Should You Buy an Investment Property with an IRA or 401k?

Have questions about investing funds from your IRA or 401k into our multifamily fund? Contact us for the pros and cons.

GET NOTIFIED OF INVESTMENT OPPORTUNITIES

If you're reading this, you likely know that there is enormous value for investors in property investing. Real estate, particularly in multifamily and commercial properties, offers some of the highest ROI. But doing so takes a large investment of funds. What many prospective investors don't know is they may have those resources in their IRA and/or 401K. There are ways to use either of these to invest in multifamily and commercial properties.

With the stock market at record highs, many investors are looking to buy an investment property as a way of diversifying their portfolios. But with real estate also at record highs, it has created a dilemma for some investors: should they be saving for and investing in real estate, or should they stay the course and continue maxing out their retirement accounts?

Most people don't realize that it isn't an either-or situation.

In fact, it is possible to use both your 401k and individual retirement accounts (IRAs) to invest in real estate. And contrary to popular belief, it is possible to do so without suffering from steep withdrawal penalties.

There are some key differences between how to invest with either an IRA or 401k, which we'll cover in this article. This guide is intended to be an investor's go-to resource for learning about how to leverage their retirement plans to buy an investment property, including the pros and cons of using this approach and alternative investment strategies to consider.

Please note that this article is **not** intended to provide tax advice. Please consult with your qualified tax accountant or attorney for a financial advisor to determine the best options for your unique circumstances.

What is an IRA?

An IRA is a type of account set up at a bank, brokerage firm, mutual fund company, insurance company or other types of financial institution. Regardless of where the account is held, the purpose is the same: it is a place to hold assets to be used during retirement. IRAs can be used to invest in many types of assets (unlike a 401k, which has limitations on how funds can be invested). Some IRAs can be self-directed, allowing you to choose how to invest, ranging from investing in CDs, government bonds, mutual funds, stocks, even investment property (more on this below).

There are many kinds of IRAs, but the two most common are Traditional IRAs and Roth IRAs. They differ based on the tax rules that regulate each type of IRA account, and specifically, how and when the account holder gets a tax break.

1. Traditional IRA

With a traditional IRA, sometimes referred to as a deductible IRA, your contributions are tax-deductible in the year they are made, which reduces your gross income and therefore, your current tax burden. As such, if you expect your tax rate to be lower in retirement than it is now, a traditional IRA may be better for you than a Roth IRA. Of course, it is hard to predict what your tax bracket will be in retirement, particularly if you are a long way yet from retirement.

2. Roth IRA

The Roth IRA was established in 1998 and is taxed differently than the traditional IRA. Contributions to a Roth IRA are taxed as income in the year they are deposited, which means contributions cannot be taken as tax deductions. The benefit of a Roth IRA, though, is that the earnings on those contributions are not taxable at the time of withdrawal. After the age of 50, all or part of your Roth IRA contributions may be withdrawn income tax-free and without penalty.

There are some exceptions to the tax treatment of Roth IRA contributions, however. Under certain circumstances, the IRS allows penalty-free and tax-free early withdrawals on Roth IRAs. In order to do so, two criteria must be met: (1) the withdrawal must be used for a qualified purpose, and (2) the withdrawal cannot be made until five years after the account was originally opened. Nonqualified withdrawals are subject to a 10% penalty.

Eligibility

Another key difference between a traditional and Roth IRA is eligibility.

In order to invest in a traditional IRA, a single person or head of the household must have a modified adjusted gross income (AGI) of $64,000 or less. They can take a partial deduction if their modified AGI is less than $74,000. This increases to $193,000 (full deduction) to $203,000 (partial deduction) in the case of a married couple filing jointly.

A Roth IRA has slightly higher income eligibility. Those who are single or head of household can have a modified AGI of up to $122,000 (full contribution) or $136,999 (partial contribution). Those who are married and filing jointly can have a modified AGI of up to $193,000 (full contribution) or $202,999 (partial contribution) and still qualify.

In either case, the maximum contribution amount is the same: individuals can contribute up to $6,000 per year (or $7,000 if 50+ years old). The last key difference between a traditional and Roth IRA is when you are required to take distributions. Traditional IRAs require you to start taking a required minimum distribution (RMD) at 70.5 years old. There are no RMD rules for Roth IRAs; you can continue to contribute and earn tax-free interest for as long as you live.

What is a 401k?

A 401k is an employer-sponsored retirement plan that many, but not all, companies establish for their employees and often contribute some amount too. Upon enrollment in the plan, you can choose how much you'd like to contribute – either a set dollar amount or a percentage of your salary. That amount is then deducted from your paycheck and goes into your 401k investment plan on a pre-tax basis. As of 2019, people can invest up to $19,000 (or $25,000 if over age 50) in their 401k each year.

Each plan has its own limited list of available investment options for you to choose from. If you do not select a specific plan, you will be auto-enrolled into a default investment selected by your plan provider.

The big thing to understand about a 401k is that you will be taxed upon withdrawing money from your account in retirement. It doesn't matter if the funds you withdraw came from your own contribution or the earnings from your investment – in either case, the funds will be considered part of your gross income on your tax return and taxed accordingly.

What is the Difference Between an IRA and 401k?

As outlined above, the key differences between an IRA (Traditional or Roth) and 401k are as follows:

- Anyone who falls within the income criteria can set up an IRA, whereas a 401k must be established by an employer.
- There are no income limits for investing in a 401k.

- Individuals can only invest up to $6,000 (or $7,000 if over age 50) in an IRA each year vs. up to $19,000 (or $25,000 if over age 50) in a 401k.
- Money can be withdrawn from an IRA at any time, whereas a person must have reached a distribution event before they can access their 401k savings.
- Investment selection may be more limited when investing in a 401k vs. an IRA.

What are the Requirements to Buy a Property with an IRA?

Most IRAs are set up in a way that allows people to invest in stocks, bonds, mutual funds, and the like. But it is also possible to buy a property with an IRA. The key here is using what's called a "self-directed IRA".

Pursuant to the Employee Retirement Income Security Act of 1974 (ERISA), the custodian of a self-directed IRA is free to invest however he or she pleases. If your IRA is managed by a third-party, the custodian may not allow you to invest in real estate. But there's no legal reason why you can't. A growing number of financial firms are offering self-directed IRA plans that make it easier to invest in real estate through your IRA.

The rules around buying real estate through your IRA are somewhat complicated. The government wants you to have at least an arm's length distance from the investment. As such, if you purchase real estate through an IRA, you cannot live in or actively manage the property. Technically, the title to the property is held by a custodian for the benefit of the IRA (you cannot be the custodian). You must also hire a third party to handle all operations. Any revenue generated by the property – whether it be rental income or sales proceeds – must flow back to the IRA to protect the tax-deferred status of the account.

What are the Requirements to Buy a Property with a 401k?

Whereas IRAs can be used to invest directly in real estate, tax laws prohibit people from using their 401k to invest directly in real estate. That said, there are still ways to purchase investment property by leveraging your 401k.

There are a few ways to do this.

The first way to invest in real estate using your 401k is by taking out a loan against it. Most (but not all) plans will allow you to do so, so it's important to check with your plan administrator before pursuing this route. Assuming it's allowed, you are typically able to borrow half of the value of your 401k account, up to $50,000. The loan must be structured as a bona fide non-recourse loan, which is a type of loan that is secured by collateral – in this case, it will usually be the rental property being purchased. This way, if the borrower defaults, the issuer of the loan (the 401k plan administrator) can seize the collateral but cannot seek any additional compensation, even if the collateral does not cover the full value of the defaulted amount.

Most plans require you to repay the loan in full within five years, and you'll be required to pay interest on that loan (typically, 1% point above the prime lending rate). That said, the interest payments are made back to the retirement account, so you are essentially just paying that interest back to yourself.

If the loan is not repaid by the deadline, the loan will be treated and taxed as though it was an early distribution – resulting in a 10% penalty as well as income taxes owed based on your tax bracket.

An alternative option is to roll funds from your 401k into a self-directed IRA, and then invest in real estate as you would with a self-directed IRA as described above. You will need to check with your plan administrator to determine whether the plan is eligible for transfer into a self-directed IRA, and if so, what paperwork is necessary.

The Pros of Buying Property with an IRA

The benefit of buying a property with a self-directed IRA is twofold: Not only will the property you purchase have the potential to appreciate in value, but all of the income you receive in the meantime will be tax-deferred. This includes both rental income and capital gains.

The Pros of Buying Property with a 401k

The primary benefit of [buying investment property] via a 401k is that you're able to do so by taking a loan that is both tax-free and penalty-free.

There are other tax benefits worth consideration. For instance, when purchasing a property with a 401k, any income generated from that property will not be taxed. Instead, the income is put directly into the 401k plan. This means that the owner never actually receives the income, but they'll have this income available in their 401k upon retirement.

However, there is one important exception to this rule: loans against a 401k need not be the only investment in a rental property. Let's say you take out the maximum loan amount ($50,000) and then use the proceeds to invest in a property that requires a $200,000 down payment. The property then generates $2,000 per month in rental income. The 401k would be entitled to $500 of that income each month. The remaining funds would be dispersed to other investors accordingly, even if the person investing is the only investor in the deal. In the latter case, the remaining 75% of rental income each month would flow back to him for use as he pleases.

What are Alternatives to Buying an Investment Property?

A middle-ground approach that many investors consider is using their retirement accounts to passively invest in real estate, for instance, via a real estate investment trust (REIT). Buying shares of a REIT is just as straight-forward as buying any other stock, and these shares can be purchased and sold with ease using most retirement accounts.

Another alternative, for those who may not have enough cash on hand to fund a down payment on their own, is to invest in rental property alongside a group of others. Here at Trion Properties, for example, you can invest cash or invest in deals using your self-directed IRAs. In either case, investing alongside others can reduce some of the risk involved, because the projects have been thoroughly vetted and are being managed by a highly-qualified sponsor.