

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

In this issue, Quincy Long of Entrust Retirement Services explains prohibited transactions and disqualified persons in detail. This is the second of a five article series devoted to the subject of investing in an entity. Jack Kiley of Entrust MidAtlantic explains what we must know to understand IRS Rollover provisions. Brandon Hall and Dave Owens, with 1031 Tax Free Strategies, explore Tenant-In-Common rules as a strategy when acquiring real estate. Catherine Wynne, Entrust New Direction, shares how to use your IRA to help non-profit organizations. Maggie Polisano, EntrustCAMA, writes about today's real estate marketplace and the astute investor, and J.P. Dahdah of Entrust Arizona explains the value of a Solo 401 (k).

Now more than ever, all of us need the tools and know-how to help achieve growth using your IRA and 401(k). The articles in this issue go a long way to assist in developing an investment strategy and grow your nest egg.

Enjoy this month's issue.

Lisa Moren, Editor

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Things to Avoid with Rollovers

By: Jack Kiley

Over the past several months, our office has had several instances of clients or potential clients not understanding the IRS rollover provisions. Generally speaking, if you have your current custodian directly transfer your funds to your new custodian (referred to as a trustee to trustee transfer), you will avoid any tax (and penalty) issues regarding the rollover. The following are some of the more common rollover issues:

Calculating the 60 day period. The sixty day period is sixty consecutive calendar days from the day you receive the funds. This includes weekends and holidays. Keep in mind that some months have 31 days, so don't figure that if you received the funds on December 15 that you would not need to deposit them in another IRA until February 15. The actual date would be February 13.

Rollovers from a Traditional IRA to a Roth IRA. These are not allowed. You must first convert your IRA to a Roth and then roll it over or complete the rollover to a Traditional IRA and then convert it to a Roth. If you complete incorrect paperwork (Roth paperwork when you need Traditional IRA paperwork), the custodian will not accept your rollover until you complete the correct forms. This could add a couple days to the process.

Like kind rollovers. If you received a cash distribution, you must rollover cash. If you received an 'in kind' distribution, securities for example, you may rollover the

securities or liquidate these and rollover cash. We have had a few instances where clients have received cash and, as the sixty day period neared its end, wanted to deposit securities. This is a no-no.

Partial rollovers. When a client takes a distribution and is under 59 ½ years of age, the custodian is required to withhold 20% for federal income tax thus netting a payment of 80% of the total amount distributed. Then the client will turn around and deposit the funds received into an IRA account within the sixty day period. This avoids tax and penalty only on the 80% re-deposited. The client must cover 'out of pocket' for the other 20% that was withheld as income tax. Remember, the total distribution includes the tax withheld (and remitted to the IRS) on your behalf. As a matter of course, you will not get the 20% withholding back until you file your tax return for that year.

These are the most common rollover issues we receive in our office. Carefully planning your rollover and consulting with your advisors will eliminate costly issues.

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Purchasing Through Tenant-In-Common (TIC)

By: Brandon Hall and Dave Owens

One of the easiest ways to facilitate the pooling of resources for the joint ownership of real estate would be to purchase through Tenant-in-Common (TIC). Legally, a TIC isn't really an "entity", but rather a combination of fractionalized interests.

The biggest advantage of a TIC is the ease of formation. There are no set up fees or other attorney expenses as you would have with other types of entities. Each party manages their own investments and are responsible for reporting their share of the income and/or expenses.

For example, John Smith has an IRA with \$22,000 in it. His wife Betty has \$12,000 in her IRA. They want to use a combination of the IRA funds to purchase a \$50,000 vacant parcel of land. Their IRAs will come up with a total of \$30,000, and they will pull the remaining \$20,000 from their home equity loan. Therefore, as far as the IRS is concerned, there are three legal owners to the property, purchased through Tenant-in-Common.

The deed will read as such:

IRA Custodian FBO John Smith, IRA #11111 as an undivided 40% Interest and IRA Custodian FBO Betty Smith, IRA #22222 as an undivided 20% Interest and John and Betty Smith, Husband and Wife, as an undivided 40% Interest.

The biggest disadvantage of a TIC is that the investment stands for all the liability. For example, John Smith owns half of a property and his friend, Mike Jones, owns the other half. Mike then gets divorced and loses his hat in the settlement. The court could require that the entire property be liquidated to satisfy a legal remedy. Another disadvantage is that there is no direct chain of command. What if John Smith wants to sell the property and Mike Jones does not? In order to alleviate that issue, you will often find that Mike and John have an agreement that if one wants to sell, the other would have first right of refusal. For these reasons, you

usually only see close friends or family investing through a TIC.

Getting back to our example, it is two years later and John and Betty sell the property for \$100,000. Because IRAs are tax deferred, the Smith's tax responsibility will be 40% of the gain (or \$20,000) in this transaction. Furthermore, if the Smiths were planning on reinvesting the \$20,000 into another property, they could do a

1031 Exchange and end up deferring 100% of the taxes on the sale.

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Lending to Fund Non-Profit Organizations or How to use your IRA Creatively and Mindfully

By: Catherine Wynne

Private schools, churches and other non-profit entities, regardless of focus or denomination, frequently have difficulty borrowing funds for building projects. The addition of classrooms, labs, a new steeple, additional capacity added to an existing facility, or even remodeling of an existing space all take money. The use of building fund drives has long been the method of fundraising, requiring significant long term planning and the uncertainty of consistent results.

There is another way.

Ask the members to lend funds from their IRA and other tax-advantaged plans! Self-directed plans may lend funds and can benefit both the organization and the IRA holder. IRA lending using a self-directed IRA administrator allows the individual to choose their own investments, one of which can be a loan to the organization. These loans, for example, could be:

- In the form of a Note
- Can be secured by the organization's property
- Would represent an investment for the IRA and would have to reflect a reasonable rate of return.
- Would pass the benefit of interest on principal and fees to the IRA account as opposed to an outside lender.

Consider these examples:

The Youth Center

An inner city church has decided to add a teen social center in an existing space currently used for storage. The 1000 square foot area needs new flooring, painting, drywall partitions and restrooms. In addition, the furniture and equipment for Friday night movies and a pool table will be purchased. The cost of this project is estimated to be approximately \$50,000. The youth group will charge for movies and food purchased at the location.

Funds are raised by creating a \$50,000 note which will pay 5.5% interest annually. The note will be amortized on a 5 year schedule and the investors will be church members' IRAs. Let us assume that 5 individuals come forth, each lending \$10,000 from their IRA accounts using a self-directed administrator who is responsible for maintaining the tax-deferred status of the IRA accounts. Principal and interest flow back to the IRA account. The IRA holder has made a retirement investment that is secure and feels good too.

The Theatre

A small private school would like to have a venue for school assemblies and theatrical productions. It is anticipated that this new facility will boost enrollment as the Board has decided to focus on the arts in their curriculum. They have the room to expand on their current property and approach a local bank to fund the \$500,000 price of this addition. The bank is interested in the project based on the reputation of the school and the predictability of the annual tuition paid by the students but is not willing to provide 100% funding.

With a \$250,000 loan from the bank, the school trustees decide to issue "bonds" for the construction to interested parents and alumni. They structure the issue in \$50,000 increments that will be offered in step with the construction. The interest rate offered will be based on some margin over the T-Bill rate at the time the bonds are issued. This allows them to only borrow the money when it is needed, thus controlling costs and allows them to offer current competitive rates to their investors.

Many individuals these days want their investments to, in some way, reflect their personal or political values. What better way to invest, not only in "what you know" but in what you believe as well.

Catherine Wynne is a principal in Entrust New Direction IRA, Inc., Serving the states of CO, WY, MT www.NewDirectionIRA.com

Entity Investments in your IRA - Prohibited Transactions and Disqualified Persons

By: Quincy Long

This article is part of a series of articles discussing some issues arising when investing your IRA into an entity, such as a limited liability company, corporation, limited partnership or trust. In October, I will be delivering one of the breakout sessions on entity investments at the Entrust Client Education Conference in Las Vegas, Nevada. Other articles in this series include advantages and cautions when making entity investments, unrelated business income (UBI) and unrelated debt-financed income (UDFI) as it relates to entity investments, the plan assets regulations and other regulations which may apply, and formation and management issues, including the “checkbook control” LLC which has become so popular in the self-directed IRA industry.

As with any self-directed IRA investment, when investing your IRA in an entity you must know what transactions are prohibited and who is disqualified from doing business with your IRA or benefiting from your IRA’s investments. The general rule, as defined in Internal Revenue Code (“IRC”) Section 4975(c)(1), is that a “prohibited transaction” means any *direct or indirect* -

- A) Sale or exchange, or leasing, of any property between a plan and a disqualified person;
- B) Lending of money or other extension of credit between a plan and a disqualified person;
- C) Furnishing of goods, services, or facilities between a plan and a disqualified person;
- D) Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the plan;
- E) Act by a disqualified person who is a **fiduciary** whereby he deals with the income or assets of a plan in his own interest or for his own account; or
- F) Receipt of any consideration for his own personal account by any disqualified person who is a **fiduciary** from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

Essentially, the prohibited transaction rules are intended to discourage disqualified persons from dealing with the assets of the plan in a *self-dealing* manner, either directly or indirectly. The assets of a plan are to be invested in a manner which benefits the plan itself and not the IRA holder (other than as a beneficiary of the IRA) or any other disqualified person. Investment

transactions are supposed to be on an arms length basis. There are various exceptions and class exemptions to the prohibited transaction rules, but unless you know of a specific exception, the wisest course is to stay away from a transaction involving one of the above situations.

Note that the last two restrictions listed above (E and F) apply to a special class of disqualified persons who are also fiduciaries. These two provisions are designed to ensure that the fiduciary does not participate in a transaction in which he or she may have a conflict of interest. At least in the context of a self-directed IRA, the IRA holder is considered to be a fiduciary of the plan. Other fiduciaries may include officers, directors and managers of entities owned by IRAs. Fiduciaries of retirement plans owe a duty of undivided loyalty to the plans for which they act. The prohibitions are therefore imposed on fiduciaries to deter them from exercising the authority, control, or responsibility which makes them fiduciaries when they have interests which may conflict with the interests of the plans for which they act. Any action taken where there is a conflict of interest which may affect the best judgment of the fiduciary is likely to be a prohibited transaction.

All prohibited transactions involve a plan and a disqualified person. There are nine different classes of disqualified persons. They are:

- 1) A **fiduciary**, which is defined to include any person who -
 - exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets;
 - renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or
 - has any discretionary authority or discretionary responsibility in the administration of such plan.

Note: This definition of a fiduciary is much broader than in traditional trust law, and at least with a self-directed IRA, includes the IRA holder who exercises control over the management or disposition of its assets.
- 2) A person providing services to the plan. This can include attorneys, CPAs and your third party administrator.

- 3) An employer whom any employee is covered by the plan.
- 4) An employee organization in which any member is covered by the plan.
- 5) An owner, direct or indirect, of 50 percent or more of the voting power of stock in a corporation, the profits or capital interest in a partnership, or the beneficial interest in a trust or other unincorporated enterprise which is an employer or employee organization described above.
- 6) A member of the family of any of the above individuals, which is defined to include only a spouse, ancestor, lineal descendant and any spouse of a lineal descendant.

Caution: Although other members of the family are not disqualified persons (for example, brothers, sisters, aunts, uncles, step-children), dealing with close family members may still be a prohibited transaction because of the indirect rule. For example, in the IRS Audit Manual it states: "Included within the concept of indirect benefit to a fiduciary is a benefit to someone in whom the fiduciary has an interest that would affect his/her fiduciary judgment (sic). An example would be the retention by the fiduciary of his/her son to provide administrative services to the plan for a fee." This is true even though the son's provision of services to the plan may be exempt under the "reasonable compensation" exception.

- 7) A corporation, partnership, trust, or estate owned 50% or more, directly or indirectly, by the first 5

types of disqualified persons described above. Note that indirect ownership may include ownership by certain related parties such as spouses.

- 8) An officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder, or a highly compensated employee (earning 10 percent or more of the yearly wages of an employer) of a person who is an employer or employee organization, the owner of 50% or more of an employer or employee organization, or a corporation, partnership, trust, or estate which is itself a disqualified person.
- 9) A 10 percent or more (in capital or profits) partner or joint venturer of a person who is an employer or employee organization, the owner of 50% or more of an employer or employee organization, or a corporation, partnership, trust, or estate which is itself a disqualified person.

As I always say, "Don't mess with the IRS, because they have what it takes to take what you have!" An Entrust self-directed IRA is an excellent tool to help your retirement savings grow, often at rates far exceeding those of ordinary IRAs. Knowing these rules is a critical step in learning to use your self-directed IRA in a way that will safely lead to vastly improved retirement wealth.

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.

Your IRA and 2006 Real Estate Market

By: Maggie Polisano

It is obvious, to even the casual observer, that the real estate market has softened. There are three times as many listings as there were a year ago, property is taking longer to sell, and the days of receiving offers over the asking price are gone. It must be a bad time to buy real estate—not true!

Bill, a client of EntrustCAMA, explains "this is a market that separates a professional from an amateur and an investor from a speculator." Bill's IRA paid \$1.00 (One Dollar) for a property in Philadelphia and used a non-recourse, subject-to loan to finance the property. Bill found a tenant and his IRA is the recipient of the positive cash flow. The "due on sale" clause was addressed at closing and all parties were accepting of the terms. Bill summed up his thoughts as follows: "It is always a good time to buy real estate, although some times are better

than others—you never lose money on real estate except when you sell it too soon."

Many analysts are comparing today's real estate market to the bust of the "dot.com" stocks in 2000/2001. However, there are a few key differences:

1. Real Estate will always have some value
2. Real estate is cyclical and proven to increase throughout history, and
3. There is no reason to think that it will be different in the future.

Steve, a younger investor in his early thirties, comments, "I want to buy property in my IRA because I'm not going to use that money for another 25 years and I

am sure the return will be better than social security. Tenant contributions, sometimes referred to as rent, will be as good as, or better than, company matches to a retirement plan. I'm not sure if I will sell the property and collect the appreciation or just continue to collect and spend the rent. Either way, I like my options and I'm in control." Steve further elaborates, "the Roth IRA or 401(k) is the only way to really control your financial future and minimize government involvement." Steve plans to convert all his tax deferred accounts to a Roth when the law changes in 2010, eliminating income restrictions on the conversion to a Roth IRA.

The day of the quick flip for profit without adding value is ending and that is a good thing for the market and the country as a whole. What most people have not yet realized is the increase in property is directly proportional to their real estate taxes, school taxes, and insurance premiums. This again means more money for the government and less for the property owner. Successfully building wealth means you must find ways to offset or mitigate these rising costs. Your self-directed IRA, 401(k), or other retirement plan is a useful tool in reducing your overall income tax burden.

Investors should focus on the positive aspects of the present market.

From the buyer's perspective:

There is more time to analyze a property, sellers are

Solo 401(k) Offers Long-Term Savings

By: J.P. Dahdah

As a small business owner or independent contractor, you may be jealous of the tax advantages associated with the retirement savings plans offered by large companies and organizations - even those with only a handful of employees.

If you're the type of person who prefers to be independent or perhaps have started some kind of small business, there's no doubt that you want the same benefits as big-business 401(k) plans, but don't want to deal with the complex rules and administrative expenses associated with them.

As a single business owner without employees (i.e. Real Estate Agent), consider a Solo 401(k) over some of its popular cousins, including SEP, SIMPLE, or Profit Sharing plans. Popular names for these plans include "Uni-401(k)," "Individual 401(k)," or "Single participant 401(k)," but regardless of what they're called, a Solo 401(k) gives owner-only businesses the advantages of a traditional 401(k) - including higher contribution limits and the ability to borrow from the plan at a relatively affordable price.

more willing to negotiate, and creative financing is better received.

From the seller's perspective:

Holding a purchase money mortgage at today's rates increases profit, competition from speculators adding no value is minimized, and more buyers are looking for handyman specials that sweat equity can be used to make up for a shortage of cash thus eliminating the need for costly rehabbing.

From an owner's perspective:

Property values are stabilizing, rents are on the rise, and there are more tenants with better credit.

It is imperative to understand what the market is doing and adjust as the times dictate. All of the pros and cons discussed in this article are germane to owning property in or out of your IRA. However, you must always remember that IRA/401(k) profits are tax deferred or tax free dependent on your plan type. That simply means, with an IRA/401(k) you will have more cash, and in this market, it is better to have more money than less. It is a classic example of making interest with your taxes versus paying taxes on your interest.

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Contribution Limits Vary

The rules governing Solo 401(k) plans apply to incorporated and unincorporated businesses. Any business that employs only the owner (and his or her spouse) qualifies, including C corporations, single-member Limited Liability Companies, sole proprietorships and partnerships.

The higher the contribution limit, the larger the tax break, although combined contributions for salary deferrals and profit sharing may not exceed the lesser of 100 percent of compensation or \$44,000 for 2006. Under catch-up provisions, that limit is \$49,000 if you will be age 50 by the end of the calendar year.

The employee may make a salary deferral contribution up to \$15,000 (\$20,000 if the catch-up applies). Employer contributions are limited to 25 percent of employee compensation. Together, these contributions may not exceed the lesser of \$44,000, or 100 percent of compensation. Note that there is no catch-up for employer contributions. The maximum amount of

compensation that can be considered is \$220,000, and these overall limits (\$44,000 and \$220,000) also apply to self-employed or unincorporated businesses. Considering the two-part contribution structure, contributions can amount to a very nice sum every year.

Other Considerations

A Solo 401(k) gives you the flexibility to save more in years when you are doing well and hold back in less profitable ones. For example, your business might boom in some years and bust in others, but no matter the circumstances, you control whether, and how much, to contribute to the plan.

If you include plan loans as a feature of your Solo 401(k), you can generally take a tax-free loan from your plan. However, loan limits and repayment terms are

mandated by IRS rules, and no deviations are allowed.

In addition, a Solo 401(k) plan can permit rollover contributions, making it an attractive planning tool if you are thinking about leaving a corporate position to start your own business. For calendar-year companies, your Solo 401(k) accounts must be established by December 31 of the year in which you want to claim a tax deduction, and contributions must be made within a very short time after year end.

In conclusion, Solo 401(k)s offer an array of notable advantages, including higher contribution limits, loan provisions and flexibility. Take control of your retirement plan today with a Solo 401(k) plan!

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INTERESTING INSIGHTS

A recent poll of 2200 retirees 65 and older were asked if they were still employed. 45% of retirees polled enjoy working part time; 35% work full time; and 34% do not work at all.

Source: Merrill Lynch retirement study (2006)

Private apartment investors are cashing out due to maintenance hassles and other tenant complaints. A recent survey was conducted of 700 apartment transactions ranging between 1 million and 10 million in the last 12 months. 41% reinvested in apartments; 20.3% cashed out with no immediate plans for reinvestment; 15.5% did single-tenant net-lease properties like drug stores; 14% invested in multi-tenant properties such as small strip malls; 5% invested in the stock market; and 4.2% did tenant-in-common investments.

Source: Marcus & Millichap (2006)

QUESTION OF THE MONTH

" 401(k) Owning a Business"

Question:

Can a Solo 401(k) (Roth or regular) also own/invest in a business? Example: The 401(k) buys a Subway sandwich franchise.

Answer:

Yes. Note that when a retirement plan owns an operating business, income taxes on the operating profits will have to be paid, either by the business or by the plan owning that business.

TIP OF THE MONTH

Your children should have a Roth IRA!

An 18 year old who invests \$1,000 initially, and contributes just \$1,000 per year can expect their ROTH IRA account to grow to \$271,030 by the time they reach age 65. If they contributed \$4,000 a year, this amount would be worth \$1,037,724 at 65. Plus, a Roth is tax free! Encourage your adult children to start saving for their retirement today. You can even contribute for your children if they have earned income.

Attention Real Estate Licensees, CPAs, and CFPs...

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