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Take charge of your IRA

More and more entrepreneurs are using their IRA funds to invest in real estate, private equity and even their own businesses.

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(FSB Magazine) -- Last November, Dave Hanrahan, 37, of Vineland, N.J., decided to try something different to improve the returns in his retirement account. Rather than putting his money into the latest hot stock or biotech fund, Hanrahan used $60,000 in his self-directed IRA to purchase a small residential building lot. Thirty days later he flipped it for a tidy profit.

Ordinarily such a move would result in a capital gains tax. But because the property was held by his IRA, Hanrahan will owe no tax on the gain until decades from now when he starts taking distributions on the account. "Otherwise I would have paid about 30 percent tax on the sale," he says.

Surprised that the IRS allows this type of transaction? You're not alone. You probably already know that you can buy stock through a self-directed IRA at a brokerage firm. But many don't realize that it's perfectly within IRS rules - and actually has been since the code for IRAs was first written in 1974 - to buy real estate and private equities with IRA money.

In fact, as long as you watch out for what the IRS calls "prohibited transactions" (more on that later), almost any type of investment is permitted, from a house to a Hollywood film to stock in a startup company - with the exception of collectibles (such as artwork and jewelry), life insurance and the stock of S-corporations.

The good news is that these less-common IRA investments enjoy the same tax benefits on gains that you'd get from investing in mutual funds, stocks and bonds. Should you take a loss, however, you can't write it off.

Since Hanrahan's initial success, he's become even more ambitious with his IRA. He is now making a $100,000 bet - the majority of his IRA money - to help launch Capital Bank of New Jersey (capitalbanknj.com), a community bank funded by 27 investors who have already raised $19 million, about 23 percent of it from IRAs.

"Our minimum investment is $25,000, and a lot of people just don't have that kind of scratch lying around, except in their retirement account," says Hanrahan, the bank's CEO. He feels that because retirement money has a long time horizon, it is appropriate for riskier investments - even startups.

While there are no official numbers for the self-directed IRA market, Tom Anderson, founder of Pensco Trust (penscotrust.com), an IRA custodian in Portsmouth, N.H., with more than $2 billion under management, believes that this small subset is growing several times faster than the overall IRA market. "Anecdotally," he says, "all our competitors are seeing about 30 percent growth."

Why so popular? Investors want true diversification in their retirement portfolio. "Sometimes when the stock market is not doing well, real estate is," says Jim Wagner, CEO of Trust Administration Services (trustlynk.com) of Carlsbad, Calif., which specializes in nontraditional IRA investments.

Not all self-directed IRAs are created equal. Most major brokerage firms put you in control of which mutual funds you invest in but restrict your holdings to traditional securities. They may not be equipped to handle real estate, private equities or others among the more than 40 asset classes that the IRS permits.

So what can your IRA legally own? Shares of almost any type of private company and all forms of real estate, from boat slips to storage facilities to strip malls, or even a beach house.

"The most off-the-wall investment I've seen was a cemetery, where a group of investors formed a limited partnership with their IRAs that made the purchase," says Raymond Yu, chief administrative officer of Entrust Administration (theentrustgroup.com) of Oakland, which handles $1.7 billion in self-directed IRAs. "We have a client who is a cattle guy in California who is purchasing 40 cows for $1,000 a head in his IRA," says Trust's Wagner. "Look, if you've never made money in the stock market and you know real estate or cattle, invest your IRA in that."

Keith Kjarval, 33, knows movies, so in 2005 he founded Unified Pictures, with approximately 20 percent of his fundraising from IRAs. "A typical investment is $50,000, which might represent 5 percent of an investor's total retirement savings," he says. His Northridge, Calif., company has funded four films so far, including one last year starring Penélope Cruz. He says investors typically expect to see a return on their money within 24 months.

Important restrictions do apply, which brings us back to those "prohibited transactions." One critical rule governs what the IRS calls "self-dealing," using tax-deferred money for something that benefits you today. "If you get a benefit as a byproduct of a transaction that your IRA is involved in, that would be a violation," says Anderson.

For example, you may buy a vacation house through your IRA and rent it for profit. But if you or your family use the house, that would be self-dealing. You are also forbidden to mix sweat equity with your investment. If you do repairs on the house yourself, you're breaking the rules.

Using IRA funds to start a business can be a minefield. You can legally invest IRA money in a startup, but you can't be a majority owner or pay yourself a salary unless the company is structured so that your salary is not in your control. To stay abreast of the tax codes, seek professional guidance.

"If you file the papers to incorporate and name yourself the sole shareholder," says Anderson, "then you can't put your IRA money into it." Anderson encourages entrepreneurs to put a portion of their retirement money into their company, "particularly a Roth IRA, if you really believe your company [is] going to pay off."

Before incorporation, you'll want to enlist the help of a knowledgeable attorney to make sure that ownership is structured properly. If the IRS finds you're violating its self-dealing prohibitions, the penalties can be severe. Your entire retirement plan could be disqualified, which could result in a penalty plus income tax on the full value of your plan, as well as early-withdrawal penalties for those under age 59 and a half.

One way to limit the risk is to have a separate IRA for more speculative investments, with the majority of your retirement funds safely housed elsewhere. Of course, you don't want to put a large share of your retirement savings in risky investments anyway - remember that more private companies implode than pay off. Depending on your appetite for risk, it's prudent to invest no more than 25 percent of your IRA in alternative investments.

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