What is a Self-Directed IRA?

Many people are confused about the term "selfdirected," 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 institu-Guest IRA Experttion 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, our advisors 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 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.

acquiring or selling an asset to or from yourself, your

Can a SDIRA Finance a Real Estate Investment?
spouse, your ascendants, descendants, or the spouses of Whenever investors think of investing in real estate,
your descendants. For example, your IRA cannot buy a they think of leveraging their investment through financing.
property that you already own personally, nor can your Many are surprised to learn that this is permitted for IRAs
IRA buy or sell a property or any other asset to your under the regulations, but some potential issues must be
daughter. She and other related parties are also not able to dealt with. First, an individual cannot use an IRA as collat
make use of (rent, etc.) a property held by your IRA. eral for a loan or guarantee an IRA's debt (see IRS
Other prohibitions also apply, and they can be quite com-Publication 590, p. 41), so an investor won't be able to use
plicated in their application. their IRA to make a down payment and then take out a personal bank loan for the balance of the purchase price.
While SDIRAs can be a tremendous source of capital Furthermore, there has to be enough remaining liquidity in
for new businesses, the correct execution of initial seed the IRA to cover any mortgage payments or other contin
investments is critical to avoid prohibited transactions. gencies (taxes, insurance, repair expenses, etc.). That's
Often, people let go from prior employment are ecstatic to because when the IRA holds the property, the individual is
learn that they can use their share of their former employ-not allowed to cover any deficit personally.
er's 401(k) to fund a new venture. This allows them to "bootstrap" their new enterprise—putting in plant, equip-There is also a tax liability associated with any ment and personnel, so that raising additional capital income on debt-financed investments within

becomes easier and less costly. One aspect of an IRA, which is a tax-exempt entity under
Code Section 4975 that frequently comes into the tax code, much like a non-profit.
play with these private equity investments is Specifically, any income or capital gains

the prohibition of a transaction between an associated with a debt-financed asset in an IRA and an entity (the startup in this case) IRA is generally subject to income tax under owned 50% or more by the IRA owner(s) and Code §514(a), requiring the filing of IRS certain related persons collectively. This can form 990T and the payment of any tax due.
make the timing of the IRA's involvement a While this tax will affect the yield on lever- crucial element. The various prohibitions aged investments, the net income still flows center on the issue of self-dealing. These so-into the IRA and grows tax deferred thereafter.
called self-dealing prohibitions may only be overcome by filing for and receiving an exemption from the Department

Other SDIRA Investment Examples

of Labor, which can be an expensive and protracted People are often shocked to learn, for example, that
process with no guarantee of success. IRAs can buy foreign real estate. We have also seen people buy commercial fishing rights in Alaska, the deed to a boat
There are other rules as well. For example, co-investslip to be rented out, a locomotive, an earth-moving
ment by an individual and his or her IRA in the same machine, a condominium in the U.S. Virgin Islands or a
enterprise (such as an investment partnership) is permishome in New Zealand, to name just a few. In addition, there
sible provided certain conditions are met. (See ERISA is an equally broad range of traditional real estate invest-
Opinion Letter 2000-10A.) Among the conditions is that ments that can be made through SDIRAs. For example,
the IRA investment is not made to "enable" or protect the under some circumstances, one can invest both personal
individual's investment, the individual does not receive funds and IRA funds in any type of real estate, or a group
any benefit from the IRA's investment (although receipt of individuals can co-invest together on larger properties.
of an "incidental" benefit is permitted), and that conflicts between the individual's IRA and non-IRA interests are

Important Rules Affecting SDIRA Transactions

avoided or resolved. Depending on the situation, addi-There are some fundamental transactions that cannot be
tional conditions may be applicable. performed by an IRA without subjecting the IRA and/or the individual to taxes and possible penalties. It is very impor-
Another important set of rules appears in the tant therefore that the investor, aided by a knowledgeable
Department of Labor's "plan asset" regulations, which professional adviser, become aware of potential pitfalls
appear at DOL Regulations Section 2510.3-101. These before they occur.
rules govern when assets of a business or other entity in which an IRA invests are treated as assets of the IRA for IRC 4975 is a set of rules affecting IRAs and quali purposes of the prohibited transaction provisions of Code fied plans such as 401(k)s. These rules state that you can-
section 4975. Because many types of prohibited transacnot enter into a transaction with your IRA that involves

tions depend on whether IRA assets are involved, the plan 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.