Real estate is an attractive asset class for many reasons and should have a place in every diversified portfolio. There are many ways to obtain exposure to real estate, with varying risk, reward, and liquidity characteristics. In the past, real estate investments were most easily accessible through publicly-traded real estate investment trusts, or REITs, as well as non-traded REITs. In recent years there has been a considerable increase in real estate investment through other channels, especially syndications, crowdfunding, and direct real estate investment. While REIT investments may be accessible through a traditional brokerage account, the newer avenues of real estate investment are not.
Investing in Real Estate Through Tax-Advantaged Accounts

Increased interest in the real estate asset class has led many investors to ask if tax-advantaged accounts – IRAs, 401(k)s, HSAs, ESAs, and others – can invest in real estate via syndication, crowdfunding or direct investment. Investors are cognizant of the unavailability of such investments in their brokerage accounts, leading to the erroneous conclusion that regulated tax-advantaged accounts are precluded from pursuing illiquid investments.

The truth is that the Tax Code imposes few restrictions on the types of assets in which tax-advantaged accounts may invest in. As such, all retirement accounts can invest an array of alternative assets, including private lending, hard money lending, litigation finance, cryptocurrency, livestock, tax liens, and many others. Notwithstanding, the most popular application of the tax code’s “permissiveness” has been real estate investment, for which the most favorable vehicle is a Solo 401k Plan. A Solo 401k Plan is a Qualified Retirement Plan for small businesses that is exempt from many ERISA requirements. It is designed for businesses that have no full-time employees beyond the business owner(s) and spouse(s).

This article will address 15 key conceptual and practical aspects of Solo 401k Real Estate Investing, using the format of a Q&A with a representative Solo 401k Direct Real Estate Investor.

Q&A for Self-Directed Real Estate Investing

1) What kind of real estate investment
did you pursue with your Solo 401k?

A: I made a direct real estate investment, meaning that I identified a specific property that met my investment criteria and bought the property using my 401k funds. I prefer direct real estate investment over REITs and other pooled vehicles because of the control and transparency it provides. I know my real estate market and work with knowledgeable real estate brokers to identify local opportunities that have little risk relative to their upside potential.

2) I’m considering using a Solo 401k for real estate investing. Are you confident that Solo 401k Direct Real Estate Investment is legal?

A: I am completely confident that Solo 401k Direct Real Estate Investment is legal, albeit there were several individuals that informed me otherwise. Generally, the tax code aims to be economically neutral, so that financial decisions will be made based on economic factors, not taxes. Therefore, the tax code stays away from favoring some asset classes over others. The only asset class that is disallowed to 401K Plans are collectibles, such as artwork, alcohol, rugs, gemstones; other than the limitation regarding the collectibles asset-class,
the tax code imposes no asset-class restrictions on 401K investing.

3) How did you select a Solo 401k Provider to set-up your Solo 401K Plan?

A: There are many Solo 401k Providers, providing very distinct service offerings. It is imperative to understand the structure of the industry and the nature of the various service providers. Above all, it’s important to understand the scope of services that you may need, so that you can determine which service-provider can best help you meet your objectives. I selected a provider based on my unique profile.

4) Doesn’t a Solo 401k Provider address all my Solo 401k needs? What needs could I have that are outside the scope of services offered by a 401k provider?

A: At the most basic level, Solo 401k Providers provide the backbone of a tax-advantaged Qualified Plan – a Qualified Plan Document. However, there are several other items that need to be addressed both prior and subsequent to signing a plan document. Those are items related to Solo 401k Plan Qualification, Solo 401k Compliance, Solo 401k Operations, and Solo 401k Strategy.

Addressing these items requires knowledge of complex areas of taxation and personal finance, including controlled group rules, affiliated services group rules, prohibited transactions, UBIT, and many others. Some of those impact whether-or-not you actually qualify for a Solo 401k Plan!
5) What is a Solo 401k Provider? What distinguishes one from another?

There are several types of 401k providers:

(a) Brokerage House Solo 401K Providers

Brokerage houses, such as Fidelity, Schwab, E*TRADE, Vanguard and others offer Solo 401k Plans with varying tax features, but which do not allow for Direct Real Estate Investment. These providers generate revenue from the investments on their platform. Therefore, they provide a free Solo 401K plan, but require you to invest on their platform. They can’t advise on any tax matters.

(b) Self-Directed Custodian Solo 401K Providers

Self-Directed IRA Trust Companies and Administrators provide Solo 401k Plans with varying tax features, which do allow Direct Real Estate Investment. However, such plans require that the Solo 401k funds and assets be administered by the custodian. An important distinction between IRAs and 401(k)s, per the Tax Code, is that IRAs require a qualified custodian, but 401K Plans do not. Although a Solo 401k Custodian may add value, the use and cost of such a custodian is voluntary. These providers generate revenue from administering assets and processing transactions. They can’t advise on any tax matters.

(c) Independent Solo 401k Providers

Such providers will, generally, provide plans with the greatest flexibility and, of course, allow you to invest in real estate. Such Solo 401K Plans are referred to, in industry parlance, as Checkbook 401k Plans, because they allow you to keep investable 401k funds in a bank checking account that the plan participant directly controls. The “checkbook control” provided by these plans provides great flexibility, while reducing fees and streamlining 401k investment transactions. These providers generate revenue by providing 401k Plan
Documents that provide broad flexibility with regard to plan investments and operations. They don’t custody assets or provide investments.

(d) CPA & Attorney Affiliated Solo 401K Providers

Such providers are similar to Independent 401K Providers but can go beyond just providing a Solo 401k document to advise on every aspect of a Solo 401K. These providers generate revenue by providing Solo 401K Plan documents, Solo 401K Filings (990-T, 1099-R, Forms 5500), and consulting on Solo 401K compliance.

6) So, what type of provider did you work with?

A: Thankfully, I identified a CPA & Attorney Affiliated Solo 401K Provider to work with. I’m a partner in a medical practice and have some income from a side-gig that I used to form my Solo 401k. I benefited from guidance regarding whether-or-not I qualify for a Solo 401k Plan, as ownership in the medical practice could disqualify my side-business from sponsoring a Solo 401k. In addition, I benefited from guidance about how to structure, and how-not-to-structure, my side gig for optimal tax treatment. As part of the Solo 401k formation process, I had a comprehensive Solo 401k operations consultation in which we discussed prohibited transactions,
7) How did you fund your Solo 401k Plan?

A: I funded my Solo 401k with a combination of rollovers from IRA accounts and new contributions. The new contributions were based on the net income from my side gig *(Note: Roth IRAs may not be rolled-over to a 401k Plan, even the plan allows for Roth 401k subaccounts)*. By consolidating retirement funds within the Solo 401k, I was able to pursue larger real estate deals.

8) Direct real estate investment benefits from leverage, borrowing money to finance larger deals. Were you able to do the same with your Solo 401k?

A: I did finance a portion of the deal, but it was not identical to financing a deal outside a 401k. Although my Solo 401k can borrow money to finance an investment, I can’t personally guarantee the loan – doing so would be a prohibited transaction. The solution was to get a loan that is non-recourse, meaning the bank can’t look to me to satisfy the debt with my personal assets, only to the investment property itself. The terms are not as favorable as with a traditional loan to compensate for the decreased risk to me and increased exposure of the bank. I was able to address all this with my Solo 401k provider during the plan set-up.

It’s noteworthy that a Solo 401k does NOT generate UDFI when using leverage to finance real estate investment. UDFI, which stands for Unrelated Debt Financed Income, is a type of income that is taxable to tax-exempt entities, such as charitable not-for-profit organizations and retirement plans. UDFI is, usually, generated when a tax-exempt entity uses borrowed
funds to finance an investment. However, there is a special carve out that exempts Solo 401(k) plans from this tax when indebtedness is incurred for real estate acquisition.

9) What other differences were there when investing a Solo 401K into real estate?

A: The deal proceeds very much as it would with any other investment, only the assets are titled in the name of the 401k Plan. Likewise, all transactions are conducted in the name of the 401k Plan.

An option that my Solo 401k provider presented was having the Solo 401k invest in real estate through a solo 401k-LLC. They pointed out that if I were to purchase multiple properties, the 401k would benefit from the segregation of liabilities and that investment operations would be streamlined, as all could be conducted in the name of the LLC, a familiar business entity that is widely recognized. They emphasized that this was optional and for my first deal I chose to proceed without the LLC. When I purchase my next 401k real estate investment, I’ll put that one in a Solo 401k-LLC.

10) Did you have difficulty conducting transactions in the name of the 401k?

A: 401k real estate investing is a novelty to many people and it takes a few moments for them to adjust. Getting a bank account set up required educating the bankers about Solo 401k Plans. My provider assisted me with this and introduced me to some bankers that are knowledgeable about Solo 401k Plans.

11) Did your 401k property require any rehabbing and how’d you get that done?

A: The 401k property did require some rehabbing and upgrading. I hired some folks to do the work and paid them out of the
401k bank account. My Solo 401K provider cautioned against me actually doing any of the work myself – and I was more than glad to comply with that.

12) What are the limitations of Solo 401k real estate investing?

A: There are few “per se” limitations, but there are compliance matters that you must be cognizant of. My Solo 401k provider pointed those out to me before initiating the plan formation. Anybody considering using a Solo 401k Plan for direct real estate investment must be aware of Prohibited Transactions.

13) Prohibited Transactions! Sounds intimidating – what are those?

A: They sound prohibitive, but they really have a very limited impact on my real estate investment. Conceptually, the Prohibited Transaction rules are designed to preclude us from generating any personal current benefit from our Qualified Plans. Congress created 401(k)s and other qualified plans to incentivize us to save for our futures. Therefore, legislation was enacted to remove any conflicts-of-interest to maximizing the plan’s ROI.
The prohibited transaction rules don’t allow me and certain other disqualified persons to transact with my 401k plan. Of course, I can act on behalf of my plan in my capacity as plan trustee. It is only that I, as an individual representing myself, can’t be a party to a 401K transaction.

14) How has Self-Directed 401k real estate investing been working out for you?

A: It’s been working out very well. Each month, my 401k bank account receives rental income. The property is performing well and has appreciated since bought by my Solo 401K. The real estate has provided diversification and is outperforming (at least for the moment) my securities portfolio.

I always maintain a cash reserve in a 401k account. Any excess cash is available for further investment. My plan is to accumulate enough funds to purchase a second property with my 401K. In the interim, that excess cash is loaned to other real estate investors, a high return investment that is secured by real estate. This is known as secured private lending and is another form of real estate investment.

15) What advice would you provide to anybody contemplating Solo 401K real estate investment?
A: Successful real estate investing is very rewarding, but is far more demanding than the mouse clicks required to buy index funds. The outcome of my 401k real estate investment has been overwhelmingly positive and I’m confident that anybody that properly executes a 401k real estate plan can experience similar success.

What do you think about investing in real estate through your Individual 401(k)? Is it something you would consider? Why or why not? Comment below!