capital gains. The rate for 2005 is 15 percent. Some real estate investors are selling their real estate investments because of the possibility that this rate may increase in the future. Selling gives the investor the opportunity to shift investment gains from a higher tax bracket to a lower bracket and keep more of what he or she has accumulated.

Real Estate
Since real estate is not subject to minimum/mandatory distribution rules, again, it is more consumerfriendly and can be liquidated or rented to provide the investor and his or her spouse the freedom of choice. At this point, the survivor may not want rental income, but many financial alternatives are available.

Another financial possibility real estate offers is a stepped-up basis. A stepped-up basis provides the property owner the opportunity to leave real estate, at death, to any beneficiary, including his or her spouse, children, grandchildren or another person of choice. On the date of death, the owner's basis changes to the new basis, which is the fair market value. The beneficiary can now sell the transferred property and keep all the proceeds, minus any closing costs. This provides many family planning opportunities.

As people explore the possibility of using certain retirement accounts to purchase real estate, they can discover new opportunities for themselves and their spouses, children and grandchildren.