



Investment Guide

## The IRA Steps Out

Carrie Coolidge 06.05.06

**You can buy exotic investments with your tax-deferred account. Just because you can doesn't mean you should.**

Philip D. King, an insurance agent and volunteer fire chief in Bardwell, Ky., wasn't satisfied with the money his IRA was earning in mutual funds. So last year King channeled a chunk of his retirement dollars into an unconventional venue: He bought 246 acres of timberland in Hickman County, Ky. He and his sister, Janine, who invested from her own IRA, paid a total of \$180,000 for the land previously owned by MeadWestvaco, a packaging producer. King estimates the thousands of trees and underlying property will be worth as much as \$1.2 million in 20 years. "My IRA was earning a return like a certificate of deposit," says King, 36, who now joins the roster of individuals and private owners who control three-quarters, or 350 million acres, of the nation's woodland. He likes the tangible nature of this asset: "You can go out and walk on it and say, 'I own this.'"

Heartwarming. But is timberland a smart investment in an IRA? For most people, no. Held in a taxable account, timber has the rare attribute of throwing off both dividends and capital gains that are taxed at the low 15% (maximum) rate for long-term capital gains. That is, if you sell cutting rights, the check you get is considered a long-term gain; and of course if you sell the whole lot after holding for a long time, the appreciation is a long-term gain. Put those trees into your IRA, however, and you convert both cutting fees and land appreciation into ordinary income taxed at 35% when you eventually withdraw it in retirement.

For now the Kings aren't chopping trees, but they are making money renting the land to hunters. Outside the IRA this revenue would be taxable at ordinary income rates, so the shelter is of some value here.

Self-directed IRAs, the kind that let you pick investments like candy, are quite the rage these days, growing at an annual rate of 25%, compared to 8% for the overall IRA market. The vast majority of the self-directed money is in self-directed brokerage accounts, meaning that the saver can mix stocks, bonds and funds at will. But the concept includes investments that are far less tame. Among the permitted investments: business ventures, real estate, tax liens, gold bullion and oil wells. Outlets that are off-limits: life insurance, S corporation stock, alcoholic beverages and collectibles like artwork, rugs or antiques, warns Ralph Anderson, partner at Weiser, a New York-based accounting firm.

"People want to take more control," says Tom W. Anderson, head of Pensco Trust, a custodial firm that holds self-directed IRA assets. They can't have too much control. The custodian in the middle must purchase the land or other assets. People like the Kings aren't allowed to manage their property; they must hire someone else to do that.

The main no-no is "self-dealing," meaning you can't benefit from the IRA investment beyond its tax-deferred growth, which you will tap in retirement. So forget about using IRA money to buy a building you already own. You can't operate a business out of property owned by your IRA. Nor can you use personal funds to pay for property-related expenses and dip into the IRA for reimbursement. All rental profits must go into the IRA account. And if you sell the asset, ditto for the sales proceeds.

A good advisory firm can help you navigate the rules. Violate the rules and the Internal Revenue Service might treat your entire IRA investment as an early (before age 59½) withdrawal. Then you must pay ordinary income tax on the sum and also a 10% penalty.

If timberland is often a poor choice for IRA investing, what about commercial real estate? Almost the same objection can be raised. Real estate has such favorable tax treatment outside the IRA that it doesn't benefit from the IRA's umbrella.

With modest leverage, office buildings and apartment houses held directly throw off no currently taxable income, because the rent is offset by operating expenses, depreciation and interest. The payoff that comes years down the road, in the form of a capital gain, is taxed at the reduced 15% rate for long gains.

Put that same building into your IRA, however, and you convert the gain into ordinary income taxed at up to 35% at withdrawal time. Pretty dumb.

There's yet another problem for IRA real estate. Use any debt at all and some of the rental income could be taxed inside the IRA (as a form of "unrelated business taxable income"--don't ask what that is). If nothing else, you have an accounting nightmare on your hands.

Wait, we have still another reason to hold real estate outside the IRA. Outside, the capital gains escape taxation if you still hold the property at your death. Say your apartment building has a tax basis of \$100,000. You die when it's worth \$300,000. Your heirs owe no income tax on the \$200,000 appreciation, under the "step-up at death" rule. But if the property is in your IRA, the gain is taxed at ordinary income rates.

And let's not forget the fees. They aren't onerous, but even land lying fallow costs something to maintain, beyond property taxes. To make the forest investment, the Kings first transferred the funds from their IRAs to a custodian, Trust Administration Services of Carlsbad, Calif., which oversees \$1.4 billion in IRA assets in 11,000 individual accounts and charges a one-time flat fee of \$100 per investment. Philip and Janine each pay this custodian another \$190 a year. The siblings hired a self-directed IRA advisory firm from Leander, Tex. called **Asset Exchange Strategies**, which gives the Kings the paperwork to make the IRS happy. For \$3,000 the firm set up a limited liability company to manage the King timberlands.

The Kings haul in \$4,800 a year renting the land to people chasing turkey, ducks and deer; out of this revenue the IRA spends \$400 on property taxes and \$250 for a \$1 million liability insurance policy on the timberland.

Not all real estate investments are direct ownership of property. Maria Fee, 42, a Houston real estate investor, has \$100,000 of her IRA savings invested in real estate debt--small notes that have high yields (as high as 14%), including second mortgages and tax liens in the \$5,000-to-\$10,000 range. Fee prefers dealing with paper obligations rather than the property ownership headaches of, as she puts it, "termites and trash."

Fee buys notes from mortgage brokers and lenders who lend to owners of low-value single family homes in the suburbs of Houston. Risky, no? Fee insists the collateral protects her. "If Exxon goes down, you lose your investment," she says. Fee claims that her IRA has more than doubled in value since she started

buying junk debt a year ago. For Fee's first IRA investment, she had to pay \$50,000 for a deed on a seven-acre property with two homes on it.

If the owner fails to buy back the deed with interest within the next five months, Fee will take possession of the property, which she estimates is worth \$185,000.

Finding the investment opportunity takes some work. Fee advertises in newspapers her desire to buy liens and notes. She also networks with probate attorneys in the know about lenders who have taken back owner financing. Sometimes she buys directly from a bank, other times at municipal auctions.

So far Fee has not had occasion to call in a foreclosure attorney or try to sell repossessed property. A few bad experiences may alter her cheery view of subprime lending. In the meantime, we can think of at least one thing in favor of putting junk debt into a tax-sheltered account: It throws off a lot of income that would otherwise be taxed at high ordinary income rates.

Another type of investment that people are putting into their IRAs is private stock--that is, issues not publicly traded. Brent A. McFarland, a general contractor who lives in San Diego, invested some of his IRA money in a California community bank stock when the company was in the early stages of being organized. By betting on this private stock, he had to believe that the bank would go public and thrive.

Last spring McFarland made the investment of \$10,000 for 1,000 shares, or \$10 per share, of a community bank headquartered in San Clemente called Pacific Coast National Bancorp. In May the bank opened its doors in two locations, Encinitas and San Clemente, with a handpicked group of highly experienced bankers and \$23 million in capital.

So far, so good. It's now trading on the Pink Sheets, the o-t-c bulletin board, where the stock is at \$14.50. McFarland's investment is now valued at \$14,500, a decent appreciation in a little more than a year.

McFarland, 32, realizes the investment he made for his retirement was speculative. "I knew I was gambling," he says. "But I am young. If the investment didn't pay off, I am young enough to make it up. Would I take these risks at an older age? Maybe not. I will be more conservative as I get older."