A GUIDE FOR U.S. CITIZENS AND REALTORS

KNOW THE RULES BEFORE YOU START

Investing in alternative assets has been permitted by the IRS since 1974. The IRS references the lists of investments that are prohibited in IRAs. Therefore, anything that is not prohibited is permissible if the IRS rules governing retirement plans are also respected. Assets that are not permitted in an IRA are: artwork, rugs, antiques, gems, stamps, coins, alcoholic beverages, life insurance policies, and certain precious metals. The reason that they are not permitted is that they are difficult to accurately appraise the value of these items, and their possession and ownership is difficult to ascertain. Who is the legitimate owner of an expensive, rare bottle of champagne? What is it worth? Other than these prohibited items, all other types of assets, including foreign real estate, is permitted.

Eligible self-directed account types

In addition to traditional and Roth IRAs, any self-directed account can be used to make alternative investments. However, for the reasons explained later, only a self-directed IRA LLC will enable you to acquire Mexican real estate.

Self-directed IRA Limitations

To ensure that you continue to invest your self-directed retirement account within the limitations described by the IRS, it is essential that you are aware of the following rules *before* you make your acquisition.

Arm's-length Investing

IRS rules state that you cannot directly benefit from an asset owned by your IRA. Keep in mind that the IRA was created to provide for your retirement and not intended for you to benefit and enjoy the property now. Therefore, it is strictly prohibited for you to engage in transactions that, directly or indirectly, will benefit you. Here are some examples of transactions that are strictly prohibited: using the real estate purchased through your IRA for personal use, vacation home, retirement, or as an office. You cannot occupy or rent it to yourself. It must be rented to others, and your IRA can sell it at any time. You cannot lend yourself money from your IRA nor can you pay yourself a salary or fees for managing the property.

Disqualified Individuals

The IRS code stipulates that your IRA cannot buy an investment from, sell to, or otherwise be involved with any disqualified person. A disqualified person includes the account holder, your spouse and your ascendants and descendants. This means parents, grandparents and great-grandparents, children and their spouses, grandchildren, great-grandchildren, and their spouses are also covered by the prohibition. This also includes individuals that provide services to the IRA such as your custodian, your attorney, CPA and financial advisor.

Surprisingly, the law does not specifically include brothers and sisters as disqualified individuals. Therefore, it is feasible for them to occupy the property and even manage it for you.

Penalties

The IRS takes the dealing of disqualified individuals with the IRA seriously. If you participate in a prohibited transaction as described above, your IRA will be de-registered, and it will be treated as though the property was distributed and you will have to pay the tax on that distribution. If the IRS considers this a distribution, it can also impose a tax equal to 100% of the amount involved.

Raising Capital

It may be necessary for you to raise capital to make this purchase, as your IRA account may be insufficient. Even though you are a disqualified person, you can use your finances and buy the property with your IRA as a partner, but you cannot lend to it. There are several other ways of doing this. The **first** would be to buy the property with other individuals as partners. These individuals can use their own IRA accounts, in which case they must follow the same process as described below, or invest directly by using their own, non-pension funds. Profits generated by the property will be shared according to each owner's vested interests. The **second** way would be to get friends or members of your family to invest in your Mexican LLC, as shareholders, in which case they would receive dividend payments, or as a loan with a guaranteed return in the form of interest payments. Finally, your American LLC. self-directed IRA can borrow the money required to purchase the property under specific conditions.

Borrowing Money

Property owners know that cash flow is an important consideration for property repairs and renovations. As your IRA contributions are limited to $5000 per year or $6000 if you are over the age of 50, you will need to pay for these expenses by using liquidity in your IRA. It would be prudent to set aside reserves from operating income within your IRA or obtain the required liquidity elsewhere. As mentioned earlier, you cannot lend money to your IRA personally. The same applies to other disqualified individuals as defined above. Therefore, your IRA will have to borrow the money, not you. The IRS code provides that the IRA can only borrow money from a non-disqualified individual or entity on a nonrecourse basis. This means that if the IRA is in default of the loan conditions, the lender can only have recourse against the IRA to collect. Only the property held within the IRA can serve as collateral for the loan, and you cannot provide any other property as security. Nor can you personally endorse the loan.

Five Steps To Acquire Mexican Real Estate

STEP 1- IRA LLC

Before investing in Mexican real estate or identifying your investment using your IRA, it is recommended that you prepare for the process in the U.S. first. If you haven't already done so, you should rollover or transfer any existing 401(k) or other private pension fund vehicle into a self-directed IRA LLC. For the reasons mentioned below, an American LLC will be required for this investment.

Not all private pension fund managers or custodians are familiar with investing in foreign real estate using an IRA. Before you proceed further, confirm with your custodian that they are familiar with the process and are willing to accompany you through it. If not, change custodians.

In chronological order, you should:

- Create an American LLC with the wording in its Operating Agreement required for this type of investment. You will need to consult an attorney for this as few pension fund managers and custodians will participate in the creation of your LLC;
- Appoint your pension fund manager as custodian for this investment. They will surely provide you with numerous forms to complete this process;
- Open a bank account for your LLC;
- Transfer your existing pension fund money to your new bank account.

Other than the creation of your LLC, it can take between five to seven business days to transfer your existing pension funds to your new self-directed IRA.

STEP 2 – Choose Your Property

This is the fun part, choosing your Mexican property. If you are using the services of a local **realtor**, inform them of the fact that you will be acquiring your property using your IRA and that the process will be slightly different from what they are familiar with. They should know that: (1) you will be making an offer *"on behalf of a Mexican legal entity to be formed and not personally"*; (2) the deposit will come from your IRA LLC in the U.S. The balance of the funds for the acquisition at the closing can come from the Mexican corporation or an escrow account. (3) Inform your realtor of the IRS limitations prohibiting you or members of your family from using the property. Ask them to identify opportunities that guarantee a return on your investment, or a property manager that can offer you similar assurances. This way your realtor will know what properties to focus on and will not waste your time.

STEP 3 – Mexican LLC

The Mexican Constitution prohibits foreigners from purchasing property within 50 km *(31 miles)* from the shore, or 100 km *(62 miles)* from any border. Since 1973, foreigners have been able to purchase property within this restricted zone by purchasing through a bank trust *(Fideicomiso)* or a Mexican LLC. If you are using your self-directed IRA to purchase property within this restricted zone, you cannot use a bank trust to do this as your custodian would have to be the beneficiary of the trust and not you personally. Custodians, which are usually large corporations with numerous shareholders and complex statutory compliance requirements, will not accept to act as your beneficiary of the trust as the process is complicated, prolonged and time-consuming. For the same reasons, they will also not act as the shareholder or representative of your Mexican LLC. Therefore, the only practical way to purchase Mexican real estate using a self-directed IRA is to do so through an American LLC, as a shareholder of a Mexican LLC.

The process of creating a Mexican LLC is relatively simple. However, you should verify that your Mexican lawyer has previous experience in creating one that will be used for the specific purpose of investing your IRA funds. In general, the process is:(1) the incorporation certificate of your American LLC must be notarized by a Notary Public in the U.S. and *"Apostilled"* by the U.S. Secretary of State in your area; (2) the Board of Directors must appoint you as the legal representative of the American LLC to create the Mexican LLC, and act as its director and (3) you must provide information on the head office and the names and address of the directors of your American LLC. These documents must be translated into Spanish in Mexico before your Mexican lawyer can proceed to create your Mexican LLC. Finally, remember that the operating agreement for the Mexican LLC must also provide the specific language required by the IRS specifying that disqualified individuals cannot use or occupy the property.

STEP 4 – Closing

By now, you have created and registered an American LLC as your self-directed IRA, appointed a custodian, opened a bank account for your American LLC, selected your property in Mexico with an accepted offer and created a Mexican LLC in which your American LLC is a shareholder. You are now ready for the closing or the titling of the property.

The balance of the funds can come from your Mexican LLC. A bank account should be open for your Mexican LLC, and the funds should be transferred from your American LLC bank account. To expedite the process and avoid having to open a local bank account, consideration should be given to using escrow services. The funds can come from the escrow account on the condition that the beneficiary of the account is identified as the Mexican LLC.

At the closing, you will be signing as the official representative of the Mexican LLC and take possession of the property on its behalf.

STEP 5 – Manage the Investment

Once your IRA owns your Mexican property, all expenses and profits related to the investment must come from and return to the IRA account. Your custodian and occasionally the IRS will need to see proper accounting and the traceability of transactions. At this point, you can have two bank accounts open. One in the U.S. for your American LLC and one in Mexico for your Mexican LLC. Regardless of which account you use to operate, it is advisable to keep all transactions in the same account. In other words, income and expenses should be reflected in only one of the two accounts. Occasionally, profits *(in the form of dividends)* may be directed from the Mexican account to the U.S. account.

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