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Voices: Angela Thomson, on Putting Retirement Funds in Real Estate

Voices is an occasional column that allows wealth managers to address issues of interest to the advisory community. Angela Thomson is a financial adviser at Coastal Financial Planning in Lincoln, R.I.

I have a lot of clients who want to use dividend income to shore up their retirement accounts. A really good way of doing that is by having them purchase and invest in real estate, particularly distressed properties. This type of investing can be a huge profit generator for clients and tends to make more money than traditional REITs while giving the client complete control in choosing the property.

To begin, clients can use assets from any retirement vehicle, including 401(k)s, IRAs and Roth IRAs to buy real estate, which is considered an alternative asset. The real estate is then held in the retirement account. This strategy works particularly well now because real estate valuations are still relatively low.

I tell my clients to buy distressed properties from Fanny Mae and Freddie Mac 's foreclosed property resale programs, HUD, or auction properties. I like to tell the client to make sure property is in a good location where they feel the real estate will appreciate and where there's a rental market. The rental market is very strong now, so it's a good time to take advantage of that as well.

Before deciding on a property, clients need to open a real estate trust to hold the designated retirement account. These are simple to set up, but they can take up to 30 days to establish. This can hold you up if you want to go into an investment quickly, so it's good to have one in place before you begin looking.

When your client finds a property they like, they transfer the necessary assets from their retirement fund to the real estate trust. There's never any cash actually distributed, but instead the payment for the property is wired to the escrow account and ultimately the seller. By taking away the middleman, the bank, you also eliminate many of the fees for the client – an added bonus. Otherwise, it's like any other closing, except the assets for the purchase come from a retirement account.

It's a great way to buy a discounted property that will produce a stream of income almost every month. For example, if a client buys a $100,000 condo and rents it for $1,000 per month, that creates dividend income of $12,000 per year, which goes back into the retirement account. When the client later sells it, let's say for $120,000, the client makes the purchase price back and then some—a win-win situation.

It's important to remember that all transactions must remain arm's length transactions, or the IRS will disallow it. For example, all income and deposits need to be directly deposited to the trust, and any expense payments have to come directly out of the trust. At no time can the client retain any of the cash from the investment.

That said I see most clients earning a minimum of a 20% return on the real estate investments in their retirement accounts. It's a great method of building cash flow into a retirement fund, and hopefully the capital appreciation will also boost portfolio value at retirement.

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