

## Retirement

### **The Back-to-School Issue: Alternative Investments in an IRA**

by William J. Supper, CFP®, and Christopher R. Coccozza, CPA, J.D., LL.M.

*William J. Supper, CFP®, is the director of financial planning for Massey, Quick & Company in Morristown, New Jersey. He is responsible for developing wealth strategies for high net worth individuals and can be contacted at [bill.supper@masseyquick.com](mailto:bill.supper@masseyquick.com).*

*Christopher R. Coccozza, CPA, J.D., LL.M., is an associate professor of business at DeSales University in Center Valley, Pennsylvania. His primary professional focus is providing tax planning strategies for retirees. He can be reached at [crc0@desales.edu](mailto:crc0@desales.edu).*

Do you hear the ticking of the clock? It is the collective sound of the baby boomers anticipating retirement. Their retirement will create significant opportunities for financial planners who are prepared. It is time to go back to school to learn of the potential benefits and pitfalls of holding alternative investments in an individual retirement account.

As boomers retire, they will begin to roll their 401(k) assets into self-directed IRAs and their investment choices will become infinitely more abundant and potentially more complicated. Your role will no longer be to advise them to simply choose from a menu of mutual funds in their 401(k). As a planner, you now have a great opportunity to differentiate yourself by understanding the nuances of IRA investing.

Traditionally, IRAs were invested in cash, bonds, and stocks, depending on the risk tolerance, time horizon, and needs of a particular client. In recent years, however, many clients have sought diversification in their portfolios by investing in alternative assets. Today, clients are interested in placing part of their savings in hedge funds, real estate, and the like.

Although these types of investments can create opportunities for both planners and their clients, we know that asset location is also an important aspect of the portfolio construction process and must be adhered to. In addition, the tax advantages of having assets in a retirement wrapper are clear to all, yet must be carefully employed to maximize clients' after-tax returns. But when placing more sophisticated investments in an IRA, additional issues arise, and it is critical that clients and their advisors fully understand the numerous tricks and traps.

## Real Estate

With the boom in the real estate market over the last decade, many clients have been asking our advice on buying real estate for their IRAs. Although some real estate (see below for details on the restrictions) can be held in a self-directed IRA, we generally advise clients against this strategy, since we find the pitfalls outweigh the potential benefits.

One such pitfall relates to the tax deferral status of the IRA. Typically, a client holds money in an IRA to take advantage of the tax deferral. Having investment real estate in a retirement plan may actually harm a client's income tax position since the investment real estate typically throws off losses, due to depreciation and expenses, that can no longer be used to offset other rental income, resulting in no current income tax savings. Also, income from investment real estate is typically shielded from current tax due to the benefits of the depreciation expense so you are not really benefiting from the retirement wrapper.

Additional issues arise if the property needs repairs and the IRA does not have cash to make the repairs. What can be done? If cash is contributed to the IRA, the owner must be careful to make sure those monies are not considered "excess contributions." Running afoul of the excess-contribution rules will result in income tax penalties being assessed against the client. Perhaps to circumvent this issue, you advise your client to allow the IRA trustee to borrow money on behalf of the IRA. But this raises two potential problems. First, it's doubtful that a bank would even make a loan to an IRA trustee without a personal guarantee from the IRA owner—and a personal guarantee is considered a prohibited transaction. Second, when an IRA borrows funds, it could create unrelated business taxable income (UBTI), which would generate current tax and additional compliance costs.

In addition, self-dealing issues may arise when real estate is held in an IRA. This issue will be addressed more completely below.

## Hedge Funds

The recent headlines showing the successful use of hedge funds by institutional investors have many individual investors realizing that they, too, can benefit from having this asset class. Investing in uncorrelated assets is a great way to mitigate the overall risk of the portfolio and create diversification. We like to place these alternative investments in self-directed IRAs because this is a perfect match for an accredited investor: tax-inefficient investment in a tax-efficient vehicle. The main criticism of hedge funds is they are tax inefficient; however, this issue is eliminated by holding the hedge fund investment in an IRA.

One potential pitfall relates to the lock-up period imposed by most hedge funds (typically, one-year lock-up with semi-annual liquidity thereafter). In particular, clients who are required to take minimum distributions or who have cash-flow issues must be aware of potential illiquidity issues created by these lock-up requirements.

## Pitfalls

As with many investment strategies, it is often more important to know what traps may arise for the unwary. We believe this axiom is especially true for IRA investing. Unfortunately, the IRS has never explicitly stated which investments may be held in self-directed IRAs. But it has given guidance as to what types of investments are not allowed by issuing rules against "self-dealing" and "prohibited investments." Before placing an investment in an IRA, a financial advisor must be aware of these prohibitions:

- Collectibles (artwork, rugs, antiques, alcoholic beverages, and stamps)
- Coins (though some gold, platinum, and silver coins are allowed)
- S corporation stock
- Life insurance (consider a Keogh plan instead)

We have had the most issues from clients who would like to invest in collectibles such as artwork, antiques, and coins. In fact, we had one client who wanted to have his IRA own his wine collection. Despite the compelling investment returns he was generating, we were able to convince him that this would not be a permissible investment for his retirement account. But this story reminds us that these rules are quite detailed. Therefore, before any items are bought by an IRA, it must be determined if they are prohibited investments.

Self-dealing occurs whenever a transaction inside the IRA benefits a "disqualified person." Essentially, a disqualified person is the IRA owner, spouse, lineal descendant or some other entity that they control (see Internal Revenue Code Section 4975).

There are many examples of self-dealing. From a practical perspective, some of the issues that will most likely arise with your clients relate to the personal use of, or deriving benefit from, property such as a vacation home. Disqualified persons are prohibited from leasing or using any property held by the IRA. Therefore, the client cannot buy real estate within their IRA if

disqualified persons intend to use that property in the future. In addition, the client cannot receive unreasonable compensation for managing an IRA.

No lending to, or borrowing from, an IRA is permissible. The IRA assets cannot even be pledged.

In the event that self-dealing or a prohibited transaction has occurred, it should be remedied as soon as possible. The penalties vary depending on the severity of the transgression. In most cases, the entire balance in the IRA will be deemed to have been distributed at the beginning of the tax year when the prohibited transaction occurred (IRC section 408(e)(2)(b)). Therefore, the investor would be subject to ordinary income tax immediately and the 10 percent early withdrawal penalty would also apply if the investor is younger than 59½. For some infractions, the penalty may be limited to the amount involved in the prohibited transaction, not the entire IRA.

If someone other than the owner of the IRA engages in a prohibited transaction, they may be subject to a 15 percent tax. And there would be an additional 100 percent tax if it is not corrected. This is the reason why many IRA custodians say no to their clients when they are trying to enter into a transaction that the custodian believes could be jeopardizing, such as buying a vacation property for an IRA owner.

## **Custodians**

Another issue that arises when placing nontraditional assets in an IRA is the use of a custodian. For traditional investments, the brokerage house will already have a relationship arranged with a custodian. With a nontraditional asset, you typically need to find the custodian since the IRA must have a custodian trust company hold investments in hedge funds and other illiquid investments like promissory notes, mortgages, oil, gas, and real estate. This issue is not insurmountable. There are many organizations that can assist with this process.

## **Conclusion**

The impending retirement of the baby boomers will create a large shift from 401(k) retirement holdings to self-directed IRA holdings. As with any change, this will create opportunities for both you and your clients. This generation is open to a whole new style of investing and many are interested in enhancing their retirement returns by investing in alternative investments. Strengthen your knowledge of the potential pitfalls and benefits of placing alternative investments in an IRA.