Self-Directed IRAs

Options & Info for Local Investors

Getting Started

Many local investors have said, "I love the **Invest Local** concept – but how do I get started?"

For many of us, the majority of our investment dollars are located in retirement accounts. Others don't necessarily have their investment dollars in retirement accounts yet, but are interested in starting to make retirement contributions. As a result, self-directed retirement accounts are one way increasing numbers of investors are using the funds that they've already designated for investing activities to further support their local economy, neighborhoods, or community initiatives.

What is a self-directed retirement account?

In general, a self-directed retirement account is one in which *you* are able to choose where your retirement funds are invested. The specific example we discuss most often is a *Self-Directed IRA*, or a Self-Directed Individual Retirement Account. While Traditional IRA's are the most common form of self-directed retirement accounts, others such as Roth IRAs, 401ks, SEPs and others may also be appropriate to your personal financial situation. Your financial advisor or tax accountant can help you identify which retirement plan best fits your needs and unique financial position – and then find a version that allows for self-directed investments.

For the purpose of Local Investing, *Self-Directed* is the key term when choosing an account. There are a range of accounts on the market that purport to be self-directed, so we've broken down the spectrum:

- Self-managed retirement accounts allow investors to pick between mutual funds or even individual stocks when choosing how funds are invested, but not to initiate individual loans or small business investments. While this may be beneficial for non-local investors who want greater control over their non-local investments, these accounts often aren't flexible enough for more local investors.

- True self-directed retirement accounts have a custodian agency that oversees account transactions – meaning the custodian wires the funds to businesses or individuals you wish to invest in, and they also receive loan or equity payments back. While the custodian arrangement helps ensure that funds won't be used for personal, non-investment purposes, the investor has full freedom to invest in anything not excluded by law or the IRS. The investors pick the loans, businesses, or other investment opportunities, and the custodian agency directs the funds. This is the route that the Invest Local initiative has seen several local investors choose for the most control, combined with the most protection, of their funds.[i]

When setting up your IRAs, make sure to check which level of flexibility is actually being offered!

Why open a self-directed retirement account?

There are many possible reasons to open a self-directed retirement account, including but not limited to wanting greater control over your investments, wanting to align your investments with your values, or for the tax benefits of saving for retirement.

Most self-directed IRA's begin in one of two ways:

- **"Rolling Over" Former Retirement Accounts:** Many individuals, upon leaving a job, have retirement accounts associated with that job that are no longer receiving new contributions, and which they aren't directly managing or monitoring. Rolling these accounts into a self-directed IRA is one way to gain additional control over where those funds go and how they are invested over time.

- **Starting a New Retirement Account:** Another common reason to open a self-directed IRA is to place additional dollars into retirement savings, often at tax advantaged rates. For example, an individual may contribute up to $4,500 per year if single (or $5,500 if married) to a self-directed IRA without paying any income taxes on the contribution. Once in the retirement fund, interest, dividends and capital gains that are earned from investments also accrue tax free until all funds are taxed and withdrawn after retirement.

  While this is one example of possible tax advantages of Traditional IRAs, different tax rules apply for Roth IRAs, self-directed 401ks and SEP accounts. Always consult your financial advisor for the tax advantages and disadvantages that best apply to you.

When opening a retirement account, it is important to remember that most accounts place strong limits on funds being withdrawn before retirement – only place funds there if your true intention is to save them until retirement.

What types of investments can I make?

Self-directed IRAs can be used for a wide variety of local investments. Loans (to both persons and businesses), equity investments, real estate investments, membership in a co-op and more are all common local investment options. When not placing funds in local investments, it is also possible to invest funds in money market accounts, bonds, mutual funds, or other more "traditional" investment options.

The most important limitation for IRAs is that investments **cannot constitute self-dealing.** This means that investments cannot be made in individuals or businesses that are substantively controlled by the investor, the investor's spouse, the descendants or ancestors of the investor (including children, grandchildren, parents, grandparents, etc) or the spouses of such descendants and ancestors. Not only should investment funds not flow to these individuals, neither should **indirect benefits**. For example, investing in a real estate property that you or your family

Types of IRA Investments

Residential real estate
Commercial real estate
Undeveloped or raw land
Real estate notes
Loans / Promissory notes
C-Corps
LLC and limited partnerships
Tax lien certificates
Equipment leasing
Livestock
Foreign currencies
Stocks, bonds & mutual funds
Structured settlements
Accounts receivable
and more

use as a home, office space, or vacationing destination would be considered an indirect benefit and would constitute prohibited self-dealing. To further explain this limitation, we've included some sample transactions that are prohibited with related individuals.

Transactions you *cannot* conduct with related individuals (including descendants, ancestors, spouses and self):

- Borrowing money from the account
- Selling property to the account
- Receiving unreasonable compensation for managing the account
- Using the account as security for a loan
- Buying property with the account for personal use

As a rule, IRAs are designed to facilitate investments in *non-personal or family ventures.* Any direct or indirect benefit the investor and her family receive from the investment should only occur *after* retirement.

Finally, always consult your tax advisor regarding how best to align your chosen investments with the tax structure of your retirement account. For example, IRAs can accrue tax-free returns inside the retirement account from loans, c-corp equity, and real estate. IRA investments that result from general partnerships or regular business income from an LLC, however, are often taxed in the year they occur. A qualified financial and/or tax advisor can help you navigate these intricacies.

Always remember…

- No self-dealing
- No family dealing
- No projects that provide "in-direct benefits" to you or your family
- Never do business in your own name – your IRA is the one conducting transactions!

How large or small can my IRA be? What are the fees?

Theoretically, IRAs can be any size. In practice, annual fees to custodians managing your IRA do mean that larger accounts pay a smaller percentage in annual fees than do very small accounts. In the example chart below, taken from Equity Trust's self-directed IRA program, an IRA of $5,000 would pay 3.9% in annual fees per year, while an IRA of $20,000 would pay only 1.4%. An IRA of $100,000 would pay but less than half a percentage point in custodian fees.

PORTFOLIO VALUE	ANNUAL FEE
$1-14,999	$195.00
$15,000-24,999	$275.00
$25,000-49,999	$315.00
$50,000-99,999	$375.00
$100,000-199,999	$460.00
$200,000-299,999	$630.00
$300,000-399,999	$675.00

Different custodians offer different fee programs, which range from basic annual fees to a fee-per-transaction approach. For investors new to IRAs, considering how you want to use your IRA, what level of fees you're willing or able to absorb or pass on to your investments, and how many transactions per year you intend to make, can all be informative for choosing an IRA size and custodian agency that works best for you.

Are self-directed IRA's for everyone?

Not necessarily! Self-directed retirement accounts provide lots of flexibility for choosing your investments, and that flexibility works best for investors who feel confident in managing their own investment decisions. Custodian agencies generally do not provide assistance in reviewing loans, in choosing equity investments, or in managing losses. The hallmark of local investing – knowing the people and places behind your investments – is a potential benefit for investors using self-directed retirement accounts, but these investments still require important due diligence by the investor.

Additionally, not all existing retirement plans are eligible to "roll into" a self-directed IRA. In particular, retirement plans with current employers, with defined benefits, or with particularly long work histories are often not good candidates for full transfers to an IRA. While individuals with these accounts might still be interested in setting up an IRA and beginning new contributions, not all retirement plans or retirement fund managers are capable of allowing self-direction of investments.

How do I learn more and get started?

A great place to start is always to talk with your tax accountant and/or financial advisor, as he or she can help you determine what retirement accounts may best fit your individual goals and circumstance. While self-directed IRAs have been available for many years and are not new investment vehicles, many larger retirement and mutual fund managers have never prioritized self-directed and customized investments in their offerings. Finding a custodian agency that meets your needs and is flexible enough for local investments in an important next step.

To help get you started, we've included two profiles of local investors who have used self-directed IRAs to make local investments. Check out their "Stories from the Field" to see how they got started, what custodians they used, and lessons they learned along the way.

Want More Info?

Invest Local is a project of the Staunton Creative Community Fund. We serve small businesses and entrepreneurs in the Shenandoah Valley, providing funding, consulting services, and mentoring opportunities. We'd love to hear from you.

[i] A note on "Checkbook IRAs": Checkbook IRAs are a relatively new form of self-directed retirement accounts, in which investors write their own checks out of their retirement account while also collecting the returns, without a custodian overseer. As the Internal Revenue Service has not yet provided clear guidance on whether these transactions meet the requirements of a maintaining tax-deferred status on retirement accounts, we have not seen any local investors choose this riskier option.

Please Note: This report is provided for informational purposes only and not for the purpose of providing legal or financial and investment advice. Choosing to solicit and/or accept investments in your business is a process governed by multiple state and federal laws and regulations. You should contact an attorney to obtain advice with respect to laws in your state relating to the extension of credit and securities regulation.