

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

Message From the Editor

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

In this issue, Catherine Wynne of Entrust New Direction, shares a strategy that has been available since 1975, but few know about. You must read her article on 72t Distribution! Bill Humphrey, also of Entrust New Direction, shows us why too many choices for your Individual Retirement plan may not necessarily be a good idea; Jennifer Watson and Jamie Raskulinecz of Entrust Northeast give us a primer on how to become an informed investor; Steve Miszkowicz, with Entrust Chicago, looks at the role of "lender" in your IRA!

New strategies and techniques to help you become a successful investor!

Enjoy our May issue.

Lisa Moren
Editor
IRA Insights!

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Is It True That You Can “Buy Real Estate With Your IRA and Use It NOW!” ?

By: Catherine Wynne

You have seen this on the Internet and wonder, “Is it possible to use your IRA to purchase real estate that you can actually live in?” The answer to that question is NOT a simple “yes.” There are two ways to buy real estate with your IRA:

#1 Purchasing as personal property but paid for with your account

The advertising that states you can buy real estate with your IRA and live in it is not actually referring to the purchase of real estate within the IRA. What it is talking about is a little known rule for IRAs whereby you can take distributions from your Plan before reaching the age of 59 ½ years without penalty. This type of transaction is called a **72(t) Distribution**.

In IRS Publication 590, included in the list of allowed distributions without penalty is one in which you establish an agreement with the IRS for you to take equal payments from your IRA account. The IRS states:

Annuity. *You can receive distributions from your traditional IRA that are part of a series of substantially equal payments over your life (or your life expectancy), or over the lives (or the joint life expectancies) of you and your beneficiary, without having to pay the 10% additional tax, even if you receive such distributions before you are age 59 ½. You must use an IRS-approved distribution method and you must take at least one distribution annually for this exception to apply.*

The payments under this exception must generally continue until at least 5 years after the date of the first payment, or until you reach age 59 ½, whichever is later. If a change from an approved distribution method is made before the end of the appropriate period, any payments you receive before you reach age 59 ½ will be subject to the 10% additional tax.

Those who sell annuities primarily market the 72(t) Dis-

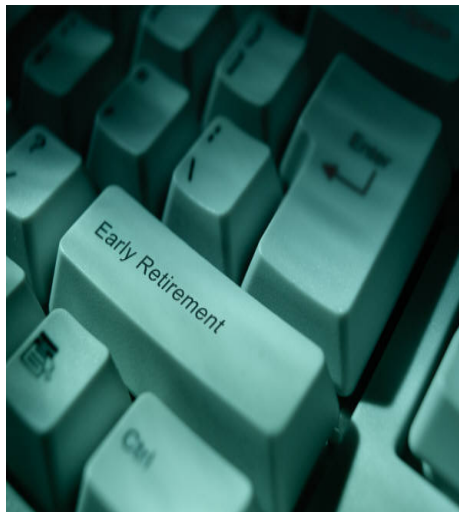
tribution concept. The IRA is actually investing in an annuity that guarantees a series of payments which are taken as distributions. This is how it is used for real estate purchases:

- Sellers of annuity contracts will have the individual transfer their annuity based IRA into a self-directed IRA, which in turn will purchase an annuity contract that guarantees a fixed payment in order to meet the required payment agreed upon with the IRS
- The individual will find a piece of real estate and buy it using a mortgage guaranteed by their personal assets with payments from the annuity used to pay the mortgage on the property.

How is this different from real estate held in your IRA? The substantial differences are:

1. You must have enough wealth to guarantee the mortgage on the property to begin with.
2. This is **not** an IRA investment. The real estate is outside of your IRA. Sale of the property, unless it is your primary residence, will follow all the rules of any investment sale.
3. The IRA is being liquidated to make the distribution payment. You may not put those funds back into the IRA after taking them out.
4. There is generally little flexibility on the rate of return or how you invest the IRA after the annuity is purchased and the 72(t) Distribution election is made.
5. You will be taxed on the distributions at your current tax rate rather than at your tax rate at retirement.
6. You have a mortgage on your credit rating as well as the need to come up with a down payment.

#2 Purchasing real estate as an investment within your self-directed account



Using a self-directed custodian, you may, if you choose, buy and sell real estate within your IRA. The proceeds of each sale go back into your account, tax-free, to be used for the next purchase. There is no time limit on how long real estate is held nor is there any requirement for “like kind” purchases with the proceeds as there is in a Section 1031 Exchange. Taxes occur when you take distributions from the IRA at age 59 ½ or later, at which time they are taxed at your income tax rate at that time. With this type of investment, however, there is a requirement that this be an *investment* and that the IRA owner cannot use it personally while it is still in the IRA.

Which method or real estate purchase is right for you?

If your intent is to use your IRA now for the purchase of a second home to use now, for example, the 72(t) option could be for you. If your attraction to real estate is for building wealth within a tax-deferred account by buying and selling for a profit and growing your IRA, then a 72(t) is probably not what you want. The tax-deferred status of IRAs is specifically designed for the purpose of tax-free **growth**. You lose this status when the real estate is purchased outside the IRA and funded with taxable distributions from an annuity.

Are there other options available?

Must you purchase an annuity contract in order to take a 72(t) Distribution? The answer is no. It is possible to do a 72(t) Distribution from any IRA, regardless of the assets held. For ease of distribution, the investments in the IRA should have sufficient liquidity available to make the mandatory distributions. You, or your advisor, need only to be able to make the calculation of the required annual distribution amount. It is a relatively simple calculation, and most tax advisors can advise you. Your self-directed custodian can hold any investment of your choosing for the purposes of the 72(t) Distribution—purchasing mortgages, income property or any cash-producing asset, for example. Consider that the purchase of an appreciating asset that also produces cash flow sufficient for your distributions may allow the account to grow for your future retirement needs while still funding the 72(t) Distribution. Making your investments inside a self-directed account allows you to keep maximum flexibility rather than locking you into the purchase of annuity contract. As

an example, consider the following for your IRA:

- Purchase a condo for cash within your IRA for \$150,000
- Your IRA rents the condo for \$800 per month, which nets \$700 per month cash flow into the IRA.
- You determine that the required monthly distribution for a 72(t) will involve taking \$700 per month from your IRA account.
- You use the \$700 to make payments on your “second home” mortgage.
- The condo appreciates at a rate of 5% per year, making your IRA worth \$190,000 in five years even while paying out the required distributions.
- Your IRA is going up in value because it contains real estate.

You have your second home to use now.

Conclusion

Choosing the right option is important, especially when one of the choices is electing a 72(t) Distribution which involves a commitment to the IRS to take mandatory distributions. Seek input from your tax and financial advisors before embarking on investments either inside or outside of your IRA in order to quantify the tax consequences of the various options. For information on self-directed IRAs and the IRS rules applicable to those types of investments contact your local self-directed IRA administrator.

Catherine Wynne is Vice President and Co-Founder of Entrust New Direction IRA, Inc. in Lafayette, Colorado. Entrust New Direction IRA is a self-directed IRA plan administrator for investors who want to diversify their retirement into non-traditional investments, including real estate. www.newdirectionira.com

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Do Retirement Plans Have Too Many Choices? Are New Limits Coming? Independent Investor Alert!

By: Bill Humphrey

“Too many choices can hamper decision making.” Current and historical research reveals that too many investment options may be a bad thing. Retirement plan providers may well be inclined to reduce the investment options available for their plans in order to meet the needs of the masses. Independent retirement investors should be concerned about this trend and keep their eyes open for providers allowing true self-direction of their plans in the face of reduced options in standard retirement plan offerings.

If more choice is bad, then self-directed plans, with their almost unlimited choices would seem likely to induce complete decision freeze-up in the standard, less-sophisticated retirement plan investor! However, a key difference for truly self-directed retirement investors is that the investments available to them are not selected from an already limited menu “pre-screened” by someone else.

Other research shows that investors with less financial knowledge are less likely to be able to make investment selections from a large assortment of choices. It is likely though, that the less astute investor would be able to take advantage of a truly self-directed retirement plan. The self-directed IRA allows the investor to invest in what they already understand. Entrust New Direction IRA, Inc., has discovered that many self-directed IRA investors are comfortable with investments beyond securities and mutual funds. Self-directed investors don't even consider investments that they don't understand because they are able to cull the unknown from the known, zeroing in on those investments that they understand and that have a proven track record with them personally.

For retirement plans, including IRAs, the plan providers face decisions about issues with regard to what investment choices to offer. Unlike self-directed plans, all standard plans must include a specific assortment of investments within the plan. The assortment must provide a wide enough investment selection to meet the needs of all the plan participants rather than allowing each individual to choose for themselves. Nearly all of these selections, with few exceptions, are in publicly traded securities, representing “diversification” across

many industries, but the entire portfolio is just securities. With the increased popularity of defined contribution plans and IRAs in the past decade, plan providers have continually worked to provide more options for the plan, thinking that more is better, but without realizing that true diversity is missing.

In a 2004 work entitled: “Asset allocation and information overload: the influence of information display, asset choice and investor experience,” Julie Agnew and Lisa R. Szykman of the Center For Retirement Research at Boston College discuss an interesting side effect of the increase in the number of options. Their work explores the impact of investor information overload and the consequences of too many choices!

A study conducted by Iyengar and Lepper (2000), “When Choice is Demotivating: Can One Desire Too Much of a Good Thing?” published by the Journal of Personality and Social Psychology, compared consumer reaction to two displays of jam - one with six flavors, the other with twenty-four. The study revealed that the bigger display attracted more attention, but the smaller display elicited more purchases. “This experiment demonstrated that consumers not only reduce the amount of processing when a task becomes overwhelming,” but may instead choose to do nothing when too many choices are presented.

The Agnew/Szykman work compares two groups of individual retirement investors, one with a lesser amount of financial knowledge and the other with a higher financial sophistication level. It analyzes the tendency of individuals to, when presented with numerous options, throw up their arms and do nothing. The results of their study reveal that those with lesser financial knowledge were overwhelmed when investment options numbered as few as six or less. For those more knowledgeable, the six choices were acceptable but when the options numbered sixty, they too experienced overload. For those on overload, the inclination was to *make no choice*.

Agnew/Szykman concluded that participants needed additional financial education and that “individuals with above average financial knowledge do report signifi-

cantly less overload when given fewer investment choices..." Will plans therefore begin to reduce already restricted investment options? Time will tell.

What about owners of self-directed plans? As self-directed administrators, our experience shows that self-directed investors tend to be among the most financially knowledgeable. A self-directed plan provides almost unlimited investment choices. However, any investor's choices are made from investments that the investor understands, not a menu of choices pre-chosen for them. Thus, while the retirement plan industry works to limit choices for the good of the group, the self-directed inves-

tor, rather than making a choice from a limited menu, chooses from his or her own preferred, select investments—the ones they know, understand and are comfortable with.

Those interested in the full results of the Agnew/Szykman study may find it at: http://www.bc.edu/centers/crr/wp_2004-15.shtml.

Bill Humphrey, President and Co-Founder of Entrust New Direction IRA, providing self-directed IRA administration, including real estate IRAs, in Colorado, Wyoming, and Montana. www.newdirectionira.com

How To Be an Informed Self-Directed IRA Holder - A Primer

By: Jaime Raskulinecz and Jennifer N. Watson

Chances are that you are reading this publication because you want more information on Self Directed Retirement Plans. That's great! Retirement Plan Self Direction has some wonderful benefits, including diversification of your retirement funds, greater personal control, and many others.

If you currently have, or are thinking of opening a Self Directed IRA, consider this: Are you an Informed Self Directed IRA Holder? If you said yes, chances are there's actually a lot more you could learn to make sure that your interactions with your administrator go smoothly. If you said no, read on for some great tips.

TAKE NOTES. Yes, like in school. This is the most important advice for anyone considering a Self Directed IRA. You probably have lots of questions, and you will get lots of information when you speak with an administrator. Try to jot down your questions before you call your administrator so that you can be sure to ask all of them in one phone call. Leave space to put in notes on the answers that you get. Write things down even if you think you will remember what the answer was. You don't want to have to waste time and energy calling back to get the same information again.

Do you know who to contact at your local Entrust office to get the answers to the questions that you have? When you call, be sure to get the name of the person that you speak with, and find out if he or she is the best person to answer the type of questions that you have. If not, ask who is.

If you are planning to open an account, make sure to read the application carefully. Fill in all the information as completely and accurately as possible. Also, make sure to send in the complete application packet. We've found

that the most commonly forgotten items in an application packet are a copy of a valid photo ID and a check for the account setup fee. If you're not sure if you have everything, call your local Entrust office. It saves time in the long run if you find out that something is missing before you mail in your application.

Try to understand and be familiar with the time frame that it will take to complete each type of request, so that you can plan your transactions accordingly. For example, it usually only takes about two business days to have your account number assigned after you send in your complete application packet. But if you are transferring an account from another custodian, it usually takes 3-4 weeks to receive the funds. Whether you are requesting a transfer or doing a transaction, try to start the ball rolling as early as possible, so that you avoid having to rush things later on.

Ok, so you've got your account set up and you want to do a transaction. Now what? You can always start by looking at the website of your local Entrust office. There you can find Buy Direction Letters and lists of documents required prior to funding a transaction. If you are not sure which type of Buy Direction Letter to use, call your local Entrust office. The website also has information on what types of transactions are allowed, prohibited transactions, and disqualified persons. Make sure you are familiar with these.

When you call an Entrust office to get information on how to do a transaction, be sure to explain exactly how you want the transaction to be done so that you get accurate information. For example, we have had clients call and say that they want to purchase real



estate. So we go through the instructions for funding a real estate purchase. Then somewhere towards the end of the conversation they say something about an LLC. It turns out they actually want to invest in an LLC which will then be purchasing the real estate. This is a totally different type of transaction, so we have to go back to the beginning and explain things all over. This can make the transaction seem more confusing, because they have now heard two sets of instructions, when they really only needed one.

By remembering these tips when dealing with your Self Directed IRA administrator, you will make it easier for your requests to be honored quickly and correctly.

Jennifer N. Watson is the Accounts Manager at Entrust Northeast, LLC. Jennifer has a bachelor's degree in Business Administration from Rider University, and has been using her educational background in finance to assist Entrust clients for the past year. She can be reached at 973-857-8058 to discuss any questions regarding opening accounts or doing transactions. www.entrustnortheast.com

Taking notes....Self-Directed Options in a Changing Real Estate Market

By: Steve Miszkowicz

As I write this newsletter, the media is hawking the slow down in the real estate market. Most of the historically "hot" areas of the country are experiencing a 10% slow down in re-sales and new construction permits, with the Midwest being the positive exception. If real estate speculating based on rapid appreciation for a new construction project was your game plan, then you may now be rethinking your strategy. Instead of owning property directly, a new light is being cast on the role of being the lender instead of the owner of the property. Let's take a look at some of the options of being the lender and holding notes in your IRA or self-directed retirement plan.

Case Study 1: John B., a top producing agent with Coldwell Banker, has had a long relationship with a small custom builder that constructs 3 homes a year. John didn't want to purchase the "spec" home directly because he believed the marketing time for the custom home may exceed 6 months. The builder took on the risk because he had a crew on payroll and would "churn dollars" if that was what was required in order to keep his company viable. John agreed to partner with the builder but not in owning the property directly. He would act as the construction or, "mezzanine," financier in the transaction. Current construction financing was at 9.75% from traditional sources. John agreed to a rate of 8.25 which was substantially more than he could receive from a money market or CD. They came to an agreement on the interest rate and now needed to iron out the terms of payment. John could be paid monthly, quarterly or in a lump sum when the property sold. Needless to say, the builder opted for the latter and John agreed to be paid at closing for all of the accumulated interest and repayment of the original principle balance. John's attorney drew up the note that indicated the note holder as

"Entrust Chicago, LLC. FBO John B. IRA". His attorney asked if he wanted to collateralize his note by placing a lien on the land with a mortgage. John called us and asked what his options were while still being in compliance with IRS guidelines. The answer was, either way, with or without a mortgage, he would be in compliance with the IRS. Being a prudent investor, John opted to have a mortgage prepared and recorded with the County. One year later, the property sold after being on the market for 8 months. John's attorney prepared the payoff letter and proceeds were sent to the IRA custodian directly from the title company at closing.

Case 2: Jackie O., a commercial real estate broker and CCIM with Equity Partners, had a client that owned 22 acres along State Highway 47. The client had inherited the land several years earlier and wanted to develop the land with the necessary site improvements to make the parcel of land more marketable. Jackie had \$225,000. in her individual 401(k). She and the client, Ari, decided to partner in the project. Jackie had two issues to consider when structuring the transaction. First, there is the ethical issue her company has in partnering with clients. Simply put, they discourage it because of the implied liability to the company. Second, Jackie's prior experience with partners was not pleasant. They did not understand the risks inherent in real estate investments and expectations often exceeded performance. Ari trusted Jackie and her reputation in the real estate community. He also knew that Jackie's contacts with the municipality and contractors were invaluable. The situation was resolved as follows:

- Ari retains ownership and control of the land.

- Jackie's 401(k) will lend Ari the development and site improvement costs.
- An outside, unrelated party will complete the site improvements and handle the necessary municipality permits.
- Two separate companies, a REIT and a single box user, Whalblue, have approached Jackie about purchasing the improved parcel of land.
- Since Ari has no capital to repay the note, Jackie's 401(k) will write the note as a "participation note". In other words, Jackie's 401(k) will lend the money in exchange for a percentage of the profit when the improved parcel is sold, and Jackie's initial 401(k) loan is repaid. They agree to a 15% participation fee.
- Jackie's attorney prepares the 401(k) note in the name of "Entrust Chicago, LLC. FBO Jackie 401(k)." The note is secured with a lien/mortgage on the land. Ari's attorney reviews the documents along with the participation clause in the note and approves the transaction.

Eight months later, the site improvements are completed and Whalblue purchases the parcel from Ari for \$2,500,000. Net profit after closing expenses, commissions and repayment of Jackie's 401(k) note of \$225,000.00 is \$2,000,000. Jackie's 401(k) also receives \$300,000.00 from the title company as repayment of the participation agreement in the note.

For more information, try surfing www.noteworthyusa.com. Remember, "taking notes" can be profitable.

Steve Miskowicz is the President & Managing Member of Entrust Chicago, LLC. Serving Chicago & East Wisconsin. www.entrustchicago.com

TIP OF THE MONTH

Check out this web site! Annualcreditreport.com. Get a free credit report online. It's an excellent way to keep track of your credit status and any potential misuse of your credit activity.

QUESTION OF THE MONTH

" An LLC in a Pension "

Question:

I am looking to use my IRA to buy an existing LLC with its only asset being a vacant lot. Can this be done keeping the property in LLC and having my IRA hold the LLC. Or can I leave the property in the LLC and dissolve the LLC leaving only the land in my pension plan?

Answer:

The LLC can own the property, or the IRA can own the property, either one works. Make sure that the existing LLC is not one owned by a disqualified person, such as you, your spouse, ascendants, descendants or spouse thereof, or any other person or entity which violates IRC 4975.site or review IRS Code section 4975.

INTERESTING INSIGHTS

Working past 65

A recent USA Today poll surveyed adults aged 45 to 64 and asked this question. "Do you plan on working past 65 years old?" 54% said yes. 45% said no and 1% aren't sure. So maybe we aren't quite ready to quit just yet!

Percentage of Women Working at 65 years or older: 29%

Source: U.S. Census Bureau

Percentage of people confident they will have enough money to live comfortably throughout retirement: 81% of those polled over the age of 65 felt they would live a comfortable retirement with enough financial resources to last their lifetime.

SAVE THE DATE!

Worried about Social Security, Medicare, increased taxes? Looking for interesting ideas to invest your IRA? Then you must be at The Entrust Client Conference in Las Vegas on October 4th & 5th 2006! Your financial future is in your hands! Let us help you expand your knowledge to grow your retirement account NOW so you can enjoy your future! To learn more about the conference email Yvonne Garcia at ygarcia@entrustadmin.com. Or visit www.entrustclientconference.com

With over 15 sessions, this conference includes CE credits for Realtors and Financial Professionals plus many other surprises! Don't wait, register today!

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