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Self-Directed IRA Myths Can Result in Heavy Costs

by Phoebe Chongchua

If you're one of those people who has diligently been putting away money into a traditional IRA for your retirement, but now is questioning what else to invest in, the self-directed IRA might be the next step. Different from a traditional IRA, the self-directed IRA allows you to invest in things such as real estate properties, raw land, rental properties, and even businesses.

But it can be a risky investment if you don't know the rules. Here's a look at some common myths that can result in costly penalties and fees.

Myth # 1: I can use my self-directed IRA for a vacation property

If you're going to use a self-directed IRA and custodian of the account, here is an important term to know: self-dealing. Your traditional or self-directed IRA can only be used to provide for your future retirement. That means using your self-directed IRA to buy a vacation or second home that you intend to use before you're of retirement age is prohibited. If you violate this, you are essentially taking an early distribution and the IRS can disqualify the IRA and slap hefty tax bills and penalties for under-retirement-age account holders.

Myth # 2: Custodians of self-directed IRAs charge the same fees

Fees for being the custodian of self-directed IRAs vary greatly. It's important to shop around and understand all of the associated fees before you decide which custodian to use. Other things to look for are whether the custodian allows leveraged/debt-financing or foreign real estate properties. Some custodians offer services such as rental income collection and filing of the deed, while still others require that you hire an independent entity to handle these services.

Myth # 3: Setting up an IRA LLC must be costly

Many people who use the self-directed IRA as a vehicle to invest in real estate also choose to set up a Limited Liability Company. If you look on the Internet you can find numerous businesses and law firms that assist in this process. But the fees can vary considerably.

"A lot of times people will end up paying \$10,000 or more to get an LLC put together and an opinion

letter," says Jeff Nabers, founder of the IRA Association of America.

Nabers says a more reasonable market rate for getting that service is in the range of \$4,000 to \$6,000. But great deals can be found here. The association offers its members a significant discount on this service.

Myth # 4: Thinking the do-it-yourself kits always save you money

Setting up an IRA LLC to fund your real estate transactions is growing in popularity. But as with anything that becomes more prevalent, do-it-yourself options quickly pop up.

"People are selling these kits for \$400; I've actually seen them on eBay for \$90," says Nabers.

Experts who handle these types of transactions recommend that investors beware of doing it yourself.

"The kits aren't providing any actual service. They'll just provide a sample operating agreement and a rundown of how to file an actual LLC yourself with your state," says Nabers.

According to experts, the kits don't offer any liability protection instead you are held responsible for legal compliance of your IRA LLC. So, while you may save initially, the end result could cost you a fortune if you end up inadvertently taking a distribution.

"A lot of people even go so far as to label the do-it-yourself kits a scam because really it's kind of convincing people to do it themselves and then they are the ones on the hook for it should something legal go wrong," explains Nabers.

Investing in real estate with an IRA opens up possibilities for many people who are ready for more diversification of their financial portfolio -- just be sure you consult with experts before diving in.

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