

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:

editor@theentrustgroup.com

Message From the Editor

Welcome to the October 2006 issue of IRA/401(k) Insights!

In this issue, Quincy Long of Entrust Retirement Services examines the "Checkbook Control" IRA and explores the unanswered questions many of us should take into consideration before we attempt to control a checkbook with our IRA. J.P. Dahdah of Entrust Arizona looks at the pros and cons of Roth IRA conversions—a very popular concept; Carl Fischer of Entrust CAMA discusses the importance of IRA Retirement Planning and why you owe it to your family to plan now; and Tracy Stice of Entrust Hawaii gives us the real scoop on leasehold versus fee simple properties...what every investor must know before they buy Hawaiian real estate.

I hope to see and meet those of you who will be attending the Entrust conference in Las Vegas on October 3 & 4th.

Enjoy our October issue.

Lisa Moren
Editor

editor@theentrustgroup.com

Inside This Issue:

Cover

- Message From the Editor
- Retirement Planning—You Owe it to Your Family

Page 2

- Roth IRA Conversions will Become Widely Available

Page 3

- Continuing Education

Page 4

- Swanson v. Commissioner and the "Checkbook Control" IRA-Owned LLC

Page 5

- Tip of the Month

Page 6

- Leasehold vs. Fee Simple Properties in Hawaii

Page 7

- Question of the Month
- Interesting Insights

Retirement Planning—You Owe it to Your Family

By: Carl Fischer

Retirement planning is more important than ever before in American history. Studies have shown that only one third of affluent families have been able to transfer and grow the family fortune into the next generation. Life expectancy has dramatically increased. At age 65, a man has a 50% chance of living to 85, and a woman to 88. In addition, you have a 1 in 4 chance of being around well into your nineties. Previously, most planners considered only 20 additional years of life expectancy, which potentially left them under funded. Adult children are helping the elderly to their own demise and leaving a legacy of the same problems for their own children.

The simple answer is education and communication among the intergenerational members of a family. The internet has plethora

of retirement calculators and information on retirement. You owe it to your family to have a plan—no matter what stage of life you are in. It is not as hard as you may think. However, you must understand how the rules change and what you must do to keep documents and plans current. For example, in 2006 the first \$2 million you leave is exempt from taxes and that limit is expected to rise to \$3.5 million by 2009, then disappear completely in 2010, and be reinstated at \$1 million in 2011. The families that are able to preserve wealth and grow it in future generations are those that pass on the tools and techniques used to build and manage wealth. It is no longer sufficient to build only your wealth, you must teach and help family members to build wealth for themselves. "Give a person a fish-- feed him for a day,

teach a person to fish-- feed him for a lifetime."

There are four major vehicles to consider in retirement planning: 1. **Tax free assets** (Roth IRAs, Roth 401(k)s, and Health Savings Accounts), 2. **Tax deferred assets** (401(k)s, Traditional IRAs, and qualified company savings/pension plans), 3. **Taxable savings accounts** and 4. **Social security**—not counting working a part time job. Health coverage is not considered in this article although it is another factor that must be accounted for to assure not burdening the family finances—managing health care costs is mandatory in preserving wealth.

It is obvious that **tax free assets** are the top priority because that money is all yours and may be passed to your heirs tax free. **Tax deferred assets** are important because of the savings you obtain by deferring the taxes. Both these categories take advantage of the compounding of tax-sheltered investments. In essence, you are making interest on your taxes versus paying taxes on your interest. Taxable savings accounts are "ready money" if you have to have it for a rainy day. I suggest this stay at a minimum because in the tax deferred and tax free accounts, the money can be used for emergencies, in many cases, without penalty. Even with the potential 10% penalty, you may still net more money. Social security is simply what the government will give back to you, if they have it and is fairly easy to estimate.

You must become educated with these tools, especially the tax free and tax deferred type of accounts. You must use them **now**. Help yourself and your family-if you are the teenager just starting out, the adult in the

"Give a person a fish-- feed him for a day, teach a person to fish-- feed him for a lifetime."

prime earning years of your life, or the grandparent either enjoying or worrying about your retirement, develop a family plan. Your plan should also consider using truly self-directed IRAs or 401(k)s so that you can take advantage of your knowledge and expertise.

Don't feel alone—a New York Life Retirement Income survey suggested that more than half the men and women in the US are clueless on several issues such as:

What amount of savings is needed to retire comfortably?

What percentage could be safely withdrawn each year?

What is inflation's impact on spending power?

There are many strategies that financial advisors and planners endorse, but it is most important that you choose one that you understand and are comfortable with. In conclusion, I leave you with the following wisdom from one of my clients: "You need more to retire than when you are working even if your house is paid off—my house taxes and insurance are more now than my principle interest taxes and insurance were before I retired. In addition, medical costs, gas, cars, vacations, golfing fees, fishing costs are all more ---the best thing I did for myself and family was to convert to a Roth IRA in 1998 and use the

truly self-directed IRA account. Every member of my family has a Roth IRA"

Carl Fischer is Manager of EntrustCAMA-Serving Delaware, New Jersey, Pennsylvania, and West Virginia. www.theentrustgroup.com

Roth IRA Conversions will Become Widely Available

By: J.P. Dahdah

For many of our clients, the decision on whether to convert their Traditional IRA into a Roth IRA can be confusing. In order to make an informed decision, please consider the following information regarding conversions. Remember, at Entrust, we are committed in helping our clients obtain the knowledge they need to grow their wealth prudently.

A Traditional Individual Retirement Account (IRA) may be converted to a Roth IRA, fully or partially. Such a

conversion involves a tradeoff, as follows:

- On the negative side, a conversion now requires earlier payment of deferred income tax. Without a conversion, tax may be deferred for many more years.
- The positive aspect of a conversion is the prospect of future tax free income. Five years after opening up a Roth IRA, all withdrawals will be tax free as long as you're at least 59 ½ years old.

In addition, no minimum distributions from a Roth IRA are required. If you don't need the money, you can leave it in the account indefinitely, benefiting from tax free wealth accumulation. Moreover, your beneficiaries can stretch out tax free withdrawals over their lifetimes.

The \$100,000 Question

For many taxpayers, Roth IRA conversions are appealing. Generally, the longer you have until you plan to take the withdrawals, the more a conversion makes sense. There is a catch, though. You can't convert a Traditional IRA to a Roth IRA in a year when your adjusted gross income (AGI) is over \$100,000. This upper limit applies to single and joint tax returns alike. The \$100,000 income ceiling has prevented some people from implementing a desired conversion.

The new tax law eases those rules. Beginning in 2010, anyone with a Traditional IRA can convert it to a Roth IRA, and it won't make any difference how much income you report. A special rule applies to conversions in 2010. Unless you elect to recognize the taxable income resulting from the conversion in 2010, that income will be averaged between your tax returns for 2011 and 2012.



Planning Possibilities

Even though the \$100,000 limit on income applies through 2009, you can begin to do some planning now. As long as you have earned income this year, you can make a "non-deductible contribution" of up to \$4,000 to a Traditional IRA in 2006. If you'll be at least 50 years old by December 31, you can contribute up to \$5,000. For married couples, each spouse can make a \$4,000 or \$5,000 non-deductible contribution in 2006, as long as one or both spouses work. (Note: The same \$4,000 and \$5,000 opportunities apply to deductible contributions to Traditional IRAs and non-deductible contributions to Roth IRAs, but income and other limits apply. Non-deductible contributions to Traditional IRAs can be made regardless of income.)

Similar non-deductible contributions to Traditional IRAs can be made for each subsequent year. The \$4,000 and \$5,000 limits will be increased each year to keep up with inflation. Through 2010, therefore, a married couple in their fifties with at least one working spouse could contribute more than \$50,000 to their Traditional IRAs, no matter what their income. Then, in 2010, high-income taxpayers could convert their Traditional IRAs to Roth IRAs, including amounts derived from non-deductible contributions.

Fine Points

If this strategy sounds attractive, please consider the following issues.

- Mixing Deductible and Non-deductible Contributions: If you already have a Traditional IRA that was generated by deductible contributions, adding non-deductible contributions increases the paperwork and the complexity of calculating the tax on distributions. To minimize such complexity, plan on converting all of your Traditional IRA to a Roth IRA in the same year. (You'll still need to work with your tax advisor to determine the right amount of income to recognize and avoid paying tax on already taxed non-deductible contributions.)
- Cash Concerns: For the best results, you should pay tax on any Roth IRA conversion from other funds rather than from the money in your Traditional IRA. The larger the amount you can keep in the Roth IRA for long-term accumulation, the greater the ultimate tax-free payoff. So start putting some money aside!
- Congressional Second Thoughts: Depending on politics and federal budgeting, Congress could once again change the law before higher-income Roth conversions become available in 2010.

J.P. Dahdah is President of Entrust Arizona. Serving the state of Arizona. www.theentrustgroup.com

Attention Real Estate Licensees, CPAs, and CFPs...

Entrust Provides Continuing Professional Education Credits

Interested in having a presentation or workshop for your group? Call us today!

For an office near you, visit our website: www.theentrustgroup.com

Swanson v. Commissioner and the “Checkbook Control” IRA-Owned LLC

By: Quincy Long

One of the most popular ideas in the self-directed IRA industry today is the “checkbook control” IRA. You may have wondered what exactly it means to have “checkbook control” over your IRA’s funds. In this article, we will examine the celebrated case of *Swanson v. Commissioner*, on which the idea of “checkbook control” is based. The entire text of the *Swanson* case is available on our website at www.theentrustgroup.com.

The essential facts of *Swanson* are as follows:

- 1) Mr. Swanson was the sole shareholder of H & S Swansons' Tool Company (Swansons' Tool).
- 2) Mr. Swanson arranged for the organization of Swansons' Worldwide, Inc. (Worldwide). Mr. Swanson was named as president and director of Worldwide. Mr. Swanson also arranged for the formation of an Individual Retirement Account (IRA #1).
- 3) Mr. Swanson directed the custodian of his IRA to execute a subscription agreement for 2,500 shares of Worldwide *original issue stock*. The shares were subsequently issued to IRA #1, which became the sole shareholder of Worldwide.
- 4) Swansons' Tool paid commissions to Worldwide with respect to the sale by Swansons' Tool of export property. Mr. Swanson, who had been named president of Worldwide, directed, with the IRA custodian's consent, that Worldwide pay dividends to IRA #1.
- 5) A similar arrangement was set up with regards to IRA #2 and a second corporation called Swansons' Trading Company.
- 6) Mr. Swanson received *no compensation* for his services as president and director of Swansons' Worldwide, Inc. and Swansons' Trading Company.

The IRS attacked Mr. Swanson’s setup on two fronts. First, the IRS argued that the payment of dividends from Worldwide to IRA #1 was a prohibited transaction within the meaning of Internal Revenue Code (IRC) Section

4975(c)(1)(E) as an act of self-dealing, where a disqualified person who is a fiduciary deals with the assets of the plan in his own interest. Mr. Swanson argued that he engaged in no activities on behalf of Worldwide which benefited him other than as a beneficiary of IRA #1.



The court agreed with Mr. Swanson and found that the IRS was not substantially justified in its position. The court said that section 4975(c)(1)(E) addresses itself only to acts of disqualified persons who, as fiduciaries, deal directly or indirectly with the income or assets of a plan for their own benefit or account. In Mr. Swanson’s case, the court found that there was no such direct or indirect dealing with the income or assets of the IRA. The IRS never suggested that Mr. Swanson, acting as a “fiduciary” or otherwise, ever dealt with the corpus of IRA #1 for his own benefit. According to the court, the only direct or indirect benefit that Mr. Swanson realized from the payments of dividends by Worldwide related solely to his status as a participant of IRA #1. In this regard, Mr. Swanson benefited only insofar as IRA #1 accumulated assets for future distribution.

The second issue the IRS raised was that the sale of stock by Swansons' Worldwide to Mr. Swanson's IRA was a prohibited transaction within the meaning of section 4975(c)(1)(A) of the Code, which prohibits the direct or indirect sale or exchange, or leasing, of any property between an IRA and a disqualified person. Mr. Swanson argued that at all pertinent times, IRA #1 was the sole shareholder of Worldwide, and that since the 2,500 shares of Worldwide issued to IRA #1 were *original issue*, no sale or exchange of the stock occurred.

Once again, the court sided with Mr. Swanson. The critical factor was that the stock acquired in that transaction was *newly issued* - prior to that point in time, Worldwide had no shares or shareholders. The court found that a corporation without shares or shareholders does not fit within the definition of a disqualified person under section 4975(e)(2)(G). It was only after Worldwide issued its stock to IRA #1 that the petitioner held a beneficial interest in Worldwide's stock, *thereby causing Worldwide to become a disqualified person*. Accordingly, the issuance of stock to IRA #1 did not, within the plain meaning of section 4975(c)(1)(A), qualify as a “sale or exchange, or leasing, of any property

between a plan and a disqualified person".

On the surface it seems like the court endorsed the idea of an IRA holder being the sole director and officer of an entity owned by his IRA. In other words, by having the IRA invested in an entity such as an LLC of which the IRA owner is the manager, the IRA owner gets to have "checkbook control" over his or her IRA's funds. This sounds like a great idea. However, before jumping too fast into this area, there are some issues to consider.

One thing to remember is that the LLC does not insulate the IRA from the prohibited transaction rules. Amazingly, the IRS and the court in *Swanson v. Commissioner* ignored completely the fact that Mr. Swanson's non-IRA owned corporation, Swansons' Tools, paid commissions to Worldwide, thereby reducing Swansons' Tools' taxable income and indirectly benefiting Mr. Swanson. Especially after the recent case of *Rollins v. Commissioner*, it seems clear that this would be a prohibited transaction. In the Rollins case, Mr. Rollins loaned money from his 401(k) plan to corporations in which he served as president, but of which he owned only a minority interest. The corporations were clearly not disqualified persons, but the court nonetheless held that there was an indirect benefit to Mr. Rollins, who was the largest shareholder and an officer of each corporation.

The IRS also might have argued that Mr. Swanson's service as the president and sole director of Worldwide was a prohibited transaction as described in 4975(c)(1)(C), which prohibits the furnishing of goods, services or facilities between an IRA and a disqualified person. Although Mr. Swanson stated that Worldwide had no "active" employees, one has to wonder at what point the services rendered to an IRA-owned entity become a problem. Another question which was not raised in the *Swanson* case was whether or not an IRA owner having checkbook control over his IRA funds through a 100% IRA-owned entity violates IRC Section 408(a)(2), which requires that the custodian of an IRA be a bank or other qualified institution. Why have that requirement at all if the IRA owner can get around it merely by having his

or her IRA own 100% of an LLC managed by the IRA owner?

Although the *Swanson* case appears to be good case law, a great deal of care is merited when relying on this case. Several questions which were not raised in the *Swanson* case remain unanswered. As noted by the court, Mr. Swanson was "following the advice of experienced counsel." Even then, Mr. Swanson had to fight the IRS in tax court to win his case. For most people, even getting into a battle with the IRS is a losing proposition. Some people, perhaps through ignorance of the rules, appear to be abusing Swanson-type entities. For example, in IRS Notice 2004-8 on abusive Roth transactions, the IRS states that it is aware of situations where taxpayers are using a Roth IRA-owned corporation which deals with a pre-existing business owned by the same taxpayer to shift otherwise taxable income into the Roth IRA. If the IRS has become aware of the problem, there may come a day when they decide to go after these types of arrangements more actively.



When relying on the *Swanson* case to set up a "checkbook control" LLC or other entity, always use experienced legal counsel who is very familiar with how to set up this type of entity and who will be there to guide you on issues such as the prohibited transaction rules, the plan assets regulations, unrelated business income tax issues and the other rules and regulations which may apply. What happens after the LLC is formed is just as important as the initial setup and can get you into just as much trouble. To attempt a "checkbook control" entity without knowledge of all the rules and regulations or competent counsel to guide you is sort of like jumping out of an airplane without a parachute - it may be fun on the way down, but eventually you're going to go SPLAT!

H. Quincy Long is an attorney and is President of Entrust Retirement Services, Inc. in Houston and CEO of Entrust IRA Administration, LLC in San Antonio. He may be reached by email at QLong@theentrustgroup.com. Nothing in this article is intended as tax, legal or investment advice.

TIP OF THE MONTH

Do you know how much money you really need to retire? If not, or just curious, read the book "The Number" by Lee Eisenberg. He goes into detail based on one's lifestyle and gives you a number that is realistic. It shocked me to see what our incomes really reflect and what dollars are needed today in order to retire tomorrow. By depending on your ability to self-direct your retirement plan today, you can compound the wealth you need NOW. Let one of our local offices show you how. www.theentrustgroup.com.

Leasehold vs. Fee Simple Properties in Hawaii

By: Tracy Steven Stice

Many investors look longingly at Hawaii as a place to sink their hard earned dollars. Looking for a reasonable return on cash has been difficult in recent years, but has been greatly offset by huge price appreciation in the Hawaii market. All of the islands have experienced huge price appreciation beginning in 1998 and continuing until recently with prices now leveling off. One of the many myths that abound about Hawaii real estate is that you don't own the land in Hawaii.

Over the years, many long term leasehold ownerships were established under both residential houses (primarily on Oahu) and under many condominium projects. Land owners who held very valuable parcels including Bishop Estate, The Wineberg Foundation, Kaiser Estate, and many other large trusts and estates created long term ground leases and allowed developers to construct houses or condos on the property.

Most leases originally ran from 30 to 99 years, almost all with a reversion clause. At the end of the term of the lease, the property would revert to the land owners' estate.

This has created an interesting dilemma for both land owners and leasehold property owners. Most of the leases have re-negotiation clauses in them, typically with an appraisal clause that ties the land value to the real market. In many cases, however, the leases may have undervalued the appreciation of the land or contained too long of a period between re-negotiation on land values.

What has happened in recent years has been a trend towards purchase of the "fee" or the underlying land in many condo projects and most of the single family homes. With changes in tax laws that favor depreciation of improvements, leasehold ownership has attracted investors to properties that are leasehold ownerships with lower annual lease payments. The return on these units is equal to fee properties for rental purposes, provided that the offset in purchase price on the leasehold vs. fee simple acquisition price reflects the higher cost of annual ownership of the leasehold property.



With 100% ownership of improvements and no ownership in the land, the depreciation advantage can be huge on some of these properties. With an acquisition value set at 100% for the basis on the property, and, if the cash flow presents a good return, leasehold may present a very interesting investment opportunity.

Typically, a leasehold property will be discounted relative to a fee simple similar property in the range of 20% to as high as 90%. Of course, the 90% discount will be a property very near the reversion time, without any mandatory conversion in the lease.

Where are the opportunities in Hawaii on leasehold property? All of the islands have some leasehold. Many condominium projects have been recently going through the conversion process. Financing the conversions presents great opportunities for private lenders. Returns of 12% to 14% to finance the conversions are possible. Additionally, purchasing units in projects that have historically had resistant fee owners will provide a distinct advantage to informed

buyers. Once a conversion begins, values jump, as leasehold owners usually purchase the fee quickly once it is offered.

Hawaii has a mandatory leasehold disclosure law and it is an accepted practice to purchase an individual unit subject to full review of the underlying lease. As the Hawaii market begins to soften, the first item that speculators sell are rental condos. As the appreciation curves dips in to the negative numbers, you will see more opportunities present themselves, especially on leasehold properties. The reason is that the uninformed have an aversion to purchasing leaseholds because "you don't own the land." In my opinion, all the better when you are dealing with the active investment and management of real property.

Tracy Stice is Co-Owner of Entrust Hawaii. You may reach him at Tracy@TracyStice.com or Tracy.Stice@TheEntrustGroup.com or on his cell at 808-281-5411.

QUESTION OF THE MONTH

“Prohibited Transactions: LLC and Bank Financing”

Question: If an LLC owned by a profit sharing plan and a SEP IRA of two different beneficiaries obtains a banking construction loan for the LLC which is guaranteed by the two beneficiaries, is there a prohibited transaction occurring and if so, please cite the IRS code, cases or letter rulings?

Answer: This is a gray area, although it appears that this is not allowed. See Internal Revenue Code 4975 (as paraphrased below).

Prohibited transactions

Some types of transactions violate the basic intent of your IRA and subject your account to risks and penalties. "Transactions" are defined as the means of moving funds into your account and making use of the funds in the account. They include contributions, purchases, sales, and distributions.

Fundamentally, your retirement plan is intended to benefit you *when you retire* and not before then. Thus, transactions that can be construed to provide immediate financial gain to self-directed account holders are not allowed. This type of transaction is otherwise known as "self-dealing."

For example, IRA owners may not borrow money from their IRA, sell property to it, receive unreasonable compensation for managing it, or use it as security for a loan.

Qualified plan members may not transfer plan income or assets; sell, exchange, or lease property; lend money; extend credit; furnish goods, services, or facilities to disqualified persons; or allow fiduciaries to obtain or use the plan's income or assets for their own interest.

For IRAs, a disqualified person is:

- The IRA holder and his or her spouse
- The IRA holder's ancestors, lineal descendants, and their spouses
- Investment advisors and managers
- Any corporation, partnership, trust, or estate in which the IRA holder has a 50 percent or greater interest
- Anyone providing services to the IRA, such as the trustee or custodian

INTERESTING INSIGHTS

Did you know that 40% of the American public retires unexpectedly? The top reasons are job loss and health issues and/or disability.

Source: AARP – September/October 2006

Further, 45% of the 40% polled are involved in company downsizing, closure or being fired; 55% of those polled have health problems or a disability; 20% have family reasons; and 60% retire by choice.

*Source: Limra, Public Misrepresentations about Retirement Security 2005:
as seen in the Boomer Market Advisor – July 2006*



9444 Double R. Blvd
Suite A
Reno, NV 89521

Phone: 888-340-8977
website: www.theentrustgroup.com

What's Inside...

- Message from the Editor
- Retirement Planning—You Owe it to Your Family
- Roth IRA Conversions will Become Widely Available
- Continuing Education
- Swanson v. Commissioner and the “Checkbook Control” IRA-Owned LLC
- Tip of the Month
- Leasehold vs. Fee Simple Properties in Hawaii
- Question of the Month
- Interesting Insights