

Do's and Don'ts of IRA Investing

by Robert Carlson

Article Highlights

- There are three categories of investments that can cause problems for an IRA.
- Prohibited investments, including collectibles and life insurance.
- Taxable investments, including master limited partnerships (MLPs).
- Prohibited transactions, particularly transactions between the account and its owner.

Individual retirement arrangements (IRAs) are supposed to be simple and flexible investment vehicles, but their investment rules are more complicated and restrictive than many investors realize.

When you invest only in publicly traded stocks, bonds and mutual funds, there are no special issues. However, the tax law prohibits or penalizes some other investments by IRAs. Though part of the law for a long time, these pitfalls are becoming more important as the investment options available to mainstream investors increase and as investors are attracted more to “hard assets” and other non-traditional investments.

The restrictions on IRA investments are not well-known and, as a result, investors often stumble into penalties or other problems. The most common mistake is using a retirement account to hold an investment that falls under one of three categories: prohibited investments, taxable investments and transactions, and prohibited transactions.

Prohibited Investments

The prohibited investment rules apply to IRAs and also to other self-directed accounts, such as 401(k)s. The main category of prohibited investments is “collectibles” as defined in Section 408(m) of the Internal Revenue Code.

When an IRA acquires a collectible, the amount used for the acquisition is treated as a distribution to the IRA owner.



It does not matter whether the collectible is held or eventually sold.

For example, if \$10,000 of IRA funds is used to pay for a collectible in 2010, the transaction will be viewed by the IRS as a \$10,000 distribution. This means the owner of the IRA will be required to report the \$10,000 as gross income. In addition, if the account holder is younger than 59½ and does not qualify for any of the exceptions to the early distribution

penalty, a penalty tax of 10% of the value of the distribution will also be assessed.

The prohibited transaction penalty apparently can result in double taxation. The price paid for the collectible is included in gross income in the year the IRA acquired it. Eventually, either the collectible itself or the proceeds from selling the collectible will be distributed to the IRA's account owner or his beneficiaries. The amount of this distribution also will be included as part of gross income. There is no credit or deduction for the penalty tax paid on the purchase of the collectible, and there is no provision that allows the IRA's basis to be increased by the amount that was previously taxed because of the collectibles penalty.

Collectibles include any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage, or any other tangible personal property specified by the IRS. To date, the IRS has not issued any regulations expanding the list of collectibles.

There are exceptions to the definition. Certain bullion coins issued by the U.S. (generally the American Eagle gold, silver, and platinum coins) and any coins issued by any of

IRS Treatment of Collectibles in Taxable Accounts

Collectibles are allowed to be purchased in non-IRA accounts. Collectibles held for more than one year, however, do not receive the same maximum 15% long-term capital gains rate as other capital assets. Instead, collectibles have a maximum long-term capital gains rate of 28%.

Exchange-Traded Funds

Exchange-traded funds (ETFs) whose primary assets are bullion and are purchased by taxable accounts also receive special treatment, but the tax implications are different than they are for IRAs. An IRA owning a bullion ETF, such as SPDR Gold Shares (GLD), is treated as owning a share of stock. In a taxable account, however, when a share of a bullion ETF is sold, it is treated as selling a share of the bullion owned by the ETF. Any long-term capital gain on the sale is taxed at the maximum 28% rate instead of the 15% rate on securities.

In addition, bullion ETFs may periodically sell some bullion to pay expenses. These sales are passed through to the shareholder; if the bullion sold by ETF was held for more than one year, the transaction is taxed at a maximum rate of 28%.

The IRS reached these conclusions in an internal opinion, and the bullion ETFs state in their prospectuses that this is the correct tax treatment.

Exchange-Traded Notes

Exchange-traded notes (ETNs), which hold contracts rather than physical assets (e.g., gold bullion), also have different tax treatment in taxable accounts than IRAs. The tax treatment of ETNs can be complicated

and for some ETNs, uncertain.

The tax consequences vary depending on the structure of the note, promises made by the issuer, and investment actions taken by the issuer. For many ETNs, the tax treatment in taxable accounts is uncertain because neither the IRS nor Congress has established firm rules.

However, the IRS has indicated that for many ETNs the appreciation of the index each year is treated as interest due to the owner. The ETNs do not make distributions until maturity, but the IRS believes ETN owners must accrue the interest each year and report it in their gross income, similar to the way zero-coupon bonds are taxed. Investors who own ETNs in taxable accounts will owe taxes on interest income they do not receive. The treatment also converts what the investor considers capital gains into interest income.

When an ETN is sold from a taxable account, the sale results in a capital gain or loss. The gain or loss is the amount realized minus the tax basis in the ETN shares. The tax basis is the original cost of acquiring the ETN plus any accrued income that was included in gross income but not distributed. This prevents double taxation, but places a recordkeeping burden on the ETN owner to avoid paying taxes twice on the same income.

This is only one treatment for some ETNs. In general, the tax law has not caught up with the financial innovations of ETNs. Because of the uncertainty of the tax treatment of ETNs, read the tax treatment section of the prospectus carefully. In many cases, the prospectus states that the tax rules are uncertain and it describes several possible tax outcomes. Until the IRS or Congress establishes rules, investors are on their own when reporting income and gains from ETNs.

the states are not collectibles. Also gold, silver, platinum, or palladium bullion is not a collectible when the metal equals or exceeds the minimum fineness required under a regulated futures contract and is in the physical possession of a qualified trustee.

Only the physical collectibles are prohibited investments. Securities of firms that produce or deal in collectibles may be purchased with IRA funds. Among the many possible collectible-related investments that can be added to an IRA are securities of precious metals mining companies, art dealers, and producers and distributors of al-

coholic beverages.

ETFs With Prohibited Investments

An outright purchase of bullion that fails to meet the minimum fineness requirements is prohibited with IRA funds, but exchange-traded funds (ETFs) that hold gold or silver bullion are treated differently. These ETFs purchase physical bullion and have it stored under their names. The IRS has not issued public regulations or rulings on the issue, but the agency has made taxpayers aware of its views through private letter rulings sought by issuers of bullion ETFs. The ETFs publish

the substance of these rulings in their prospectuses.

Under the private letter rulings, when shares in a bullion ETF that is organized as a trust, such as SPDR Gold Shares (GLD), are added to an IRA, the transaction is not considered to be a purchase of bullion or a share of bullion. Rather, the transaction is considered to simply be the purchase of securities—just as though shares in any other ETF, mutual fund, or company were added to the retirement account. The IRS has reasoned that shareholders are not able to force the ETF to distribute bullion or take other actions,

so the IRA is not the owner of the bullion. Therefore, shares of the bullion ETF are not a collectible subject to the prohibited investment rule.

There is an exception: Should the ETF distribute its bullion in-kind to shareholders, an IRA owning the ETF shares would be treated as acquiring a collectible when the distribution is made.

An IRS private letter ruling technically applies only to the taxpayer to whom it was issued and may not be cited by others. But letter rulings do reveal the thinking of the IRS and generally are followed by its auditors. Tax advisors generally agree that you can rely on the conclusions made in these private letter rulings.

The private letter rulings apply to ETFs that are organized as trusts and buy physical precious metals, such as iShares COMEX Gold Trust (IAU), iShares Silver Trust (SLV), and SPDR Gold Shares. Currently, all precious metals-owning ETFs are organized as trusts.

The prohibited investment rules also do not apply to ETFs that use futures or derivative contracts to track the performance of metals or metal-based indexes, such as PowerShares DB Gold (DGL), PowerShares DB Silver (DBS), and PowerShares DB Precious Metals (DBP). Mutual funds and ETFs that buy the securities of companies in the bullion business, such as gold mining companies, also avoid the prohibited investment rules.

ETNs in IRAs

An exchange-traded note (ETN) is a promise to pay the investor an amount equal to the return of a specific index or other price benchmark, minus the ETN's fees and expenses. For example, the iPath Dow Jones-UBS Precious Metals Subindex Total Return ETN (JJP) is intended to reflect the unleveraged returns from futures contracts comprising the index in the name of the ETN.

This is another example of a collectible-based investment that does not involve ownership of the physical collectible. The ETN is not even a fund that holds investments, but rather a

debt of the issuer. Since ETNs do not hold physical assets, the IRS does not consider them to be a direct investment in collectibles when purchased with IRA funds.

Life Insurance Prohibition

Another category of prohibited investments for IRAs is life insurance. IRA funds cannot be used to purchase a life insurance policy. However, an investor can set up an IRA through a life insurance company and hold an annuity that has incidental life insurance benefits.

The difference may sound subtle, but the IRS has clear rules on the matter. The annuity must be issued in the name of the IRA owner and the benefits can only be paid to the owner or the surviving beneficiaries. Furthermore, the entire interest in the contract must be nonforfeitable, the contract can only be transferred back to the issuer, premiums must be flexible to adjust to changing compensation and contributions cannot exceed the annual maximum for IRA contributions.

Taxable Investments

IRAs and other qualified retirement plans generally are tax-deferred vehicles. Their capital gains and income are not taxed to the plans or their owners as long as the profits remain in the accounts. Owners pay ordinary income taxes on the investment returns when they are distributed.

However, a retirement plan might pay income taxes on income that is considered unrelated business income. The unrelated business taxable income (UBTI) rules were added to the tax code to prevent tax-exempt entities from unfairly competing against tax-paying businesses. Though originally focused on charitable organizations that own businesses, the UBTI rules also apply to IRAs and other qualified retirement plans.

If an IRA earns UBTI exceeding \$1,000 per year, it must pay income taxes on that income. The IRA has to file Form 990-T when gross unrelated

business income is more than \$1,000. It also must pay estimated income taxes during the year if the adjusted UBTI exceeds \$500.

Though Roth IRAs and distributions from them generally are tax free, all tax rules apply to Roths unless they are exempted specifically. Roth IRAs are not exempt from the UBTI rules, so a Roth IRA can be taxed when it earns UBTI.

The IRA owner essentially will be taxed twice on UBTI. The IRA is a separate taxpayer and will be taxed on the income as it is earned. Subsequently, the owner or beneficiary will be taxed on distributions of that income. The IRA owner receives no deduction or credit for UBTI paid by the IRA, and the tax paid by the IRA does not increase the tax basis of the IRA. For example, an IRA could receive a large amount of distributions from a master limited partnership and pay taxes on part of them. Eventually this money will be distributed to the account owner. The account owner will include the full amount in gross income and pay income taxes on it at his rate.

In most cases, the UBTI is targeted at tax-exempt entities that control businesses, but the rules can apply even when the IRA owner is not in control of a business or active in business decisions.

Master Limited Partnerships

Investors are most likely to be trapped by UBTI when an interest in a pass-through business entity (partnership, S corporation, or limited liability company) is held in an IRA. The IRA's share of a pass-through entity's income is considered UBTI regardless of the account holder's ownership percentage of the entity. Pass-through entities generally do not pay federal income taxes. Instead, their income and expenses are passed through to their owners' income tax returns.

This rule most often trips up individuals who invest their IRAs in master limited partnerships (MLPs)—such as pipeline partnerships—or real estate partnerships. Master limited partnerships are traded on major stock ex-

Table 1. Potentially Problematic Investments for IRAs

The following types of investments and transactions could incur additional taxes or violate regulations regarding retirement accounts.

Collectibles	The amount used to acquire the collectible is treated as a taxable distribution from the IRA.
Precious Metals	Gold, silver and platinum must meet certain fineness requirements. In addition, restrictions exist as to what types of gold coins can be held by an IRA.
Exchange-Traded Funds	In the event that an ETF distributes its bullion in-kind to shareholders, the IRA would be treated as acquiring a collectible.
Life Insurance	IRA funds cannot be used to purchase a life insurance policy.
Master Limited Partnerships	Distributions to a retirement account exceeding \$1,000 per year are taxable.
Related-Party Transactions	Funds from an IRA cannot be used for transactions involving the account owner or a related party.

changes, and many people think of them as being the same as corporate stock. In fact, these are limited partnership units, and the income and expenses of the partnerships pass through to the owners at tax time. When distributions from master limited partnerships to an IRA exceed \$1,000, taxes are due on that income.

Individuals generally are urged not to purchase master limited partnerships through IRAs. Unlike collectibles, investments in MLPs and other pass-through entities can be held in an IRA. However, the ownership triggers the UBTI tax and the requirement to possibly file a version of Form 990 and pay estimated taxes.

When an IRA does own master limited partnerships and earns income of more than \$1,000 for the year, some tax advisors recommend taking the easier and cheaper route of reporting any IRA-owned pass-through income on the IRA owner's individual tax return instead of preparing a separate return for the IRA.

[See the Investment Offerings column in this issue on page 6 for more on master limited partnerships.]

Using Debt to Finance Investments

An IRA also has UBTI when debt is used to finance its investments. Any type of income can become UBTI when debt is used to finance the property that generates the income. For example, if

an IRA receives a margin loan from its custodian or broker, income generated by the securities purchased with the loan proceeds would be UBTI. Real estate mortgages also are debts that convert exempt income into UBTI. The tax law allows an IRA to own real estate and earn rental income, and that rental income will be tax deferred. However, if the real estate is financed with a mortgage, the rental income becomes UBTI and is taxed as earned.

The UBTI rules are broad and extensive. It is not possible to fully explain them here. This article highlights the investments that are most likely to trigger UBTI for IRAs. IRA owners should be aware that any ownership of an operating business (other than through a regular C corporation) or use of debt to finance investments can produce UBTI.

Prohibited Transactions

The prohibited transactions rules generally outlaw transactions between the IRA and its owner or any person closely related to the owner (including businesses). The rules apply to all qualified retirement plans as well as tax-exempt organizations.

As the name implies, the prohibited transactions rules target deals or transactions involving the IRA, not necessarily investments. The basic rule is this: No deals are allowed involving the IRA and

the owner or a person related to the IRA or its owner. An investor cannot borrow money from his IRA, nor can the account loan money to the account owner's business or one of his close relatives. The IRA cannot buy property from or sell property to the account owner, his business, or a close relative. It does not matter if the transaction is done at arm's length or at fair market value; the transactions are prohibited under any terms.

The prohibited transactions rules are a vast and complicated body of law. Thus, investors wanting to engage in a transaction that might be prohibited should consult a tax advisor who knows the specific rules.

The penalty for engaging in a prohibited transaction is severe. The entire IRA will be considered fully distributed when the prohibited transaction was made, even the portion of the IRA not involved in the prohibited transaction. The IRA owner must include the account's full value in gross income, regardless of the amount of the prohibited transaction. If the owner has multiple IRAs, only the IRA that engaged in the prohibited transaction is penalized.

Exceptions

Despite the broad and seemingly final list of prohibited transactions, exceptions are allowed under some circumstances under the regulations and rulings. In addition, an IRA owner can

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Returns are also influenced by expense ratios and loads. All things being equal, lower expenses are preferable. However, a higher expense or load may be justified. Some asset categories (e.g., emerging market stocks and bonds) incur greater costs than others (e.g., short-term U.S. government bonds). Expense ratios that are above the category average may be justified if performance is high enough to offset the costs. Finally, keep in mind that the performance ratios factor in expense ratios, but not load fees.

Total assets and the number of holdings provide insight as to how big the fund is. There is no magic number for either, but a fund that is too big or too small could incur problems. A fund that is too large may be forced to acquire larger positions or invest in lower-quality securities than the manager prefers. A fund that is too small could potentially be invested in too few securities, increasing risk. There is also a higher potential of the fund being folded into a larger fund. Smaller funds may also have higher expense ratios due to higher relative overhead costs.

Further Evaluation

Before investing in any fund, read the prospectus. Have a clear understanding of the fund's objective, strategy, risks

How to Judge the Numbers

Top-performing lists can be dangerous to your financial health unless you take the time to carefully analyze the numbers.

When perusing any top-performers list, make sure you understand *how* a fund managed to thrive over the long term. If it did so by taking a riskier approach, then the possibility of greater returns comes with the possibility of greater return variability.

Less Risk

- Low Expense Ratios
- High Tax Efficiency
- Consistently Good Performance Year-to-Year Relative to Similar Funds
- Low Category Risk
- Well Diversified

More Risk

- Big Variations in Year-to-Year Returns
- Bull Market Star, Bear Market Dog
- High Category Risk
- Small Number of Holdings, Industry Concentrations

and cost structure.

Next, obtain the latest fund report and review the holdings. What does the fund hold? How much of the portfolio is concentrated in each of the key holdings? If the fund manager provides commentary, read it to get additional insight into the thought process.

Finally, remember that just because mutual funds are intended to be long-term holdings, you should never buy them and forget about them. Like any investment, mutual funds should be periodically monitored to make sure

the objective has not changed and the fund is performing as expected given prevailing market conditions and historical performance. Do not only pay attention to current performance, but also current performance relative to historical performance and the fund's category average. A fund that lags in market conditions that it historically has done well in should receive more scrutiny than a fund that is following its historical volatility trends and is producing similar returns to those of its peers. ▲

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Portfolio Strategies

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apply for a waiver from the Department of Labor for specific transactions. Many waivers have been issued over the years for various reasons and can be reviewed on the Department of Labor's Web site (www.dol.gov).

For example, it is possible for you to

sell real estate to your IRA under either a waiver from the Labor Department or an exception in the regulations. But the penalty for violating the transaction prohibition is severe, so you need to be sure the transaction is allowed. Before engaging in a transaction with your IRA,

consult with an experienced tax advisor who is familiar with the prohibited transactions rules. Determine if the transaction is clearly allowed under the regulations or if you need to apply for and receive a waiver before undertaking the transaction. ▲

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