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Your Self-Directed IRA: Common Questions from Investors

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In my 7/30/08 AZ Republic column, I mentioned why the recent IndyMac bank collapse and Wall Street fraud reminds us that we may want more control over our investments by establishing a truly self-directed IRA. Here are common questions that clients and investors have asked me over the years:

1. What is a Self-Directed IRA?

It's legally no different from any other IRA. The term "self-directed" simply indicates that you choose your IRA's investments. Most investors (97% of IRA money) do not have a truly self-directed IRA because their investment choices are limited to those given by the plan custodian (almost always tied to Wall Street).

2. What can a Self-Directed IRA invest in?

The IRS only excludes: life insurance contracts (a policy on the life of the IRA owner or designated family members); collectibles (e.g. antique rugs, cars, stamps, etc.); and capital stock in an "S" corporation. Virtually all other investments are allowed, such as raw land, rental real estate, start-up businesses through private placements, and mobile home notes. You the account holder are your own investment advisor.

3. Why haven't I heard about this before?

Wall Street only makes money when you buy stocks, bonds, mutual funds, and other products such as limited partnerships. Traditional banks want to pay you low interest on your savings account and then lend it out at 12-32% on credit cards. Neither have an incentive to tell you about truly self-directed IRA's as they would not make a profit.

Many experts in this field believe that only 1% of CPAs and attorneys are aware of the self-directed IRA rules.

4. What funds are allowed into a self-directed IRA?

In addition to the (small) annual contribution limits, one can transfer or rollover larger sums from one's other retirement accounts, such as SEP IRA; 401(k); 403(b); profit sharing plan; money purchase plan; defined benefit plan, Keogh plan, and other qualified pension plans.

5. Which custodian will allow you to have a truly Self-Directed IRA?

There are perhaps only 20 custodians (including 5-7 large ones) in America that allow this. They make their money by charging fees (such as an annual 1/2-2% of the total assets), similar to a bank trust department. They normally do NOT sell investments, which would be a conflict of interest.

Common Pitfalls:

1. The funds for your self-directed IRA must be used for investment only and there must be no personal use by you or family members. E.g.: You cannot buy a condo for your son while he goes to college or a vacation home that your family personally uses.

2. Prohibited parties include your ancestors (grandparents and parents) and descendants (kids and grandkids). This also includes your and their spouses. However, it's OK for your IRA to deal with brothers and sisters (which is strange as the intent is not to have self-dealings with family members).

3. You cannot be a typical "hands-on" investor who likes to fix up the property or move furniture from your home to your rental condo. You probably have to use a 3rd-party management firm. You cannot receive a management fee or reimbursement for expenses paid. E.g.: Plumbing and other repair bills on your rental condo must be paid directly from your self-directed IRA. You cannot personally build the porch or put on a new roof, even if you do not charge anything to the IRA for your labor.

4. You cannot borrow money from your IRA or guarantee a loan for your IRA.

In conclusion, if you want to have more direct control of your assets, consider opening a self-directed IRA. The responsibility for following the rules is on you and so educate yourself on the rules.

Author: Dr. Harold Wong earned his Ph.D. in Economics from UC Berkeley and passed the CPA exam in 1979. Through his seminars, publications, and consultations, he helps Seniors and Baby Boomers maximize retirement income and reduce taxes. Contact him at: (480) 706-0177 or haroldwong1@yahoo.com, or read his previous articles on his AZ Republic blog at: www.DrHaroldWong.com.