

# 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@EntrustAdmin.com](mailto:editor@EntrustAdmin.com)

## Message From the Editor

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

In this issue, Hubert Bromma, CEO of The Entrust Group, illustrates the benefits of real estate in a pension plan; Dave Owens of 1031 Tax-Free Strategies and Elizabeth Carlson, a 1031 consultant, share the strategy of building up your portfolio through 1031 exchanges; Steve Pauley, Principal of IRA Plus Southwest shows us why a Qualified Plan makes sense and saves tax; Quincy Long, President of Entrust Retirement Services educates us on contribution limits within the various retirement plans so you can put away the maximum allowable and grow your nest egg.

We keep adding topics and speakers to provide an exciting line-up for our client conference. Be sure to visit [www.entrustclientconference.com](http://www.entrustclientconference.com) to sign up for a truly educational event that will make a difference to your financial future!

Enjoy our April issue.

Lisa Moren, Editor  
[editor@entrustadmin.com](mailto:editor@entrustadmin.com)

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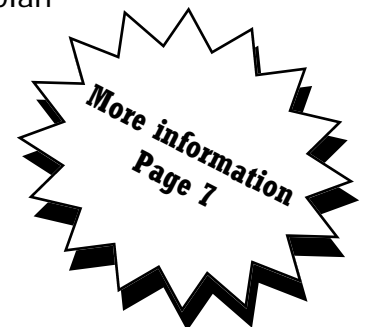
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## Real Estate as a Pension Plan Investment

By: Hugh Bromma

Since 1975, Real Estate professionals were among the first to use their "Keogh" plans (Now called Qualified Plans) to purchase real estate investments. The dollar amounts which could be contributed then were more (8 time more) than one could put into IRAs, so the Keoghs were the natural place for such contributions. The flexibility of the Keogh as a self directed tax deferred vehicle for investment property hasn't changed in 30 years. Even IRAs became popular, with the Simplified Employee Pension Plan having the same contribution limits as Keoghs. The Roth IRA in 1997 and especially the Roth 401(k) (which has no salary caps for deferrals) in 2006 made tax free investments phenomenally popular.

The methodology was and is straightforward: There is a trustee for both qualified plans and IRAs. The trustee for qualified plans can be the employer, the IRA trustee or custodian must be an institution such as a bank. In both cases, the accounts established are tax free until withdrawn, and tax free forever for the Roth versions.

Doing the math is essential. The real estate professional does math daily. The math hasn't changed much over the last 30 years either. Tax code changes have been legion. When you look at the possibilities of the investment you make in real estate there are effectively four major alternatives:

- Investments taking advantage of tax write offs personally
- Investments using Tax deferred accounts
- Investments using Tax free accounts
- Investments using tax deferred exchanges

Take these four alternatives and add the factor of debt financing, and there are eight possibilities with different tax consequences.

The Real estate investors in our experience have done the calculations in one way or another suiting their personal circumstances over the last thirty years. The results stack up as follows:

The assumptions using the same dollar amount invested identical cash flow, and a ten year time horizon for the sale of a property.

For all Cash Transactions, almost invariably the Roth account is the best alternative in the long run, even beyond ten years. The traditional IRA and Qualified plan (Keogh, 401(k), etc.) have distribution requirements at age 70 ½, otherwise the result at 10 years is no tax on an all cash transaction.

1031 exchanges and individual returns as far as taxes payable, come in third and fourth. The individual return pays tax of more than twice as much in an average transaction than a 1031.

For this reason our real estate investor professional likes the all cash transaction best in a tax free and then tax deferred investment over the long haul.

When a real estate asset investment property is debt financed, the results are very different, and are dependent on the amount of debt financing involved, recognizing that unrelated business income tax rules apply (Unrelated Debt Financed Income tax for debt) for IRAs.

At a 70% Loan to value ratio using IRAs only, the results show 1031 Exchanges are the least taxed, followed by the IRAs, and then Personally invested dollars. Of the two IRAs, the Roth is more advantaged as the traditional IRA starts paying tax at required distribution starting at age 70 ½, where the Roth doesn't get taxed again. At 40% loan to value, the IRAs come in better than 1031 exchanges.

Acquisition debt in a qualified plan is not subject to such tax making the qualified plan the best place to invest in property that has debt finance. The results are like cash. No tax until withdrawals are made at age 70 ½, but then there is the added advantage of the Roth portion never being taxed again.

For over thirty years the advantage of tax deferred investing has been available to everyone who earns income. Real estate professionals were there at the be-



ginning and are even measured in stronger numbers today. As self directed plans become more popular, and the tax laws become more sophisticated, the professional measures each situation and comes up with the best result. Each is different for everyone, and we suggest that using a local professional familiar with the investments you make, along with your professional team of administrators, advisors, attorneys, financial planners and accountants, you will make the best decisions.

*Hubert Bromma is the CEO of The Entrust Group. For over 25 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 30 locations nationwide. To learn more about Entrust, log onto our website at [www.entrustusa.com](http://www.entrustusa.com).*

## Building up to your retirement home one 1031 at a time...

By: Dave Owens and Elizabeth Carlson

Why not build up to your dream home by utilizing a 1031 exchange to your benefit? By taking advantage of a 1031 exchange you can defer your taxes by reinvesting all of your gain into a like-kind property. A recent revision in the tax code is allowing investors the chance to defer even more of their taxes. Section 121 was amended on October 24, 2004 and affects those who have completed a 1031 exchange or are considering one. The revision allows investors to convert an investment property into a primary residence, as long as they own it a minimum of five years (for all property bought after October 24, 2004). At this point, the principal residence exclusion rule will apply, and the investor can exclude capital gains of up to \$250,000 if single, and \$500,000 if married. It is that easy, if you hold the property 5 years after then exchange, you can total wipe out the gain, if the house was your primary residence for 2 of the last 5 years.

The Conference Agreement on H.R. 4520 includes the following provision to amend §121(d): "Recognition of gain from the sale of a principal residence acquired in a like-kind exchange within 5 years of sale. If a taxpayer acquired property in an exchange to which section 1031 applied, this subsection shall not apply to the sale or exchange of such property if it occurs during the 5- year period beginning with the date of the acquisition of such property."

The rules for a 1031 exchange are simple:

- Only investment real estate qualifies for a 1031

exchange.

- Replacement property must be identified within 45 days of the closing of the relinquished property
- You can't touch the sale proceeds; they must be held in escrow by a qualified intermediary.
- You must close on your replacement property within 180 days of the closing on your relinquished property.



Following the rules for a 1031 exchange will guarantee that you are able to defer the taxes on your sale and reinvest all of your proceeds into a new investment property. But wait, it gets better. If you buy a rental property, you can deduct all the expenses related to running that property. These expenses include taxes, interest, maintenance, repairs, and any other expense incurred while owning that property. On top

of that, you have a monthly cash flow and you get to depreciate the cost of the property (which is allowed as a deduction spread over 27.5 years). By making a wise investment decision and knowing about the benefits of a 1031 exchange, you can defer your taxes and benefit from appreciation.

*Dave Owens is the owner of 1031 Tax Free Strategies in Fort Myers, Florida. Elizabeth Carlson is a 1031 Consultant.*

## Do you need a qualified plan (or two)? Look at the tax savings and decide.

By: Steve Pauley

Kathy is a 50-year old self-employed real estate agent with no employees. Business is good and she expects it to be just as good for the foreseeable future. Her taxable income has been about \$250,000 for each of the last three years. Her husband is an executive with a Fortune 500 company. Their combined income provides them with a nice standard of living, but it puts them in the top income tax bracket. She has hired Sam as her new accountant because he has helped many of her friends reduce their taxes. In early December of 2006, Kathy calls Sam to discuss her year-end planning. Sam tells her that she will have about \$250,000 of taxable income for the year. Sam adds that after factoring in income tax, self-employment tax, and state and local taxes, she will lose about 40% of the \$250,000 in taxes. That means that she will pay about \$100,000 in tax and will be left with only \$150,000 of the original \$250,000. Kathy is not happy but she is not surprised. She has been paying about that much in tax for the last few years. Sam is not so passive. He suggests that they look at setting up a retirement plan for her business and Kathy agrees. Sam calls Joe, an actuary<sup>1</sup> who has helped several of Sam's clients in similar situations.

Joe confirms that a retirement plan would indeed reduce her taxes. If she set up a SEP or profit sharing plan, the company could contribute about \$44,000 to the plan. This means that she would save about \$17,600 in taxes (.40 X \$44,000). So, instead of having \$250,000 in taxable income, she would have \$206,000. Of course, she would still lose 40% in taxes, but this time that would be only \$82,400, leaving her with \$123,600. But she would also have the \$44,000 in the retirement plan, so she would actually have \$167,600 of the original \$250,000. This is a pretty good plan, but Joe proposes another idea.

Instead of a SEP or profit sharing plan, Joe recommends that she set up two plans - a defined benefit plan and a 401(k) plan. Joe explains that the company contribution to the defined benefit plan would be about \$125,000 and that she could make pre-tax 401(k) contributions of \$20,000 to the 401(k) plan. This would reduce Sharon's taxable income to about \$105,000. Again, she would still lose 40% in taxes, but this time that would only be

about \$42,000, leaving her with about \$63,000. But she would also have the \$125,000 in the defined benefit plan and \$20,000 in the 401(k) plan, so she would actually have about \$208,000 of the original \$250,000.

Kathy quickly realizes that this would save her about \$58,000 in taxes and allow her to sock away about \$145,000 for retirement, but she needs a little clarification. Joe explains that a defined benefit plan promises an employee a benefit at retirement, based on the employee's highest three consecutive years of earned income. The company's required contributions to fund the benefit depend on many factors, the most important being the employee's income and age. The maximum benefit that a defined benefit plan can provide is \$175,000 per year at age 62. Since Kathy has earned over \$250,000 per year for the last three years, her benefit under the plan would be \$175,000 even though her average income is \$250,000. The annual contribution to provide

the \$175,000 benefit at age 62 is about \$125,000. He explains that her business is an ideal candidate for a defined benefit plan because she has a history of stable income and expects her income to be stable in the foreseeable future. This is important because the contributions to a defined benefit plan are mandatory. For this reason, he advises her that if she is not willing to commit to funding the plan for at least five years, she probably should not set it up. The contributions to the 401(k) plan would be discretionary - Kathy could choose not to make them or make a contribution less than \$20,000 in any given year.

Of course, Kathy wants to know if the plans could invest in real estate and whether she could self-direct her accounts. Joe explains that Kathy would be the trustee of the plans and that as trustee, she would make the decisions regarding the investments. Since she would be the only participant in the plans, she would, in effect be self-directing her accounts. Both plans could invest in real estate, but he cautioned that she should be careful in the defined benefit plan because the contribution is affected by the investment return - if the assets per-

<sup>1</sup>Some have described an actuary as someone who is good with numbers but doesn't have enough personality to be an accountant. However, there are some of us who are just as much fun as accountants.



form very well, the contribution will be reduced, resulting in a reduction in her tax deduction; if the assets perform poorly, the contribution will increase, possibly beyond her budget.

This was a lot of information to absorb, but Kathy understood the bottom line - she could save about \$58,000 in taxes and sock away about \$145,000 for retirement.

*Steve Pauley is a Principal of IRA Plus Southwest, LLC. Serving North Texas, East Texas, West Texas and Oklahoma. He can be reached at (800) 473-1977 ext. 305 or [stevep@IRApusSouthwest.com](mailto:stevep@IRApusSouthwest.com). [www.IRAplusSouthwest.com](http://www.IRAplusSouthwest.com)*

## Case Study on 2005/2006 Contribution Limits

By: Quincy Long

In this article we will discuss how much money can be put into various plans by Ira N. Richer, his wife Hope B. Richer, and his son Will B. Richer. But first we must set forth some assumptions.

1. Ira and Hope's modified adjusted gross income for 2005 was exactly \$100,000, and will be the same for 2006. This includes \$80,000 in wages paid by Ira's S corporation and the remaining profits from that company plus investment income, etc. Hope does not work outside the home, other than helping Ira in his business.
2. Ira will be 56 in 2006, and Hope will be 51 in 2006. Their son Will turns 17 in 2006.
3. Will worked part time as a busboy at Old San Francisco Steakhouse in Houston in 2005 and earned \$8,000. He expects to continue his employment there in 2006 and earn at least \$10,000.
4. Ira is a diligent saver and has plenty of cash to pay taxes on any Roth conversion he does, and his company also has plenty of cash in the bank.
5. Ira's family is covered by a High Deductible Health Plan (HDHP) with his maximum out of pocket expense of \$5,450 for 2006 (it was \$5,250 for 2005). This plan has been in place since prior to January 1, 2005.
6. Ira and Hope file jointly on their taxes.
7. Hope has \$25,000 in a former employer's 401(k) plan, which she would like to use for investing in real estate and loans secured by real estate.

**Roth IRA** - Since it is before April 17, 2006 (the contribution deadline for Roth IRA's for 2005) and Ira and

Hope's modified AGI is less than \$150,000, Ira and Hope can both still contribute for 2005 as well as for 2006. Even though Hope does not earn wages, she can still contribute to a Roth IRA based on Ira's income. Since Ira is flush with cash, he contributes \$4,500 into each Roth for 2005 and \$5,000 into each Roth for 2006 (\$4,000 base each year plus \$500 catch up for 2005 and \$1,000 catch up for 2006 since they were both at least 50 years of age by 12-31-2005). Will may also contribute \$4,000 to his own Roth IRA for 2005 and \$4,000 for 2006, even if Ira gives him the money to do so, since he had earned income exceeding \$4,000 for 2005 and expects to do so again in 2006.



**Traditional IRA** - Hope can roll her former employer's 401(k) plan into a traditional IRA at Entrust. Hope and Ira could have contributed the amounts described under the Roth IRA into the traditional IRA, but their total contributions cannot exceed \$4,500 for 2005 and \$5,000 for 2006 each into both their traditional IRA's and their Roth IRA's. In this case they elected to put their entire contribution into their Roth IRA's. If neither Ira nor Hope were covered by a retirement plan at work, their contributions to a traditional IRA would be fully deductible.

If Hope wants to, she can convert the \$25,000 from the traditional IRA into her Roth IRA in 2006, since their total modified AGI was \$100,000 or less. Roth conversions are taxable in the year in which the funds are converted, but there is no penalty for doing a Roth conversion.

**SEP IRA** - Since Ira is paid W-2 wages from his business, he can contribute up to 25% of those wages into a SEP IRA for 2005. The wages were \$80,000, so he can contribute \$20,000 to his SEP IRA at Entrust. If he wants to, Ira can begin making contributions for his 2006 SEP

IRA as well. The money contributed to his SEP IRA comes from the employer, which in this case is Ira's S corporation. If you change the facts so that Ira is self-employed and his Schedule C shows \$80,000 net income from his business, then Ira can contribute up to 20% of this amount, or \$16,000 into his SEP IRA. The difference is that Ira's corporation has already deducted the amount of the SEP IRA contribution and 1/2 of the Social Security and Medicare taxes, whereas if Ira were self-employed these amounts get deducted on his personal tax return. The difference in contribution limits is intended to equalize the contributions based on the true net income after deducting one-half of the Social Security and Medicare taxes and the contribution to the SEP IRA itself.

**SIMPLE IRA** - Another alternative is for Ira to have a SIMPLE IRA at his company. This is not as advantageous at Ira's income level, but is appropriate if his income is less than \$50,000 or if he has employees and he doesn't want to contribute an equal percent into their retirement plans as he does for himself. Assuming he had the plan set up by October 1, 2005, he can defer out of his salary \$10,000, plus \$2,000 catch up because he is 50 or over by 12-31-2005. For 2006, Ira can defer another \$10,000 plus \$2,500 catch up from his salary. Additionally, Ira's employer (his S corporation) adds another 3% of his salary, or \$2,400. So the total SIMPLE contribution is \$12,500 in salary deferral and \$2,400 in employer contribution, for a total of \$14,900 for 2005. Since this is less than IRA can put in a SEP IRA, he probably will not chose this plan, absent other factors.

**Individual 401(k)** - The plan which Ira can put the most into is an Individual 401(k) plan. In this plan Ira can defer \$14,000 plus \$4,000 catch up for 2005 out of his \$80,000 salary (this increases to \$15,000 plus \$5,000 catch up in 2006). In addition, Ira's employer (his own S corporation) can contribute up to 25% of Ira's wages into the plan, or \$20,000. This means that for 2005, Ira can get \$38,000 into his Individual 401(k) plan!

Starting in 2006, Ira's salary deferral can be a Roth 401(k), which means that he will pay taxes on his salary deferral when he contributes, but will pay NO TAXES when the funds are distributed to him, provided they are qualified distributions. What an opportunity! Although Ira qualifies for a Roth IRA because of his income level, even if he makes too much money to qualify for a Roth IRA he can contribute to a Roth 401(k).

The 3 work plans, SEP IRA, SIMPLE IRA, and 401(k), DO NOT PREVENT Ira and Hope from contributing to a Roth or traditional IRA, but do affect the deductibility of a traditional IRA contribution.

**Health Savings Accounts** - Yet another way Ira and Hope can save taxes for 2005 is to open a Health Savings Account, or HSA. In order to do this, they have to have a

special type of insurance plan, called a High Deductible Health Plan, or HDHP. Just having a plan with a high deductible does not necessarily qualify you for an HSA. Since Ira and Hope have a family plan, they can contribute up to \$5,250 for 2005 up until April 17, 2006 and \$5,450 for 2006. Because Ira is over 55 years old, he can add \$600 catch up for 2005 (\$700 for 2006) in addition to the regular contribution. Ira and Hope can split the contribution into 2 separate accounts or put all of it into one account. **Contributions to HSA accounts are tax deductible, and there is no tax on the distributions if the money is used for qualified medical expenses.**

**Coverdell Education Savings Accounts (formerly Education IRA)** - Since Will is under age 18, Ira can put up to \$2,000 into a Coverdell ESA for 2005 and another \$2,000 for 2006. IRA will receive no deduction for the contribution, but any earnings which are withdrawn for qualified education expenses are not taxed. Qualified education expenses include certain expenses for grade school and high school as well as for college.

Summary - Concentrating on the tax year of 2005, here is the maximum amount of money that Ira and Hope's family can put into self-directed accounts at Entrust:

Ira	Roth IRA	\$ 4,500
Hope	Roth IRA	\$ 4,500
Will	Roth IRA	\$ 4,000
Hope	Traditional Roll-over IRA	\$25,000
Ira	Individual 401(k) Plan	\$38,000
Ira	HSA	\$ 5,850
Will	ESA	\$ 2,000
	<b>TOTAL</b>	<b>\$83,850</b>

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

## TIP OF THE MONTH

April 15<sup>th</sup> is right around the corner. It is TIME to contact your Entrust affiliate to help you make those contributions on TIME! [www.iraplus.com](http://www.iraplus.com) to find a location near you.

## INTERESTING INSIGHTS

### Back to Work

A recent study showed that 67% of retirees plan to return to work following their first retirement. Retirees who reentered the workforce first took a pause of 1.5 years on average.

Source: "Retirement Only a Breather: 7 Million Go Back to Work," Putnam Investments

### Investing Outside of the U.S.

Retirement-minded Americans are increasingly settling in Central America. Number one on the list; Mexico. The climate, beaches and cost of living have proved a potent lure for people of all ages. Eager to capitalize on the trend, U.S.-based home builders are teaming up with Mexican partners to offer everything from condos to million-dollar sea-side homes.

Source: AARP Bulletin

## QUESTION OF THE MONTH

### " Work on Investment Rental "

#### Question:

OK. I buy a rental home outright and have a tenant. The house needed some cosmetic work, rugs, paint, fixtures.

Can I do the work and have the IRA pay for the materials only?? If not, what is the disadvantage of paying for materials out of my pocket (not the IRA) and doing the work myself because this will only improve the value and thus upon selling will increase benefit to IRA??

Please be specific.

#### Answer:

You are asking if you may provide your personal labor at no cost to the plan. You may not provide a benefit to your IRA other than the annually allowed contribution to the plan. The contribution must be made in cash to the administrator. Contributions not made in cash are either excess contributions or prohibited transactions.

Please review the prohibited transaction section of our site or review IRS Code section 4975.



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Richard Lipton, Baker McKenzie  
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### Wednesday, October 4, 2006

8:30 am - 9:00 am	Registration and continental breakfast
9:00 am - Noon	General Session
Noon - 1:30 pm	Special Luncheon—Keynote Speaker
1:30 - 5:00 pm	Breakout Sessions (3 tracks—9 choices)
6:30 pm - 8:30 pm	Welcome Reception

### Thursday, October 5, 2006

7:30 am - 8:45 am	Round Tables and Continental Breakfast
9:00 am - noon	General Session
Noon - 1:30 pm	Lunch (on your own)
1:30 - 3:45 pm	Breakouts (3 tracks— 6 choices)
4:00 pm - 5:00 pm	Closing Session

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