



## Self-Directed IRAs

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*Nontraditional investments provide big opportunities.*

Balances in individual retirement accounts (IRAs) and the number and types of people who own significant IRA account balances are increasing rapidly. Retiring employees and job movers rolled over close to \$200 billion to their IRAs last year, and more than \$387 billion is expected to roll over into IRAs by 2010 as the baby-boomers retire.

Though total assets in IRAs have surpassed assets in both defined-contribution and defined-benefit plans, most IRA money is parked in traditional investments like stocks, bonds, and mutual funds. Savvy investors, however, increasingly want to invest their IRA funds in nontraditional and sometimes unusual assets that allow them to diversify their assets and that have a greater potential to yield a higher return on their investment. Some retirees would like to invest in products or businesses that they know well rather than in the stock market. Others, feeling a sense of social responsibility, would like to invest part of their funds in nonprofit or charitable organizations. These IRA owners use self-directed IRAs to achieve their goals.

A self-directed IRA is held by a custodian (typically a bank or a trust company) that allows the IRA holder greater control over his or her investment decisions. This article explores the potential benefits of self-directed IRAs as well as some representative examples of investors who are reaping these benefits.

### **ASSET DIVERSIFICATION**

For years, conventional wisdom has suggested investing retirement money conservatively in FDIC-insured certificates of deposit, Treasury bills, and other secure investments. But with life expectancy for future retirees increasing, more and more investors are looking for real asset diversification so that if part of their retirement portfolio does poorly, it can be buffered by other investments that do relatively better. Self-directed IRAs provide opportunities for true diversification that traditional retirement accounts do not allow.

For example, as the stock market fluctuates, many investors want to invest part of their IRAs in private notes secured by deeds of trust, mortgages, and mortgage pools. Often, the owner of a self-directed IRA sets the interest rate and dictates the terms of the loan, secured by property. If the loan goes into default, ownership of the property can be taken on by the IRA through foreclosure, at which point the IRA has the option to sell the property.

Of course, a self-directed IRA can be invested in stocks and bonds. But it can also invest in nontraditional assets such as private notes, shares in limited liability companies (LLCs), private placement stock, start-up businesses, limited liability partnerships, commercial real estate, or

vacation rentals, which can help the IRA holder weather market fluctuation.

### **INCREASED POTENTIAL FOR RETURNS**

Many self-directed IRAs have been used to invest in high-risk (and thus potentially high-return) investments. Sophisticated investors are not interested in mutual funds. These investors are buying interests in LLCs or limited partnerships that are invested in commercial buildings, hotels, apartment buildings, and shopping centers.

The process is easier than it might seem. The IRA owner simply directs the account custodian to purchase the interest in the LLC. The funds are transferred to the LLC, the property is purchased by the LLC, and the property is titled in the name of the IRA LLC. It is not uncommon for these IRA investors to see double-digit returns on their investments in the current market climate. An IRA holder in Placer County, CA, is invested in cellular tower leases. A doctor in Marin County is investing his retirement dollars in boat slips. And a retiree in Palo Alto invested in a start-up bank and earned over 40% on his original investment.

### **AN INVESTMENT IN WHAT YOU KNOW**

Many retirees are not well versed in the stock market. Further, corporate scandals, market fluctuations, and a weakening economy make them nervous about placing their hard-earned retirement savings in stocks and mutual funds.

However, many retirees have been investing in real estate for 30 or 40 years — and they want to invest in what they know. Self-directed IRAs allow investors to purchase rental property, mortgages, raw land, or LLCs holding real property.

For example, a mortgage broker invested his IRA in notes available through his own mortgage company. He invested \$50,000 of his IRA money in an undivided 50% interest in a \$100,000 multibeneficiary note paying 12% per annum. His IRA receives monthly principal and interest payments.

As another example, one IRA holder who has experience in the life insurance business has purchased life settlements, also known as *viaticals*, in his self-directed IRA. A life settlement is the sale of an existing life insurance policy from an individual looking for immediate cash. The IRA purchases the life insurance policy at a discounted price and receives the full face value of the policy when the insured dies. The amount of life settlement transactions is expected to grow into the billions with the backing of major financial investors, and returns are often 20–40%.

### **SOCIAL RESPONSIBILITY**

IRA holders who are concerned about social responsibility can achieve those goals through a self-directed IRA.

Many IRA holders have named charity groups or nonprofit organizations as the beneficiary of their IRAs. This can be done in a traditional IRA or a self-directed IRA. The self-directed IRA holders can also invest in nonprofit organizations by purchasing unsecured notes, or an equity interest in a charitable organization. This way, the money is invested in a socially responsible cause during the lifetime of the IRA owner. In some instances, the loan is paid back and the charity eventually receives the money in the form of a death benefit.

### **SETTING UP A SELF-DIRECTED IRA**

Since most IRA providers don't allow their clients to diversify their investments, it can be difficult to find a custodian who will hold nontraditional IRA investments. Some broker-dealers offer a self-directed IRA that allows the IRA holders to direct their investments to a degree, but still limits



them to a range of publicly traded investment options.

When you are searching for an IRA custodian and administrator, look at the way the fees are charged. Some custodians charge asset-based fees, while others charge transaction and quarterly or annual administration fees. Asset-based fees are determined by multiplying a percentage by the value of the assets. A small asset-based fee can amount to thousands of dollars annually on an IRA holding significant assets. Most transactions should be processed within two to four days after receipt of all necessary paperwork. Look for a company where you can build a relationship with your administrator and receive consistent technical expertise, not a company where you are routed to a call-center representative.

A good company invests in continuing education and has credentialed staff who can give reliable answers to technical questions and creative solutions to complex issues. In addition, a custodian or trustee should process all IRA transactions. When the administrative company has the ability to write checks and move money from the IRA account without the oversight of a custodian or trustee, there is a greater chance for mistakes and fraudulent activities.

### **SOME LIMITATIONS**

It is important to note that the law governing the type of investments permitted within IRAs is exclusive rather than inclusive. That means that there is a list of investments that are prohibited, but there is no similar list of acceptable investments. An IRA cannot hold collectibles, life insurance on the IRA holder, or coins (other than US gold coins). In addition, the prohibited transaction rules of the Internal Revenue Code apply to IRAs so the IRA holder cannot buy, sell, or lend money to his or her IRA and cannot self-deal or directly benefit from the IRA. For example, an IRA holder cannot use a beach condominium or mountain vacation home that is owned by the IRA, nor could the IRA purchase a piece of property adjacent to the land owned by the IRA owner in order to drive up the value of the IRA owner's land.

In spite of these limitations, more and more investors are using self-directed IRAs to invest their retirement portfolios. Self-directed IRAs offer a sophisticated investor a myriad of opportunities that are capable of outperforming traditional investment vehicles.

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