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Self-Directed IRAs

Just because a self-directed IRA allows you to choose certain investments, it doesn't mean that you should. Some investment choices aren't suitable for all investors.

Certain risks are involved in investing in real estate. Changes in real estate values and economic downturns can have a significant negative effect on real estate investments, including REITs, mutual funds, and ETFs. Rising interest rates (which can impact the cost of borrowing), declines in real estate values in general, and other factors including property taxes, zoning laws, demographic changes, and natural disasters can all negatively impact the value of your investment property.

A self-directed IRA isn't a different type of IRA. Rather, the term refers to any individual retirement account (traditional or Roth) that allows you to direct the investment of your IRA assets into nontraditional investments. For example, in addition to the usual IRA mainstays (stocks, bonds, mutual funds, and CDs), a self-directed IRA might invest in real estate, limited partnership interests, or anything else the law (and your IRA trustee/custodian) allows. In fact, the only investment you can't have in an IRA is life insurance. Collectibles (e.g., artwork, stamps, wine, and antiques) aren't prohibited, but if your IRA purchases these items, you could suffer adverse tax consequences.

Getting started

First, you'll need to find a trustee or custodian that specializes in self-directed IRAs. Make sure you understand the expenses involved — some trustees charge transaction fees and/or asset-based fees, depending on the particular investment. You also need to be aware of the prohibited transaction rules. These rules are designed to make sure that only your IRA, and not you (or your immediate family), benefits from your IRA transactions. For example, you are prohibited from buying investments from, or selling investments to, your IRA. If you violate these rules, your account will cease to be treated as an IRA, with potentially devastating tax consequences.

Finally, you need to understand the UBIT (unrelated business income tax) rules. Even though IRA investments usually grow tax deferred (or even potentially tax free in the case of a Roth IRA), if your IRA conducts certain business activities or has debt-financed income, then your IRA could be taxed currently on all or part of the income generated.

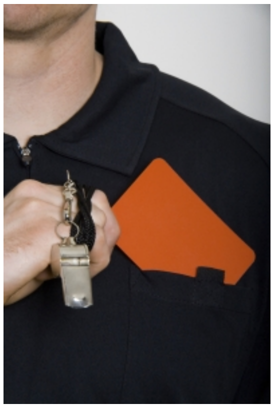
Investing in real estate

Your self-directed IRA can invest in virtually any form of real estate. That includes direct ownership in property as well as indirect ownership through limited partnership interests, REITs, and mortgage obligations. Your IRA can buy a beach house, a multifamily home, commercial property, raw land, time shares, condos, an island — almost anything. Your IRA can be the sole owner of the real estate, or a partial owner with others.

Your IRA can even borrow money to purchase real estate. However, it may be difficult to find a bank that will lend money to your IRA (since you can't personally guarantee the note). Borrowing may also cause some of the income (or sales proceeds) from the property to be taxed currently to your IRA under the UBIT rules. When you invest in real estate, you'll also need to pay particular attention to the prohibited transaction rules. You can't, for example, sell property you already own to your IRA. And neither you nor certain family members can use real estate while it's owned by your IRA. As discussed below, that sort of self-dealing can result in your entire IRA becoming taxable to you.

Keep in mind that when you hold real estate in a traditional IRA, you'll have to pay tax at ordinary income rates when your account is ultimately paid out to you — whether you receive cash or the property itself. Qualified distributions from a self-directed Roth IRA, on the other hand, are free from federal income tax, which makes the Roth IRA an attractive vehicle for real estate ownership. Say you've found your dream retirement home. It may be possible to have your Roth IRA purchase the property, rent it out to an unrelated party to generate income, and then, when you're ready to retire, have the IRA distribute the property (and any income) to you tax free. (A distribution is qualified if you satisfy a five-year holding period and you're either age 59½ or disabled when you receive the distribution.)

Finally, note that you'll need to pay any expenses related to your real estate investment out of your IRA, so make sure it will have enough cash each year to cover any real estate taxes, legal fees, repairs, insurance, and other costs.



What are prohibited transactions?

Generally, a prohibited transaction is any improper use of an IRA account or annuity by you, your beneficiary, or any disqualified person. Disqualified persons include IRA fiduciaries (see below) and members of your family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant). The following are examples of prohibited transactions with an IRA:

- Borrowing money from it
- Selling property to it
- Receiving unreasonable compensation for managing it
- Using it as security for a loan
- Buying property for personal use (present or future) with IRA funds

For this purpose, a fiduciary includes anyone who does any of the following:

- Exercises any discretionary authority or discretionary control in managing your IRA or exercises any authority or control in managing or disposing of its assets
- Provides investment advice to your IRA for a fee, or has any authority or responsibility to do so
- Has any discretionary authority or discretionary responsibility in administering your IRA

Consequences of engaging in a prohibited transaction

Generally, if you (or your beneficiary after your death) engage in a prohibited transaction at any time during the year, the account stops being an IRA as of the first day of that year. The account is also treated as distributing all its assets to you at their fair market values on the first day of the year. For a traditional IRA, if the total of those values exceeds your basis in the IRA, you'll have a taxable gain that's includible in your income. If you're not yet age 59½, the 10% premature distribution penalty tax may also apply. The IRS hasn't yet provided specific guidance describing how these rules apply to Roth IRAs. However, it's probable that if you've satisfied the requirements for a qualified distribution, the distribution will still be tax free. A nonqualified distribution from a Roth IRA will result in a taxable gain to the extent the distribution exceeds your Roth IRA contributions (and again, the premature distribution penalty tax may apply if you haven't yet reached age 59½).

What is UBIT?

UBIT stands for "unrelated business income tax." While not common, it can apply to your traditional (and Roth) IRA. (The UBIT rules also apply to most employer retirement plans and tax-exempt organizations.) In simple terms, if your IRA regularly conducts a trade or business (for example, you buy and operate a bakery using IRA funds), then the income from that trade or business (less any expenses directly connected with carrying on the trade or business) is subject to UBIT. The IRA is taxed on the income (unrelated business taxable income, or UBTI) at trust tax rates.

The term "trade or business" is defined as any activity carried on for the production of income from selling goods or performing services. This has been broadly interpreted to apply even if an IRA doesn't directly conduct a business, but instead invests in a pass-through entity, like a partnership, that conducts a trade or business. If an IRA invests in a partnership that conducts a trade or business, then the IRA must calculate its UBTI based on its share of the partnership's gross income and deductions. This information is provided by the partnership to the IRA on Schedule K-1.

There are numerous exclusions from the definition of UBTI, including dividends, interest, annuities, royalties, and rents from real property. However, even otherwise exempt income can become subject to UBIT if the property is acquired with borrowed funds. For example, if your IRA purchases real property and finances the purchase with a mortgage, any rental income attributable to the financed portion of the property will be UBTI, even though that rental income would otherwise be exempt. An IRA needs at least $1,000 of gross income from unrelated businesses for the UBIT to apply. The IRA itself is responsible for paying the tax. This may result in double taxation as the income will be subject to tax again, under the regular IRA distribution rules, when ultimately distributed from the IRA (although qualified distributions from Roth IRAs will be tax free).

As you can see, a self-directed IRA can provide you with almost unlimited investment flexibility, but also presents some traps for the unwary. Your financial professional can help you weigh the benefits and risks of a self-directed IRA, and help you determine if it's the right choice for you.