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Benworth Series:

Seizing Control of Your Retirement Plan by Investing in Mortgages

Part 1 of 6: Self-Directed IRAs

This will be the first in a six part series of articles on using your IRA to invest in non-traditional investments such as mortgages.

Since their establishment in 1975, IRAs have become a vehicle of choice for long-term retirement savings. Several years later, the IRS included employer plans such as 401(k)s to permit pre-tax savings via payroll deduction. The success of these plans has been staggering, with over $4.5 trillion held in IRAs representing over 48 million households.

IRA holders have felt trapped in traditional investments. We are all tired of the stock market fluctuations and investment advisors telling us that we have no other choice than to hold. Have you heard of a self directed IRA?
A self-directed IRA allows you to invest in real estate, mortgages, private companies and many other categories that have been possible since 1974. Curiously, IRS does not provide a list of "permissible" investments that can be held in an IRA. IRS Regulation Section 408 does indicate that certain collectables cannot be held, as well as life insurance.

The IRS does require that a custodial institution serve as the trustee to hold the assets of the IRA. We have partnered up with one of the most reputable company in this field to be our custodial institution. While some banks provide those services for market-based investments such as stocks, bonds, CDs and mutual funds, most do not provide such services for real estate, mortgages, and other non-traditional investments. Through these custodians and the administrators and record-keepers that they appoint, a much broader array of investments are possible.

Where are the IRA Non-Traditionalists Investing?

Although real estate continues to be the main choice of self-directed IRA holders, many have discovered the power of lending. In essence, becoming the bank to rehabbers and others seeking alternate financing. This debt can be secured by a first mortgage with many account holders issuing IRA loans from 10%-16%, interest only, amortized, or other terms amenable to both parties.

IRA holders also can partner with companies such as ours. In other words, we use other people's IRA money to invest in first mortgages. Our clients have made an average return of 9.95 – 13%. We tailor our mortgages to the IRA holder. We ask every investor what type of mortgage they are comfortable with. This has proved to be a very successful approach both for us, as facilitators, as well as the individual IRA investors. Many of our clients are no longer working, and use the proceeds of the interest only loans as an IRA distribution for living expenses.

What are the issues?

As with all investments, there are inherent risks, not because the choices may be non-traditional, but simply due to the nature of the investment chosen.

If mortgages are purchased in the IRA, the IRA holder should ensure that there will be sufficient cash balances to make the proper payments to the taxing authorities as well as HOA dues, insurance, maintenance and other anticipated and unanticipated expenses of the property. This is for the possible event that the loan may go into default. Although future IRA contributions may be possible, it shouldn't be relied as an alternative for keeping a reserve fund in your IRA.

Recent Retirement Plan Changes Provide Huge Benefits

Three interesting events have transpired in the past couple of years worth noting. First, in October 2005 the US Supreme court ruled that IRAs receive Federal Creditor Protection. This protects IRA holders from asset seizure due to bankruptcy actions. Previous to this ruling, such protections were unevenly applied state by state, leading to a great deal of anxiety on the part of IRA holders.

Secondly, as of January 2006, 401(k)s now have a Roth provision. Why is that significant? It is the only way that an individual with a household income greater than $176,000 can contribute to a Roth, and he or she can now contribute up to $22,000 per year ($16,500 if under aged 50). Even if an individual's adjusted gross income is less than $176,000, outside of this 401(k) provision, the most they contribute is $5,000-$6,000 per year. This is great news for those individuals that wish to pay taxes before they invest, then never pay taxes again on those contributions or earnings (must hold a Roth for at least 5 years and reach the age of 59.5 before withdrawal).

In December 2006, Bush signed into law the Tax Relief and Health Care Act which contained a provision that opened up the possibility for IRA holders or those wishing to roll-over 401(k) regardless of earnings to convert those funds to a Roth starting in the year 2010, regardless of their adjusted gross income (AGI). You previously couldn't convert if your AGI was $100,000 or more. Included in the legislation was the ability to defer taxes owed.

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Bottom Line – You Choose

Whether an investor uses an SEP, Simple, Roth or Traditional IRA, 401(k), or other tax-advantaged vehicle – they should be informed about the wide variety of choices available. You may also find yourself adding some new advisors to your circle of influencers, including CPAs, Attorneys, and Real Estate professionals. The IRS provides a great deal of latitude in your investment choices - use it to your greatest advantage. Strongly consider investing in mortgages through a self directed IRA. In the end, even if the mortgage goes into default you still have something tangible that can be rented.

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