

# IRA & 401(k) Insights



## Message From the Editor

Welcome to the October issue of IRA Insights! After reading the cover story by H. Quincy Long, President of Entrust Retirement Services, Inc., we will all be asking nicely for a Roth IRA. Lisa Bromma, President of The Entrust Group reminds you of the importance of saving for a rainy day. Don't miss 25 & Planning for retirement on page 4 written by Jennifer N. Bzik, Accounting Manager for Entrust Northeast, LLC. If only we all started saving for retirement in our twenties... Making use of "useless" land is talked about by Jack Kiley, Principal of Entrust MidAtlantic, LLC. He makes tripling the value of your IRA sound so easy. Enjoy learning more about private stock on page six with Catherine Wynn, Principal of Entrust New Direction IRA.

All of these articles have been written for you by Entrust professionals. Our local offices are made up of experts in the law, financial planning, real estate and accounting fields, providing you with a wealth of information and experience to draw from for all of your self-directed investments. We love to hear from our readers. Our goal is to write articles that educate you about all the benefits of self-directed retirement plans. If you have a topic you would like to see in an upcoming issue, please let me know.

Roxanne DeCarlo, Editor, IRA & 401(k) Insights, [editor@theentrustgroup.com](mailto:editor@theentrustgroup.com)

## Can I Have a Roth Too, Please? Yes, You Can!

By: H. Quincy Long

Most people want a Roth IRA once they understand the tremendous tax benefits. You do not receive a tax deduction for contributing money to a Roth IRA, but qualified distributions are TAX-FREE FOREVER. Essentially, the concept of a Roth IRA is that you pay taxes on the "acorn" (the initial contribution) instead of the "oak tree" (the potentially large amount in the Roth IRA after many years of tax-deferred accumulation). This is especially beneficial in a truly self-directed IRA, which can invest in real estate, notes, options, private company stock, LLCs, limited partnerships and other non-traditional assets.

Unfortunately, there are income limits for contributing to a Roth IRA or converting money from a Traditional IRA to a Roth IRA. For contributions, a married couple filing jointly may not contribute if they have Modified Adjusted Gross Income (MAGI) of more than \$166,000. For single individuals the MAGI limit is no more than \$114,000 to be able to contribute to a Roth IRA. The news is even worse if you want to convert assets from a Traditional IRA to a Roth IRA. Whether married or single, you are not eligible to do a Roth conversion if your MAGI is more than \$100,000.

For people who exceed these income limits, it might at first appear that they

### 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. Nothing in this publication is intended as tax, legal or investment advice. Entrust does not sell securities or other investments products.

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### Inside This Issue:

#### **Cover**

- Can I Have a Roth Too, Please?

#### **Page 3**

- Make a World of Difference to Your Retirement Plan
- Interesting Insights

#### **Page 4**

- Female, 25, Planning Retirement

#### **Page 5**

- Tripling Value with "Useless" Land
- Question of the Month

#### **Page 6**

- Distributing Shares of Entities from IRA/Qualified Plans

#### **Page 7**

- Tip of the Month

are left out in the cold when it comes to Roth IRAs. Fortunately, this is not actually true. There are at least 3 ways in which a person who exceeds the income limits may end up with a Roth IRA. The key phrase is “end up with” in the preceding statement.

The first method of acquiring a Roth IRA if you exceed the income limits is to inherit one. There is no age discrimination for contributing to a Roth IRA, unlike the Traditional IRA. Anyone with earned income within the limits can contribute. Earned income is generally income on which you must pay social security and Medicare taxes. Passive or investment income, including rents, interest and dividends do not count as earned income, but it is not that hard to create earned income. An elderly relative or friend may be able to help in your business in some way, for example, and your payment to them for their assistance would be earned income. They may even be predisposed to name you as their beneficiary in the event of their death.

When a Roth IRA is inherited, the new account owner must take required minimum distributions from the IRA, unless the inheritor is a spouse (required minimum distributions are not required for the original account owner). However, this does not mean that the balance in the account cannot be invested, and it is easy, at least with a self-directed IRA, to create income which exceeds the yearly required minimum distributions. Even better, if the person who died had a Roth IRA for at least 5 tax years, distributions from the account are tax-free, even if the inheritor is under age 59 ½. There is never a 10% premature distribution penalty either, since the distribution is due to death.

A second method to acquire a Roth IRA has to do with excess contributions. Many people do not really know whether their income will exceed the limits when they make their Roth IRA contribution, especially if they contribute early in the year. This is certainly true of self-employed persons. So what happens if you make a mistake by contributing early and it turns out your income exceeded the MAGI limit for the year?

If you take action before your tax filing deadline, including extensions (generally October 15), you can recharacterize the contribution to a Traditional IRA, along with all of the net income attributable (NIA) to the contribution. You may also remove the contribution from the Roth IRA, along with any income. In this case the only penalty is on the income attributed to the contribution, not on the contribution itself. However, in neither of the first two options do you end up with a Roth IRA. A third choice, however, is to leave the contribution in the Roth IRA past the October 15 deadline.

If you choose this method, you are required to pay a penalty of 6% of the amount of the excess contribution for each year that the excess remains in the Roth IRA. For example, if you contribute \$4,000 to a Roth IRA and your MAGI exceeds the limit, your penalty is only \$240 for each year the excess remains in the account. This is the penalty regardless of how much money you make in the Roth! Since the penalty only applies for as long as the excess contribution remains in the Roth IRA, you will no longer have to pay the penalty if you qualify for a Roth in a future year and do not contribute. If you do not think that you will qualify again in the near future, you may remove only the excess contribution after the October 15 deadline has passed. The profits stay in the Roth IRA! Once you have a Roth IRA, the account may continue to be invested regardless of your current year income.

Finally, in 2010 the \$100,000 MAGI limit for converting assets from a Traditional IRA to a Roth IRA is eliminated. Although a person who exceeds the MAGI limit will still not be able to contribute to a Roth IRA, in 2010 and future years, anyone may convert assets in a Traditional IRA to a Roth IRA, no matter what their income level. The amount converted is generally added to your taxable income for the year of conversion to extent it exceeds any non-deductible contributions in the account. For conversions in the year 2010 only, however, the person converting has the choice of paying 50% of the taxes on the conversion in 2011 and the other 50% in 2012. You have 3 years to pay taxes on Roth conversions done in 2010!

As I always say, there are worse things than not qualifying for a Roth IRA, such as qualifying for a Roth IRA! Whether by inheriting a Roth IRA, through an inadvertent excess contribution, or by conversion in 2010, even those who are fortunate enough not to qualify for a Roth IRA due to income exceeding the MAGI limit may end up with a Roth IRA. Even a small Roth IRA can be built into a large IRA with careful investing, which means that even the wealthy can have a substantial amount of tax-free retirement income.

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## Make a World of Difference to Your Retirement Plan

By: Lisa M. Bromma

Read the news lately? No matter how old you are, start today to put as much money away as you can for that rainy day. Many investors worry about the type of investments one should make in their retirement plan. I would like to focus on saving those pennies for retirement in the first place. Your retirement plan gives you one of the last tax breaks available. No matter who gets elected into office in 2008, this, more than likely, will not change.

Paying taxes is a lot like going to the dentist. If we could put it off we would. Taxes can reduce our net earnings making it harder to save. We all think we need every penny for today's expenses.

The government, realizing that taxes can make it harder for people to save, has created several tax-deferred, and yes, even tax-free options for you. Whether you work for a Fortune 500 company or are self-employed, take advantage of one of these options and start saving today.

401(k) – Start with your company's savings plan. Put the maximum into your company plan—if your company matches contributions this is the fastest way to grow your savings and fund your retirement. Your contributions are tax-deferred until you start to withdraw them after age 59 ½.

Roth IRA – Fund that Roth! There is no better deal out there to accumulate savings on a tax-free basis. With a Roth you pay taxes on contributions but withdrawals are tax-free at age 59 ½ provided you have had the

account for at least 5 years. You can withdraw the principal penalty free at any time after meeting the 5 year/59 ½ rule. Make sure you check with your financial advisor to see if you qualify for a Roth, or you can contact a representative of The Entrust Group ([www.TheEntrustGroup.com](http://www.TheEntrustGroup.com)) who can give you the guidelines.

Deductible IRA – Like a 401(k) the money is tax-free when you contribute but taxed when you withdraw. These plans include Traditional IRA, SEP for self-employed and SIMPLE for small company type plans.

No matter which plan works for you, the key is smart saving and investing. With a retirement plan, you accumulate the money you need so that when you are ready, the money is there—not the other way around. If we all wait until the money is there and do nothing to put it there in the first place we will have no retirement.

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## INTERESTING INSIGHTS

By now, most workers understand that the responsibility for funding their retirement is going to fall on them. The fact that traditional pensions are disappearing is no secret, and the possibility of troubles ahead with Social Security is well discussed. Your 401(k) may be all you have someday.

Unfortunately, your 401(k) may also be all at sea. Many plans offered by employers across the country are just not very good, not offering enough options to craft the kind of well-diversified portfolio you need or offering high-cost choices that bleed your returns over the years.

You need to get the tax breaks from sheltering some income and you need to collect your employer's matching contribution, which most companies give. What you don't need is to compound the problems of the lousy plan by making lousy choices within it.

By: MarketWatch - [Marketwatch.com](http://Marketwatch.com)

## Female, 25, Planning Retirement

By: Jennifer N. Bzik

I'm 25 years old and female. That makes me sort of the opposite of the average Entrust client, who is about 55 years old and male. But I think others in my situation would do well to learn more about retirement planning, particularly self-directed retirement plans.

It is unfortunate, but it is still true that women earn less, save less and know less about personal financial planning than men. I hope to see that change over the course of my lifetime, but for right now, I work with the system we've got. One thing that means is that I talk to women of all ages about money. I try to explain to them that while having money is important, understanding money is even more important. A self-directed retirement plan can be great for someone who is not really comfortable with traditional financial planning or traditional investment. A self-directed retirement plan allows you to invest in what you know best.

I've barely started my working life and I'm already planning my retirement. That makes me unusual for my age, but it shouldn't. I estimate that I have about 40 years to save for my retirement. A 55-year-old has much less time. Regardless of political views, I think it is fair to say that the future of Social Security is questionable. That being the case, I'm doing my retirement planning with the assumption that I won't get anything from Social Security. If I do get something, I will view it as a "bonus" to the other funds that I will have saved personally. Starting my retirement savings plan early also means I have much more opportunity to develop and perfect my investing strategies. For example, I have a better chance to take advantage of the potential gain of a long term real estate investment than someone who is closer to retirement.

There are plenty of options for self-directed investments that you can make if you are just starting your retirement savings. One of the most common is some type of loan. Loans are popular for small accounts because there is usually no minimum amount. You can structure the loan for whatever amount you have available. And you might be able to help a friend in the process, like I've done. I have a lot of friends my age that are struggling with debt, usually that they acquired while in school. So I instructed my Roth IRA administrator to lend the \$8,000 in my Roth IRA (my 2005 & 2006 contributions) to one of

my friends. She is much happier paying my Roth IRA 12% than she was paying credit card companies 18%, 20% or higher. And I think a 12% return is not too bad for my first self-directed investment.

No matter who you are or what your age is, it is always a good idea to be involved in your personal financial planning. Self-directing your retirement plan can be a wonderful tool to help you achieve higher potential gains while your funds are held in investments that you are comfortable with. Call your local Entrust office today for more information on beginning your Truly Self-Directed Retirement Plan. Remember – it is never too early, or too late, to start planning for retirement.

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## Tripling Value with “Useless” Land

By: Jack Kiley, CPA

We recently learned of someone who nearly tripled the value of his account buying a ‘useless’ piece of real estate. He had noticed several land sales in the area to large developers. He observed that two large tracts had recently been sold to different developers; and between these parcels was a little over two acres of land which was currently zoned such that no dwellings could be built on the property.

In doing a little research, he discovered that the owner of the property in question also owned another property and had tried to sell them together. It seemed that the seller thought he could unload the ‘useless’ property easily by bundling it with a more desirable property.

The buyer convinced the owner of the ‘useless’ property to give him an option to purchase the property for \$45,000 (\$5,000 more than market value) in 120 days. He paid \$10,000 for the option which he did in the name of his IRA.



Once he had the property under contract, he immediately approached both developers owning the adjacent properties to determine whether jointly using the parcel for storm water management for both projects would be feasible. Both developers were interested in the proposal and determined that they could get better use out of their respective properties (i.e. build more houses!) and began negotiating for the parcel.

When the deal was complete, the buyer was able to sell the property to the developers for \$ 82,000 and returned \$27,000 to his IRA (\$82,000-\$45,000-\$10,000).

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## QUESTION OF THE MONTH

### QUESTION

My IRA custodian made a loan for a note using funds from my self-directed IRA account under my direction. I am servicing the loan myself with the loan payments being directly sent to the IRA custodian (FBO my name). I believe I need to send the borrowers a 1098 or 1099 Interest form for 2006. The note is un-secured. I'm wondering which form and how to fill out the form so I do not incur the tax liability for the payments deposited into my IRA. I assume for the Recipient box I would give the IRA custodian name, address, phone info and include a FBO my name, acct #. Not certain about the Recipient Federal Identification Number?

### ANSWER

You are correct regarding the reporting of these payments, if over \$600 for the year. A 1098 is required to be filed on behalf of your IRA. Instructions for the form can be found at [www.irs.gov](http://www.irs.gov).

Regarding your specific questions, the recipient would be your IRA custodian on behalf of you IRA. The Federal Tax ID # would be the custodian's.

# Distributing Shares of Entities from IRA/Qualified Plans: Use of the Discount for Loss of Marketability for Valuation Purposes

By: Catherine Wynne

Phil Jones' IRA was invested in Denver Rehab, LLC (DR), a privately held and profitable apartment building rehab company in Denver. DR had been in business for over 5 years and consisted of a group of 25 investors, some of which were IRAs. Phil was very satisfied with both the quality of the work and the earnings of DR, but was now contemplating the tax impact of distributing his IRA shares to himself and the consequent tax impact. The question loomed: *what was the value of these shares for tax purposes?*

Unlike the distribution of publicly traded stock with a daily market value, or real estate, which can rely on an appraisal, the value of stock in a privately held company is a completely different story.

Why? Here are a few reasons:

Unlike public stock, there is no effective way to market the shares.

A less-than-majority ownership leaves the share owner with no substantial control over the company, and therefore the stock has less value to a prospective purchaser.

Lastly, because there are likely no competing potential buyers due to lack of marketing for the shares (above), there may be only one "take it or leave it" offer on the shares.

CPAs and business valuation experts frequently are required to answer the question: *what is the value of minority shareholder stock in a privately held company for tax purposes?*

This is referred to as the "Discount for Loss of Marketability", DLOM for short, and would apply to Phil's IRA's share distribution in Denver Rehab LLC.

In general, valuation of this type of stock has only been extensively evaluated in the following two circumstances:

- Pre-public offering stock or IPO stock, which will eventually be offered to the public.

- Restricted stocks, which may not, because of SEC rules, be offered to the public for a certain period of time.

These are the two types of stock that require valuations and may be discounted. Historically, IPO stock has had a discount in value of 45% while restricted stock may vary between 30% to 35%<sup>1</sup>. Although private stock is not the same as restricted stock, the two are still somewhat analogous when looking at valuation discount scenarios.



Phil's IRA's stock would fall into the private stock category. It would be more prudent to use the DLOM evaluation for restricted stock (above) when evaluating the stock in DR. This means that if the value of DR is \$5 million and the IRA owns 1/25 of the issued stock, the value of this stock, undiscounted, would be \$200,000. Discounted, this value could actually be in the neighborhood of \$130,000 to \$140,000. Splitting the difference to \$135,000 for the sake of illustration,

Phil would be paying \$41,850 in taxes as opposed to \$56,000 on the distribution of the IRA shares based on a personal income tax rate of 31%. This is a substantial tax savings, and it is tempting to stop at this point and go no further with the valuation.

What are the cautions in the application of DLOM? In some cases, because of lack of thorough analysis on the part of the taxpayer or his/her experts, the standard 30% to 35% has been challenged.

In *McCord v. Commissioner*, 120 T.C. 38 (203), a family limited partnership (FLP)<sup>2</sup>, the business valuation expert used the DLOM of 35%. The IRS expert thought differently and estimated the discount at 7.2%. Ultimately the court decided that the discount should be 20%. The argument, in this case, was the applicability of the restricted stock model to a FLP.

In other cases such as *Peraccio v. Commissioner* TC Memo 2003-280 and *Lappo v. Commissioner* TC Memo 2003-258, both FLP entities, similar valuations

were at issue, both resolving in a lower DLOM than expected. The decisions resulted in a DLOM of 25% and 24% respectively.

What do these numbers mean to Phil or any other individual with regards to the valuation of stock being distributed from their IRA? The lesson is, although there are some “industry accepted” standards for valuing private stocks, it pays to do your homework when taking advantage of DLOM.

It is nearly certain that there is a discount in Phil’s and maybe your IRA’s stock valuation for taxable distribution purposes, but how do you make use of DLOM and still stay on the right side of the IRS? To take advantage of DLOM, you and your experts need to answer the questions, “*What is the discount and how can I support this?*” before jumping into the “industry standard” trap.

### SUMMARY

An IRA can take advantage of the DLOM when valuing its shares for taxable distributions. Although the industry has historically used 30% to 35% as the discount, caution should be exercised when applying this discount randomly. Always seek the guidance of a qualified tax or legal expert in this area to avoid running into a dispute on applying the discount without supporting evidence of its validity.

### References:

<sup>1</sup> “Understanding the Valuation Discount for Lack of Marketability” by Russell T. Glazer CPA, ABV, MBA, The CPA Journal, August 2005 Issue

<sup>2</sup> “The 35% “Standard” Marketability Discount: RIP” by Michael A Paschall, ASA, CFA, JD

*Catherine Wynne is a principal in Entrust New Direction IRA, Inc., a licensee of The Entrust Group (TEG). TEG has been, since 1981, the leader in self-directed IRA, Roth, SEP and 401(k) administration. New Direction, in Lafayette Colorado, provides administration services as well as continuing education for tax and investment professionals and the general public. Website: [NewDirectionIRA.com](http://NewDirectionIRA.com).*

## TIP OF THE MONTH

Health Savings Accounts (HSAs) are fast becoming the medical equivalent of IRAs.

New rules make HSAs an even better way to save for a rainy day. Tied to high deductible health insurance plans, the accounts accumulate pretax earnings toward medical expenses, and the money remains untaxed when it’s spent. Because balances can roll over year to year, HSAs are an increasingly attractive long-term investment tool for those who are healthy now but expect to pay more for medical care as they age. The latest news makes these plans even more useful as investments. Restrictions that once limited contributions to the insurance deductible have been lifted. For 2008, individuals can put away \$2,900, and a family’s limit is \$5,800. That exceeds minimum required deductibles for these insurance plans which are \$1,100 for individuals and \$2,200 for families.

You can also get a one time transfer of funds to your HSA from your IRA or your employer’s flexible spending or health reimbursement accounts. And even if you drop your high deductible health plan, you can still maintain and spend your HSA funds indefinitely.

Best of all, the HSA can be self-directed just like an IRA and used to invest in assets you know, understand and can control. To learn more about the new rules visit [www.TheEntrustGroup.com](http://www.TheEntrustGroup.com).



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## What's Inside...

- Message From the Editor
- Can I Have a Roth Too, Please?
- Make a World of Difference to Your Retirement Plan
- Interesting Insights
- Female, 25, Planning Retirement
- Tripling Value with "Useless" Land
- Question of the Month
- Distributing Shares of Entities from IRA/Qualified Plans
- Tip of the Month