



## **Top Ten Things You Need to Know** **When Investing in Real Estate Notes in Your IRA**

Many self-directed IRA clients, including me, invest in notes within their IRAs, mostly secured by real estate. In my years of experience as a hard money lender personally and as a third party administrator for self-directed IRAs, I have seen some common mistakes made. As a result, I have developed some guidelines for lending your IRA (and non-IRA) money out secured by liens on real estate. I wish someone had shared these ground rules with me before I made some of the loans in my portfolio, although fortunately I have not been hurt too much by my mistakes.

- 1) Do not loan on something you wouldn't be excited for your IRA to own if the borrower defaults. Loaning money out of your IRA at relatively high interest rates secured by real estate is inherently more risky than leaving the money in a bank certificate of deposit, but it is also more profitable. We routinely see yields from these loans at 12% and higher. However, if you would be upset if the borrower defaulted and you had to take the property in foreclosure you probably should not make the loan. With a properly secured hard money loan the worst thing that can happen is that the borrower pays you back!
- 2) Generally, do not advance money for repairs until the repairs are done, and then have the repairs inspected before advancing the money. This is one of the biggest mistakes I see clients make with their IRAs. They fund the full loan amount expecting the repairs to be done on the property, but the borrower just needs a little more money on another project and diverts some of the loan proceeds to that project. When the loan goes bad, the IRA can end up with a property which has not had the repairs completed on it.
- 3) Do not loan money to someone you would feel uncomfortable foreclosing on. William Shakespeare wrote in Hamlet, "Neither a lender nor a borrower be; For loan oft loses both itself and friend, And borrowing dulls the edge of husbandry." For the most part I cannot agree with this advice, because lending and borrowing money drives our economy and increases economic activity. However, the part about a loan losing a friend is absolutely correct, in my opinion. If foreclosing on your borrower would cause you heartache, it is best not to make the loan. I have seen friendships destroyed over a loan gone bad.
- 4) If the loan goes into default, take action immediately. No one wants to admit they have made a mistake, but delaying action can be costly. You can always stop the foreclosure process once it has begun, but you cannot complete the process unless you start it.
- 5) Collect interest monthly so you will know if the borrower is getting into trouble. Many borrowers, especially investors, would love to just pay interest at the end of the loan, but this can expose the lender to additional risk. The purpose of collecting payments monthly is both to make sure the borrower remembers he has to do something with that property in order to avoid the pain of the payment and to let you know if the borrower is



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in trouble because he starts missing his payments. Also, unless you have contracted for monthly payments, you may not be able to foreclose even if you find out through other means that the borrower is in financial trouble because the loan may not be in default. This actually happened to some of our clients.

- 6) If you are unsure about how to evaluate the loan, hire a professional to help you. Although a hallmark of the self-directed IRA is that it is “self-directed,” meaning that you make your own decisions and find your own investments, most IRA owners either do not possess sufficient knowledge or, in my case, sufficient time to properly evaluate a loan transaction. My solution is to hire a professional to help me with the deals. He checks out the borrower, coordinates with the title company, orders the appraisal and usually a survey, makes sure insurance is in place, and generally evaluates the loan. Naturally he charges a fee for this service, which is passed through to the borrower, on top of any interest and fees that my retirement plan may charge. This increases the cost of the loan, but in this case the non-Biblical version of the golden rule applies, which is “He who has the gold makes the rules.”
- 7) Get title insurance for the loan. The purpose of title insurance is to shift risk away from you and to the title company. In Texas, where my office is, the incremental cost of title insurance is very small when issued in conjunction with an owner’s title policy. Regardless of the cost, making sure that your IRA is protected from title flaws is very important.
- 8) Verify that hazard and, if necessary, flood insurance is in place naming your IRA as an additional insured. It is very easy to miss this issue when you are trying to get everything done right before a closing. Borrowers may get insurance at the last moment and simply forget to add your IRA as an insured. But if something goes wrong, you will want to make sure your IRA is named on the check.
- 9) Insist that the borrower provide you evidence of payment when property taxes and homeowners association fees become due. The same thing would apply to hazard and flood insurance premiums, although normally you would receive notice of cancellation for non-payment of those bills. Depending on where you live, property tax bills can increase quickly due to penalties and court costs, which reduces your equity position in the property.
- 10) Get a personal guarantee if lending to an entity or to an individual with some weakness. When things are going well, you might be tempted not to insist on a personal guarantee, and indeed many borrowers will resist this. However, as we all have discovered recently, circumstances do change, and a personal guarantee may be helpful in collecting the debt. I collected on a note once where the property had decreased substantially in value due to vandalism and market conditions. Instead of foreclosing, I had my lawyer send a letter explaining to the guarantor, who had a significant amount of assets, that he was personally liable on the debt and that if he was unable to satisfy the note I would pursue



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legal action against him and the borrower. A week later a cashier's check showed up satisfying the lien.

This list of suggestions is not meant to be exclusive. Other issues you will need to understand include your lien position (personally I only invest in first lien loans), any state usury laws that might apply to the loan, and at least a general idea of what the foreclosure process is in your state in case the loan goes into default. Always get good legal counsel to assist you with loan documentation. Especially since the borrower traditionally pays for all expenses including legal fees, there is no reason not to have an attorney draw up loan documents.

Lending can be an excellent investment in an IRA. It is relatively easy to do and if done correctly has a comparatively low risk. Getting to know successful real estate entrepreneurs who borrow your IRA money may also lead to other, intangible benefits as well.

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