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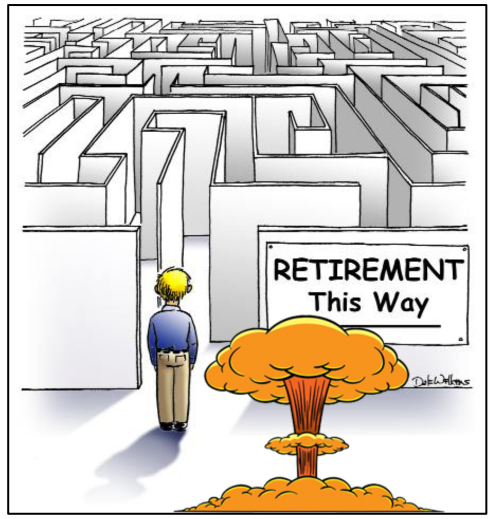
Self-directed IRAs: Caveat Investor

"Risk comes from not knowing what you're doing."
- *Warren Buffett, investor, philanthropist, sage (1930 –)*

Navigating the Retirement Maze



The past decade has been a boon for investors, as markets and asset classes have been on an upward path, save for a few small corrections along the way. In addition to the growth of traditional investments like stocks and mutual funds, other asset classes have also demonstrated significant gains, including real estate, cryptocurrencies, collectibles, and precious metals.

Cashing in these gains can result in considerable taxes, so investors seek ways to defer the taxes due for both conventional and alternative investments. With the constraints on the types of investments that brokerage firms allow to be held in their qualified retirement accounts, there has been a growing interest in the use of self-directed IRAs.

The DIY IRA

Individual Retirement Accounts, or IRAs, came into existence under ERISA – the Employee Retirement Income Security Act of 1974 – but it wasn't until 1997, when a tax court ruled in favor of an investor's choice of non-conventional investments for his IRA, that self-directed IRAs began to take off. Most IRAs are held by brokerage firms and other financial institutions acting as IRA custodians. They permit many asset classes – mutual funds, stocks, bonds, exchange traded funds, options, and the like – to be held in IRA accounts, but none outside of these.

A self-directed IRA is one that can hold alternative investments that are legally permitted to be held in IRA accounts, but which most custodians won't allow. Thus, a self-directed IRA needs to be opened with custodians that specialize in self-directed IRAs. These accounts tend to have higher administrative fees because of the additional reporting requirements. Like regular IRAs, a self-directed IRA is administered by the custodian, but the management of the assets is under the control of the account holder. This gives the account owner greater flexibility of holdings but also exposes them to a different set of risks than those of a traditional IRA.

Self-directed IRAs can work well for non-conventional investments that either generate considerable income or have high growth potential. But with greater investment latitude comes greater responsibility by the investor, and missteps with self-directed IRAs can be costly. Let's look at some of the risks.

Investment choices: Don't get too creative

The biggest danger to owning a self-directed IRA is doing something that would cause the IRS to declare it to have lost its tax-deferred status, resulting in the tax bill from Hades plus fines. Therefore, it is important to understand the "Do's and Don'ts" of self-directed IRAs.

For starters, here are some alternative investments that are permitted in a self-directed IRA: real estate, cryptocurrencies, tax liens, foreign currencies, precious metals with minimum purity standards, limited partnerships, and stock in privately-held businesses. Real estate is one of the most common holdings in these accounts, though special rules govern real estate investments in IRAs that need to be followed. Just as important are the types of assets that are prohibited from IRAs. These include life insurance, collectibles (art, stamps, coins except for those minted by the US Treasury, wine and alcoholic beverages, baseball cards, etc.), and S Corporation shares. The IRS specifies these categories in Publication 590.

Prohibited transactions: Caveat investor

Another risk with self-directed IRAs is engaging in a prohibited transaction. Do one, and your whole IRA could be subject to dissolution, resulting in taxes and penalties. Not surprisingly, the investment most likely to have prohibited transaction issues is real estate.

The IRS considers a prohibited transaction to be one involving the IRA assets and a "disqualified person." The list of disqualified persons includes the account owner (you), any IRA beneficiaries, your spouse, your lineal ascendants (parents, grandparents), your lineal descendants (kids, grandkids) and their spouses, fiduciaries and service providers to the IRA, and entities in which you hold at least 50% of the voting stock. The types of prohibited transactions between the IRA and disqualified individuals include selling or exchanging IRA property, lending or borrowing money, furnishing goods or services, and receiving benefits from plan assets. The lists aren't that extensive, but you can run afoul of the rules with seemingly innocent actions.

For example, let's say that you decide to rent the house you hold in your IRA to your child. That is a prohibited transaction. Even letting your child use the house for a night isn't allowed, as no disqualified person is permitted to benefit from the assets in the IRA. Thus, don't even think about painting or cleaning your rental house on your own to save money, as that would have your IRA receiving benefits from a disqualified individual, namely you. Instead, hire an unrelated third party to do these tasks and pay for them with IRA funds, not your own.

Similarly, putting a business that you control into a self-directed IRA can be a recipe for disaster. If that business pays you a salary, you have used IRA assets for self-enrichment. Boom! A prohibited transaction. Penalties and taxes to follow. Want to put real estate into a self-direct IRA? The purchase of the real estate and all the costs related to the investment must come only from the IRA.

Self-directed IRAs can work well to defer taxes from non-conventional assets, but not being familiar with all the constraints and prohibitions on these accounts can be quite costly to you and your heirs. The IRS rules about prohibited transactions are extensive, so it is best to work with someone experienced with them, lest you inadvertently violate them and void your IRA. To reap the rewards of using a self-directed IRA, make sure that you understand all the risks associated with them and stick to the rules. Otherwise, the beneficiaries of your IRA may be the US Treasury and lawyers.

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