What is a Self Directed IRA?

Self directed IRAs have been getting a lot of press recently, but not all the information presented has been clear or accurate. Let's take a step back, define the terms, and find out what's really under discussion.

Before we jump into the mechanics of a self directed IRA, let's start at the beginning and get our bearings with a standard IRA. In 1974 Congress passed an important act known as ERISA. One of the features of this act was a tax incentive for working Americans to save for retirement. A worker could designate a part of his/her salary as retirement funds, and then not have to pay taxes on those funds until a much later date. This tax deferral saved money on the immediate tax bill, and provided possible future tax savings when the worker might be in a lower tax bracket. As a whole, this program became known as an Individual Retirement Account, or IRA.

One of the specific provisions in this legislation was that the IRA be held by a custodian. This was done primarily to provide some kind of oversight and tax accountability. The institutions that in turn found themselves acting as custodians were for the most part banks and brokerage houses. They did a fine job holding the IRAs, but they didn't do such a good job in providing investment options. The large majority of investors found that they were limited to stocks or a few mutual funds. The reason for this limitation is that these were the products that earned the banks and brokerage houses significant profits. With that fact in mind, it's easy to understand why for a very long time there was little to no self direction in retirement investing.

As investors grew tired of being unable to diversify their retirement portfolios, a small number of self directed custodians sprung into existence. These custodians provided IRA platforms that allowed workers to dedicate retirement funds which could then be placed into almost any asset. No longer limited to the stock market, investors turned to real estate, franchises, and other wealth building investments to solidify their retirement accounts. From an asset perspective things were great, but from a procedural perspective a lot of work still remained to be done.

The custodian model as an investment platform did nothing to encourage active investing. In fact, in many ways it discouraged activity. Every investment and transaction required time consuming paperwork, and was accompanied by prohibitive fees. Investors who wanted to take charge of their retirement funds found themselves frustrated by the endless and costly delays. It wasn't until relatively recently that an efficient and economical self directed platform was established.

The perfected model of the self-directed IRA came to be popularly known as the Checkbook IRA. Although a custodian still officially holds the IRA, the investor has unlimited access to the IRA funds and may use them in real time without any fees. The way the Checkbook IRA works is via a dedicated LLC. A new LLC is set up with the investor being appointed as the non-compensated manager. This LLC in turn receives its funding from the investor's IRA. The investor may then go and open up a checking account in the name of the LLC. At this point, the investor can utilize the IRA funds (as they are found in the LLC) simply by writing a check. There are no delays and obviously no transaction fees. The path is now clear for solid and profitable retirement investing.