The Problems With Self-Directed IRAs

Although these IRAs offer more investment flexibility, they also come with more hassles.

By **Matt Dembicki**
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You can put almost any type of investment into an IRA. Most people select mutual funds. But if you want more flexibility in picking your investments, you can do it with what's called a self-directed IRA. Below, we touch on some of the options they offer, as well as some of the problems self-directed plans present.

What you can't invest in

So many investments can go into an IRA that it's easier to list the ones that can't: works of art, rugs, antiques, gems, and stamps and other collectibles. Also barred are most types of metals and coins, except for gold, silver, platinum and palladium bullion, and gold and silver American Eagle coins (issued by the federal and state governments).

However, putting such assets in would waste the tax advantages of an IRA. Precious metals produce no income; to make money you must sell them for more than you bought them for -- in other words, to take capital gains. Typically, if you sell property you've owned for a year or more, you pay the current capital-gains tax of 15%. But withdrawals from an IRA are treated as regular income, and depending on your tax bracket, the tax could be as high as 35%.

It's better to confine your IRA to investments that would otherwise generate taxes over the years. This allows you to take full advantage of the opportunity to defer the taxes and thus enhance the compounding effect.

Stocks and bonds

Owning individual stocks and bonds in an IRA also means paying regular income tax when you take the money out, not the usually lower capital-gains tax.

For active investors who trade several times a year and would incur short- or long-term gains tax each time, it's a reasonable trade-off. But note: Losses you incur in an IRA are not deductible.

Municipal bonds, which are already tax-free, are also a poor choice for IRAs, because they merely convert the tax-free income of a municipal bond into the taxable income of an IRA distribution. Result: less income.

Real estate in your IRA

The spirited real estate market of recent years may tempt you to park some real estate in an IRA. It's possible to do this in a self-directed account, but we think it's not a good idea. You would forfeit the low capital-gains rate for property that appreciated in value, and you'd be unable to claim depreciation-induced losses along the way.

Also, real estate creates headaches if it's still in your IRA when the time comes to start taking your minimum required distributions. You'll need a professional appraisal to determine the value of the property on which you must base the distribution. But you can't sell your real estate a little at a time in order to take out the required amount. If you have liquid assets in another IRA that you can use to cover the required distribution from your real estate IRA, that might solve the problem. If you don't, your only option may be to sell the property and incur a hefty tax all at once.

Even before you have to take distributions, you still must have the property appraised annually. The IRS requires the custodian of your IRA to record the real estate's value each year on Form 5498, IRA Contribution Information.

Setting it up

Self-directed IRAs come with more fees than the off-the-shelf variety offered by mutual funds. Aside from an annual maintenance fee imposed by the custodian of the account, which typically runs from $25 to $60, you may be charged a one-time setup fee of $10 to $25. Precious metals held in IRAs require special storage, which incurs another annual fee. American Church Trust, in Houston, charges $1 per $1,000 asset value for gold, platinum and palladium, with a minimum fee of $60 and a maximum of $200.

Setting up an IRA that holds real estate also racks up additional fees. There may be management fees for the property itself. In addition, the custodian typically charges an upfront review fee of about $100, an annual account fee (which can range from $120 to $200) and fees tacked on for services such as wire transactions, transfers and notaries.