

Self-Directed IRAs: Advantages, Challenges, and Options

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American taxpayers have several options for saving and investing for retirement. The recent shift from company-sponsored defined-benefit pension plans to 401(k) defined-contribution plans, along with the uncertainties associated with Social Security, has some taxpayers beginning to feel an urgent need to supplement their retirement savings. Individual retirement accounts (IRAs) can be an excellent addition to any retirement portfolio. IRAs allow individuals to save up to \$4,000 in 2007 (\$5,000 if age 50 or older) for retirement in a tax-advantaged account.¹

There are two types of IRAs available to taxpayers, traditional and Roth IRAs. Traditional IRAs, under Sec. 408, allow qualified individuals generally to deduct contributions on the current-year income tax return. In addition, traditional IRAs also allow tax deferral of capital gains on investments and retirement savings that are not taxed until age 70½. Roth IRAs, under Sec. 408A, allow qualified individuals to contribute \$4,000 a year into a tax-free account. Taxpayers contributing to a Roth IRA do not receive a tax deduction for the annual contribution; the contribution to the account is made with after-tax dollars. However, assuming that retirement savings will grow, the Roth IRA generally allows taxpayers to receive all of the growth tax free. In other words, the Roth IRA requires individuals to pay taxes on the seed, instead of the harvest. On the other hand, the traditional IRA requires individuals to pay taxes on the harvest and defers the tax liability until withdrawal. Other types of IRAs include the simplified employee pension (SEP), the savings incentive match plan for employees (SIMPLE), and self-directed IRAs.

Background

Since 1974, IRAs have given individuals the flexibility to place funds into a trust or retirement account for the exclusive benefit of their beneficiaries or themselves. Sec. 408, which governs IRAs, specifically identifies who can serve as custodian of an IRA. It also establishes strict guidelines for operation. Under Sec. 408(a)(2), a trustee can be a bank or other person granted permission by the Secretary to serve as custodian to the account.

A self-directed IRA is simply an account in which the custodian agrees to allow the taxpayer to exercise greater control over investment decisions. (The term “self-directed” does not actually appear in the Code.) Self-directed IRAs are often called “real estate IRAs” but can contain any investment allowed under Sec. 408. Thus, self-directed IRAs can be invested in real estate, notes, options on real estate, private placements, investment partnerships, and operating businesses. However, the Code specifically disallows certain investments, such as collectibles (Sec. 408(m)) and insurance contracts (Sec. 408(a)(3)). Currently, the number of self-directed IRAs is relatively small in comparison with the total IRA world.

Traditional and Roth IRAs are typically invested in stocks, bonds, and mutual funds. The self-directed IRA is ideal for individuals who are not comfortable with the ups and downs of the stock market and want more control in directing their IRA dollars. A self-directed IRA can be held as a traditional IRA or a Roth IRA. Essentially, this means that the laws related to these retirement savings options apply to self-directed IRAs. Custodians should be careful not to violate qualification rules or trigger unrelated business income tax (UBIT).

In order for a self-directed account to qualify for IRA treatment, Sec. 4975 requires that the assets be purchased by the custodian (as directed by the individual) in an arm’s-length transaction.² Under Sec. 4975(c)(1), the asset is not permitted to be titled in the individual’s name. The individual cannot have owned the property, live in the property, or be involved in the investment of the asset. This stipulation also applies to the individual’s spouse, parents, children, fiduciaries, and various business associates and to persons providing services to the plan (Sec. 4975(e)(2)). Thus, any transactions made with these individuals are prohibited. There are significant taxes and penalties for prohibited transactions in self-directed IRAs, including disqualification of the IRA (Sec. 408(e)(2)).

Under Sec. 408(e)(1), the UBIT is triggered when a self-directed IRA, which is a tax-exempt entity, generates income from a business unrelated to its exempt purpose or function. Therefore, if a self-directed IRA holds a

business, the income generated from that business will be taxable. However, the capital gains appreciation of the business held by the IRA would receive the tax advantages of an IRA.³

The UBIT also applies when financing is used to purchase the asset in a self-directed IRA. The rationale is that the income generated from the financed portion of the asset does not receive the tax advantage because its base is not IRA funds. On the other hand, the income received based on the IRA funds invested would receive the tax advantage. This scenario would result in an allocation based on the source of the asset's original basis. This would also apply to the gains on the sale of the asset attributable to the financed portion of the cost. Financing has to represent non-recourse lending to the IRA plan. The individual is not permitted to guarantee the loan to a self-directed IRA.⁴

Advantages

There are several advantages to a self-directed IRA. The owner has the flexibility to choose from a wide variety of investment options that will increase the diversification of the IRA. Self-directed IRAs can be held in conjunction with other employer-sponsored retirement savings, such as a pension plan, a 401(k) plan, or a 403(b) plan. The flexibility to set up the self-directed IRA as a Roth IRA allows for tax-free growth of the investment asset. This greater flexibility allows for potentially larger returns than are traditionally available for retirement assets.

The flexibility of self-directed IRAs allowed individuals to take advantage of the real estate boom. Self-directed IRAs can be used to purchase single-family homes, urban loft development, farms, liens, and mortgage notes. Investments can include anything except life insurance or collectibles.⁵

Challenges

There are several risks and challenges to consider when setting up a self-directed IRA. First, the potential for prohibited transactions has to be considered, along with the investment growth opportunity for each and every asset placed inside a self-directed IRA. All transactions must be considered arm's-length transactions. In order for the plan to be truly self-directed, the custodian cannot give the owner advice about investments. Like all IRAs, the funds are not FDIC insured. The plan asset needs to generate enough income to pay the expenses of that asset. However, the individual can make annual contributions to the IRA based on current limits (up to \$5,000 in 2007).

In most cases, owners must go outside of the trusted relationships they have with their bankers, brokers, and financial planners to set up a self-directed IRA. The custodian selected will hold title to the plan assets; the owner therefore needs to be comfortable with this person. The setup and management of this IRA is complicated and will take more energy than other types of retirement accounts.⁶

Options

There are options available to overcome the risks and challenges of the self-directed IRA. One option is to transfer only a portion of original IRA funds into the self-directed IRA. This way the risk exposure can be limited to those funds. The profit potential of setting up this type of account must be carefully considered and analyzed. If a small business is the investment, someone other than the IRA owner needs to run the business or the IRA must represent a minority interest, having independent investors with a large vested interest to make apparent that this is an arm's-length transaction. Private letter rulings can be obtained from the IRS before transactions occur that could result in penalties and taxes. The Labor Department can also provide guidance on prohibited transactions.

The taxpayer can truly direct the activities of the plan without tax consequences as long as transactions are structured appropriately (see *Ancira*, 119 TC 135 (2002)). And although the trusted adviser that the individual is accustomed to may not be able to assist directly in the transactions related to the self-directed IRA, the individual should seek advice from a trusted financial planner or banker related to this option.

Setting Up a Self-Directed IRA

Individuals looking to set up a self-directed IRA need to locate a plan sponsor or custodian with flexible investment options. Under Regs. Sec. 1.408-2(e), this plan sponsor/custodian must be approved by the Service.

Then the individual should adopt the plan document. At this time, funds from existing IRA or other qualified plans should be rolled over into the new self-directed plan. Next, a determination needs to be made as to the appropriate diversification level, and the trustee or custodian should be directed to make the asset purchases on behalf of the plan or IRA. Income and expenses should be allocated in proportion to ownership of the assets and recorded. Finally, distributions are not required to be made until April 1 of the year following the year the individual reaches age 70½ (Sec. 408(a)(6)).

There are different types of advisers and custodians that provide different levels of service for the setup of a self-directed IRA. IRA advisers are appropriate for individuals who need handholding through the process. They find investments and handle all aspects of the IRA while working with independent IRA custodians. Independent IRA administrators provide some assistance by handling transactions and working with their own custodians. However, the investor is responsible for finding the properties and making the deals. The probable option for experienced investors is the independent IRA custodian. This custodian acts as a trustee for the IRA account by handling the money as it comes in and goes out. In this situation, the taxpayer is on his or her own in choosing and managing the investment asset and doing the paperwork.

Recent Legislation

The Pension Protection Act of 2006, P.L. 109-280 (PPA '06), enacted on August 17, 2006, addressed numerous funding issues surrounding pension plans that have arisen in the past several years. PPA '06 created a statutory exemption for the provision of investment advice to IRAs and allows fiduciaries to charge a fee for investment advice (Sec. 4975(d)(17)). It also amends ERISA Section 105(a) to require administrators of individual retirement accounts to provide participants with a quarterly statement of plan benefits. These changes must be incorporated into current self-directed IRA plans.

The following comments were not a part of the original article. They were added by Creative Asset Protection Strategies, Inc. staff and Creative Asset Protection Strategies, Inc. is solely responsible for the correctness of the comments.

¹ Solo 401K contributions can total \$45,000 or \$50,000 depending upon age and income. Click Retirement Plans to download a spreadsheet which gives the details of each type plan.

² When a True Self-Directed account is established, a single-member LLC is formed and the custodian is the original owner of the single-membership certificate; it is held by _____ Custodian for the benefit of "Account Owner". The membership certificate in the single-member LLC is held by the Custodian as an investment. The account owner instructs the custodian as to the price that should be paid for the membership certificate.

³ There are few instances when a self-directed IRA or other retirement account should hold ownership to an operating business. Those instances will generally be limited to owning the stock of an entity taxed as a "C Corp" and which does not employ or pay benefits to either the account holder or to any disqualified party. The IRA owned entity might do business with an entity owned by the account holder, but great care must be taken to not utilize the assets of the IRA in doing so and great care must be taken to assure that all transactions are "arms-length." Ultimately, the IRA owned stock in the entity would be sold and the capital gains retained in the IRA (or other retirement account).

⁴ Avoiding UBIT in real estate transaction accomplished through self-directed retirement accounts may be accomplished through the use of Land Trusts. The retirement account becomes a beneficiary of the Land Trust and thus is the owner of personal property and is neither named on either the mortgage or the deed. (If this is a new concept for you, please see Land Trusts for Flips & Rentals & Partial Interest Deals.) There are other creative means of avoiding UBIT, contact us – we can help.

⁵ With a True self-directed retirement account, you are allowed to become the Manager of the single-member LLC which holds your assets. This means that you have the check-book on your retirement accounts and may act within the rules to manage your accounts to your best advantage.

⁶ Our work is to guide you through the process and to connect you with reputable custodians that are familiar with the strategy of true self-directed retirement accounts.