



SHADES OF GREEN

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Leveraging IRAs with mortgages

Retirement savers can take loans to buy rental property

By Chris Pummer

Third of three parts

SAN FRANCISCO (MarketWatch) -- So you'd like to take advantage of depressed housing prices and buy a rental property, but you lack a down payment or can't meet lending criteria for investment properties? Consider using your IRA assets -- even if the purchase price exceeds their reach.

Little-known IRS rules allow retirement savers to take "nonrecourse" loans against IRAs and leverage their savings as a down payment to buy investment real estate. With 30% to 40% down, IRA borrowers can get loans on a condo or townhouse, a single-family home, a multiunit apartment building and even commercial property -- so long as the rental income will yield positive cash flow.

While the market for these mortgages has been miniscule -- recognized leader North American Savings Bank has closed about 850 residential IRA loans since 2005 -- demand is expected to mushroom in coming years, especially among baby boomers seeking to diversify out of stocks and into income-producing investments.

Eager to lend

Unlike cash-hoarding banks today, lenders in the IRA nonrecourse loan market are champing at the bit to extend mortgages. The reasons:

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)

- By putting up coveted retirement savings, IRA borrowers have valuable "skin in the game" and are less likely to default on their loans
- Most IRA-backed loans made today are on foreclosed properties bought at steeply marked-down prices rather than the risky hyperinflated prices of three years ago

- The minimum 30% down payments give lenders a considerable downside allowance in the event they must take back a property and resell it

Michael McNair, trust officer for self-directed IRA custodial firm IRA Services Trust, suggests clients initially buy property outright with cash if possible to "keep things simple." Yet he recognizes the opportunity in leveraging IRA funds now given fire-sale prices and historically low borrowing costs. [Read six reasons why now is a good time to buy real estate with your IRA.](#)

"If you have a quarter-million dollars, you could buy one property outright, or buy multiple properties putting 30% down on each one," McNair says. "The math in leveraging can make good sense."

Adds Matt Allen, North American Savings' director of IRA lending: "This is a niche product that a lot of people could benefit from right now." [Read more on owning and managing property in an IRA.](#)

Ins and outs

A nonrecourse loan means the lender can only recoup the pledged collateral in the event of default -- in this case the piece of real estate -- and can't go after an individual's personal assets as with a traditional mortgage to cover any shortfall on the loan balance.

For that reason, rates on nonrecourse IRA loans tend to be slightly higher than those on owner-occupied properties, but are roughly on par with typical investor mortgage rates.

Grandview, Mo.-based NASB is considered the nationwide leader in the nonrecourse IRA mortgage market. Founded in 1927, the bank will loan up to 60% of the purchase price on condominiums and townhouses, 70% for one- to four-unit residences and 65% on five- to 12-unit buildings.

Because a property's appraised value and cash flow are its key concerns, NASB doesn't care about employment status nor ask for W2s, pay stubs, tax returns and other personal financial data typically required by mortgage lenders.

A borrower's personal credit rating and debt-to-income ratios also are of little consequence, says Allen, who is co-authoring a forthcoming book "Leverage Your IRA." The overriding factors are whether the property appraises for the sale price and will produce enough income to cover mortgage payments, property taxes, insurance and related costs.

"We're not lending to the person so we don't get personal," says Roger St. Pierre, senior vice president of First Western Federal Savings Bank, which entered the IRA loan market last year with similar underwriting practices. "Qualifying is very simple. It's all about common sense, which unfortunately left the banking industry 15 years ago."

Account reserves

To ensure the IRA assets can cover mortgage payments during extended vacancy and unforeseen major repairs, NASB and First Western Federal both require that 10% of the loan value remains in the IRA at closing as a reserve, along with enough funds to cover closing costs.

"Real estate needs care and feeding and just because you have positive cash flow, that doesn't mean you can build up enough income in your account in three to six months to pay for a new roof," St. Pierre says. "It's for their own protection as well as ours that we require the 10%; they can keep it in a money-market fund or in stock funds within the IRA, but they must have that set aside."

NASB offers two types of nonrecourse IRA loans, a 30-year-fixed at 7.25% and a five-year ARM at 6.5%, with a

1.5% origination fee. For anyone who might hold the property beyond five years, the minimal added cost of the fixed loan is worth absorbing. The ARM is more appropriate for investors who might resell the property within five years should the housing market recover, perhaps after doing some major remodeling or building an addition to increase its value and marketability.

"The majority of borrowers are taking the 30-year-fixed loans just to be safe," Allen says.

As a newcomer to the market, First Western Federal's rates are higher and its loan durations shorter than NASB's. It offers a one-year ARM at 7.25% and a three-year ARM at 7.75% with a 2% origination fee. Like NASB, First Western holds the loans it originates.

"We've been a portfolio lender for 30 years making loans the old-fashion way, with 30% down on nonconforming deals like 50-acre pieces of land, farms, ranches and lake lots that the secondary market doesn't want," St. Pierre says. "There's going to be a good-sized market for these loans, certainly more business than one bank (NASB) can do, so we realized why shouldn't we get involved in this business given our lending style?"

Risk for lenders

Extending loans without a personal guarantee doesn't pose much risk given the size of the down payments, St. Pierre says, and a borrower has a good reason not to take on considerable risk themselves.

"A person's retirement plan is sacred -- that's how people expect to put food on the table and gas in the car in 20 or 30 years," he says. "They're not going to take these investments lightly because if that money's lost, they're going to be working many extra years. Our interests are really aligned; they want to be safe with their investment and so do we."

And with housing prices down 15% to 30% in most markets, there's far less downside risk for lenders than in the past, St. Pierre says. "I can't tell you where the bottom is, but we're a lot closer to it than we were three years ago."

NASB and First Western Federal both will not loan on properties that need more than cosmetic fixes because they want to be sure the property is rentable at the time of closing. Private-capital, nonrecourse lenders that can be found through an Internet search may do so, but their rates typically run 10% and higher and may require four to five points -- a point is 1% of loan value -- up front.

Lenders tend to have tighter underwriting requirements on condos -- and may require up to 50% down -- because condo values are more volatile than single-family homes and homeowner-association fees reduce cash flow.

Tax consideration

One issue to account for when taking a mortgage on IRA-owned property is the requirement to pay "unrelated business income tax," or UBIT.

In any year the IRA-owned real estate generates taxable income -- i.e. income that exceeds expenses -- the IRA must pay UBIT on the percentage of taxable income attributed to the leverage, says Eric Wikstrom, a certified public account and financial planner, and founder of Seattle-based Integrated Wealth Strategies, which specializes in self-directed IRAs.

For example, if an IRA accountholder earned \$10,000 in annual income on a 50% mortgaged property, \$5,000 would be subject to UBIT, Wikstrom says. Factoring in a \$1,000 allowable deduction, \$4,000 would be subject to UBIT, which at trust tax rates would be \$780.

"If you made that real-estate investment with discretionary funds and generated the same \$10,000 of taxable

income, you'd owe federal and state income tax at your marginal bracket, which would likely range from 25% to 40% -- or \$2,500 to \$4,000," Wikstrom said.

"Would you rather pay a UBIT tax of \$780 or income taxes four to six times higher?" Wikstrom says. "Having higher taxable income on federal and state tax returns also can reduce the benefit of itemized deductions and personal exemptions."

Leveraged property in an IRA also qualifies for deductions for depreciation, mortgage interest and real-estate taxes in computing UBIT. And contrary to what many accountants only fleetingly familiar with self-directed IRAs will tell you, Wikstrom says the after-tax return on buying, renting and selling a property inside an IRA and then withdrawing funds is better than buying with nonretirement funds, even with depreciation allowances and tax deductions.

"At the end of the day, you'll ultimately keep more of the income and gain working for you as opposed to paying immediate taxes on that income and gain if that investment is owned with discretionary funds," Wikstrom says.

Cash flow vs. future capital gains

The key question for borrowers is whether they want to keep their loan amount to a minimum to reap the most current income, which they can direct into stocks, mutual funds or money market accounts. The alternative: Sacrifice cash flow now to leverage into a more expensive property in the hope it regains significant value for an eventual resale.

The first strategy means more money in the bank, where the latter entails gambling on the time frame and scope of a housing recovery when it ultimately comes.

Investors who choose to buy a property outright can take out a loan later of up to 70% on its value and use the proceeds to buy another property or as a down payment on another mortgaged purchase. That way, they can gain experience with a single property and then decide if they want to take a bigger leap and be a landlord on multiple properties.

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