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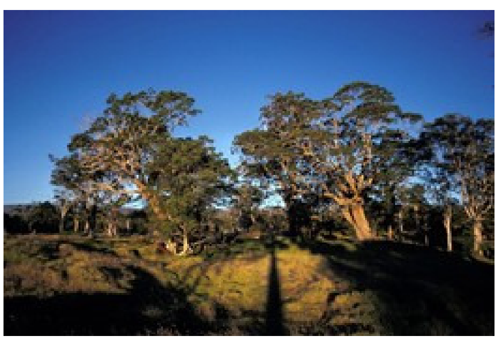
IRAs Get Sexier

Disillusioned With Returns on Conventional Investments, IRA Owners Are Turning to Private Equity, Condominiums, Farmland and Other Alternatives. Here's What You Need to Know

By LAURA SAUNDERS

Presidential candidate Mitt Romney has gotten lots of attention for holding as much as $100 million in his individual retirement account.

Less well known is that the account is also chockablock with complex private partnerships rather than the traditional stocks, bonds and mutual funds that make up most IRAs.



Alamy

Koa trees in Hawaii, used for furniture and musical instruments, are among the assets allowed in IRAs.

Following a decade of market turmoil, Mr. Romney isn't the only one wise to the fact that IRA rules allow enormous latitude in choosing investments.

"This topic used to be boring tax talk," says Kelly Rodriques, chief executive of Pensco Trust, a San Francisco firm that has helped venture capitalists and private-equity investors put private shares in IRAs. "Now it's lively cocktail-party talk."

For shrewd investors, alternative-asset IRAs can be a boon, allowing them to diversify their portfolios far beyond everyday holdings while deferring income taxes for years.

The ability to put unusual assets in an IRA doesn't mean it always is a good idea, of course. Few people have the expertise of Mitt Romney, and individual investors are notorious for letting hope trump skepticism and buying the wrong asset at the wrong time. What's more, fees to maintain alternative-asset IRA accounts can be high, and cases of fraud involving such IRAs, while rare, are on the rise, regulators say.

Although IRAs have been allowed to hold a variety of assets since Congress first authorized them in 1974, most investors opted for conventional stocks and bonds

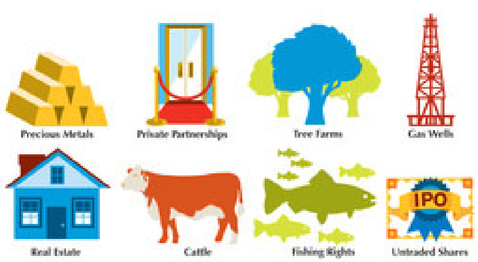
Laura Saunders on The News Hub shows how you can invest in relatively exotic assets, from cattle to condominiums, in your retirement account while shielding the proceeds from taxes - and how to avoid getting tripped up. Photo: AFP/Getty Images

during the bull markets of the 1980s and '90s. They still do: The Retirement Industry Trust Association, a group of alternative-asset IRA providers, estimates that such accounts make up just 2% to 5% of the $4.6 trillion held in IRAs overall.

Still, "virtually all of our members have experienced explosive growth in the last three years," says Mary Mohr, spokeswoman for RITA, which began tracking assets last year.

Millennium Trust, an alternative-asset IRA provider in Oak Brook, Ill., says assets have doubled since 2009, to $5 billion. Pensco says its assets have doubled to $4 billion since 2008. Equity Trust, based in Elyria, Ohio, declined to provide asset figures, but it says purchases of real estate in its IRAs have increased 90% since 2008.

The Internal Revenue Service has stringent rules affecting IRA management, but a few assets are off limits. They consist mainly of life insurance, subchapter S company stock and collectibles such as wine, antiques, art, stamps and some coins. (For a list, see IRS Publication 590.)



Heidi Schmidt

Mr. Romney's portfolio seems almost tame compared with the exotic assets currently held in IRAs by some investors, according to interviews with executives at five firms. Among them: hedge funds, untraded securities, foreign-exchange contracts, precious-metal bullion, tax liens, natural-gas wells, private mortgages and other secured debt, movie partnerships, cattle, fishing rights and even investments in bull semen.

Angela Thomson, a 54-year-old certified financial planner in Lincoln, R.I., recently used IRA assets to bid on a second foreclosed condo in her area. She used cash in her IRA to buy the first for $105,000, far below the previous sale price of $180,000.

During the housing boom, some advisers warned against buying property in IRAs, but now it can make sense. "I would never have done this a few years ago," Ms. Thomson says, "but prices are distressed."

Because she doesn't plan to take payouts for at least a decade, she is willing to put as much as 40% into real estate now, even though it is illiquid. She says she knows her local market well, her first condo rented right away, and the return has been about 8% a year after management fees.

The rent payments go straight to her IRA, untaxed, as will any profits if Ms. Thomson sells. The assets grow tax-free within the IRA until withdrawal. In Roth IRAs, which also are allowed to hold alternative assets, withdrawals can also be tax-free.

Gary Hutto, a 48-year-old financial planner in Tustin, Calif., has grander dreams for his alternative investment. He has put about 20% of his IRA assets into Koa trees in Hawaii. Koa is an exotic hardwood prized for use in furniture and musical instruments such as guitars.

Mr. Hutto says he learned about the investment from one of his clients. With no payout for eight years, it requires extreme patience, but he is hoping for a return of more than $250,000 on each $7,500 investment for a lot of 100 trees over the deals' 25-year life cycle—an average annual return of about 15%. "Koa wood only grows in Hawaii, and at certain elevation," he says.

Some investors have run into trouble with alternative-asset IRAs. Last year the SEC and some state securities regulators warned that they have become vehicles for Ponzi schemes and other frauds.

In one ongoing case, the SEC alleged in a civil suit in an Albuquerque, N.M., federal court that a firm called United American Ventures sold fraudulent convertible bonds to some IRA owners that purported to pay an annualized interest rate of 25%, plus a 10% upfront "interest bonus." The SEC also alleged that UAV claimed to be a venture-capital fund investing in pharmaceutical or medical technologies.

Eric Hollowell, the new president of United American Ventures, disputes the allegations. "Our doctors created real economic value," he says. "In support of us, our investors have petitioned for the disbarment of the SEC lawyers."

IRA custodians say they work with regulators to stymie fraud by, among other things, rejecting assets from unregistered brokers who approach them with money from clients.

The bottom line: Alternative-asset IRAs can work well, but investors who want to go this route have plenty of homework in store. Here is a to-do list.

Brace yourself for higher fees. IRAs invested in conventional assets often cost nothing to maintain beyond investment fees, but that is far from true for alternative-asset accounts. Fee schedules vary: Pensco has a base charge of $395 plus additional fees for certain assets. Mr. Rodriques says the firm's average account of $180,000 incurs average annual fees of $700. Providers often charge extra to exit an account.

Also be prepared to pay for specialized legal advice, which the IRA provider may require before accepting certain assets.

Research providers carefully. There are two general categories of providers. Some are state-regulated banks or trust companies, such as Pensco Trust, Millennium Trust and Equity Trust. "Third-party" administrators, such as Guidant Financial and Entrust Group, maintain records but place accounts at a different institution. Entrust, based in Oakland, Calif., says its lead custodians are Provident Trust in Las Vegas and Kingdom Trust in Murray, Ky.

Segregate alternative assets. IRS rules allow owners to split one IRA into two or more smaller accounts, each distinct from the others, with no tax consequences. Ami Givon, a lawyer at GCA Law Partners in San Francisco, suggests putting each class of alternative asset in its own IRA so that if a problem causes it to be taxable, the other accounts can remain intact.

Mandatory payouts on regular IRAs, which begin at age 70½, don't have to be taken proportionally from each account.

Bone up on tax rules. While a variety of assets are allowed in IRAs, there are strict rules on how investors manage those assets. Any "prohibited transaction" can cause the account to dissolve and become fully taxable, and the owner will often owe a 10% penalty if he or she is younger than 59½.

The IRS defines prohibited transactions as any improper use of your account by you or any disqualified person. Disqualified persons include the owner, his fiduciary, a member of his family, or any entity such as a corporation, partnership, trust or estate that is at least 50% controlled by the owner or a disqualified person.

What's improper behavior? It often boils down to "self-dealing." That includes, but isn't limited to, buying, selling or leasing an asset to or from your IRA; borrowing or lending money to or from your IRA; and personal use of IRA property.

Here are examples supplied by Mr. Givon: cutting a Christmas tree from a farm in your IRA for personal use; lending your IRA assets to your child to buy a house; selling your medical practice or other business to your IRA; or staying in a vacation timeshare owned by your IRA.

He adds that owners of rental property held in IRAs shouldn't perform maintenance like painting or make improvements like redoing a kitchen themselves. The value of the labor could be considered an excess contribution to the account, which incurs a penalty.

If an IRA owns a business or borrows money, things get more complex. Debt is allowed in an IRA so long as the loan isn't guaranteed by a disqualified person, but the IRA may then owe "unrelated business-income tax" on earnings. With certain assets, one end-run around this can be to put the debt in an offshore corporation that is then owned by the IRA.

Despite the prohibitions, some rules are flexible. Two IRA owners, such as a husband and wife, could buy an asset such as a rental property together, and split the ownership according to the amount each put up. Payouts from accounts can also be taken "in kind," meaning the account could distribute an acre of land or a cow rather than having to sell the asset and pay out cash. Applicable taxes would still be owed, however.

Expect more paperwork—and possible snafus. Don't underestimate the red tape required to place and maintain an alternative asset in an IRA. Simply to put one private placement in an account can mean sending the custodian 10 or more documents, including the articles of organization, investor agreements and a certificate from the secretary of state. The custodian keeps these on file.

All IRAs must be valued once a year for the IRS, and elaborate steps are sometimes necessary to avoid prohibited transactions. Ms. Thomson, for instance, mails every rent check she receives for her IRA's condo across the country to the custodian. Depositing it into her own account and transferring the money later might kill the IRA.

Alternative-asset IRA management is a service-intensive business, and rapid expansion in recent years has resulted in delays in processing customer requests. The firms say they are working to improve their systems.

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