

Self-Directed IRAs: Are They Right For You?

What is a Self-Directed IRA?

Many people are confused about the term “self-directed,” thinking such accounts are somehow different from traditional IRAs. “Self-directed” is simply a functional and not a legal term. “Self-directed” means that the individual owner of an IRA makes or “directs” the investment decisions, not the institution that sponsors the IRA. The SDIRA owner can also work with an adviser or broker, but in all cases, the institution offering the IRA does not participate in the client’s investment decision-making.

Even when an IRA owner is allowed to call the shots, however, the majority of financial institutions still limit the range of investment options to their own products. Institutions specializing in SDIRAs typically do not sell proprietary products and therefore provide much more investment flexibility for their customers. Unfortunately, even when an investor discovers the possibility of investing an IRA in something other than mutual funds, public stock and bonds, or bank certificates of deposit (CDs), it is common for the investor’s broker or banker to discourage this by claiming such opportunities are illegal or ill advised. While many agents are simply unaware of the full range of eligible IRA investments, the fact remains that banks, broker-dealers, insurance companies and mutual fund companies only make money when their customers buy, sell and hold the investment products they offer.

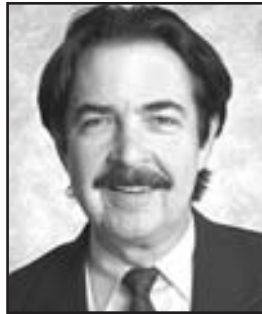
What Kind of Assets Can a SDIRA Invest In?

The range of possible investments through such self-directed IRAs far exceeds traditional choices. In fact, with the exception of S corporations, life insurance contracts and collectibles such as stamps, art, antique furniture, etc., there are virtually no restrictions on what an IRA can invest in.

Because the possibilities are vast, PENSICO Trust Company is going to great lengths to educate attorneys, financial planners and CPAs about the rules and intricacies of SDIRA investing, so that they can assist those who want to self-direct but don’t have the confidence to go it alone.

The rules for SDIRAs are really no different than for other IRAs. But again, because investment options are so

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varied and may involve multiple parties (e.g., family members), some transactions can become complicated and/or prohibited. It is therefore important to work with an experienced custodian who is familiar with the type of investing you want to undertake, as well as the rules and scenarios that may come to bear on the mechanics of the desired investment. It is frequently important for an SDIRA owner to consult with a professional adviser as well.

Real Estate: A Popular SDIRA Choice

An SDIRA can purchase any type of real estate, provided the particular SDIRA sponsor and the particular state or country permit it. For example, many custodians will allow people to buy income properties with their IRA; some don’t allow debt financing or leveraging, although in most cases it is perfectly legal to do so. Many people confuse the prohibition of borrowing from your IRA with that of debt financing a real estate transaction. Quite simply, they are two different types of investments. In the case of the financed real estate investment, the IRA (and not the IRA owner) owes the debt to a third party lender exclusively. In fact, the IRA owner would create a prohibited transaction if he or she guaranteed the loan for the IRA.

A Real Estate Investment Example:

Let’s assume an individual in Nevada wants to use her IRA to buy a single-family rental property in Las Vegas for its income and appreciation potential. First, she needs a broker to negotiate the purchase, an attorney or broker to draw up the contract in the IRA’s name, and a title company to handle the closing. Once drafted, all of the traditional elements of a real estate transaction (title report and possibly evidence of insurance, etc.) are approved by the buyer (SDIRA owner) and then sent to the SDIRA custodian for actual signing, execution and funding for the close. The SDIRA owner’s IRA now holds a single-family house, instead of, let’s say, 100 shares of IBM.

Income produced by the rental property must flow directly back to the IRA and not the IRA owner, and all expenses must be paid by the IRA as well. At the appropriate time, the owner may direct the IRA to sell the property for its appreciation, and all of the capital gain flows back to the IRA without any tax or penalty. Then the process can be repeated, or the client can choose to have the IRA invest in other types of real estate (e.g., raw land) or other traditional (e.g., mutual funds) or non-traditional investments. Most SDIRA custodians allow clients to invest in both traditional and alternative investments.

Can a SDIRA Finance a Real Estate Investment?

Whenever investors think of investing in real estate, they think of leveraging their investment through financing. Many are surprised to learn that this is permitted for IRAs under the regulations, but some potential issues must be dealt with. First, an individual cannot use an IRA as collateral for a loan or guarantee an IRA's debt (see IRS Publication 590, p. 41), so an investor won't be able to use their IRA to make a down payment and then take out a personal bank loan for the balance of the purchase price. Furthermore, there has to be enough remaining liquidity in the IRA to cover any mortgage payments or other contingencies (taxes, insurance, repair expenses, etc.). That's because when the IRA holds the property, the individual is not allowed to cover any deficit personally.

There is also a tax liability associated with any income on debt-financed investments within an IRA, which is a tax-exempt entity under the tax code, much like a non-profit. Specifically, any income or capital gains associated with a debt-financed asset in an IRA is generally subject to income tax under Code §514(a), requiring the filing of IRS form 990T and the payment of any tax due. While this tax will affect the yield on leveraged investments, the net income still flows into the IRA and grows tax deferred thereafter.

Other SDIRA Investment Examples

People are often shocked to learn, for example, that IRAs can buy foreign real estate. We have also seen people buy commercial fishing rights in Alaska, the deed to a boat slip to be rented out, a locomotive, an earth-moving machine, a condominium in the U.S. Virgin Islands or a home in New Zealand, to name just a few. In addition, there is an equally broad range of traditional real estate investments that can be made through SDIRAs. For example, under some circumstances, one can invest both personal funds and IRA funds in any type of real estate, or a group of individuals can co-invest together on larger properties.

Important Rules Affecting SDIRA Transactions

There are some fundamental transactions that cannot be performed by an IRA without subjecting the IRA and/or the individual to taxes and possible penalties. It is very important therefore that the investor, aided by a knowledgeable professional adviser, become aware of potential pitfalls before they occur.

IRC 4975 is a set of rules affecting IRAs and qualified plans such as 401(k)s. These rules state that you cannot enter into a transaction with your IRA that involves

acquiring or selling an asset to or from yourself, your spouse, your ascendants, descendants, or the spouses of your descendants. For example, your IRA cannot buy a property that you already own personally, nor can your IRA buy or sell a property or any other asset to your daughter. She and other related parties are also not able to make use of (rent, etc.) a property held by your IRA. Other prohibitions also apply, and they can be quite complicated in their application.

While SDIRAs can be a tremendous source of capital for new businesses, the correct execution of initial seed investments is critical to avoid prohibited transactions. Often, people let go from prior employment are ecstatic to learn that they can use their share of their former employer's 401(k) to fund a new venture. This allows them to "bootstrap" their new enterprise—putting in plant, equipment and personnel, so that raising additional capital becomes easier and less costly. One aspect of Code Section 4975 that frequently comes into play with these private equity investments is the prohibition of a transaction between an IRA and an entity (the startup in this case) owned 50% or more by the IRA owner(s) and certain related persons collectively. This can make the timing of the IRA's involvement a crucial element. The various prohibitions center on the issue of self-dealing. These so-called self-dealing prohibitions may only be overcome by filing for and receiving an exemption from the Department of Labor, which can be an expensive and protracted process with no guarantee of success.

There are other rules as well. For example, co-investment by an individual and his or her IRA in the same enterprise (such as an investment partnership) is permissible provided certain conditions are met. (See ERISA Opinion Letter 2000-10A.) Among the conditions is that the IRA investment is not made to "enable" or protect the individual's investment, the individual does not receive any benefit from the IRA's investment (although receipt of an "incidental" benefit is permitted), and that conflicts between the individual's IRA and non-IRA interests are avoided or resolved. Depending on the situation, additional conditions may be applicable.

Another important set of rules appears in the Department of Labor's "plan asset" regulations, which appear at DOL Regulations Section 2510.3-101. These rules govern when assets of a business or other entity in which an IRA invests are treated as assets of the IRA for purposes of the prohibited transaction provisions of Code section 4975. Because many types of prohibited transactions depend on whether IRA assets are involved, the plan

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ED SLOTT'S IRA Advisor

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asset regulations will often affect whether a transaction between the business and the individual or other "disqualified person" is prohibited.

Generally speaking, the assets of a business will not be treated as an IRA's assets if the business is primarily involved in the sale or manufacture of a product, the provision of a service, or the active management or development of real estate. There are additional circumstances under which the assets of the business or entity will not be treated as assets of an investing IRA. If the assets are not assets of the IRA, then it may be permissible for the individual or other IRA owner to receive compensation from the business, make loans to the business, or sell or lease to the individual or other "disqualified person." Because these rules can be quite complicated, a knowledgeable advisor should be consulted if any of these transactions is being considered.

PENSCO Trust Company provides a free continuing education program for professionals who want to learn more about SDIRAs in order to enhance their

practices. E-mail akliever@pensco.com for more information. If you would like to know more about real estate investing with SDIRAs, read Pat Rice's book, *IRA Wealth*, by Square One publishing, You can order it at www.iraresource.com. ■

Tom Anderson founded PENSCO Pension Services (now PENSCO, Inc. and PENSCO Trust Company) as an IRS approved "passive" non-bank custodian. Now a bank and trust company, PENSCO offers administrative and custodial services for self-directed retirement accounts, including assisting clients in all fifty states who want to invest in real estate or private placements through their IRAs. Anderson is a member of the Retirement Industry Trust Association, the National and California Mortgage Broker Associations, and the Savings Coalition of America. To learn more about self-directed IRAs, visit PENSCO's website at www.pensco.com or call (800) 969-4IRA (4472).

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