



## The IRA Steps Out

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

By Carrie Coolidge | Jun 5, 2006 | 1559 words, 0 images

**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 59 1/2) 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.