Using IRA Proceeds to Invest in Real Estate and Other Alternative Investment Vehicles

By Salvatore J. Bauccio

September 15, 2010

Funds in a self-directed IRA typically are invested in stocks, bonds and mutual funds. What you may not know is that you can use your self-directed IRA to invest in real estate, privately held companies and other alternative investment vehicles, and defer any tax gains associated with those investments until retirement. Sound too good to be true? This technique has been permissible under IRS rules since 1974.

Benefits of Alternative Investments

Besides deferring the tax gain on any "alternative" IRA investment until distribution, perhaps the biggest advantage of such an investment is that it allows the IRA owner to invest in a vehicle with respect to which he or she is most comfortable. For example, if the IRA owner is knowledgeable about real estate transactions, the IRA owner may prefer to invest his or her IRA assets in real estate instead of stocks and bonds. At the same time, however, when investing in illiquid assets, if the IRA owner is at or near retirement age, the IRA owner must be sure to leave sufficient liquidity in his or her IRA account in order satisfy the required minimum distribution rules.

Below is a list of example investments which an individual IRA owner may and may not make through his or her IRA.

Permissible Investments:

- Real estate (sole ownership or tenancy in common)
- Closely held C corporation stock
- LLC membership interests
- Limited partnership interests

Impermissible Investments:

- Privately held S corporation stock
- Life insurance
- Artwork and jewelry
- Any business where the IRA owner and/or his family owns 50% or more

Prohibited Transaction Rules

When making an alternative investment through an IRA, in addition to complying with the standard IRA rules (e.g., receiving required minimum distributions at retirement age), the IRA owner must also comply with the IRS's "prohibited transaction" rules. These rules are designed to prevent the IRA owner from receiving a current benefit from the use of IRA proceeds, even though such proceeds may not be distributed to the IRA owner until retirement age.

For example, the IRA owner may use IRA proceeds to invest in an investment property if the property is leased to a third party. However, an IRA owner may not use IRA proceeds to invest in a vacation home if the IRA owner or his family would use the home for personal enjoyment. By personally using the vacation home, the IRA owner is receiving a current benefit from the IRA, even though the IRA cannot make distributions to the IRA owner until retirement age. The IRA owner also needs to be careful of transactions with any closely held corporation, LLC or partnership in which his or her IRA has an ownership interest.

Tax Consequences of Failure to Comply

If an IRA violates the prohibited transaction rules, the IRA is deemed distributed as of the date of the prohibited transaction, resulting in taxable income for the IRA owner in the year of the transaction. In addition, there is a 10% penalty if the IRA owner has not attained the age
59-1/2.

Depending on the type of impermissible investment made, different or additional penalties and taxes may apply. For example, if the IRA invested in an S corporation, the S corporation would automatically be converted to a C corporation and would not be eligible to reapply for S corporation status for 5 years. Further, if the IRA invested in a business where the IRA owner and related parties (family members) owned 50% or more of the outstanding stock or partnership interests, there would be an additional tax equal to 15% of the amount invested.

Prior to making an alternative investment through an IRA, it is strongly recommended that the IRA owner consult with competent legal counsel, as well as an IRA custodian experienced with these types of transactions. Beware – alternative IRA investments are not for the unwary!