Thou Shalt Not:

5 Commandments For IRA's

By

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The 5 IRA Commandments

Q – I'm thinking about setting up a self directed IRA to invest in rental property. What's your advice?

A - In the movie, *History of the World – Part I*, Moses descends from Mount Sinai holding three stone tablets. Delivering the law to the Israelites, he says, "The Lord Jehovah has given unto you these fifteen..." [Moses then drops one of the stone tablets – which shatters – and he says] "*TEN Commandments*! For all to obey!"[i]

Of course this is my own personal theology, but as I ponder the 5 missing commandments, I think the God of Investing might say:

Thou shalt not place these assets in your IRA:

11. Rental Real Estate
12. Real Estate Investment Trusts (REIT)
13. Limited Partnerships
14. Gold
15. Variable Annuities

The following summarizes why I don't recommend these investments for my client's retirement accounts:

11. **Rental real estate.** One of the reasons for purchasing rental real estate is the tax benefits, which you lose when you place it in an IRA. You cannot take advantage of the annual depreciation deduction on your 1040 and when you sell the property you lose favorable capital gains treatment. Another big issue is that you cannot comingle funds. For example, if the roof needs to be replaced, you cannot use non-IRA money to pay for it. You could potentially incur a 50% penalty for making an excess contribution to your IRA. Another downside is that the custodian of the IRA is required to report the fair market value of the assets to the IRS annually. This may require an expensive appraisal. A final headache is finding a custodian who specializes in this type of asset. When you do find one, the fees are much higher than you would pay to a bank or brokerage firm – who generally offer their custodian services for no additional charge.

12. A **REIT** is a little better than owning individual real estate, but there may still be a custodian problem. I recently met with a gentleman who invested $20,000 of his IRA money in a private REIT. Imagine his shock when he discovered that the firm who was serving as custodian was charging $2,000 per year! This was in addition to the REIT management fees. Regrettably, he found out that he couldn't liquidate the investment. He is stuck until the managers decide to sell the property and distribute the cash back to the investors.

13. **Limited partnerships** (that aren't publically traded) have the same liquidity issue. You often can't liquidate them if you need the money and must wait for the general partner to close the business. The worst case that I saw was a woman who received several limited partnerships in her ex-husband's IRA as a divorce settlement. These partnerships were defunct, but the amount reported to the IRS (and the courts) was the initial investment of $500,000. Not only was she stuck with a worthless asset, but since she was over 70 ½ years old, she was compelled to take a distribution from the account per the IRS rules. She was forced to hire an attorney to intervene on her behalf with the IRS.

14. **Gold** - With gold, you not only have to pay custodian fees, but safekeeping fees as well. Additionally, you will also have to pay fees to buy and sell the gold within the IRA account – you can't just add in coins that you already own.

15. **Variable annuities** - When Suzy Orman was asked the question, "My financial advisor is recommending that I buy a variable annuity within my retirement account. What should I do?" Her reply was "Get yourself another financial advisor, pronto"[ii]. I agree with Suzy on this point. A variable annuity is an insurance contract that holds mutual funds. There are fees assessed by underlying mutual funds – as well as another layer of fees charged by the insurance company. The biggest advantage in owning a variable annuity is that you can defer the taxes on the gains in the account. However, assets held in an IRA are already tax deferred. You can own the same mutual funds in a regular brokerage account without paying additional fees to the insurance company.

Therefore, while these five investments might have their place in a financial portfolio, it is best not to hold them in an IRA.

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[i] Mel Brooks, *The History of the World – Part 1*, Twentieth Century Fox, 1981

[ii] Orman, Suze, *The Road to Wealth: A Comprehensive Guide to your Money – Everything you Need to Know in Good and Bad Times* (New York: Riverhead Books, 2008). 510