For Real Estate Professionals, an Individual 401(k) is Better Than an IRA

By Ken Holman, President – National Association of Real Estate Investment Advisors

Most licensed real estate professionals know they need to have a retirement account, so they go to their friend, the stockbroker, and set up an IRA account. The stockbroker tells them about risk, diversification and asset allocation, and then asks them which mutual fund accounts they want to invest in. From there on out, they blindly deposit $5,500 or $6,500 (depending on their age), into the account each year before April 15 and hope they will have enough money to live comfortably when they retire at age 65. Then they forget about it until next year. For some, they don’t want to even know how much they are earning.

Do you have the real estate education to grow your nest egg?

Many real estate professionals don’t have a clue what mutual fund accounts they have put their money in. Some can barely remember the name of the stockbroker or company with whom they have their life savings invested. Most don’t realize they can earn better returns in real estate than in the stock market. But the IRA account they’ve invested in won’t let them invest directly in real estate. There is a better way to invest your retirement money.

A much smarter approach is to open an Individual 401(k) account with a third party administrator/custodian who permits self-direction. A Self-Directed Individual 401(k) is similar to any large company 401(k) account except it is tailored to businesses that only employ the owner and his/her spouse. They may have some part-time employees but no full-time employees. This describes most licensed real estate professionals who are 1099 independent contractors.
Some Background on 401(k) Plans
The 401(k) retirement plan is named after Section 401(k) of the Internal Revenue Code. In 2002, as part of the Bush Tax Cuts, these accounts became permanent for individuals with passage of the Economic Growth and Tax Relief Act of 2001 (EGTRRA). The Internal Revenue Service refers to these accounts as one-participant 401(k) plans. Some administrators call them by other names, like Individual (k), Solo 401(k), Solo-k or Uni-k. Regardless of the name, they are all the same type of account.

Advantages of a Self-Directed Account
The advantages of having a Self-Directed Individual 401(k) plan are significant:

1. The contribution limits are significantly higher for an Individual 401(k) than for an IRA account. Compared to $5,500, the limit for 2014 is $17,500 for the employee and another $34,500 for the employer if you’re under 50 years of age. You can add $5,500 in a Catch-Up contribution if you are 50 or older. Your spouse can also have an account and contribute the same amount.

2. A Self-Directed account allows you to not only invest in the mutual fund accounts of your choice, but also to invest directly in real estate, mortgages, tax liens and deeds, and other related real estate products.

3. The Individual 401(k) account allows you to borrow up to $50,000 or 50 percent of the account balance, whichever is less. It’s a great savings account that lets you borrow the money for an emergency. You can’t do that with an IRA. The only restriction is that you have to pay the money back to your account over five years at the rate of 4.25 percent. Imagine, you pay yourself back with interest rather than pay some other lender!

4. If set up properly, the Individual 401(k) permits you to have a Roth component on the employee-portion of the contribution. A Roth account allows you to invest after-tax dollars that earn interest tax-free. When you retire, you are required to take minimum distributions at age 70 ½, but you pay no taxes on the RMDs.

5. With your Individual 401(k) you can invest directly in leveraged real estate with no detrimental tax consequences. If you invest IRA money in a real estate deal that has debt, the IRA account is subject to Unrelated Debt Financed Income taxes on the leveraged portion of the investment. These taxes can be as high as 35 percent. However, 401(k) accounts are not subject to UDFI taxes.

Getting Started
First, three general requirements qualify you for a Self-Directed 401(k) account:

1. The presence of self employment activity;
2. Taxable compensation received during the year; and
3. The absence of full-time employees.

Second, you set up an account with a Third Party Administrator (TPA) who acts as custodian for the account. The three biggest TPA/custodians are **Equity Trust, Pensco Trust** and **The Entrust Group**. All three have Individual 401(k) programs and permit self-direction. Visit their websites, and they will direct you on how to set up the account.

Third, set up an LLC for which you are the manager, and have your Individual 401(k) buy an ownership interest in the LLC. You then can manage the money and direct it to the investments you want. You must keep this money separate from your personal funds. However, you can personally be an investment partner with your Individual 401(k). Be careful to avoid prohibited transactions and self-dealing. Oh, by the way, you can have both a Self-Directed Individual 401(k) and an IRA, if you like.

With your new Individual 401(k) account, you are captain of your own ship, master of your own destiny. As Napoleon Hill once said, “You are the master of your destiny. You can influence, direct and control your own environment. You can make you life what you want it to be.”

If you need help setting up a Self-directed Individual 401(k) account or want more education on in real estate investing, send me an email at **KHolman@NAREIAGroup.org**.

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