Entrust Group

November 2006 Issue

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. Nothing in this publication is intended as tax, legal or investment advice. Entrust does not sell securities or other investments products.

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Message From the Editor

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

I want to thank all of you who attended our client conference last month. It was a stellar success! I hope you took advantage of the opportunity to meet other like-minded investors, got the education you need to secure your retirement and learned from the leading experts some creative techniques and strategies you can start using today! I appreciate all of the wonderful feedback and recognize the need to continue conferences like this one.

Enjoy our November issue.

Lisa Moren-Bromma
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Creating Capital with Notes

By: Magi Bird

One of the greatest challenges faced by people who are directing their own retirement investments is how to step around the maximum contribution limitations imposed by the federal government. One of the simplest and most direct methods of circumventing this limitation is to use the classic business maxim, “buy low, sell high.” To that end, I would like to you consider applying that principle to real estate securities, otherwise known as “notes.”

Occasionally, you will see an ad placed in the financial section of the classifieds indicating that someone has a trust deed they wish to sell. Trust deeds are the recorded document securing a note on a piece of real estate. People selling a note have two problems! First, they are generally aware that they will take a discount off the unpaid note balance to get the cash they need. Additionally, if they carried this note when they sold a property (other than their personal residence, in which case part of the gain may be tax-free), they will also trigger a capital gain and a corresponding tax liability. Sometimes people are so pressed for cash they forget this second aspect of selling a note and are very unhappy at tax time.

For a real estate investor, this much motivation frequently spells opportunity. The investor will make a cash offer on the note at a discounted figure that delivers the desired return for the risk being assumed. If the investor decides a

return of 12% is sufficient yield on a first note position on an owner occupied home—provided there is a 20% equity behind his encumbrance—he makes his calculations and prepares an offer. Suppose a note like this is available for sale whose unpaid loan balance is $105,000, amortized over 30 years and payable at $731.83 per month including interest at 7%. All the payments have been made on time for the last 4 years and the property is worth $145,000 in today's market. To obtain the desired yield, the note buyer makes an offer of $69,900.97.

This can be a terrific deal for all the parties involved. The note seller gets cash today for the emergency or opportunity he has found. The note buyer gets the note rate of 7% on $105,000, or approximately $7350 in interest in the first year. That amount of interest is being earned by an investment of $69,900 for an interest rate returned of 10.5%. If return of principle is included in the payments, then the return becomes 12%! Spectacular returns in a 2 to 4% marketplace for cash held in a bank account.

THE DOWNSIDE

Q. *What if the note is not a first but a second note? Or the property is non-owner occupied or even vacant land?*

A. The experienced investor will determine how much increased risk each one of those factors represents and increases the yield accordingly, offering less for the note. For instance the same note bought at an 18%-yield would cost $48,319.94. Of course, any note buyer willing to accept the same risk at a lower yield would offer more and probably win the bid, but at all times, the first, best and most likely buyer for the note would be the payor who could refinance the property to buy back their own note. Too often the most interested party is overlooked, and this may cost a note seller thousands of dollars!

Q. *Why would someone sell a note if they take such a discount?*

A. Sometimes an opportunity comes along to double or triple your money in a short period of time. Some people are willing to take such a chance and the discount amount is offset by their anticipated profit. Sometimes the need is urgent enough that a discount doesn't matter. However, if the note holder's credit is still good, we can sometimes get full face value for a note by using it as a down payment on real estate and then refinancing out the cash that is needed. This formula then produces both a real estate acquisition and often the return of the initial investment capital to the IRA.

The particular advantage to acquiring a real estate security and moving it forward in real estate is that we are both creating the capital gain and conducting activities normally assigned to real estate dealers in a tax-free, tax-deferred environment. This accelerates your capital growth by as much as 48%, assuming the normal real estate dealer is in the 28% tax bracket and must also pay self-employment tax over 15%!

Magi Bird is the President and Broker of Remcor Real Estate and the founder of Remcor Educational Systems. She is an instructor for the National Council of Exchangors and life member of "Who's Who in Creative Real Estate," and teaches the Gold Card Course for EMS designation, taught to the top strata of investment real estate brokers and counselors. www.magi@remcor.com

When is a Participation Mortgage and /or Real Estate Option Useful?

By: Roger Lord

I have a client who happens to be a Real Estate agent. He sold a large property and wanted to do a 1031 exchange. He located the replacement property and needed additional cash to get the deal done. In addition, he needed to match the debt coming out of the property he sold. He had clients who had IRA funds that wanted to participate in the purchase of the new property. The money available was sufficient to purchase the property (warehouse) without debt but the agent needed to match the debt he had coming out of the previous property. The IRA owners were not interested in simply holding the debt; they saw great upside potential in this particular property and wanted to "participate."

The group hired an attorney, a fundamental need, to develop a participation mortgage. Some of the language from the Participation Agreement follows:

Maker agrees to pay in lieu of interest due on note an amount equal to eighty-three and 33/100ths (83.33%)of the net cash flow…

In lieu of final payment of amounts due under the terms of the note, maker agrees to pay to Payee as full and final payment of principal on the note an amount equal to eighty-three and 33/100ths (83.33%) of the net cash proceeds from the sale of other disposition of the property…

Of course, the agreements are many pages long and cover expenses, losses, debt disposition, minimum interest rate on the note etc. We (The Entrust Group) strongly recommend competent legal representation when dealing with participation mortgages or Real Estate Options.

This case has recently taken on another angle. The participants, (owner and mortgagors) have located an additional property (raw land) they would like to own and develop. They do not have enough cash to purchase the raw land. The real estate agent who does not have retirement plan assets involved owns the warehouse. He, the agent/owner of the warehouse, is able to go to a bank and borrow the funds necessary to purchase the raw land using the warehouse as collateral. However, this means the original Participation Mortgagors must be willing to subordinate their debt on the warehouse.

Of course, the original mortgagors are not willing to subordinate if they are not going to receive any financial incentive to do so. The cure: the original mortgagors will subordinate their positions to the bank in exchange for an option to purchase a share of the raw land at a specified price within a specified time frame. In this case, the price will be the original acquisition cost so the original mortgagors may enjoy the same upside potential as the property owner. The plan is to market the warehouse, and soon after it is sold, the original mortgagors will be able to exercise their option if they so desire.

The other highly beneficial aspect of using a participation mortgage is the utilization of depreciation. IRAs cannot utilize the deprecation but when a participation mortgage is used in lieu of joint or TIC ownership, the whole amount of deprecation can be used by a taxable entity!

Along with the example above, I have run into numerous investors who are funding the construction of spec homes and participating in the profits after the home is sold. This is a perfect opportunity to utilize the participation mortgage. In fact, many development and construction projects could be funded with participation mortgages. Loans to private corporations are another opportunity for investment with a participation mortgage or option.

The rage lately seems to be the use of LLCs and other entity structures for IRA real estate purchases.

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INHERITED IRA ASSETS: Making the Best Choice

By: Keith Stunek

You have inherited an IRA – Traditional or Roth does not matter. These assets are valuable assets, but the value can greatly increase or diminish depending upon the choices you make as a beneficiary. Making the right decisions can be challenging at a time when you have stressful matters on your mind. You may have found the rules for inherited IRAs unexpectedly confusing. There are two key things to keep in mind. You have choices and you will want to protect the value of your IRA. First, lets take a look at your choices.

The choices you have are the stepping stones to maintaining the value of the IRA should you desire to do so. First choice you have is to take a total distribution of the assets. Should you do this and the IRA is a Traditional IRA, you will experience taxation but no penalty for early withdrawal, even if your under 59 ½. If the IRA is a Roth IRA, you may receive the assets tax–free if the individual you inherited the assets from maintained the IRA for 5 years.

Another choice you have that will assist you in protecting the value of the IRA is to begin to take annual distributions over your own life expectancy. This allows you to choose the investment of your choice, allowing the IRA to continue to grow while satisfying the IRS rule of taking annual distributions from the IRA as a beneficiary. You will need to commence these distributions no later than December 31 of the year following the year of death if you are a non-spouse beneficiary. A spouse can move the IRA into their own IRA and maintain control as an IRA holder.

Another choice is to draw the IRA value down to zero within 5 years following the year of death. This will maintain the value of the IRA for a small period of time while you decide. As a beneficiary, you have a choice. A choice to maintain the value and importance of the tax benefits with an IRA either for a short time or long term. And you have a choice where your inherited IRA is held during this payout time. Individual choice is the whole reason Congress created IRAs.

Keith Stunek is Director of Training and Development for The Entrust Group. He can be reached at kstunek@theentrustgroup.com.

The ABCs of Retirement Plans or, Which Retirement Plan is Right for You?

By: Lisa Moren-Bromma

I recently spoke at an international event on how one uses their IRA or 401(k) to invest abroad. I kept getting the same question over and over by participants in the audience. “Do I have the right retirement plan for my needs or how do I know I am contributing to the right type of IRA? I am so confused, which one is right for me?”

Well, it depends. Are you self-employed or do you work for a company? If you work for a company, do they have a 401(k) plan in place that you can take advantage of? If you are self-employed, what are your financial goals as it pertains to saving for retirement?

Let me try to take a stab at explaining the different types of retirement plans available in plain English as to eliminate any confusion so you can take your next step…funding the right plan.

Most Americans work for a company. About one half of the smaller companies in the U.S. provide a company 401(k) where they may or may not match your contributions. Generally, these plans are not self-directed meaning you cannot buy an asset directly with a company 401(k). If your company provides a company 401(k) you should take advantage of it and put in the maximum contribution allowable by the plan.

Individual 401(k) - If you are the owner and sole employee of the company (aside from your spouse), an Individual 401(k) plan makes sense. It has higher contribution limits for the owner/employee than other plans.

In 2006, you can generally put away up to $44,000 in an Individual(k). In addition, you can save as both employer and employee. As an employee you can put away up to $15,000. As the employer, you can contribute 25% of your compensation on top of this, up to the max of $44,000 or $49,000 if you are over 50.

SEP (Simplified Employee Pension) - This is the most popular choice with Realtors and other commissioned professionals or those with 1099 income. IRA Maximum contributions are 25% of compensation up to $44,000 or whichever is less for 2006. It allows more ability to put dollars into an IRA than the Traditional IRA.

Traditional IRA – Anyone who works can have a Traditional IRA. Its counterpart, the Roth IRA offers the same flexibility with better tax treatment. While you do not get a deduction for Roth contributions, you get to take out the Roth's earnings tax-free in retirement. You won't be hit with early withdrawal penalties if you are at least 59 ½ and have kept the money in your Roth for at least 5 years.

Other differences: You can save in a Traditional IRA no matter how much you earn. You can use a Roth only if your adjusted gross income before deductions does not exceed $110,000 as a single person and $160,000 as a married couple filing jointly.

SIMPLE (Savings Incentive Match Plan for Employees) - Employees can invest up to $10,000 a year, less than what is allowed under the SEP. Employers are required to contribute up to 3% of employees' pay or give all workers—whether or not they contribute—2% of pay.

There are many other types of plans, some very new such as the Roth 401(k). I would encourage you to talk to your local Entrust office to find out specifically what the right plan is for you. To find a local office near you, visit www.theentrustgroup.com.

No matter what you decide, if you do not have an IRA or 401(k), open one now! Let's face it. No one else is saving for our retirement, and the days of the gold watch and pensions are dwindling. None of us can afford to wait. Get the help you need and start banking your bucks today!

Lisa Moren-Bromma is the President of The Entrust Group, the nation's largest network of 3rd party administrators who specialize in administration and record keeping for self-directed retirement accounts. You can reach Lisa through editor@theentrustgroup.com.

Entity Investments in Your IRA — Who Cares About the Plan Assets Regulations?

By: H. Quincy Long

This article is the last in a series of articles discussing some issues arising when investing your IRA into an entity, such as a limited liability company or corporation, limited partnership, or trust. For the rest of the articles in this series, please review the IRA Insights issues from July through October. Additionally, there is a great article in the June issue on using the Roth 401(k) plan and the exemption from unrelated debt financed income tax to retire rich using other people's money while never paying taxes.

What are the plan assets regulations, and why should you care about them if you are investing your IRA through an entity? If the plan assets regulations apply to your entity investment, there are two major effects. First, your IRA is deemed to own not only the equity interest in the entity but also an undivided interest in the underlying assets of the entity for purposes of the prohibited transaction rules of Section 4975. For example, suppose you want to sell a piece of real estate to your IRA. Unfortunately, the prohibited transaction rules say you cannot sell any property to your IRA. So can you form an LLC owned by your IRA and sell the property to that LLC instead? The answer is no, because under the plan assets regulations, selling the property to your IRA-owned LLC is the same as selling it directly to your IRA, which is prohibited.

Second, if the plan assets regulations apply, the officers, directors and managers of an entity may be considered fiduciaries of the investing IRA, which means the prohibited transaction rules apply to them and other disqualified persons related to them. This is a critical issue and has many implications. Basically all of the prohibited transaction restrictions which are imposed on the IRA owner now also apply to the managers of the LLC. As fiduciaries, they are responsible for making decisions in the best interests of the IRA as opposed to their own best interests or the interests of parties related to them.

For example, suppose an LLC is formed which is subject to the plan assets regulations. Because the manager of the LLC is now a fiduciary of the investing IRA, neither the manager nor any other disqualified person related to the manager may sell property to, exchange property with, or lease property from the LLC.

Because of the serious implications of these regulations, when investing your IRA through an entity you should evaluate whether or not they apply. If you are forming an entity or advising clients as an attorney, knowing when these rules apply is crucial since it may affect how the entity is structured and whether or not you agree to accept retirement plan money.

When do the plan assets regulations apply? The plan assets regulations apply to any investment which is not a publicly offered security or a mutual fund **unless** either 1) the entity is an operating company (essentially, a business), which can include a real estate operating company or a venture capital operating company or, 2) equity participation in the entity by benefit plan investors is not significant (meaning total retirement plan investors own less than 25% of each class of securities). This means that the plan assets regulations will apply unless the entity is either running a business (in which case the unrelated business income tax rules apply) or all retirement plan investors together own less than 25% of each class of securities. Even if the entity meets the requirements for an operating company, the regulations still apply if an IRA or a related group of IRAs own all of the outstanding shares of the entity.

According to an additional set of regulations which stem from the Department of Labor's Interpretive Bulletin 75-2, even the investment in the entity itself may be a prohibited transaction if a fiduciary (including the IRA owner) causes the plan to invest in an entity, and as a result of that investment, the fiduciary or another disqualified person derives a current benefit. For example, if the IRA invests in or retains its investment in an entity, and the entity hires the fiduciary or a related disqualified person, this arrangement would be considered a prohibited transaction. Under those same regulations, if a transaction between a disqualified person and an IRA would be a prohibited transaction, then it will ordinarily be a prohibited transaction if the IRA and other disqualified persons collectively have voting control in the entity.

There is no doubt that this is a complex topic which is hard to explore in a short article. In most cases, the plan assets regulations will apply to your IRA's entity investment. If so, you should be aware of the following implications:

1) Your IRA's assets include a proportionate interest in each company asset.
2) Company managers, directors, officers and advisers are likely fiduciaries of the IRA.
3) Because they are likely fiduciaries, certain compensation and indemnification plans for officers and directors may give rise to prohibited transactions.
4) Prohibited transactions may result if the company engages in business transactions with disqualified persons, including the company's managers, directors, officers, advisers, and related parties to them.

If you hire an attorney or a company to assist you in setting up an IRA-owned LLC or other entity, including the "checkbook control" LLC, make sure they have a complete understanding of the prohibited transaction rules of Section 4975 and the associated regulations, the plan assets regulations, and the regulations from Department of Labor's Interpretive Bulletin 75-2. Sadly, there is a perception that investing an IRA through an entity is somehow a "prohibited transaction washing machine" which will protect the IRA from all the pesky rules of Section 4975. In fact, the opposite is true, since the additional layers of complexity make it more likely that an inadvertent prohibited transaction may occur.

For those who want to know more, the prohibited transaction rules may be found in Internal Revenue Code (26 U.S.C.) Section 4975. The regulations for Section 4975 are in 26 C.F.R. 54.4975-6. The plan assets regulations are in 29 C.F.R. 2510.3-101. The regulations relating to Department of Labor Interpretive Bulletin 75-2 are found in 29 C.F.R. 2509.75-2.

H. Quincy Long is an attorney and is President of Entrust Retirement Services, Inc. in Houston CEO of Entrust IRA Administration, LLC in San Antonio. He may be reached at QLong@TheEntrustGroup.com.

QUESTION OF THE MONTH

Question: My Solo(k) has a Roth component. I intend to direct all monies into an LLC investment which means there will be pre-tax and Roth contributions sitting in the same LLC. I understand that I'll have to allocate all cash inflows/outflows accordingly between the pre-tax & Roth funds.

Let's say there's 80k pre-tax and 20k Roth funds invested into the LLC. All transactions will have to be allocated as such, so that 20% is attributed to the Roth. Let's say the LLC invests the entire amount and 3 months later I make my yearly contribution which increases the Roth component to 25%. When the LLC exits the investment, would I attribute 20% to the Roth or 25%?

I'm guessing the money would be divided based on the % at the time the investment was made......and the next time the LLC invested, 25% would be attributed to the Roth....

Is this correct?

Answer: Your question, and answer is correct. Your purchased shares are accounted for at the time of purchase. This accounting is what creates the basis.

INTERESTING INSIGHTS

Population in the USA hits 300 million in October.
Source: US. Census Bureau, October 2006

It figures….According to a Monster TRAK poll, 48% of 2006 college graduates plan to move back home after graduation. And 44% of last year's graduates still live with their parents!
Source: More Magazine, October 2006

45% of people in their sixties reported they were carrying a mortgage on their home, up from 34% in 1980. The increased mortgage obligations-which were partly fueled by the refinancing boom of recent years-could require retirees to be able to have the financial resources of generating 80% of their pre-retirement income in order to maintain their existing standard of living, up from 70%
Source: Journal of Financial Planning

One third of all affluent retirees have no retirement plan at all and are especially concerned about rising costs in retirement that may erode their savings. Inflation, health-care, taxes and other costs beyond their control could cause them to outlive their savings.
Source: MFS Investment Management.

TIP OF THE MONTH

It is not too late to start tax planning for 2007. Jumpstart your financial plan and visit your tax professional this month. You will have their undivided attention since December on, tax professionals are busier, gearing up for tax season. Make your appointment today!

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