

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 June 2006 issue of IRA/401(k) Insights!

In this issue, Jack Kiley of Entrust MidAtlantic, looks at future planning opportunities with the possible new Roth Conversion Rules; Jon Galane of Entrust Idaho, writes about using Real Estate as a part of Asset Allocation; H. Quincy Long, with Entrust Retirement Services, shares techniques when using OPM's (Other People's Money); and Bill Humphrey of Entrust New Direction continues to educate us on having the financial resources to retire and includes resources for further investigation.

Don't forget to register for the Entrust Conference being held in Las Vegas in October. All four of our writers this month will be featured speakers at this event! See the information at the bottom of this page.

Enjoy our June issue.

Lisa Moren
Editor
IRA Insights!

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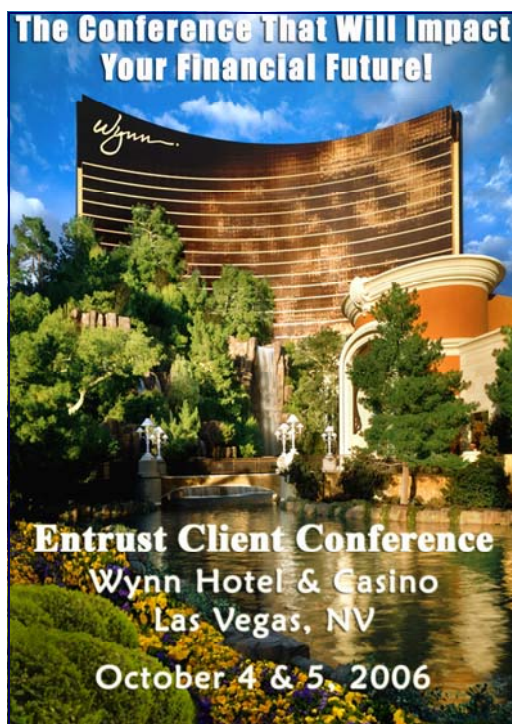
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www.EntrustClientConference.com

Possible Relaxation of Roth Conversion Rules

By: Jack Kiley

The House of Representatives has recently concluded its annual tinkering with the tax code. On an annual basis, Congress attempts to stimulate the economy, steer public policy and balance its books by changing the tax code. In recent years, there has been an agreement that any changes to the tax code need to remain 'revenue neutral.' In other words, Congress must give to us in one place (tax cuts) and take away from us (tax increases) somewhere else.

This year, they've included a provision (in the tax 'increase' side of the ledger) that many of our clients will find interesting. Under current law, traditional IRAs can only be converted to Roth IRAs if the account holder's 'modified adjusted gross income' does not exceed \$100,000 for that tax year. (Try computing modified adjusted gross income!). Assuming that this test is met, the conversion is made and the account holder pays tax on the conversion amount now; and generally speaking, all future earnings in the account



will be distributed tax free. Under the provisions in the proposed new law, the modified adjusted gross income limitation would be repealed. Furthermore, (as an incentive to convert), the proposed law will allow you spread the conversion amount over two tax years. Unfortunately, we will have to wait. This provision will apply for tax years beginning after 2009 (this must be when Congress feels they need our money!).

If this passes the full Congress, this may provide a future planning opportunity. Your financial advisors should be able to assist you in analyzing this.

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Using Real Estate as Diversification in Asset Allocation

By: Jon A. Galane

The ghost of business past

Through the last 3 decades, "financial planning" has developed from non-existent to hot button marketing for hundreds of firms. The barrage of terminology that has developed over this time has led to confusion by investors of what "financial planners" are advising their clients. Let's start with the 1990s. The financial services industry changed more in the 1990s than it had since a group of men with government bonds began trading under the buttonwood tree on Wall Street in 1792. There really was no such thing as a "financial service industry" before 1990. Prior to this there were four heavily armed camps, each occupying different sector war zones: banks, insurance companies, stockbrokers and real estate brokers.

Banks took deposits and made loans; insurers insured life and health and sold fixed annuities to the terminally chicken-hearted; stockbrokers sold stocks and bonds and did marginal business in a wimpy little product called mutual funds; real estate brokers sold homes to the American family, raw land to speculators and income-producing properties to investors. Each combatant spent tens of millions of dollars every year telling the public that the other guy's products were carcinogens.

With the advent of the wild bull market starting in 1982, stockbrokers began taking market share from both banks, through money market funds, and life insurers by licensing their reps to sell insurance/annuity products. Given the nature of this greatest of bull markets, stockbrokers' essential marketing message—"risk is good"—had turned out to be right, just as banks' and whole life insurers' message—"risk is death"—was seen to be wrong. On the outside looking in were real estate brokers whose major business was homeowners and only a select, elite few were part of the investment side of real estate.

By the early 1990s, the three major financial services combatants were all in the same business. Real estate was still left on the outside looking in. The private placements and highly leveraged limited partnerships of the mid 80s had left them bloodied and bruised. Real estate was still looking for a way to attract the average investor.

The three financial arenas had joined forces as uneasy allies when they turned together to face a new and impeccable enemy: the "no-load" fund. They now faced a foe who said, "You'd be better off not paying any of 'em." Real estate still on its own and able to sell their

product on the value of tax deductions, depreciation and write offs, continued to develop their marketing to investors. The ability to invest real estate in IRAs, although around as long as IRAs, was not being marketed by real estate agents or reps of the financial industry like it was by banks, insurers and stockbrokers. At best, the advent of REITs was the answer of stock brokerage firms to gain market share in real estate.

Now, with no-loads banging away at the ability to “do-it-yourself,” investors’ eyes were opened to the fact that they could make their own decisions for investments and retirement planning. Unfortunately for real estate agents, they never thought that there might be a way to assist in educating their clientele in do-it-yourself real estate buying. This led to the advent of “for sale by owner.” Only now in the 21st century, with loss of market share, do we see real estate agents starting to educate themselves on “do-it-yourself” retirement planning through IRAs. This awareness gives value added service to the client they may previously have lost because those investors could not see the value of their real estate broker.

Diversification and Asset Allocation

Not a day goes by when the media isn’t discussing the terms diversification, asset allocation, asset class. What exactly do these terms mean? Are they interchangeable? How does someone practice this art themselves? Where does real estate fit into the modern portfolio theory of asset allocation?

One of the most ridiculous statistics I have ever heard is one delivered with an astoundingly straight face by some professional financial advisor types (including me at one time) that 87% or 90% or whatever of your total investment return comes from asset allocation of your portfolio rather than from the selection of individual investments within an asset class. Let’s take a look at the index returns of the 3 major financial asset classes: stocks, bonds and cash, per Ibbotson Associates 1925-2005.

Stocks	10.4%
Long-term corporate bonds	5.5%
Cash (T-Bills)	3.7%
Inflation	3.0%

Looking at various indices for real estate, which is more vague, you can find conclusive historical returns using JMB Institutional realty Corp and others as a cross section from 1974-2005:

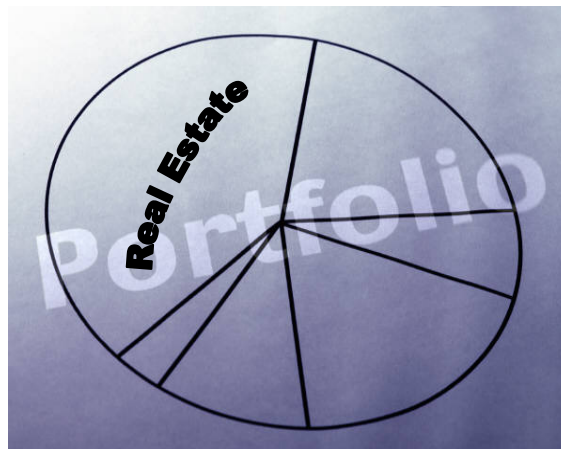
Real Estate 8.2-12%

An investor may infer from this that the more assets in the things that returned 8-12% as opposed to the things that returned 5.7% and 3.7% the higher the portfolio return would be.

Asset allocation as defined by William F. Sharpe, the inventor of the Sharpe Ratio which measures reward to risk, concluded that, “investors can allocate their money among three major asset classes—stocks, bonds and cash—and numerous subcategories within those asset classes.”

What we don’t see in any model of asset allocation or diversification within those models is real estate. It has

been conspicuously left out of the mix. Is this because the major financial institutions have not been able to figure out how to control the independence of real estate ownership, possibly? Is it perhaps because of the extra effort and work it takes for an investor to identify and consummate the real estate transaction? But, the real question I have is, “Why wouldn’t the real estate industry embrace the incredible tools available to them to assist investors in using real estate in their retirement



planning through IRAs and qualified plans?”

Well, let’s look at what professors really mean by asset allocation—the “moving into, out of, and among stocks, bonds and cash at just the right times.” What we have here is an academic theory that is of no practical utility what so ever. This is the same as saying, “the key to superior returns is to be able to consistently time the markets.” That’s terrific in a computer model and completely impossible in real life. If you simplify that argument even further, you realize that reduced to its essence, the asset allocation theory just says:

“The higher your equity exposure as a percentage of your total assets, the better your overall return.” Why then has the financial services industry made virtually a secular religion out of “asset allocation”? If you believe in the myth of “higher returns with lower risk” that by some mixture of stocks bonds and cash you can somehow magically get higher than 10.5%, then there is nothing I can say to help you understand a better model. “Higher

returns with lower risk isn't modern portfolio theory, nor even ancient portfolio theory. It's voodoo portfolio theory. It defies both logic and arithmetic." Nick Murray, *The Excellent Investment Advisor*, 1996.

At best, all an investor can ask of asset allocation is to forgo some of the permanent ups so you can miss some of the temporary downs. The question is why would anybody want to do that? The answer is nobody would—if the investor really believes that downs are temporary. The other real life problem with asset allocation as it is defined is that stocks and bonds correlate quite positively with each other. When one is taking on water in a hurry, the other usually is too, and for the same reasons.

I would like to propose a theory of total market asset allocation that simply states, "Allocate your assets between separate but equal returns. Consider using equities from the business world and real estate from the hard asset world causing your portfolio to create 'higher returns with different market risks.'" I have coined this theory as, "independent asset allocation." It's simple and obtainable. An individual can take more control over their future and direct their retirement plans towards things that are concrete and graspable. Separate your funds into 2 areas, 50% equities, diversified into 5 areas of the stock market, and 50% real estate.

If real estate debt for income is a goal, then look at first trust deeds. These give higher income that can give an investor the 6-12% area of return, equalizing it with the overall return of a stock portfolio. If an investor wants real estate equity to maximize capital appreciation, they could look at the possibility of raw land. If equity diversification is a goal, large dividend paying

stocks and funds could be allocated to an income producing property. And certainly, any bond or bond funds could be self-directed to income properties to satisfy income needs while giving the investor the opportunity of growth, stripping the direct relationship between bonds and stocks that quite frequently move in the same direction.

"Things in life will not always run smoothly. Sometimes we will be rising toward the heights---then all will seem to reverse itself and start downward. The great fact to remember is that the trend of civilization itself is forever upward: that a line drawn through the middle of the peaks and valleys of the centuries always has an upward trend."---Rev. Endicott Peabody, headmaster of Groton, quoted by his former student, Franklin D. Roosevelt, in FDR's last inaugural address, January 20, 1945.

Dr. Peabody's permanent uptrend line—"drawn through the middle of the peaks and valleys of the centuries"—is mirrored in the long-term behavior of both equity and real estate prices. It is the permanent upward bias of the trend line, not the jagged slopes between peaks and valleys, of which you should be most concerned with as you make your investment decisions within your self-directed IRA and other qualified plan accounts.

Jon A. Galane is a veteran investment advisor with 23 years experience with fortune 500 companies and is currently licensed in life, health, variable annuity and both general security and general supervisory securities licenses through AIG Investments and CEO of Entrust of Idaho 866-377-3311 or (www.entrustid.com), serving the state of Idaho. Nothing in this article is intended as tax, legal or investment advice.

Use Your Roth 401(k) Plan to Retire Rich Using OPM and NEVER PAY TAXES!

By: H. Quincy Long

The Roth 401(k) is here - and so is a way to retire rich using OPM (Other People's Money) without paying taxes, ever! Those of you who read this publication regularly know that I often write about the tax that retirement plans, including IRAs and 401(k)s, must pay on Unrelated Business Income (UBI) and Unrelated Debt Financed Income (UDFI). This tax is paid by these plans when they own a business in the plan (UBI) or own debt-financed property (UDFI), either directly or indirectly through a non-taxed entity such as an LLC or a partnership. What most people don't know is that 401(k) plans enjoy an exemption from the tax on UDFI for income from debt-financed real property in certain circumstances. Combining this exemption with the powerful new Roth 401(k) is one of the most exciting opportunities to build

your retirement wealth since the Roth IRA came along in 1998.

The real estate exception to the tax on UDFI is found in Internal Revenue Code (IRC) §514(c)(9), and applies only to "qualified organizations." Qualified organizations include certain educational organizations and their affiliated support organizations, a qualified pension plan (ie. a trust qualifying under IRC §401), and a title-holding company under IRC §501(c)(25), but only to the extent it is owned by other qualified organizations. IRAs are trusts created under IRC §408, not IRC §401, so the real estate exception to the UDFI tax does not apply to IRAs. The good news is that plans such as the Entrust Individual(k) Plan do qualify for this excep-

tion under the right circumstances.

There are six basic restrictions which must be met for the exemption from the UDFI tax to apply. They are:

1. **Fixed Price Restriction.** The price for the acquisition or improvement must be a fixed amount determined as of the date of the acquisition or the completion of the improvement.
2. **Participating Loan Restriction.** The amount of any indebtedness or any other amount payable with respect to such indebtedness, or the time for making any payment of any such amount, must not be dependent, in whole or in part, upon any revenue, income, or profits derived from such real property.
3. **Sale and Leaseback Restriction.** The real property must not at any time after the acquisition be leased by the qualified organization to the seller of the property or to certain related persons, with certain small leases disregarded.
4. **Disqualified Person Restriction.** For pension plans, the real property cannot be acquired from or leased to certain disqualified persons described in 4975(e)(2), with certain small leases disregarded.
5. **Seller Financing Restriction.** Neither the seller nor certain related disqualified persons may provide financing for the acquisition or improvement of the real property unless the financing is on commercially reasonable terms.
6. **Partnership Restrictions.** Partnerships must meet any one of three tests if the exemption from the tax on UDFI is to apply to the qualified organizations who are partners. First, all of the partners can be qualified organizations, provided none of the partners has any unrelated business income. Second, all allocations of tax items from the partnership to the qualified organizations can be "qualified allocations," which means that each qualified organization must be allocated the same distributive share of each item

of income, gain, loss, deduction, credit and basis. These allocations may not vary while the qualified organization is a partner in the partnership, and must meet the requirement of having a "substantial economic effect." Third, and perhaps most commonly, the partnership must meet a complex test called the "Fractions Rule" (or the "Disproportionate Allocation Rule").

Even with the restrictions, there are circumstances where this exemption can work. For example, one client rolled over her IRA into a 401(k) plan she created for her home based interior decorator business. The 401(k) plan then purchased 2 apartment buildings with non-recourse seller financing (which was on commercially reasonable terms). Not only is the 401(k)'s rental income exempt from the tax on UDFI, but so will the capital gains be exempt. If there is a concern about asset protection, a title holding §501(c)(2) or §501(c)(25) corporation can be formed, and the exemption will still apply.

Starting in 2006, if your plan allows it, you can defer up to \$15,000 (\$20,000 if you are 50 or over) into the plan.

But the best news of all is that we now have the Roth 401(k). Starting in 2006, if your plan allows it, you can defer up to \$15,000 (\$20,000 if you are 50 or over) into the plan. Although the salary deferrals are post tax

(meaning you still have to pay income, social security and Medicare taxes on the amount deferred into the plan), the gains are tax free forever. Unlike the Roth IRA, there are no maximum income requirements. Combining the power of an Entrust self-directed Roth 401(k) and the real estate exception for 401(k) plans under IRC §514(c)(9) means you can use Other People's Money to purchase real estate and NEVER PAY TAXES on the income and capital gains!

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. He can be reached at qlong@entrusttexas.com.

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Is Retirement an Option? Will It Be for You?

By: Bill Humphrey

You will need twenty times your current annual income in investments for maintenance of your lifestyle upon retirement. According to an expert on aging, longevity is likely to cause financial difficulties for retiring baby boomers. Speaking at a recent conference, Joseph Coughlin of the Massachusetts Institute of Technology's AgeLab, said that the next generation of retirees will live longer and healthier lives, but, because pensions have a less guaranteed payout than in the past, they had better obtain a new sophistication in financial planning. Many retirement investors are taking advantage of self-directed plans as a dynamic element in such preparation.

With baby boomers imagining a longer and more active retirement than that of their parents, questions are coming up more often: "What is it going to cost? Perhaps more than we can afford? And when will it start? How long will it last?" An individual projecting a retirement of twenty years rather than fifteen, assuming a five percent retirement fund growth rate, would have almost twenty percent less in monthly retirement checks!

Another concern for future retirees is that the past thirty years have seen a steady conversion of employer plans with fixed payments, in favor of plans such as the 401(k) plan, which provides fixed contributions. For the most part, few plan participants can expect guaranteed retirement payment amounts. Instead the participant is provided with a specific amount to invest and control for their individual retirement.

The changes to the retirement scene have been so dramatic that many future retirees find themselves mystified. A recent survey by the Employee Benefit Research Institute (EBRI) suggests that fewer than one in two Americans have attempted to calculate their financial needs for retirement.

Planning for your retirement and investing your retirement funds is completely up to you. The 2004 EBRI survey also found that "43 percent of people who tried to plan for their financial futures ended up modifying their current retirement savings plans."

Sophisticated independent investors are taking their new responsibility seriously. Many have opened new self-directed plans to help them accumulate assets for their retirement. Taking advantage of a self-directed plan to

hold your retirement assets is the only way to obtain true investment diversity and control. It allows you to invest in what you know and understand. Standard plans limit your investment options to a list of investments "pre-screened" apart from your choice.

Retirement can be an option! But it all begins and ends with you. Your financial plans should anticipate, and be ready to pay for, years of healthy, active living, travel, adventuring, and enjoyment of your well-earned retirement.

Here are a few online resources to help you determine how much you will need in retirement and also give you some ways to calculate how to afford it.



Taking the Mystery Out of Retirement Planning. The US Department of Labor has developed an excellent resource booklet: *Taking the Mystery Out of Retirement Planning*. The booklet is designed to help you get familiar with retirement issues and also includes many worksheets to help figure the dollar amounts of what you have, how much it will grow in ten years, and how much you may need to support you for a thirty-year period. It may be found at:

www.dol.gov/ebsa/publications/NRTOC.html

Choose to Save®, created by the Employee Benefit Research Institute (EBRI) and its American Savings Education Council (ASEC) program Choose to Save®, has developed user-friendly, multimedia materials to help individuals plan and save for their financial future. All materials are free and available to the public. Items include the web site www.ChoosetoSave.org, completely devoted to financial education. It includes savings tools such as the *Ballpark Estimate®* retirement planning worksheet, over one hundred online calculators, brochures, savings tips, links to related resources, and other tools to help individuals and their families manage their finances.

360 Degrees of Financial Literacy is a national volunteer effort of the nation's Certified Public Accountants to help Americans understand their personal finances and develop money management skills. It focuses on financial education as a lifelong endeavor—from children learning about the value of money to adults reaching a secure retirement. Visit their web site at:

www.360financialliteracy.org/

For information about the particular issues faced by women throughout their careers and into retirement, see: www.dol.gov/ebsa/publications/women.html and www.360financialliteracy.org/Women/.

Bill Humphrey, a Colorado CPA, is President of Entrust New Direction IRA, Inc. Serving the states of Colorado and Wyoming www.NewDirectionIRA.com

DO YOU KNOW?

Of the 59 million wage and salaried women working in the United States as of June 2000, less than half – just 47 percent – participate in a pension plan.

Womens' employment patterns are different. They are more likely to work in part-time jobs that don't qualify for pension coverage, or to work fewer years in pension-covered employment because of interruptions in their careers to take care of family members.

On average, a female retiring at age 55 can expect to live another 27 years, four years longer than a male retiring at the same age, and she needs to save for these extra years.

Studies indicate that women tend to invest more conservatively than men, receiving lower rates of return from their investments over time, thus reducing the amount of savings they have at retirement.

US Department of Labor

TIP OF THE MONTH

Your mutual fund could report you. A SAR (Suspicious Activity Report) is sent to the government for cash transactions above \$10,000. The new rules emerged from the post-September 11 Patriot Act. The law requires financial institutions to adopt programs to fight money laundering. Banks are the leading source of suspicious activity reports, however insurance products and mutual fund companies have joined the bandwagon.

INTERESTING INSIGHTS

Working past 65

Where do you plan on living when you retire? An online survey was conducted by the National Association of Realtors. 60% of baby boomers want to retire to a rural or small town; 49% want to live in an age-restricted community; 38% want to be close to family; and 12% want the city life.

Source: National Association of Realtors

Investment Real Estate still expected to buy retirement savings.

57% of baby boomers own vacation homes. 58% own rental property and 13% of baby boomers own land. 4 in 10 boomers plan on making their vacation home their permanent residence once they retire.

Source: American Demographics Magazine

401(k) money in retirement

42% of 401(k) money gets rolled into an IRA; 30% leave it in the Qualified Plan; 15% take the cash; 8% roll over to a new employer plan; and 5% take an annuity or systematic withdrawal plan.

Source: Brightwork Partners, LLC

QUESTION OF THE MONTH

" IRA Contribution "

Question:

Can the contribution to my Health Savings Account be made, pre-tax, from my paycheck?

Answer:

Yes, contributions to the HSA may be made either by the employer or the employee. The employer must have a plan which provides the contribution to all eligible employees or the contribution may be made through a cafeteria plan.

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