

**Abstract:** Traditional and Roth IRAs can be relatively “safe” retirement-savings vehicles, depending on what they’re invested in. But a drawback is that they limit investment choices. This article looks at an alternative: self-directed IRAs, which provide more flexibility in investment choices but also come with a greater risk. A sidebar examines the IRA’s role in estate planning.

## **Consider the flexibility of a self-directed IRA**

Traditional and Roth IRAs can be relatively “safe” retirement-savings vehicles, depending on what they’re invested in. But a drawback is that they limit your investment choices. A self-directed IRA gives you more flexibility in your investment choices but comes with greater risk as well.

### **Gaining more control**

A self-directed IRA is simply an IRA that gives you greater control over investment decisions. Traditional IRAs typically offer a selection of stocks, bonds and mutual funds. Self-directed IRAs (available at certain financial institutions) offer greater diversification and potentially higher returns by permitting you to select virtually any type of investment, including real estate, closely held stock, limited liability company and partnership interests, loans, precious metals, and commodities (such as lumber and oil and gas).

A self-directed IRA can be a traditional or Roth IRA, a Simplified Employee Pension (SEP) plan, or a Savings Incentive Match Plan for Employees (SIMPLE). It’s also possible to have a self-directed individual 401(k) plan, Health Savings Account or Coverdell Education Savings Account.

Self-directed Roth IRAs are particularly powerful estate planning tools, because they offer tax-*free* investment growth. (See “IRAs and your estate plan.”)

### **Navigating the tax traps**

To avoid pitfalls that can lead to unwanted tax consequences, caution is required when using self-directed IRAs. The most dangerous traps are the prohibited transaction rules.

These rules are designed to limit dealings between an IRA and “disqualified persons,” including account holders, certain members of account holders’ families, businesses controlled by account holders or their families, and certain IRA advisors or service providers. Among other things, disqualified persons may not sell property or lend money to the IRA, buy property from the IRA, provide goods or services to the IRA, guarantee a loan to the IRA, pledge IRA assets as security for a loan, receive compensation from the IRA or personally use IRA assets.

The penalty for engaging in a prohibited transaction is severe: The IRA is disqualified and all its assets are deemed to have been distributed on the first day of the year in which the transaction took place, subject to income taxes and, potentially, penalties. This makes it very difficult to manage a business, real estate or other investments held in a self-directed IRA. So, unless you’re prepared to accept a purely passive role with respect to the IRA’s assets, this strategy isn’t for you.

## **Considering the option**

If you have assets such as precious metals, energy or other alternative investments, a self-directed IRA may be worth your while to consider. Contact our firm to discuss further.

## **Sidebar: IRAs and your estate plan**

IRAs are designed primarily as retirement-saving tools, but if you don't need the funds for retirement, they can provide a tax-advantaged source of wealth for your family. For example, if you name your spouse as beneficiary, your spouse can roll the funds over into his or her own IRA after you die, enabling the funds to continue growing on a tax-deferred basis (tax-free in the case of a Roth IRA).

If you name a child (or someone other than your spouse) as beneficiary, that person will have to begin taking distributions immediately. But if the funds are held in an "inherited IRA," your beneficiary can stretch the distributions over his or her own life expectancy, maximizing the IRA's tax benefits.

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