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Self-directed IRAs allow investors to dabble in real estate

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With corporate scandals, weak earnings and an uncertain economy, more and more IRA owners are seeking alternative investments. There is in excess of $3 trillion in IRA funds in the United States today. Most is invested in the more conventional investment types, such as CDs, mutual funds, stocks and bonds. However, these funds are also available to be invested in IRS-permitted nontraditional assets, including mortgages, raw land, commercial buildings, vacation rentals, multifamily homes, private notes, private stock, startup businesses and shares in LLCs, just to name a few. The good news for investors considering this strategy is that it can be done without cashing in their IRA account, and can be done penalty-free, tax-deferred, and sometimes even tax-free.

A long-standing Internal Revenue Service ruling allows all Americans to invest their IRA funds -- or 401(k) funds rolled into a self-directed IRA -- in a wide variety of nontraditional investment types. Rolling current retirement funds from an existing IRA for 401(k) account into a Self-Directed IRA to do this type of investing is penalty-free. Additionally, the taxes due on the growth of the investments are deferred until distribution begins at retirement. If the self-directed Roth IRA is involved, the principal and earnings are tax-free when distributed at retirement.

The process itself is simple: An individual opens a self-directed IRA account with a specialized custodian, transfers his or her current IRA funds to the new self-directed account and directs the custodian to invest the funds into the specified asset. After an administrative review to determine if the asset can be administered, the custodian forwards the funds to purchase the asset, and the asset comes into the ownership of the individual's IRA account.

The timing is excellent now to take advantage of this little-known retirement planning tool, and the possibilities opened up by it. Daily headlines in the Wall Street Journal discuss the damage done to retirement funds by the low return of stocks and bonds. As a result, more and more Americans are pulling out of traditional investments and moving toward nontraditional assets as a primary or ancillary investment for their IRAs due to their potential for a higher return.

For example, over the past 13 years, home values have increased approximately 4 percent annually. This is an increase of 57.5 percent between 1990 and 2002. In 2002, $2.41 billion flowed into real estate mutual funds, according to AMG Data Services, compared with only $307 million in the same period a year earlier. Also, shares in real estate investment trusts have climbed 11 percent last year, while the S&P 500 stock index was down more than 17 percent. This isn't the first time that real estate has climbed while the stock market declined. Back in the 1970s, which was the last time the S&P 500 stock index posted two losing years, real estate values soared along with inflation. Many people saw their home values double or even triple.

The IRS code does not specify which types are permitted; however, typically you can purchase investment property such as single or multifamily dwellings, apartments, commercial buildings, raw land, vacation property, condominiums, mobile homes and so on. You can also lend money against these types of property. There are some special considerations for real estate transactions. For example, you cannot buy a property, or invest in a secured loan, that involves yourself, a son, daughter, parent, or other disqualified party -- such as a fiduciary or your sole proprietorship.

If it's so easy and potentially lucrative, why aren't the vast majority of Americans and their financial advisers aware of the unique use of self-directed IRAs? The reason is due primarily to the lack of knowledge on the subject as there are, literally, only a handful of financial service firms in the nation that are willing and capable to provide the required custodial and administrative services. Typically, institutions that are licensed to administer IRA accounts, such as banks, credit unions, trust companies or savings and loan institutions, are not willing to undertake the challenging research, extensive paperwork, and IRS reporting that is required in order to administer nontraditional assets within IRA accounts.

Others, however, such as broker/dealers and mutual fund companies, have to be separately licensed by the employee plans division of the IRS and restrict their IRA clients to a limited set of investments. They do so for several reasons. First, if they offer investment advice, sell investment product or have discretion over the management of investment assets, they will be concerned about the liability associated with the purchase and/or administration of any nontraditional investment. Second, their specific structure or license may restrict them from certain types of investments. Third, they may not be organized to profit from any investment other than their own proprietary investments (e.g., mutual fund companies). Consequently, the vast majority of institutions offering IRA servicing do not promote the fact that clients can choose from a variety of investment options for their IRAs.

Since most financial providers don't allow their clients to diversify their IRA holdings, how can the average person take advantage of these IRS regulations? They must establish a truly self-directed IRA with an institution that does not restrict the choice of investment. For example, many large discount brokerage firms claim to offer clients "self-directed" IRAs. But in fact, they are only self-directed in the sense that the investor can make the investment decisions and choices independently (for example, without advice or discretion by the provider). All of these institutions still restrict the "type" of investment to publicly traded investments.

True self-directed IRA custodians allow you to select from virtually any type of investment. While clients can still include traditional investments such as stocks and mutual funds within their self-directed IRA, they also have the freedom to diversify their portfolio by adding a nontraditional asset. Self-directed IRA custodians provide a unique service to IRA owners and serve as a vital source of funds to new and emerging companies by assisting individuals, including "angel" investors, to invest their retirement funds in such firms. In many cases, these investors have large sums of money accumulated in their retirement accounts, which they can now put to work in nontraditional investments through the services of self-directed IRA institutions. Self-directed IRA funds have been used to start a wide range of businesses from banks to dot-coms.

Self-directed IRAs, when administered by a special asset custodian, offer the opportunity to maximize retirement investment returns in a number of creative, nontraditional ways. Those interested in having a self-directed IRA are advised to contact their financial planning professional to determine if a self-directed IRA is right for their retirement planning strategy.

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