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You Did *What* With an IRA?

People Start Investing in Condos, Timberland, Even Businesses; Avoiding Trouble With the IRS

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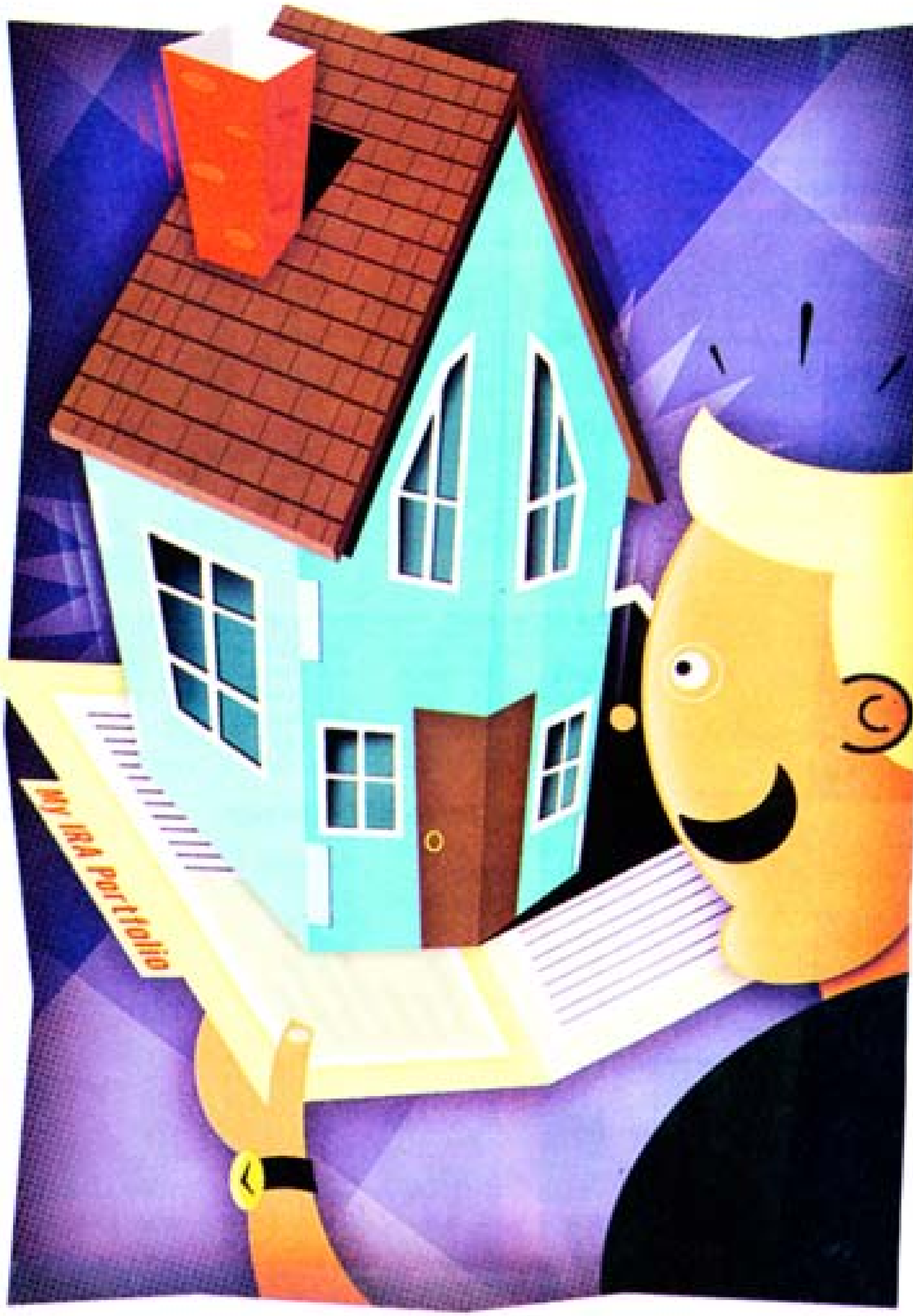

SO YOU'RE LOOKING for a new way to invest your individual retirement account. How about putting some of it into a fixer-upper, or timberland—or your son's start-up business?

Increasingly, people are pulling some of their IRA money out of their traditional IRA investments—stocks, bonds or mutual funds—in the hopes of cashing in on higher returns elsewhere. This past summer, Doug Cady, a 51-year-old real-estate agent near Orlando, Fla., plunked down $35,000 from his IRA as a down payment for a $206,000, three-bedroom home. His plan: Fix it up and sell it for a profit of $50,000 or so. Any money he makes will go into his IRA, which he plans to draw on to buy more fixer-uppers.

Mr. Cady used what is called a "self-directed IRA," and he isn't alone. **Entrust Group** Inc. in Oakland, Calif., one of the largest firms handling such accounts, says that assets in the self-directed IRAs it administers have quadrupled in the past five years to $2 billion. Assets at **Pensco Trust** Co., a major San Francisco-based custodian, have doubled in the past 15 months to nearly $1.5 billion.

Unlike traditional IRAs, self-directed IRAs enable their owners to pursue a wide variety of investments well outside the scope of the usual holdings. Some account owners are taking advantage of the real-estate boom, putting IRA dollars into single-family homes, urban loft developments, farms, liens and mortgage notes. Others go so far as to start small businesses. Essentially, you are allowed to invest IRA assets in anything except life insurance or collectibles.

The trouble is, accountants and tax-law experts say, many self-directed accounts are accidents waiting to happen. Perhaps the biggest risk is "self dealing." According to the federal government, an IRA is supposed to provide for your future retirement—not your current needs or wishes. Therefore, you aren't supposed to benefit from the investment before you start making with-

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drawals in retirement. So, if a person uses IRA money to buy an asset that he currently uses (say, a vacation home, or an apartment for a child in college), it could be in violation of tax law.

In those cases, the Internal Revenue Service could step in and simply disqualify the IRA, resulting in huge tax bills along with additional penalties for account holders who are younger than age 59½. "A lot of people are going to get themselves in trouble and wind up losing their IRAs over this," says Ed Slott, an IRA consultant in Rockville Centre, N.Y.

An IRS spokesman says the agency is aware that some investment advisers are using self-directed IRAs to promote investments that, in some cases, "amount to outright fraud." Last year, for instance, the agency issued a warning that it plans to challenge taxpayers who set up Roth IRA corporations (a type of self-directed IRA) to acquire property below market value. It is seen as a move that can skirt the $4,000 annual IRA contribution limit, if the investor undervalues a piece of property before stashing it in the fund.

The popularity of self-directed IRAs is part of a larger trend to include alternative investments in 401(k)s and other types of retirement-savings accounts, such as real-estate investment trusts, Treasury Inflation Protected Securities, and hedge-like mutual funds that short stocks. At the same time, investors turning to self-directed IRAs say they often take comfort from the higher degree of control the accounts provide.

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"The market crashed—it's a gamble. To me, land is something that's there," says Jeanine King. She and her brother set up IRAs to start a limited liability corporation this year, then used it to buy 246 acres of timberland near their Bardwell, Ky., insurance agency and a 160-acre farm in South Dakota.

There are some steps you can take to make sure a self-directed IRA passes muster with the IRS. For any transaction that might be considered self-dealing, Mr. Slott, the IRA adviser, recommends getting advance approval from the Labor Department, which has a role in this due to the agency's oversight of pension plans. (It is called a "prohibited transaction" ruling.) Second, he suggests separating your self-directed IRA from the rest of your individual retirement account. That way, if you run into regulatory problems, or the investments simply fail, you haven't put your entire nest egg at risk.

If you use a self-directed IRA to start and operate a small business, bringing in independent investors with a significant stake might cut down on potential self-dealing problems.

A self-directed IRA may make sense for people who want to invest in land that they don't plan to use in any personal way, or for an investor who wants to buy stock in a community bank, or some other conservative investment that isn't available through a traditional IRA.

If you do buy a nontraditional asset in your self-directed IRA, such as real estate, a business, or even a thinly traded stock, it is important to establish your strategy for selling it off before you have to start taking required minimum distributions from your IRA at age 70½. For example, if you own real estate, you would probably have to get a formal appraisal every year, which could get costly. The reason for getting a property appraisal: You would have to know the value of your IRA at the end of the previous calendar year to calculate the amount you are required to withdraw. Then, if you didn't have any other assets with which to make withdrawals, you would have to sell off all or part of the property to be able to make the withdrawal—or attempt to re-title part of it outside the IRA.

The mechanics in setting up a self-directed IRA are relatively simple. The holder of a traditional IRA opens an account with a custodian or administrator who specializes in self-directed IRAs and transfers the holdings from the original IRA to the new self-directed account. The IRA holder then seeks out investments himself and directs the custodian to cut a check to buy them.

A handful of custodial and administration firms specialize in handling self-directed IRAs. Most large investment companies don't handle the accounts, but some banks will set them up for longtime customers.

Costs typically include an annual custodial fee and transaction fees. Entrust and Pensco, for example, charge $50 to open accounts, plus fees for other services. Entrust charges an annual record-keeping fee based on asset size ranging from $125 to $1,750; Pensco's annual maintenance fee costs $150 to $1,000.

The use of IRA money to start new businesses was legitimized by a 1996 U.S. Tax Court ruling, Swanson v. Commissioner of Internal Revenue, which said that an IRA could form a new business with IRA assets and have the IRA's owner run it, according to William Leighton, an Austin attorney who advises Asset Exchange Strategies LLC, a Leander, Texas, firm that helps set up such businesses.

But some other attorneys who deal regularly with retirement planning worry that the law isn't clear cut, and that investors unwittingly could break the rules involving self-dealing. "The IRS has found abusive transactions in an IRA-owned company doing business with the owner's business," says Natalie Choate, a Boston tax attorney. Entrust, in California, says that once every two weeks or so the firm advises a client to undo a faulty transaction, mainly because of self-dealing problems.

One of Entrust's customers, for example, bought a condo through her IRA, then rented it to her daughter and roommates, which meant her family was contributing to her IRA.

Hugh Bromma, Entrust's chief executive, says he noticed the problem and asked the client to fix it by renting the condo to someone else, and even drove to her Napa Valley vineyard to ask her face-to-face. She refused, so he shut down her IRA, retitling the condo from her IRA to her name.

The client then moved the assets, including the condo, into an IRA managed by a different custodian, Mr. Bromma says. Two years later, the IRS disqualified the IRA, and the former customer had to sell her vineyard to pay the penalties and taxes, Mr. Bromma says.

Avoiding the Pitfalls

Ways to reduce the risk of an IRS challenge to a self-directed retirement account:

Split your IRA

When opening a self-directed IRA, transfer only part of your existing retirement account into the new self-directed account. That way, if the investments in the self-directed IRA fail, or if you run into regulatory problems, you haven't put your entire nest egg at risk.

Get advance approval

For any transaction in your self-directed IRA that might be considered self-dealing, you can get a "prohibited transaction ruling" from the U.S. Labor Department.

Bring in outside investors

If you use a self-directed IRA to start and operate a small business, bringing in independent investors with a big stake might make it possible for you to draw a salary—or at least cut down on possible self-dealing problems.

Source: WSJ research