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[Back to story](#)

REAL ESTATE

Putting property in your portfolio IRA investors can benefit from real estate options

By Scott Banerjee

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SAN FRANCISCO (CBS.MW) -- You don't have to be a mogul to spot a ripe opportunity to invest in real estate options. In fact, you can even fund these transactions tax-free or tax-deferred through your IRA.

Real estate options are exclusive contracts which grant the buyer the right to purchase property -- commercial, land or residential -- at an agreed price within a specified time frame. The options are purchased from the owner, usually at an average of five percent or less of the property's underlying value.

Traditionally the domain of sophisticated real estate professionals, a growing understanding of how to identify opportunities in this market is now captivating the everyday investor.

These derivatives lack the liquidity and transparency of equity futures and so must be approached with caution. Yet they are emerging as mainstream tax-free investment vehicles or portfolio-diversification tools.

"Many a person has kicked themselves for not knowing that they had the money to invest in certain real estate. But they actually did. It was in their IRA," says Patrick Rice, president of Camas, Wash.-based IRA Resource Associates and author of "IRA Wealth: Revolutionary IRA Strategies for Real Estate Investment."

The key to unlocking these funds, however, lies in finding a self-directed IRA custodian or administrator that allows you to invest in real estate options. Because most financial service providers are limited to selling traditional investments -- stocks, bonds and mutual funds -- there are only a couple dozen custodians nationally with this expertise.

"It's a demand-driven niche market," says Debra Greenstein, president of Entrust Administration Inc., an Oakland, Calif.-based self-directed IRA administrator.

Banks, credit unions trust companies and broker dealers are often unwilling to administer the paperwork and IRS reporting that is required to handle nontraditional assets within an IRA account, she said.

According to Thomas Lucier, chief executive officer of Tampa-based Home Equities Corp. and author of the book "How to Make Money in Real Estate without Ever Buying Any Property," the best real estate option investments are found in properties that are structurally sound but have a filthy, run-down, neglected appearance that can be easily improved with minor clean-up costs.

Though he notes that not all properties are ideal for options, he says there are a number of ways that they can prove valuable.

Real estate options are traditionally used to conserve capital for the interested buyer while he or she holds the controlling interest and conducts due-diligence.

But increasingly, "flipping," or reselling real estate options to a third-party buyer before expiration, has come into vogue because of its profit potential, especially when proceeds are captured tax-free or tax-deferred with an IRA.

"Real estate options, while they may sound speculative, really aren't so speculative when an opportunity is right in your backyard," says Tom Anderson, president and CEO of PENSCO Trust, Inc., a self-directed IRA custodian in San Francisco.

"The key is finding undervalued properties with immediate resale profit potential," says Lucier, who flips anywhere from four to six options a year. "You create the value by cleaning it up and marketing it."

Lucier once paid \$500 for a one-year option to purchase a condemned house that the seller valued at \$75,000. Armed with the knowledge that the house was worth close to \$110,000, he spent \$2,000 to remove accumulations and pressure-wash the house, driveway and walkways. Three weeks later, he sold the option for a \$15,000 profit.

Out-of-state owners of vacant buildings, he says, are often the most willing to enter into an option agreement that allows you to show, enter and therefore improve the property.

Anderson, however, points out that if you buy your option through your IRA, the option agreement has to contain a clause stating that property-improvement costs must be funded from this same source or added to the purchase price if the option is executed.

While real estate options can pay off in several ways, most require an investor do plenty of homework both on the property itself and its environs. Understanding how to increase values through maneuvering such as rezoning a residence for small office use can require calling upon a real estate broker, lawyer or title insurance company for help.

If an option should expire, the buyer has the right to purchase the property outright and subsequently resell it -- or take no action and book a loss. The ability to resell an option, according to Lucier, often boils down to one's ability to market the property -- either through property signs, classified ads or via the Internet.

Greenstein says more than half of her self-directed account holders have real estate or real estate derivative investments in their IRAs. Though Entrust does not offer investment guidance, she says: "Some clients are finding more opportunities than they know what to do with. They're making so much money that they're afraid the IRS might decide it's too good of a deal."

IRS Publication 590 does not prohibit debt-free real estate from being purchased or sold from within an IRA, Roth IRA, SEP-IRA, SIMPLE or Coverdell plan. Real estate options are not federally regulated but are governed by state statutes under real estate contract law.

Real estate option investing can hold potential pitfalls and risks. The value of the property -- and therefore the value of the option -- can always decline, or the property can be foreclosed before expiration if the owner defaults on a mortgage.

Another risk, especially for option "flippers," is the possible cold shoulder from professionals in the real estate industry, some of whom they may need to rely on.

"When people are out optioning the property without the intention of closing, and only are trying to flip to the next guy before their money goes hard or have anything at risk, that doesn't do our industry much good," says Ted Blank, a Colorado real estate investor and Certified Commercial Investment Member and Society of Exchange Counselors member.

"It creates problems, especially if the buyer doesn't have the ability to close."

Scott Banerjee is a freelance writer based in San Francisco