Ep #108: Combining Real Estate with Self-Directed IRAs with John Hyre

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Dr. David Phelps and Evan Harris

John Hyre: You are allowed to own money and the money is allowed to work for you. It is legal slavery. The money works. When they take away that money, they're not just taking away the money but the children of the money.

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David Phelps: Good day everyone. This is Dr. David Phelps on the Freedom Founders Mastermind Community and the Dentist's Freedom Blueprint Podcast. Back to you today with what's going to be a really interesting discussion with a good friend of mine, a good friend of mine who I've heard him speak. He's been in a number of groups, workshops. His name is John Hyre. John, how are you doing today sir?

John Hyre: Very Good. Thank you. Glad to be here.

David Phelps: John is a tax attorney. He's also an accountant. He's a real estate investor just like many of us with over 20 years of experience. He consults with real estate investors of all sizes, small business owners and self-directed IRA and 401K owners across the nation. He also, because of his background as an attorney and account, he represents taxpayers in audits and it tax court nationwide. It gives him some very specific insights which is what I love about him. He can bring what's really happening inside and what's happening with changes in laws and regulations. He frequently speaks nationally on the topic of self-directed IRAs and 401Ks, taxation of real estate and small businesses and asset protection.

I will add this little note that John, unlike most tax speakers, he is not boring at all. He is actually very entertaining. I would say never PC, politically correct, so with that forewarning, John Hyre, are you ready to take it to them?

John Hyre: I'm ready to go. Let's go.

David Phelps: All right, let's do it. All right. Let's frame this up because what we want to talk about today is the advantages, the opportunities then that are available to so many business professionals that we have on the podcast, business owners who are trying to get ahead of the curve on building wealth, creating wealth and finding that taxation is just eating them up today. Many people understand that real estate has many good tax preferences but there is an add on and that is how one can utilize what we're going to call self-direction using qualified retirement accounts. We'll define what that is. Self-direction and using that self-direction in the ability to defer and even create tax free distributions also utilizing every aspect of real estate investing we can do outside of the qualified retirement arena. With that kind of big beginning, why don't you frame it up John. What are these qualified accounts and let's talk about why there's advantages. Who would want to be using them today?

John Hyre: Let's start with the advantage then I'll define the accounts. The advantage is no tax. If you do it through a Roth style account which we'll describe in a minute, it's not even tax deferral. It's no tax. For especially high earning professionals, I'm in this position. I make a great living. I make far more money than I'm going to live off of. I'm not going to touch money from investments. I want to see it all reinvested. I don't want to see it taxed, so I will run investments through 401Ks, IRAs, especially Roth IRAs, Health Savings Accounts, covered Educational Savings Accounts. Those are the big four.

You can pay for later income. I wouldn't even call it retirement because people are retiring so late or not at all anymore but you could use it for that I suppose but basically income for later in life or if you don't spend it, in some cases for your kids, grandkids or great-grandkids because they can inherit some of these accounts tax free. Income for health. For example we do medical tourism and income tax free for schooling. K-12, university as well as some home computing needs. That's the broad definition. I guess when we say IRAs, since it's easy to say that, we really mean IRA, 401K, HSA and CESA because all of them follow very similar rules.

David Phelps: Good, good. Just again so people understand, a lot of people don't understand John that the effect of what I will just call interim taxation ... That is the fact that every year when you have profits, unless they are encompassed within a deferral or a tax free mechanism like you just discussed, that the federal government extracts a certain amount of that profit and takes it away. You're trying to compound wealth. The whole goal here is to compound wealth, to turn it into cashflow on demand when you need it and that interim taxation sucks away the ability to compound year after year after year. What you're talking about here is that the benefit of we actually mitigate that in some cases with the right accounts completely.

John Hyre: Yeah, we've done the math on this and on accounts that are in double digits which is very common with my clients because we're good at directing the investments. We know the investments. It's not just going to be something in the stock market or with God forbid bonds. When we're getting good returns, the real impact isn't just the taxes they take. It's what you said, the loss of that compounding. You see there are certain types of slavery that are still legal.

You are allowed to own money and the money is allowed to work for you. It is legal slavery. The money works. When they take away that money, they're not just taking away the money, but the children of the money, that compounding. If you do the math over 20 years, taxable versus non-taxable about a 30% rate, which by the way for a lot of people who are listening is a low rate. High earning professionals are well above that. But just at a 30% rate, the difference is between double to triple in savings. In other words, you lose, let's say half to 66% of the savings that you could have had by not sheltering from that kind of taxation. People don't really understand it. I challenge listeners who are skeptical, put together a spreadsheet. I'm not lying. I know I'm a lawyer but the nice lawyer is telling you the truth this time.

David Phelps: It is true. I run the same numbers and you're absolutely right. The decrease in the compounding effect with that interim taxation is huge. Most people, they don't understand that. They work ... You know, John I've had professionals, doctors, dentists who I've had conversations with and they will tell me that they have not had an increase in net worth beyond their contributions to whatever they're contributing to, not had any net worth growth, no equity increase in as long as a dozen years because, number one, they don't know where to put their money and secondly if it's not in a qualified plan that we're talking about today, the taxation just nails it.

John Hyre: I'm very passionate about it. As you know politically I'm not a huge fan of socialism or the government taking things and understand this. To say that taxation is theft is understating the case. Absolutely understating it because what are they really taking from you? Life. The time it took you to make that money is gone. They took that time that could have been with your spouse. It could have been with your family or friends. They took life from you. This is one way to really, really stop that.

David Phelps: So with these qualified accounts, combining them with what we love, asset class we love, which is real estate, is there any prohibitions against the type of real estate investment one might want to make from any of these accounts?

John Hyre: There are. This is a very high return area. Not paying tax is a huge benefit, but there is a price. There is some complexity. There are some rules that need to be learned. I'll give you the two main ones we focus on, prohibited transactions and it's just a list of things you can't do. It's not a simple list. I'll give you two examples of prohibited transactions. One, you cannot provide a service to the IRA, 401K or what not. Now what's a service? Well the government tells us you can't provide it but they don't tell us what it is. We're very conservative about ... You have a rental property. Certainly don't swing a hammer but also I would say, don't even manage it. Let a management company do it.

Do I understand the problems that brings? They won't manage as well as you. Well actually in my case, they manage better, given my time commitment and that I have no desire to manage. They actually do better than I do but for a lot of people I understand. You would do better and you wouldn't have to pay them, except you can't provide a service. You can't even risk it. Whatever could be a service.

Second, you cannot use the account to benefit yourself. This can be very subtle. I'll give you an example. There's a deal out there you want to do. You don't have enough money. You bring your IRA in to do the deal with you. You used the IRA to benefit you. Why? You needed it to do a deal. It allowed you to enter into a deal. You used it to benefit yourself. That's prohibited. How do we get around that by the way? Document that you could have done the deal without the IRA. Those are examples.

Then the other set of rules are UBIT. U-B-I-T stands for Unrelated Business Income Tax. In a nutshell that applies when your IRA borrows money. A lot of people didn't even know that the IRA could do that. IRAs can partner. They can borrow and there are times to do that, but there is a tax associated with that that we have to think about and structure around. Your IRA also should not run an ongoing trader business or it will pay UBIT. No. If the business makes enough money you might eat the UBIT. If you own a Dairy Queen, that's an ongoing trader business. That's not really an investment vehicle, so I would say if you're going to do that be prepared to pay this UBIT tax. It's a high tax. It gets to 40% pretty fast. I'd say those are the two biggest sets of rules we want to pay attention to.

David Phelps: We're talking to people who would want to take advantage of the tax benefits of using qualified accounts, John. This does take some activity. It takes somebody getting involved. Self-direction means you have to do something. It's not just as simple as putting your money in some new account with a custodian and all of a sudden things happen. What would you say to people that are thinking I want to do this. What are some of the things that you've learned and certainly I've learned over the years about taking the responsibility of self-direction? What does that mean?

John Hyre: Set aside the time. Take the time. Educate yourself. Get to know these rules very well. Get good help. Of course I'm rather biased in that respect because I happen to be the good help, but get good help. Think carefully of the asset classes you want to invest in. Ideally you do what you're good at. Now you can't always do what you're good at in an account. For example, I'm a very good law and I haven't really figured out how to run a law firm through a 401K yet.

So what else am I good at? Low income rentals. That's a big number too. Focus on it and watch out for the unscrupulous. There are a lot of people who prey on self-directed IRA investors. I really think even more than in most investments, due diligence here is absolutely key.

David Phelps: Yeah, we always talk about due diligence of two aspects. Certainly always do due diligence of the actual investment you're getting involved in, but as you just said, the person you might be "partnering with," or whatever that looks like. That's the way I do most of my investing today, John, is I used to be in my early years, when I had more time and less money, I had to get out there, boots on the ground and put stuff together. Today I prefer to invest through other people, but it's got to be the right people. No bones about it. That's the biggest piece for me.

John Hyre: My biggest losses have not been through real estate. It's actually very rare that I pick a bad real estate deal, but I have on more than one occasion ... I can remember one occasion where I lost the most money. The partner's wife was two scoops of crazy and it cost me dearly. Absolutely dearly and I didn't even get whatever benefits he got from his arrangement. You know I just dealt with the crazy part. Well, you got to watch yourself.

David Phelps: You got watch that. Some of the accounts certainly have maximum contributions so the Health Savings Account, Covered Education Accounts, to some extent we could talk about just contributions to Roth IRA having some limitations, these smaller accounts. People would say well are the worthwhile? If I can only put $5500 or maybe if I'm over age, whatever, age 50 in the catch up provision, another thousand in some of these accounts. Is it worth it to do that? John, what would you say?

John Hyre: You have to be a little more active. It depends how much you're willing to do. Let me give you an example of a gentleman who put 50 rental properties into a Roth IRA and you'd wonder, well how do you get 50 rental properties in there at five grand a year or whatever it was he was putting in. He borrowed. he borrowed on these rental properties. In his case he bought during the crash. He bought low income properties. Let's say 20 grand a property. Let's say they were 20 grand all in, rehab and everything. They rented for let's say 600. Let's say 400 of that was actual profit. 200 was expenses. That's about five grand a year on a 20 grand investment. He borrowed

100%. The cash flow was so good, he paid most of these off within five years. He did pay some UBIT tax on that, but what was the exchange?

For the rest of his life and the rest of the life of whomever inherits that Roth, there will be no income tax. He had about, last I heard, 50 some properties in there, probably pulling about 250 a year tax free. He was in his early sixties when he finished this. So let's say he only makes it to 80, he's going to have about 20 years tax free. What's the net present value of that? Plus whoever inherits and he's pretty smart. My guess is one of his grandkids or great-grandkids will inherit because the younger you are when you inherit, the bigger the benefit. I bet you there'll be another 80 years tax free after that. Is that worth a little bit of hassle?

There are rules for the loans. There are rules from whom you can borrow and how they're drafted, but not being taxed on 250 for 20 years, that's worth some hassle. That's one way to take a small account, in his case theoretically an account with a dollar in it. Now he had more than that. He had a pretty good sum but he kept it as a reserve. He didn't really touch it. He used it for oh a rehab went over. There's a vacancy. I got to cover a loan, that sort of thing. That's just one technique. Happens to be my favorite because again I like low income rentals. That really appeals to me. I also like the simplicity. The rules with debt in an IRA, when an IRA or one of those other accounts borrows, are pretty simple and not very gray. All things being equal, I like simple.

David Phelps: Yeah. Makes a lot of sense. John, what about, you talked about the rules and regulations. You deal obviously in audits, people get audited. What sort of things do you see people getting tripped up with, not following the rules? How difficult or how easy is it to get tripped up and make some mistakes that what's the cost? What kind of things do people get in trouble with?

John Hyre: That's a great question. Now we have to differentiate accounts into two types, 401K and all other. If a 401K enters into a prohibited transaction, there's a penalty but you just move along. If an IRA, HSA or CESA does a prohibited transaction, the account ceases to exist. It evaporates and it's a huge, huge tax hit. Right now, what we're seeing is because so many people have been cowboys and well unfortunately like a lot of landlords, really cheap and didn't get the education or the help, we're seeing a lot of basic screw-ups.

We're seeing things like lending your mother money, borrowing money from your kids through your IRA. These are just 101 basic newbie mistakes but it's enough to kill the account. What we've seen is the IRS is getting a lot of low hanging fruit. Now there are some more sophisticated and subtle issues. The IRS is still really getting up to speed and they're very slow to learn, so I've tried to get ahead of the curve. For example, the services issue I mentioned, the IRS hasn't really hit that yet. I think one day they're going to and I'm trying to warn my clients now. Let's just think ahead and not open ourselves up.

I would say most of it has to do with self-dealing of some sort or another. The IRA does business with you or someone close to you, it should not have done business with. You put in some time that you shouldn't have or things like that are what we're seeing on audits. The auditors are still learning. They do have a dedicated division that audits only Roths but with budget cuts it's also been reduced. So far that's what we're seeing. Here, what's the lesson?

If you can qualify I love 401Ks, because if you mess up you pay the fine and move along. The fine, compared to the savings is very small. I love the 401Ks if you can qualify. What do you need to qualify for a self-directed 401K? An earned income trader business that you own. An earned income trader business. What's earned income? Something I sold for services or where I sold goods over and over, inventory basically. My law practice is a perfect example. I do ... My first investments in my exempt accounts go first into my 401K, then into the CESA then into the HSA then into the IRAs and that's my order of priority for investing because of the safety of the 401Ks.

David Phelps: With the 401K John, how does it work when you have employees?

John Hyre: If you have employees ... You can still do this if you have employees. It gets more expensive and complicated so if you have a trader business that has for example just you and your spouse, that's ideal. But I have employees. I set up in my case what's called a safe harbor plan. It's a lot cheaper and easier to run than a regular 401K. What's the downside? My maximum contributions are limited. See in a 401K you have two types of contributions. What the employee puts in and what the employer puts in. The employee can put in up to 18,000 a year, 24,000 if they're 50 or over and then they can bring the total contributions, with a company match up to 53 or 59,000 which is a pretty hefty contribution. If you have employees, that employer contribution is going to be very limited, typically to two or three percent of salary. That's because you don't really want to give that to everybody.

David Phelps: Sure.

John Hyre: That's what I use as a safe harbor. The employees get a two to three percent match depending on how we structure it so I don't have to give them that big a match but it does limit my match, so my annual contributions through the 401K are typically going to be in the vicinity of about 20 to 22 grand. Plus I contribute to my IRA. They're not mutually exclusive. If it's a traditional IRA I roll it over into the 401K so that ups my contribution a little bit.

You figure I put about another almost 7000 a year into my Health Savings Account, which has the same rules. Your Health Savings Account for example can own rentals in the way we described and pay for your medical costs for the rest of your life, including as I mentioned the medical tourism. You know better than I do being closely affiliated with the medical profession, what are some of the problems here and what are some of the advantages of going overseas. We've done that.

Last but not least, the covered accounts where you pay for education. You can only put two grand a year in which is why a lot of people don't bother, but remember the example I gave. There are ways to expand that two grand.

David Phelps: A way to do that is you have to do arm's length transactions. You can't self-deal, so that's where having a network, people who also have a level of education hopefully somewhat comparable to yours is where these things can start to happen right? There's some cross pollination that can happen as long as it's truly arm's length.

John Hyre: One of the rental deals I bought in my 401K was a $15,000 low income property from a wholesaler. He got it for 10. He normally would have sold it for 20. We're friends. He did me a favor. He sold it to me cheap but not stupid cheap such that the IRS could look and say this is fake. 15 grand, the tenant's been there 12 years. I get 620 bucks in rent a month. It needs about 10 grand in rehab but not now and so we're taking about ... If you do the math, we cashflow about five grand a year on that thing, and about 2000 a year goes into rehab for about four years, maybe five years. The tenant is thrilled. It's been a cash cow. I haven't had to deal with it at all. I think so far I've paid for one repair visit. Why did I get that? Friend who knew what I was looking for and for a 401K gave me a cherry deal. Now will I one day do that friend a good turn? You better believe it.

David Phelps: Yeah, excellent. Excellent. Let's talk a little bit about some other examples you've used. That's a great one there. In the low income property, I don't want to get into the management of property because that's not really the topic here but some clues for some people. Some people have really been beaten up. Are you buying low income property because you're getting a great deal and you've got some great managers in place to make this happen? What's making that work for you or the other gentleman you talked about?

John Hyre: I've been doing low income property for about 15 years so I have some experience and I learned the hard way. I used to be a nice person and I used to listen to the tenants and I got absolutely financially ... I may not want to use the word I'm thinking of. Let's just say it was unpleasant. I've learned. I have some decent local management. I know how to buy cash flowing properties. I can't manage them because they're in my accounts which is ... You have to have a decent manager and again that's where friends come in handy. I have friends who are licenses and decent managers and they don't want to manage for others but they do me a favor. Of course somewhere there I'm going to do them a favor.

That's why I do low income but we've seen people do ... I got a call yesterday from an attorney who's buying a development property in Nicaragua. We're setting up an LLC for him. A lot of people use an LLC within their account in order to run the business. We see a lot of lending. Someone this week I'm drafting a note for, that they lend money to rehabbers but the interest is measured in profits. Instead of four, five, seven, eight percent interest, his interest is actually a percent of the profit. Otherwise the note is a complete note.

Instead of partnering with a rehabber which has tax implications that are negative for IRAs ... It goes back to that UBIT tax we were talking about. What else do I see? Lots of different kinds of rentals. Some businesses even though you pay the UBIT. Sometimes it's so lucrative it's worth doing and there are ways to take the bite out of the UBIT, especially if the Trump tax reforms pass. Corporations become very attractive for that. We've seen people invest in livestock. We've seen them invest in farms. I think I had one guy invest in cars. He just bought the cars and I have to ... My memory's not real good on that one because there are lines with cars that you don't want to cross in terms of collectibles. We've seen pretty much everything.

David Phelps: Pretty wide open field, isn't it? What you can be involved in. As you've seen earlier, it's what you have an interest in, what you understand, pretty much.

John Hyre: That's a great way to put it. People ask me all the time, for tax purposes what should I invest in. I tell them you don't invest that way. It's what are you good at. If we can find a way to get it inside of an IRA legally, we're going to do it. Now if there's nothing you're good at, I guess you're going to have to find something to get good at that will fit in there. That's why a lot of people like lending, passive lending. That's where the due diligence is key.

David Phelps: That can be a good way to get started. You don't have the leverage opportunities that you discussed early, but yeah if you want to get started, I think lending is a good way. You can start to learn some of the due diligence and then you can get into a ...

John Hyre: There are ways to leverage your IRA and lend the money out. I'll give you an example and this is getting a little complex but I want to throw it out there.

David Phelps: Sure.

John Hyre: You can set up an arrangement where your IRA is a partner with other people the other people are preferred partners and get a preferred rate of return, let's say nine percent. It's not technically leverage. It's not a loan, which avoids the UBIT but it feels like leverage. You're paying nine percent to others and let's say you turn around and invest it at, I don't know, 12%. There are plenty of loans out there at that rate. You're getting some arbitrage in there.

David Phelps: Yup. Yup. Good point. Good point. We have just barely dusted the surface and I love this interview because you're bringing a lot of parts and opportunities to the table here. I want people that are listening to this podcast interview to see the opportunities. I've been in many workshops that you've done and because of your experience in audits and also the fact that you are a real estate investor, a real player with knowledge out there, you are going to do a workshop specific to what we're talking about today using IRAs for investment. Talk about strategies, structures, rules, regulations, pretty much the whole gamut.

That's set up for a few months from now in May, May 6 and 7 in Dallas Texas. Do you want to talk a little bit about who should maybe come, what's going to be covered a little bit more and then maybe who maybe shouldn't come even if they are interested a little bit in the topic right now?

John Hyre: You know I would say this. It's going to be an A to Z of what IRAs, 401Ks etc. are allowed to do and how to do it properly. We're going to spend some time first of all on choice of account. We're going to look at SEPs and the Simples and the other types of accounts and decide which ones are superior and why. We've already kind of given you the answer but we're going to go into more detail.

Then we're going to discuss prohibited transactions, what not to do and because they're so costly, we're going to spend some time. There's going to be a ton of Q & A. Usually I'd say about half the class time is actually Q & A versus lecture time. Given that I go at $350 plus an hour, that's not a bad chance to get some of your questions answered.

We're then going to switch into UBIT as I mentioned. We're going to get into what have I seen in audits. I'll spend at least an hour, hour and a half, what have I seen and how do you deal with an audit in general if one of them hits you. The rest of the time is going to be deal structures. I want people to bring ... John, I want to do X can I do it? If so, what's the optimal way to do it? We're going to get up on a whiteboard. We're going to draw a here's what the deal looks like. Here's what you can do, can't do. Here's how to set it up and run it.

The deals can get pretty funky because here's what I've found. The people who show up to my workshops ... I would say it's worth going just for the networking. Some of the things I've learned from networking events ... You and I were just chatting before the call. I hired a virtual assistant and I used a search firm that did all the searching for me based on my criteria. They even called me back and said which of my criteria were not realistic. How did I find out about that? I went on a cruise with our mutual colleague Dikes Bottiford. One of the clients that I met on the cruise who's now a client, we were walking in the streets of Old San Juan, so what better environment to brainstorm.

David Phelps: That's right.

John Hyre: Smoking cigars because you're actually allowed to do that outdoors in Puerto Rico and he just turned me on to this. He said I have a VA. They've been great. Here's the firm. That networking, that creativity, the thought process, that is huge. It's another reason to go. If you want to learn the

A to Zs of how to run these, what to do, what not to do, from someone who's actually been in tax court and won. That's very rare. Been there and won, I can tell you hands on practical how it works. It's going to be 14 hours of time and trust me it won't be at $350 an hour.

David Phelps: That's right. You definitely don't want to try to do this in a vacuum. You're absolutely right. I think the creativity, the networking, it is so powerful. I agree with you 100% and this is going to be a relatively limited attendance. This is not going to be a seminar where 200 people are going to be invited.

John Hyre: No, we're keeping the room to 50 people.

David Phelps: So workshop style, solid engagement and I know the people who are going to come will be very much high caliber people that are doing this or people that want to be around people like that and you're just getting started, it's a great place to do that networking. I've already got a number of our members in the Freedom Founders community that want to be there. They won't fill all 50 seats but they'll take a chunk of them. People that would like to get more information about this John, what's the best email to email and we'll put out, put in the subject line, Freedom Founders IRA workshop and you can get some more information out to them?

John Hyre: Yeah, the easiest way is if you go to my website, iralawyer.com, there'll be a link for Freedom Founders there. If you go to that link, that's the place to register. I'll send you a few freebies. You've seen some of the articles I've written over the years and I get carried away. My articles are usually ... You laughed at me one time. I sent you and article for your newsletter and you said I can't do that. That would be the newsletter.

David Phelps: It would be.

John Hyre: I like to go into a little bit of depth. I really like to give knowledge and explore and think things through so I will send as a bonus a lot of articles that might make a good primer before coming to the event. Then the event description will be there.

David Phelps: Excellent. Excellent. Okay. So that will be May 6 and 7 in Dallas. I will be there as I said with a number of our Freedom Founders members who also are doing a lot of deals themselves. If you want to be around people that do a lot of deals, have knowledge, not just dipped their toe in the water but are actually swimming, be around someone like John Hyre who can actually lead the charge and give you the structures, you know what's legal, what you can and can't do. With his experience not only in his deal flow but also the people he sees, so many other deals. That's the additional thing that I think you bring John, is you've got that 30,000 foot elevation because you see so many other things that people do. The good things they do and the not so good things they do.

John Hyre: I get paid to see things you would pay to see.

David Phelps: There you go. There you go. Excellent. Excellent. All right. Well this has been fun. Well I look forward to it, May 6 and 7. Thank you so much for taking time today to just give some insight to what's happening in the investment world and how people can really get ahead in the game and not feel like they're behind the eight ball, trying to figure out how to get free, what kind of investing to do. There are opportunities. You've just got to step up. You've got to take some action. You've got to decide and make a commitment that you're going to make something different and not just be one of a majority that never really gets anywhere in life.

John Hyre: You asked, you mentioned who should not go to the event. I think you just hit it. If you're not willing to take action, if you're not going to do this, if you're going to be armchair general, by the book. It's a lot cheaper.

David Phelps: I got you. Got you. 100%. All right. John Hyre. Thank you so much sir. It's been a pleasure. Take care.

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