



IRA UPDATE: NOVEMBER 2011

SEC issues warning on Self-Directed IRAs and the risk of fraud

In September 2011 the SEC (Securities and Exchange Commission) issued an Investor Alert regarding self-directed IRAs being targeted by promoters of fraudulent investments. When the SEC issues such an alert, it means it is widespread enough to make a public announcement.

According to the SEC, approximately 2% of all IRA funds are in “self-directed” IRAs which allow the IRA owner to make investments with their retirement funds in less traditional investments such as real estate, private placements, etc. The risks with self-directed IRAs are many and can include lack of disclosure, liquidity, Unrelated Business Taxable Income (UBTI), potential to violate prohibited transaction or disqualified person rules that could result in taxation and subsequent loss of the IRA, etc. We can also add fraud to this list of risks.

The SEC alert warns investors of a variety of ways in which schemes are promoted. For example, the promoter may misrepresent their responsibility by suggesting that the custodian has done some due diligence on the investment. In reality most self-directed IRA custodians do no such verification as one of the purposes of a self-directed IRA is for the IRA owner to do it on their own. The custodian is merely a record keeper in most instances.

There are some warning signs such as an investment that offers high returns while indicating little to no risk, private deals that are only available through a friend, the promoter requiring a confidentiality clause that prevents you from discussing the proposed investment with a trusted professional such as a CPA or CFP[®], etc.

To read the SEC alert, go to www.sec.gov/investor/alerts/sdira.pdf.

Before making a non-traditional IRA investment, consider the following:

1. Is the investment a listed prohibited investment in an IRA? For example, an IRA cannot hold life insurance.
2. Loss of tax benefits such as depreciation on real estate held in an IRA that would normally be deductible, taxation at ordinary rates when distributed instead of the lower capital gains rates, loss of the step-up in basis at death, etc.
3. Unrelated Business Income Tax may be assessed if the IRA makes investments in businesses that are not related to the general purpose of the IRA. Such rules put tax-exempt entities such as charities on a level playing field with other regular for-profit businesses.
4. Unrelated Debt-Financed Income (UDFI) tax can be assessed if the IRA earns income that resulted from debt financed property.
5. There are many Prohibited Transactions that can result in the whole IRA being taxable in one year plus penalties as well as loss of the future tax deferral of any funds remaining (or loss of tax free status if a Roth IRA).
6. Required Minimum Distributions (RMDs)- If the IRA has invested in a non-liquid asset such as real estate, when the time comes to take RMDs, there must be funds available in cash to make the distribution because you cannot sell a door or a room to take the RMD.

7. Valuation for purposes of RMDs could cause problems annually (this would not be applicable in a Roth IRA as there are no RMDs for owner Roth IRAs). In order to calculate an RMD, you need the value of the account on December 31st of the prior year.
8. Any expenses of the IRA must be paid by the IRA. If the IRA owner were to provide any services or pay any expenses of the IRA, this would result in a prohibited transaction and loss of the IRA.

IRS issues guidance on estate exemption portability

The estate tax law now allows for each individual and exemption amount of \$5,000,000 before estate tax is assessed. Further, this exemption is “portable” to a surviving spouse. In order to elect this exemption portability, the executor of the estate must file IRS Form 706 (Estate tax return) by the normal due date of 9 months after the date of death.

“Thus, by timely filing a properly-prepared and complete Form 706, an estate will be considered to have made the portability election without the need to make an affirmative statement, check a box, or otherwise affirmatively elect, on the Form 706.” -IRS Notice 2011-82

For estates that are not above the exemption amount or are not expected to be above the exemption amount, it makes sense to take the conservative approach and file the form on time to get the portability election even though it might not be expected to be necessary.

As always, feel free to contact me directly to ask any questions you may have on these topics.

Sincerely,

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