

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

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

In this issue, Hubert Bromma, CEO of The Entrust Group shares options with the new Roth 2006 changes. Steve Miszkowicz, Entrust Chicago, shares strategies for mortgaging real estate in your self-directed plan; H. Quincy Long, Entrust Retirement Services, Inc., entices us to increase our retirement savings and receive a tax credit; Jerry Jarrett, Entrust Retirement Services of Georgia, looks at investments for the smaller retirement account; Dave Owens and Erica Dorrance of 1031 Tax-Free Strategies discuss why buying options in your IRA is a great investment; and Glen Mather, of Entrust Administration Services, provides case studies on Roth Conversions.

I hope you enjoy our February issue! Thank you for the tremendous response we had to our January issue. Feel free to email and share your ideas!

Lisa Moren, Editor

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Options for 2006

By: Hugh Bromma

Starting January 1, 2006, the biggest change to 401(k)s for some decades is happening: Individuals may make deferrals to their 401(k) accounts with post-tax dollars—the income on which will never be taxed again.

This “Roth”-like option has a special feature in that the usual restrictions of maximum income for an individual or married person are not in play.

Because the “Roth”-like portion of the account must be record kept separately, don't look for every large employer with 401(k) plans to provide this option. Allowing this option drives the cost of administration up. Small plans and Individual (k) are great candidates for the Roth 401(k). For real estate and other non-standard investments where return potential can be excellent, the ac-

count that can have these higher deferral limits generate more tax free income. Limits for deferral in 2006 are \$15,000 and if you are 50 years old or older you can get another \$5,000 in. Also, if you are below the Roth IRA compensation limits, you can make an additional contribution to your Roth IRA: \$4000, plus the age 50 or over \$1,000 catch up contribution.

Hubert Bromma, is the CEO of The Entrust Group. For over 20 years, Entrust has been providing third party record keeping services for individuals who wish to acquire alternative investments. Entrust is the nation's largest administrator of self-directed retirement plans with more than 22 locations nationwide. To learn more about Entrust log onto our web site at www.entrustusa.com.

Mortgaging Real Estate in Your Self-Directed Retirement Plan - The Lenders Perspective

By: Steve Miskowicz

Most of our clients are aware that they can use their self-directed retirement plan to purchase investment real estate. Likewise, most of you are also aware that a mortgage may be put in place on the property. However, unlike non-IRA investment property loans, these mortgages are not the same as a typical rental property mortgage.

If you have used your IRA or other self-directed retirement plan to purchase an investment property, the mortgage loan you obtain must be **NON-RECOURSE**. What does this mean? A traditional loan provides for "recourse" to the borrower. In other words, if, for whatever reason, you don't make the mortgage payment, the lender reserves the right to come after you personally for the balance of the loan.

The IRS will not allow you to personally guarantee a loan made in the name of your IRA. Therefore, all IRA mortgages must have no recourse, that is, they must be "**NON**" - **RECOURSE** to you. In simple English - the cash flow from the property must be sufficient to cover the mortgage payment and all expenses because the lender cannot come back to you for any shortfalls.

IRA property mortgages are not resold into the secondary market through the usual network of mortgage bankers, mortgage brokers and banks

IRA property mortgages fall under the category of *commercial loans*. With a traditional mortgage, the lender may look at the rent and cash flow on the property, but the majority of their decision to give you a mortgage is based on your personal credit, personal income and your current debt load. Here, the property takes a back seat to your personal ability to repay the loan.

With commercial loans you, your credit, and your income take the back seat. The property's cash flow is the major consideration. In fact, your credit and income may never even be addressed. So how does a lender underwrite an

IRA mortgage? With the same methods they apply to apartment buildings, strip malls and office buildings. The lender will want to verify the ability of a property to generate sufficient cash to pay the mortgage, taxes and operating expenses.

This is a two step process. First, the lender will look at certified copies of leases and operating expenses that have been obtained from the seller. The lender may also ask for certified copies of the seller's tax returns. The lender will develop a picture of what typical annual operating expenses will be for the property. Rents may even be verified directly with the tenants. Once income and expenses are determined, credits and debits are applied to come up with a **net operating income (NOI)** figure.

Being the conservative group that they are, the banker will then order an appraisal on the property. The appraiser will determine the value of the property based upon two approaches. First is the usual "Market" Approach which looks at recent resale of comparable properties. Most investors are familiar with this appraisal method.

What is different is the second approach called the "income approach". Here, the appraiser lets the lender know what the income and expenses are in the market for properties that are similar to the property that the lender is being asked to mortgage. This is why IRA mortgages have higher appraisal fees - because substantially more work is being asked of the appraiser.

The lender then analyzes both sets of figures—from the seller and from the appraiser—and will then calculate their own NOI. So far, the procedure is pretty straightforward. The numbers "are doing the talking".

Lenders, always conservative beings, will want a cushion in the expenses to cover the "extraordinary" expenses should they become more "ordinary". By this I mean... This "cushion" is given the name **DSCR** - Debt Service

The IRS Will Not Allow You To Personally Guarantee A Loan Made In The Name Of Your IRA

Coverage Ratio (DSCR). Depending upon how quickly a property could be sold in the event of default or foreclosure, the lender will make sure that the “cushion” is larger rather than smaller. A property like a strip mall which could take months to sell would typically have a 25% cushion. In other words, a 10 to 25% cushion is left in the available cash after expenses and before the lender calculates the maximum mortgage for the property. You now know what a Debt Service Coverage Ratio of 1.10 to 1.25 is. The .10 to .25 is the cushion. Let’s see a quick calculation:

A six flat is being sold for \$300,000, has a net operating income of \$1908.00/month. The lender uses a DSCR of 1.20 for a multi-family building. The net operating income (NOI) of \$1908/month is divided by 1.20 which leaves you with a figure of \$1590. This is the maximum **Principal and Interest - P&I** - that can be applied and still meet expenses and “the cushion”.

- Using a 25 year amortization
- Interest rate of 7%
- The maximum mortgage (PV) is \$224,950.00

Again, the numbers, in the above scenario, are “doing all the talking”. This property would require the IRA to use \$75,050 (25%) as a down payment.

So, here you have it. A peek behind the banker’s curtain in determining mortgage qualifications for IRA owned properties.

Next month, part two: **Successful Mortgage Strategies**

Steve Miskowicz is the President & Managing Member of Entrust Chicago, LLC.

How to Get up to \$2,000 FREE from the U.S. Government

By: H. Quincy Long

How would you like to increase your retirement savings and receive a tax credit of up to 50% of your contribution from the United States government FREE? Are you at least 18 years old, not a full-time student, and not claimed as a dependent on another person’s tax return? If so, and you meet the income requirements listed below, you are entitled to a tax credit of up to 50% of your contribution to almost any type of retirement plan, including a Roth IRA. If you then take your refund from the government and put it back into your IRA, your retirement savings will increase by as much as 50%! And all you have to do is ask for it!

You must have modified Adjusted Gross Income within the following limits:

Credit Rate	Income for Married Filing Jointly	Income for Head of Household	Income for Others
50%	up to \$30,000	up to \$22,500	up to \$15,000
20%	\$30,001 to \$32,500	\$22,501 to \$24,375	\$15,001 to \$16,250
10%	\$32,501 to \$50,000	\$24,376 to \$37,500	\$16,251 to \$25,000

The maximum tax credit allowed for 2005 is \$1,000 (with a \$2,000 contribution), or up to \$2,000 if married filing jointly and each spouse makes contributions. Simply attach Form 8880, Credit for Qualified Retirement Savings Contributions, to your 2005 income tax return, and you will receive up to a \$2,000 tax credit. A tax credit is a dollar for dollar reduction in your tax bill, as opposed to a tax deduction, which only reduces the amount of money on which you pay income taxes. You may get more information on this credit from IRS Publication 590, Section 4.

Let me give you an example. Lucky Larry, a married man, was downsized from his job in the corporate world in De-

ember 2004. Larry decided that he wanted to be a real estate investor instead of looking for another j-o-b. Things are going fine in 2005, but Larry's modified adjusted gross income after all of his expenses will be \$30,000, and his taxable income after the standard deduction and 2 exemptions will be \$13,600. Therefore his taxes before the tax credit will be \$1,363 (see instructions for Form 1040, page 66). He and his wife contribute \$1,363 each to a self-directed Roth IRA at Entrust which they can use to purchase real estate options, debt-leveraged real estate, and many other things. Larry and his wife will receive a tax credit of \$1,363 (50% of each of their contributions). Although the maximum contribution for purposes of the tax credit is \$2,000 each, the tax credit is non-refundable. This means that the maximum tax credit Larry and his wife can receive is equal to the

taxes they would otherwise pay. By attaching Form 8880 to his 2005 income tax return, a few weeks later Larry receives a FREE CHECK from the US Government for \$1,363, so their income tax for 2005 is ZERO! Larry and his wife wisely decide to contribute the tax refund back into their Entrust self-directed Roth IRAs. Each Roth IRA grows by 50% to \$2,044.50 absolutely FREE, courtesy of the United States government!

H. Quincy Long is an attorney and is President of Entrust Retirement Services, Inc. in Houston (www.entrusttexas.com) and CEO of Entrust IRA Administration, LLC in San Antonio (www.entrustsdira.com). Nothing in this article is intended as tax, legal or investment advice.

Think You Don't Have Enough in Your Account for Real Estate Transactions?

By: Jerry Jarrett

We receive many calls from clients and prospective clients who want to have their money working for them in real estate or real estate related assets but think they don't have enough in the account to really make it work. Frequently, that's a big misconception!

There are several investments available to the relatively small account - if you know where to look for your investors. For the purpose of this article, I define small as less than \$25,000.00. Although there are still plenty of areas of the country where this will buy real estate outright, it's generally not enough in the hottest markets today. There's still plenty of opportunity in these markets, however, for you to make that money work for you harder than it would on Wall Street.

One good possibility is for you to loan money from your IRA to an investor seeking rehab funds for properties they have purchased. You can loan money at a fixed interest rate or create an equity participation note where you will share the profits when the property sells. In some markets, these returns can be dramatic. Additionally, you can secure the note with the real estate to be rehabbed providing even more safety for your investment.

Another possibility is the use of the Purchase Option on

a property. While options generally require a more thorough understanding of the local market you are working in, if used correctly, they can produce a great return on the investment. Here's how it works - you locate a property that you believe is undervalued in the market. You negotiate with the seller and they accept your option to purchase the property within X number of days at a given price. The option is issued to your IRA and the option consideration fee is paid from it as well. This option is recorded at the courthouse to secure your position on the property. You then put your marketing skills to work to sell the property at the price you believe is appropriate. When you've found a willing buyer, they must pay your IRA the difference between the two selling prices in order to clear title at the courthouse and proceed with a closing on the property. The downside to this is that if you are unable to find a willing buyer within the days specified in the option, it expires and your IRA loses its consideration fee paid to the owner. Like I said, this requires a more thorough understanding of the market you're working in, but seasoned real estate investors can take advantage of this with great success.

A third possibility is to "buy" a house subject to the existing mortgage. There are numerous classes on this

available through your local Real Estate Investors Association, and it's too complex to cover in detail in this article. However, the concept is that you find a motivated seller looking to quickly exit their property and you take title to the property "subject to" the existing mortgage. Title to the subject property is transferred to the IRA and the IRA holder agrees to pay the existing mortgage from the funds in the IRA.

Jerry Jarrett, Partner—Entrust Retirement Services of Georgia. www.entrustga.com

Options can be a Great Investment for Self-Directed Investors

By: Dave Owens, CES and Erica Dorrance

If you are a real estate investor, you probably make the majority of your profits by being creative. Utilizing a truly self-directed IRA allows you to maximize this creativity by making the profits that you earn become tax-deferred or tax-free.

One creative method for many real estate investors is the use of an option contract. If you are among the many individuals who purchase options on land or property, you will be happy to know that you can make tax-deferred or tax-free the profits from these transactions by purchasing them with your Self-Directed IRA dollars.

An option is a unilateral contract that allows a buyer (optionee) the right to buy property from an owner/seller (optionor) at a fixed price within a specified time. There are many ways an option contract can be used, most of which are permissible in an IRA (assuming that the IRA isn't engaging in anything prohibited).

Example: Mary Mortgagor is paying on a first and second mortgage. She is able to make the 1st mortgage payments comfortably but has a \$30,000.00 balloon payment due at the end of the month for her second mortgage. She cannot come up with the money. Joe Investor can choose to loan \$30,000.00 to her to cover the balloon if she will give him an option to purchase the property in 5 years at today's market value (which is \$395,000.00) for \$1,000.00. *Note: The \$30,000.00 loan will have to be structured in a way that would allow the IRA to purchase the option without being prohibited.* The contract is structured so that Mary gets to keep her house for at least 4 years provided that her mortgage payments are current. After that point, Joe Investor can ultimately have the house sold for

\$445,000.00. This would earn him a \$50,000.00 return on a \$1,000 option. If this was done in a Roth IRA, imagine the tax-free possibilities.

The terms and conditions of any option contract rely heavily on the seller's situation/motivation to accept an option contract offer. Many option contracts are the result of a distressed seller. You should be familiar with your state laws as they pertain to lending to distressed homeowners.



Profits are commonly earned when an optionee sells and assigns their option to someone else for a fee rather than actually exercising the option by purchasing the property for themselves (or their IRA). This can be done by having the option recorded after it is purchased, finding a buyer and having a simultaneous closing between the optionor, optionee, and the new buyer. An option fee can be included in the closing statement.

In summary, the general purpose of an option is to offer consideration to purchase property at a fixed price over a certain period of time and within that time, find a buyer who will purchase at a price greater than the fixed price listed in the option contract. If the consideration comes from IRA funds, the difference/profit can flow back to the IRA. This is a unique investment strategy but should only be used by the experienced or skilled real estate investor. If this strategy is properly executed and all parties' best interests are concerned, this can be very lucrative for an IRA.

Dave Owens is the Managing Member and Erica Dorrance is an IRA Specialist at 1031 Tax-Free Strategies, LLC a company that specializes in 1031 Exchanges and Self-Directed Retirement Accounts in SW-Florida. www.taxfreestrategies.com

A Self-Directed Roth: Freeing up your Retirement Options

By: Glen Mather

For over 15 years the Hunter family vacationed in a beachside community in South Carolina, each time staying in the same condominium complex, renting from various owners. Traditionally, after releasing the children to the beach, they would grab the local real estate guide, noticing the unit prices going up each year. Nearby, they discovered that there were a few vacant lots available - and since their savings was not sufficient to purchase the condo units, they started looking into purchasing raw land as an investment.

The Hunters were fortunate to have recently attended an Entrust presentation on self-directed IRAs which provided step-by-step instructions on how to purchase investment real estate with their retirement funds. John Hunter subsequently opened a traditional IRA with Entrust, then rolled over his existing 401(k) funds.

During one vacation period, they worked with a local realtor, selected a vacant lot, then directed Entrust to purchase the property in the name of their IRA: *Entrust FBO (for the benefit of) John Hunter IRA*. Once the \$100,000 transaction was completed, the property was then owned by the IRA with the IRA being responsible for all taxes and HOA fees.

Although they were happy with their IRA investment, John remembered being told during the Entrust presentation that IRA investments must be passive, and that the IRA beneficiary cannot gain any use from the property. The rub was that John's wife, Joan, had a dream of retiring to this seaside community, building on the IRA-owned land, and living the good life. John reminded her that the dream would likely be very expensive, as to use his IRA-owned property, they would have to take a taxable distribution on the property first - at the then appraised price (assuming that the property would double in the intervening years before retirement, the tax rate would be ordinary income of \$200,000).

After listening to Joan's pleas - John took the step of contacting his CPA to see if there was any way to transi-

tion the property from the IRA to personal use and avoid the \$200,000 tax liability for distribution. After studying John's and Joan's earnings and personal finances, he suggested that John convert his traditional IRA to a Roth. John qualified for the conversion due to the fact that his adjusted gross income for the year for him and his wife was less than \$100,000. Based on his CPA's recommendation, John converted his traditional IRA, and thus on his tax return, his income was increased by \$100,000 for the year (the property was converted to a Roth soon after purchase, otherwise an appraisal would have been required prior to conversion), and he paid the resulting taxes by April 15th of the year following the conversion.

What was the benefit to John (and Joan) for paying the taxes and converting a traditional IRA to a Roth? First, the appreciation of the land will continue to grow tax deferred, much as it would in a traditional IRA. However, Joan's dream of building and living on the land now owned in a Roth IRA can be economically realized.

Once John has had a funded Roth account for five years, and has achieved the age of 59.5 years, he can take a distribution of the land from his Roth IRA without tax consequences. After taking the distribution, the Hunters' have full use of the land for any lawful purpose, including as a domicile. If he had not converted to a Roth IRA soon after purchasing the land with his traditional IRA, John would have faced large tax consequences at the very time he and Joan would need the personal resources to build their retirement home.

Whether you should—or can—convert from a SEP, Simple or a traditional IRA to a Roth is a very personal decision, one which is best reached through a consultation with your CPA or tax professional. The real power lies with self-directing your IRA with Entrust, regardless of the investment account you choose, as your choices are limited only by the IRS, not your administrator.

Glen Mather is Director of Entrust Administration Services, Inc. Serving East and Central Florida. He can be reached at (877) 259-3256 or at gmather@entrustfl.com

Roth Conversions

- Adjusted Gross Income must be \$100,000 or less in order to convert
- Ordinary Income tax due on the converted amount must be paid no later than April 15th following the year of conversion
- To avoid penalty and taxes on Roth withdrawals:
 - Must have a Roth account funded for at least five years
 - and...
 - Be at least 59.5 years old

INTERESTING INSIGHTS

Need tax help? Here are potential solutions to you with any tax issues.

CCH Inc. www.completetax.com/tools.asp Tax preparation, literature and counsel for both taxpayers and tax professionals.

H&R Block. www.hrblock.com Tax estimators, calculators and planners in addition to software, online tax preparation, and year-round access to financial and tax advisors and tax preparers.

Intuit www.turbotax.com Tax entrance to an omnibus collection of small-business financial resources.

Small-Business Tax Center www.entrepreneur.com/taxcenter Tips, terms and articles on taxes.

Tax and Accounting Sites Directory. www.taxsites.com Accountants Worlds comprehensive index of tax and accounting resources.

Yahoo! Tax Center <http://finance.yahoo.com/taxes> a web page of tax rates, calculators and links to tax preparation software and tax preparers.

Source: Entrepreneur Magazine: January 2006

Can you retire on this income?

Retiree's Income around the Globe.

Total income and expense per retiree household by country in 2004. Currency in Euros.

	<i>Retirement Income</i>	<i>Household Expenses</i>
Netherlands	1,734	1,509
U.S.A.	1,700	1,541
Germany	1,644	827
Britain	1,622	1,057
France	1,529	1,586
Japan	1,391	1,806
Italy	877	1,368
Spain	751	870
Portugal	649	751
Hong Kong	546	859

Source: *International Herald Tribune*
January 2006

TIP OF THE MONTH

Should you retire with a mortgage? Keeping a roof over our heads was at one time the most likely expense in retirement. In 2006, financial advisers suggest otherwise. You maybe in a financial situation where it would still pay to have a mortgage on your property if your cash is earning a higher return than the mortgage interest would have. Plus, as most of us continue to live longer, health care and other related expenses can exceed housing expenses. Now is the time to get a financial checkup. Get in touch with a reliable financial adviser.

QUESTION OF THE MONTH

"Roth 401(k) Questions "

My wife and I are going to take advantage of the Roth 401(k) in the amended plan doc. The accounting is the only concern I have. Our idea is to do the following: in addition to the Entrust DYO plan that we have now, we would establish 2 single member (manager managed) LLCs—one for me and one for my wife. These will be where the Roth component contributions will reside. They will each be 100% owned roth(s) by each of us. The company will deposit contributions directly into the respective LLCs for each Roth component account.

Question:

Assuming I, as trustee and custodian of our 401(k), would be the manager of these Roth LLCs:

Would the LLCs share the same tax ID of the overall plan (business trust), or would separate EINs be needed?
Would the LLC membership for each LLC read something like: Our retirement plan, FBO Roth 401(k): employee name, My name as trustee', or would something different be more appropriate?

Answer:

Keep in mind that the LLCs you intend to create are investments by the DYO plan of which the Roth IRA is just a component. The company contributions should always be made to the plan, not the investments of the plan. The titling should include the plan name [which does not include Roth 401(k)] and whatever individual distinctions that you, as the plan trustee, decide. Regardless of the investments, the plan's overall recordkeeping must distinguish between the investments made by contributions from the company and deferrals from employees, and as of 1/1/06, between pretax and post tax (Roth) investments made with employee deferrals. If your company adopts the new Roth option, you could have 3 different accountings. One for each employee, employer, employee traditional and employee Roth.

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