

IRA & 401(k) Insights

About: *IRA & 401(k) Insights*

IRA & 401(k) Insights is a monthly publication. This publication is for anyone interested in self-directing their retirement funds and investing in nontraditional assets. Entrust does not give investment advice. Entrust purposely does not sell securities or other investment products.

Deadline for article consideration is the 15th of each month. To subscribe to *IRA & 401(k) Insights*, call: 888-340-8977 or email:

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Message From the Editor



A message from the Editor

Seasons Greetings!

Welcome to the December 2005 issue of *IRA/401(k) Insights*!

Catherine Wynne of Entrust New Direction looks at prohibited transactions. This is a very important subject that all of us who invest with our IRA or 401(k) Plan need to consider. Dave Owens and Craig Haines of 1031 tax-free strategies demonstrates how to use an Educational Savings Account to purchase real estate and how that can help with your child's future education costs. Carl

Fisher of Entrust CAMA explains why Health Savings Accounts are an excellent choice for self-direction, and Jaime Raskulinecz of Entrust Northeast discusses the difference between rolling over or transferring your IRA. Another action packed issue!

I want to wish all of our clients and loyal subscribers Happy Holidays. We have seen tremendous growth and interest from you in our publication and look forward to assisting clients towards continued success. Thank you for your loyalty and your business.

Enjoy our December issue!

Lisa Moren, Editor

Prohibited Transactions—*How Close is Too Close?*

By: Catherine Wynne

The ability to successfully structure self-directed IRA and qualified plans into non-traditional and potentially lucrative investments always depends on understanding the Prohibited Transaction rules set forth in IRS Code Section 4975. In some cases these rules appear intentionally broad and cryptic. Frequently, we look to tax court decisions, private letter rulings, and the pondering of experts to guide us in the quest to find the best investment offering the most control over the outcome while still steering clear of Prohibited Transaction pitfalls.

The recent court case Joseph R. Rollins vs. The Tax Commissioner - 11/15/2004 offers self-directed investors some clarification with regards to the Prohibited Transactions

and further clarification of the definition of "disqualified persons" with regards to one's retirement plan investments. Briefly stated, the Rollins decision was based on the following set of circumstances:

Rollins was the administrator for his own 401(k) plan. He also owned less than a controlling interest in three legal entities. Each of these entities borrowed money and executed a promissory note with Rollin's retirement plan at terms that would be considered fair market. Mr. Rollins acted as treasurer for these entities and was the signer on the promissory notes on behalf of the entities as well as directing the plan to fund the loans.

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Definition of “Disqualified Persons”

A “disqualified person,” in most cases, includes the IRA holder, lineal ascendants and descendants of the IRA holder, as well as any entity where the aggregate ownership share of disqualified persons constitutes a controlling interest. For example, if the son and daughter of an IRA holder owned 50% of CrazyPants LLC, the IRA could not do business with CrazyPants LLC, regardless of the fairness of the terms of the transaction. Using these rules, it seemed permissible for Mr. Rollins’ plan to loan money to entities that were not “disqualified” as he did not own 50% of any of them.

Disqualified persons: while the definition covers employers, employee organizations such as collective bargaining units and other employer and family relationships, it is our experience that it is the IRA holder and

his family members who are most often involved when deals are put together. The IRS has provided definitions of when transactions with these individuals will run afoul of the prohibited transaction rules. As a result, transactions are often designed with those definitions in mind in order to avoid a prohibited transaction issue. Mr. Rollins did exactly that in designing the plan loans. He acknowledged that he personally was disqualified but the transactions were with entities that were not. Yet the court determined that the loans gave him an indirect personal benefit and thus were prohibited transactions.

Disqualified Persons and The Rollins Decision

The Rollins Decisions caught some of us off guard because of the “controlling interest” definition we have carried around for so long. The resulting refinement of this definition has taught investors to look further into the structure of a transaction and examine: 1) Who is negotiating for each entity? 2) Who is responsible for carrying out the terms of the agreement/note? 3) Under what circumstances could the “use of” or “investment of” plan assets indirectly (or directly) benefit the interest of a disqualified person?

Judicial Observations:

Rollins, “the petitioner,” owned from 9% to 33% interest in the three entities involved. Although he did not hold a controlling interest of “50% or greater,” the judge made the following observations after ruling against the petitioner:

- The petitioner was the single largest shareholder by a significant margin in all three entities. The com-

parison between his share and the shares of other shareholders was a focus of this decision.

- The petitioner held the positions of president, secretary, and treasurer, as well as being the registered agent of all of the entities.
- The treasurer, Rollins, was the signer on all the notes securing the indebtedness.
- The notes were at higher than market value and there was no default. Mr. Rollins’ Plan benefited from the security and the income of the investment.

- The court noted that *Mr. Rollins had the burden* of proving that he did not use the plan assets for his own benefit. The court determined that Mr. Rollins failed to carry this burden, noting

specifically the sparse evidence presented.

“Was it a good or bad investment?”

Good Deal versus Bad Deal for the IRA/Qualified Plan

It is clear from this case that the substance of the transaction, “Was it a good or bad investment?” had no bearing on the ruling against Rollins. Simplistically defining “controlling interest” as a percentage owned by a disqualified person was not looking deep enough into the issue of whether or not there is self-dealing in the transaction. Disqualified persons involved in a transaction who are deemed to be receiving an indirect personal benefit, or “self-dealing,” results in the transaction being a prohibited transaction.

Self-directed plan investors planning investments where disqualified persons or entities are involved, even in a less than controlling status, should realize that the IRS Tax commissioner can, and obviously will, look deeper than the broad percentage guidelines. He will look for, among other things, convincing evidence that there is NO personal benefit derived from the transaction, directly or indirectly, by those disqualified. Furthermore, investors must recognize that decisions with regard to prohibited transactions will not be decided solely on the merits of the investment itself. Prohibited transactions are just that - prohibited. As stated by the judge and worth noting by all of us when structuring investments for our IRAs or Qualified Plans: *“Good intentions and a pure heart are no defense”*.

Catherine Wynne is the Vice President of Entrust New Direction IRA, Inc., the Colorado-based affiliate of the Entrust Group. Based in Boulder Colorado, she teaches continuing education classes to brokers, CPAs and tax attorneys.

Don't Underestimate the Flexibility of Educational Savings Accounts

By: Dave Owens and Craig Haines

My 31-year-old brother and his wife recently gave birth to their first child and began investigating different educational savings plans. They started looking at the traditional and widespread ways of investing such as CDs, mutual funds, stocks and bonds. However, when my brother analyzed the historical increases in college tuition and compared them to the historical growth of traditional investments, he was quite disappointed.

When the education savings topic arose this past 4th of July at my parents' house in Ohio, I first suggested they open up a Coverdell Educational Savings Account (ESA). I explained a Coverdell ESA can receive tax free distributions to pay qualified education expenses.

There is no limit to the number of Coverdell ESAs that can be established for one beneficiary and each ESA may qualify to contribute up to \$2,000 a year. My parents were excited about the idea and said they would each initially contribute to their granddaughter's savings the first year. I further suggested my brother invest in Florida real estate, for I recently moved to Florida and have witnessed the soaring increase in real estate prices. My brother laughed and didn't understand how a new ESA could afford real estate. I agreed—in Ft. Myers where I live, prices are out of reach for new ESAs, but not Charlotte County. Just north of Ft. Myers, you can still find affordable lots around \$15,000 on the Real-

tor® Multiple Listings. My brother rolled his eyes and went outside to light the grill—end of conversation.

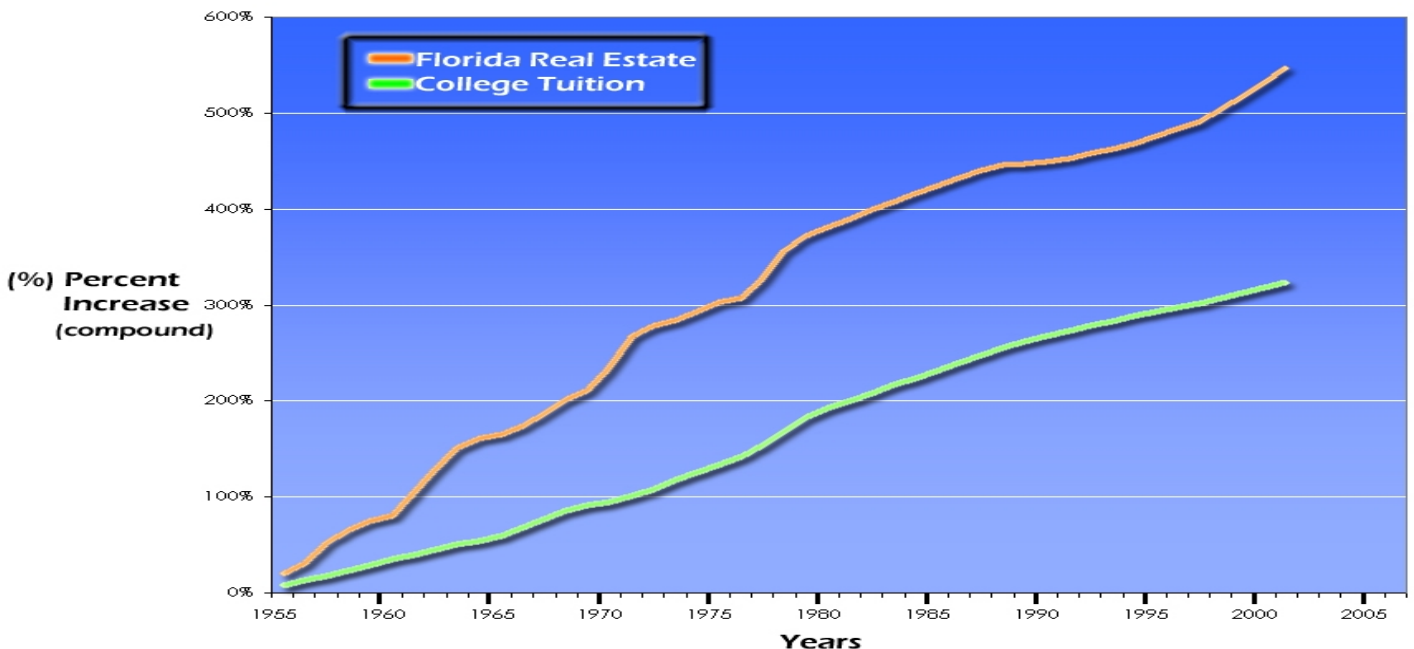
When I went back to Florida I re-ignited our childhood sibling rivalry for I was motivated to prove my brother wrong. The next weekend I printed off the listings for vacant lots for sale and drove 30 minutes north on I-75 and investigated the area's vacant lots. Although there

were only a couple of homes around these sub-divisions, I kept in mind what the area may look like in 18 years. Since I knew what realtors were asking for the lots, I only called "For Sale by Owner" signs. After an hour of burning up fuel, I finally spoke to a seller who needed to pay for

improvements on their home and negotiated a sale price of \$10,000—send the contract! I immediately called my brother and told him the deal I found.

Now that I had his attention, we came up with a plan to find the funds. The grandparents contributed \$2,000 towards the ESA. (Any individual, including the beneficiary can contribute to a Coverdell ESA) The other \$8,000 came from myself, my brother and other siblings. The ESA bought 20% of the asset as tenants in common with the other 80% prorated from the individual investors. The neat thing about self-direction is that you can partner up with almost anyone as long as purchase the

Coverdell ESA can receive tax free distributions to pay qualified education expenses



property has tenants in common. By combining the ESAs with the other investors we were able to purchase the property. The strategy is to carry the children's ESA along with the main investors every time we do a deal. Today, the same Realtor® Multiple Listings in that area have nothing listed under \$20,000, not bad in 4 months.

Vacant Florida land is the best investment for a couple wanting to plan for their child's education. They'll have peace of mind knowing their investment is stable, tangible and unaffected by an Enron or Worldcom type scandal. There are no maintenance headaches and a category 5 hurricane won't affect your vacant property. Florida's real estate values are booming right now, but we are experiencing a cycle—a cycle mainly caused by baby boomers flooding the state. This trend does not plan on abating anytime soon. According to the Census

Bureau, Florida adds about 750 people—net—every day of the year. Even before this cycle, historical data shows Florida real estate values as a whole have never depreciated once in the last 100 years. And when compared to annual college tuition increases from 1958, Florida's real estate has outperformed the increase of earning a diploma. Don't delay anymore, take a Florida vacation, relax in the sun, but spend a few days looking at vacant properties for your child's education. You will be glad you did.

Dave Owens is the Managing Member and Craig Haines is an 1031 Specialist at 1031 Tax Free Strategies, LLC a company that specializes in 1031 Exchanges and Self Directed Retirement Accounts.

www.taxfreestrategies.com

Health Savings Accounts—What's Not to Like?

By: Carl Fischer

Control—You can use the HSA to pay for any qualified medical expense as defined by the IRS. There's no need for preauthorization of services unless explicitly stated by the plan.

No "use-it-or-lose-it"—Unlike Flexible Spending Plans, unused HSA dollars remain in the HSA and continue to earn interest.

Flexibility—"Health Care" dollars can pay not only for items identified by the health insurance plan, but also for a much broader variety of healthcare needs which includes dental, vision, orthodontia, over the counter medicine and more.

Portability—If you leave your current employer or change insurance provider, your Health Savings Account stays with you.

Tax savings—Your contributions to HSA are made with pre-tax dollars, and earnings on the account are tax-free.

Alexander Pope, a 16th century poet, wrote an essay that gave us the famous quote "A little learning is a dangerous thing". These timeless words of advice seem appropriate when contemplating Health Savings Accounts. The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 authorized the establishment of new Health Savings Accounts effective January 1, 2004. These accounts are similar to Archer Medical Savings Accounts in that they permit eligible individuals to save for and pay health care expenses on a tax-free basis.

Health Savings Accounts were introduced at the end of 2003, hoping that these glorified IRA accounts would do

two things: Help people be more conscientious of their medical expenses and allow them to build wealth for health care in their old age thus relieving pressure on the Medicare/Medicaid systems.

To qualify for an HSA, you must meet the following requirements.

- You have a high deductible health plan (HDHP), minimum individual deductible is \$1,000; family is \$2,000.
- You have no other health coverage except what is permitted under *Other health coverage*
- You are not enrolled in Medicare.

Assuming your high-deductible plan meets the requirements, you then can participate in an HSA and start contributing.

For 2005, the maximum contribution for a single person is the amount of your deductible or \$2,650, depending on which is the lesser of the two. For families, it's \$5,250. If you're 55 and older, you may contribute an extra \$600 as a catch-up contribution. After 65 years of age you may no longer contribute to an HSA and there is no penalty for withdrawal of the money.

The primary document for information of the HSA is Publication 969. This is 17 pages and like most IRS publications is a good solution to insomnia. However many experts have written articles discussing the pros and cons of Health Savings Plans

Thomas Fogarty in an article for USA TODAY that headlined "Health Services Can be a Tax Shelter" states, "but

there is a catch, the new accounts are linked to high-deductible health insurance plans.” The article also quotes Greg Scandlen, a health care expert, “that the HSAs have the potential to become the dominant health care financing in the next five to ten years”. But they aren’t for everyone, says Scandlen. Families with young children probably will benefit more from traditional managed care options, such as preferred provider organizations. Additionally, he says HSAs demand more planning than many people are willing to give.

Why aren’t more people using HSAs?

Prior to January 1, 2005, Aetna (AET :NYSE-commentary-research) had a mere 10 companies with 51 or more employees signed up, according to Robin Downey, head of product development at Aetna.

Part of the reason was timing. “These accounts were authorized in December – too late for many companies to get their benefit packages together. Most do that in the fall or late summer,” says Mark Luscombe, principal federal tax analyst with CCH Inc., a provider of tax and business law information.

The other culprit was the unfinished rulebook. “The Treasury didn’t finish guidance in time”, notes Downey. In other words, no one fully understood the rules. Even with the rules ironed out, the numbers still aren’t stag-

gering. Aetna has 70 companies with 51 or more employees signed on and Cigna (CI :NYSE commentary-research) has around 30, according to Jake Biscoglia, an assistant vice president at Cigna.

Aetna and Cigna recognize there is definitely more chatter among their clients about offering these products. In the future, as companies become more knowledgeable, you may see HSAs the next time your benefits department has open enrollment.

Many self-employed individuals are beginning to take advantage of this tool. We can spend weeks analyzing what kind of

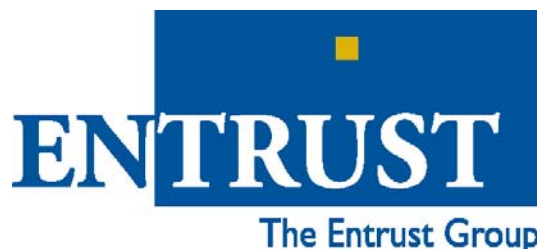
car to buy, yet we decide on health care the night before all the forms are due after an all-too-brief company enrollment period.

What’s not to like about HSAs? Contributions are deductible, the account accumulates tax-free, and withdrawals used for medical expenses are tax-free. You’re in control with flexibility and portability. Remember—do your research and consult with the professionals to determine if HSAs should be another wealth building tool to be used in your financial plan.

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Should You do a Rollover or Transfer?

By Jaime Raskulinecz

We get this question many times when speaking with new clients about setting up their accounts. There is no generic answer to this question but there are some things to consider.

When moving funds from a previous employer's 401(k) plan to an IRA, you have two options:

1. You may ask that the funds be transferred directly to your new custodian; this would be a direct rollover. Of course, you must already have a new account set up so they have the information to transfer the funds. If you choose a direct rollover, you do not ever have the funds and there is no taxable event triggered. However, it could take up to four weeks for your new custodian to get the funds. Most direct rollovers must be initiated with the current custodian.
2. You may also ask for a rollover distribution; this would mean the current custodian would write a check to you for the amount in the plan.

If you take a rollover distribution from your previous employer's plan it allows you to gain access to the funds quicker but triggers some events. The custodian for that plan will report to the IRS that you have taken a distribution. You will have 60 days in which to deposit the entire amount to a new custodian. Otherwise, you will be taxed on the amount as ordinary income and if you are not eligible for a normal distribution, there will also be a 10% penalty.

The most important consideration, we think, is the mandatory withholding. When taking a distribution from a former employer's plan, there will be a 20% withholding. This money is recouped when you file your tax return as long as the entire amount was deposited with a new custodian within 60 days. However, the real issue is that you will have to deposit the entire amount that was in the plan with the new custodian, including the amount withheld.

This means if your account value was \$100,000, the withholding will be \$20,000. If you don't deposit the entire \$100,000 within 60 days, you will be responsible for tax on any amounts not deposited. If you are not 59 ½, you will also be responsible for a 10% penalty.

Most people would find it difficult to make up the difference in order to avoid the tax and penalty. Please

keep this in mind when you are considering your options.

Jaime Raskulinecz, CPM is the CEO of Entrust Northeast, LLC, a NJ licensed Real Estate Broker and CEO and principal of Rainbow Property Management, LLC, AMO. The management company is a third party provider that is one of only 20 firms in New Jersey to be awarded the Accredited Management Organization designation by the Institute of Real Estate Management. Ms. Raskulinecz has been a successful real estate investor herself for more than 20 years.

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INTERESTING INSIGHTS

In 1980, the U.S. Personal Savings rate was 8.0% today it is 0.2%.

Source: New York Times interview with the Federal Reserve 1/05

Number of high net-worth households by state.
(Thousands)

California	859
Florida	265
Texas	204
New York	188
New Jersey	175
Illinois	172
Massachusetts	120
Virginia	107
Pennsylvania	94
Maryland	93
Ohio	91
Colorado	85
Georgia	84
Michigan	82

- High net worth refers to households with greater than \$1 million in investable assets.
Source: CIS Marketing Research; Tiburon Research and Analysis
- The majority of America's wealth resides with owners of privately held businesses, not with inheritors or public company executives.
Source: Cannon Financial Institute
- U.S. families with grandparents responsible for children: 2.4 million. U.S. children living with grandparents: 4 million.
Source: U.S. Census Bureau

QUESTION OF THE MONTH

"Purchasing Land for division between private use and IRA investment "

Question:

I want to buy an 80 acre block of land using a combination of my IRA (80%) and home equity/proceeds of the sale (20%) of our current home. The intention is to develop the private portion for near-term income and domicile and hold on to the IRA portion for long-term investment and/or possible arms-length development through some partnership. The land carries a steep discount because local regulations only allow one division every five years, thus making it an attractive long-term hold.

The local lawyer familiar with local subdivision regs has told us that we can have the seller draw up separate deeds for two equal parcels. This would keep the non-IRA investment completely separate from the current investment. Although the IRA purchase would be at a higher per-acre rate, much of the difference would be offset by lower legal and surveying fees, and would in any case be in line with comparable 40 acres parcels. From a purely investment-driven point of view, a 40 acre parcel is optimal for the IRA as this would allow the land to be subdivided to the minimum lot size at about the time we could begin taking distributions from it. A larger parcel would require holding the land longer to optimize its sale potential.

Can we purchase the two parcels at different prices in this manner?

Answer:

Of course, if they are separate transactions. If you make them all one transaction, it could be construed that you are receiving a personal benefit by using the IRA at a higher rate and therefore getting the personal property at a lower rate. Structuring, and when the asset is purchased, is very important.

TIP OF THE MONTH

Start your tax planning today! Now is the time to get those important records together before the end of the year. If you have a Qualified Plan, remember the deadline for contributions is 12/31.

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