Is a self-directed IRA right for you?

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Traditional and Roth IRAs can be powerful estate planning tools. With a "self-directed" IRA, you may be able to amp up the benefits of these tools by enabling them to hold nontraditional investments that offer potentially greater returns. However, self-directed IRAs present pitfalls that can lead to unfavorable tax consequences. Accordingly, you need to handle these vehicles with care.

Estate planning benefits

IRAs are designed primarily as retirement-saving tools, but if you don't need the funds for retirement, they can provide a tax-advantaged source of wealth for your family. For example, if you name your spouse as beneficiary, your spouse can roll the funds over into his or her own IRA after you die, enabling the funds to continue growing on a tax-deferred basis.

If you name someone other than your spouse as beneficiary, that person will have to begin taking distributions.

Advantages of self-directed IRAs

A self-directed IRA is simply an IRA that gives you complete control over investment decisions. Traditional IRAs typically offer a selection of stocks, bonds and mutual funds. Self-directed IRAs (available at certain financial institutions) offer greater diversification and potentially higher returns by permitting you to select virtually any type of investment.

Self-directed IRAs offer the same estate planning benefits as traditional IRAs, but they allow you to transfer many types of assets to your heirs in a tax-advantaged manner. Self-directed Roth IRAs are particularly powerful estate planning tools, because they offer tax-*free* investment growth.

Avoiding the pitfalls

To avoid pitfalls that can lead to unwanted tax consequences, caution is required when using self-directed IRAs. The most dangerous traps are the prohibited transaction rules. These rules are designed to limit dealings between an IRA and "disqualified persons," including account holders, certain members of account holders' families, and businesses controlled by account holders or their families.

Among other things, disqualified persons may not sell property or lend money to the IRA, buy property from the IRA, provide goods or services to the IRA, guarantee a loan to the IRA, pledge IRA assets as security for a loan, receive compensation from the IRA or personally use IRA assets.

The penalty for engaging in a prohibited transaction is severe: The IRA is disqualified and all of its assets are deemed to have been distributed on the first day of the year in which the transaction takes place, subject to income taxes and, potentially, penalties. This makes it virtually impossible to manage a business, real estate or other investments held in a self-directed IRA. So, unless you're prepared to accept a purely passive role with respect to the IRA's assets, this strategy isn't for you.

Proceed with caution

If you're considering a self-directed IRA, please contact us to determine whether this vehicle is right for you. Consider the types of assets in which you'd like to invest and carefully weigh the potential benefits against the risks.

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