

IRA & 401(k) Insights



Message From the Editor

I hope you enjoy the November issue of IRA & 401(k) Insights. This month's issue has a great variety of topics. H. Quincy Long, Principal of Entrust Retirement Services, Inc., talks about the importance of assigning a beneficiary to your IRA, based on his personal experience after the recent passing of his father. Jon Galane, Principal of Entrust of Idaho and a retired financial advisor, takes an objective look at fear and greed in today's market. If you own commercial real estate, a rental complex or, a high priced free standing rental unit, "Cost Segregation Equals Opportunity for Commercial Real Estate" by Dave Owens, Principal of 1031 Tax Free Strategies LLC., is a must-read. Jeffrey B Broadhurst, from Broadhurst Financial Advisors, Inc. gives advice on choosing a the right kind of financial advisor to meet your needs.

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
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What's in a Name? – Why It's Important to Name a Beneficiary for Your IRA

By: H. Quincy Long

Many people probably don't think too much about how important it is to name a beneficiary for their IRAs. However, as my family recently found out, ignoring this important detail when setting up your IRA can be costly from a tax perspective.

I recently received a distribution check from an IRA of my father, who passed away last year. My father was a very careful planner, so I was quite shocked at his lack of tax planning with his IRA. When setting up his IRA he named his estate as the beneficiary of the IRA (this is

equivalent to not naming a beneficiary at all). This meant that when he passed away the estate had to be probated, even though the IRA was the only asset requiring probate in his estate. IRAs that have named beneficiaries are generally non-probate assets, meaning that they pass directly to the beneficiaries instead of passing through a will. That was the first problem.

The larger problem came because of the lack of choices he left us by naming his estate as beneficiary. In a traditional IRA, required minimum

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.

Deadline for article consideration is the 15th of each month. To subscribe to *IRA & 401(k) Insights*, call 888-340-8977 or email:

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distributions must begin no later than April 1 of the year after the IRA owner turns age 70 ½. This is known as the required beginning date. My father died before his required beginning date. Since his estate is a non-individual beneficiary, the IRA had to be distributed within 5 years, or by December 31, 2011. If my father had died after his required beginning date without having a named individual beneficiary, the yearly required minimum distributions would have been based on his remaining life expectancy in the year of his death reduced by one for each year following the year of his death.

In contrast, the choices available to our family had my father simply named beneficiaries would have been much more favorable. Assuming my father wanted his wife and 3 sons to split the IRA in the same percentages he listed in the will, he could have named us specifically instead of requiring the distribution to be made through his estate. If the IRA was not split into separate IRAs by September 30 of the year following the year of his death, then required minimum distributions would have been based on the remaining life expectancy of the oldest beneficiary, which was, of course, his wife. As his wife is a few years younger than he was, this certainly would have been a large improvement over taking the entire IRA over the next 5 years.

Had my father named the 4 of us as beneficiaries specifically, an even better plan would have been to separate the IRAs into 4 beneficiary IRAs with each of us as the sole beneficiary prior to September 30 of 2007 (the year following his death). In his wife's case this would mean that she could choose to take all the money out within 5 tax years, leave the IRA as a beneficiary IRA, thereby allowing her to take distributions without penalty even if she was under age 59 1/2, or she could have elected to treat the IRA as her own. In the case of his sons, we could have taken the IRA over 5 years or we could have stretched the

distributions over our life expectancy. For example, in my case I could have elected to take the distributions over the next 39 years instead of all at once!

Since I expected nothing from my father's estate and have no critical need for the funds, I would have taken the longer distribution period. Instead I must add the distribution check to my taxable income for this year, which in my tax bracket means a substantial bite out of the money for taxes. Since I am reasonably good at investing in my self-directed IRAs, having the ability to stretch the distributions out over 39 years would have meant an inheritance of many times what I will end up with after taxes because I had to take it all within 5 years.

The problem is even worse for my father's wife, who will have an extraordinarily large tax burden this year, since she chose to take her share of the IRA out all at once instead of over a 5 year period. While I am certainly grateful that my father thought of me in his will, simply naming specific beneficiaries would have made his legacy worth so much more to his family.

Don't let it happen to your family! Review your IRA beneficiary designations, and if you haven't already done so, name your beneficiaries. Your family will be glad you did.

H. Quincy Long is an attorney and is President of Entrust Retirement Services, Inc., with offices in Houston and San Antonio, Texas. He may be reached by email at QLong@TheEntrustGroup.com. Nothing in this article is intended as tax, legal or investment advice.

QUESTION OF THE MONTH

QUESTION

My husband and I each have two 401(k) accounts from when we, as employers, were with a payroll leasing co. We are no longer with that leasing co (2002) and must close out. We've been told we, as the employer, must do an interim type thing where the funds are transferred to an interim account, and then I as administrator can write a check to Entrust or whoever to fund a new account. How would you suggest we proceed? Should we go ahead and get an account set up so when I get the funds, I can transfer them right away? I'm assuming my husband and I each have to have separate accounts. What we want is a self-directed IRA. Can that be a Roth IRA?

See page 3 for answer.

Markets of Fear and Greed

By: Jon Galane

The news we hear today in the press speaks of fear of a declining real estate market, declining stock market, increasing unemployment, unstable interest rates and a plethora of other bad news.

After 25 years of going through differing markets and watching the press take on these and other economic issues, I have learned a few tidbits of investment do's and don'ts that I would like to share with you.

1. Do keep your money working. No matter how many times I have heard in my career that all will be lost and it's never coming back, the markets seem to correct themselves. Money sitting on the sidelines in savings will never double.
2. Do what Warren Buffet, renowned investor, does. His philosophy is when there is greed, be fearful and when there is fear, be greedy. A contrarian strategy. With the press filled with fear, the weak will retreat from the real estate market allowing savvy investors to pick up the pieces and make higher profits and gains in the years to come while those that buy into the news media will be complaining in the future how they lost and missed the great market we will someday see again.
3. Do make money and be happy. Bears win, Bulls win, and Pigs get slaughtered. Make informed decisions on investments, diversify, and be responsible for your own due diligence and investment decisions. Don't always believe that someone else has all the answers because they are a financial advisor. Advisors are human too and make mistakes in bumpy markets.
4. Do take gains and move on. There is nothing wrong with making a profit. Some investors fall in love with their investment and lose track of the best time to sell for an appropriate gain that fits their risk tolerance and reward ratios.
5. Do diversify. See my article from the May issue of *IRA & 401(k) Insights* on how to diversify a real estate portfolio through Mixed Portfolio Theory.
6. Don't make a single bet and hold it all the way up and then all the way down. This is bad decision making in any business or investment. It is not investing it now turns into gambling. Gambling is for pigs and #3 above tells us what does happen to pigs.

As a retired financial advisor I have seen investors do very strange and illogical things when fear or market downturns come into play. Use the same common sense in a bumpy market like we see today as you would in a great market. Remember if you aren't retiring in the next year it could actually be a good thing for the investment markets whether stocks, bonds, real estate or other alternative investments to turn down. This creates a buying opportunity at lower prices and opportunities for much higher gains in the years to come.

For more information on how to self direct your investments contact Entrust of Idaho.

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QUESTION OF THE MONTH

ANSWER

Based upon your situation it appears that you have "separated from service" which means you have access to the funds from the retirement plan which, in turn, means that you do a "DIRECT ROLLOVER" to a Traditional IRA with Entrust as the administrator. I would suggest the following:

Set up a Traditional IRA with an Entrust office near you:

- Request via a DIRECT ROLLOVER FORM from Entrust the assets be transferred to an IRA for your benefit. FYI: The check needs to be payable to the IRA FBO your benefit - Entrust can assist with this.
- Once the assets hit the IRAs - one for you and one for your spouse - you can direct the assets to a investment of your choice and in addition to your investments, you may also choose to change from a Traditional IRA to a Roth IRA via what is called a Roth IRA Conversion. Caution: This is a taxable event to you and requires your earnings to be less than \$100,000 for the year.

Cost Segregation Equals Opportunity for Commercial Real Estate

By: Dave Owens, CPA

If you own a commercial building that is rented or owner occupied, you need to know about cost segregation. Cost segregation is the closest thing to a gift that the IRS will ever offer you. Especially if you own a profitable business or a larger rental, cost segregation can be one of the best tax saving opportunities available.

So what is cost segregation? Cost segregation is a technique that allows the owner of investment or business real estate to recoup the cost of the asset over a shorter time period versus the current 27.5 years (residential) or 39 year (commercial) real estate depreciation method. By reallocating certain types of assets to shorter lives, the depreciation deduction is substantially increased up front which allows for greater cash flow for the owner. The certain asset types which get this shorter life treatment are non-structural assets like cabinets, air conditioning duct, doors, or outdoor landscaping which can be separated from the real estate.

The best way to understand cost segregation is by using an example. Let's consider an investor who buys a piece of commercial real estate for \$2.2 million dollars. A certain percentage will be allocated to land and the balance will be depreciated over 39 years. Let's assume that \$200k is allocated to land. That means that \$2 million will be depreciated over 39 years which comes to \$51,282 per year. Now, let's assume the company does a cost segregation analysis. They hire a qualified company to come in and evaluate the property. After the analysis, it is determined that \$400,000 of the real estate cost (of the \$2 million) can be reallocated and considered to be *fixtures* which can be depreciated over 5 years. These costs are now separated from the real estate. So the cost of the asset would now be \$200,000 for land, \$1,600,000 for improved real estate, and \$400,000 for fixtures. The real estate portion of \$1,600,000 is depreciated over 39 years for a total of \$41,026 ($1,600,000/39$) and the fixtures of \$400,000 are depreciated over five years ($400,000 \cdot .20$) for a total of \$80,000 for a total deduction of \$121,026 for the first year. Compared to the standard method, this is an additional depreciation deduction of \$69,744. If the client is in the 35% tax bracket, the first year's savings will be \$24,410. The market price of this type of cost segregation analysis is approximately .5 to 1% of the cost of the

property. The cost of the analysis is typically recouped by the first year's tax savings.

So what type of real estate owner would want to consider performing a cost segregation analysis? If the real estate is owner-occupied, the analysis could generate a positive tax advantage that would directly affect the bottom-line. A real estate investor who has just purchased a rental complex or high priced free standing rental unit can also benefit with cost segregation. The higher the price of the building, the greater the tax savings will be. Real estate owners who do not plan on holding the property for a long period of time and intend on doing a 1031 exchange (where one piece of investment property is sold and replaced with another piece of investment property, thereby deferring any taxable gain) have the opportunity to reap the greatest benefit.

The analysis can be started anytime after the unit is purchased. An analysis is best performed during construction on new buildings because the engineers can easily separate fixtures from real estate during this period. One of the most auspicious features of a cost segregation analysis is that anytime during the first ten years of ownership of the building, an analysis can be done and the lost depreciation recaptured. For example, if you purchased a building 2 years ago and you wanted to do one of these analyses, you could easily hire a firm to come in. Typically, after the analysis, you would amend the last 2 years' tax returns to catch up on the depreciation not taken.

The IRS has strict qualification requirements for anyone performing cost segregation studies. The IRS Audit Techniques Guide for Cost Segregation states, "an underlying assumption is that the study is performed by 'qualified' individuals or firms, such as those employing ... personnel competent in design, construction, auditing, and estimating procedures relating to building construction." Typically your accountant will not perform a cost segregation analysis. Specialized engineering firms have emerged as the primary provider of these types of analyses. Usually they will employ a CPA to assist the firm in drafting the analysis.

One of the specialized companies in Florida that performs cost segregation is Engineered Tax Services, Inc.

out of Palm Beach. I recently spoke with Julio Gonzalez, the company CEO regarding his services. Mr. Gonzalez stated, "The big deal regarding cost segregation studies is the ability for a real estate investor to accelerate the recoupment of their investment dollars. A cost segregation study allows for a significant increase in depreciation deductions within the first five years."

Before considering having a cost segregation analysis done, there is an important caveat you must keep in mind. When you buy a piece of real estate and remove the land value, what is left is the cost of building and fixtures. There is a finite amount of dollars that can be depreciated to these items. The current IRS "life" for real estate depreciation is 39 years for commercial and 27.5 years for residential property. If you hold property for these "life" terms as defined by the IRS, the complete depreciation will be exactly the same. Cost segregation does not give you extra depreciation; again, the IRS is offering what is *close to* a gift, not an *actual* gift. What it does is accelerate the depreciation of the real estate at the beginning of the life of the asset. This means you have lower depreciation over the later years of the asset. Potentially, the increased deduction will lower the owner's taxes and increase cash flow to the business in those important early years. By reinvesting the tax savings and using the time value of money, the owner may be able to increase his or her wealth or reinvest the money back into the company for future growth. But there is no magic that can change the actual number of depreciable dollars available on the value of the real estate.

Cost segregation can be a huge tax advantage for the owner of the property. As I stated earlier, the higher cost of the real estate, the greater the benefit. The clients whom I have seen benefit the most from an analysis are small and mid-sized businesses who own their locations or offices. Even if the businesses are not profitable, a cost segregation analysis can help because depreciation can carry forward in the form of a Net Operating Loss (NOL) that can be used when the company does start making money. The example above is a simplification of the process, but the tax savings are not.

Dave Owens CPA, CES is the Managing Member of 1031 Tax Free Strategies LLC, a company that specializes in Advanced Tax Strategies including 1031 Exchanges and Self-Directed Retirement Accounts. If you have any questions, please call him at (239) 333-1031.

INTERESTING INSIGHTS

An Individual(k) Plan is actually a Qualified Retirement Plan governed by the Internal Revenue Code of 401(a). What this means is that the investments allowed by these plans are more expansive than the investments allowed with an IRA. This allows you as individual to actually use the assets held by these plans to purchase or invest in your business entity, such as a franchise.

For more information on Individual(k) Plans contact your local Entrust office.

What You Need to Know About Choosing A Financial Advisor

By: *Jeffrey B. Broadhurst*

Since self-directed IRAs are becoming more popular and investors are taking control over some of their investments, what role does the financial advisor play in helping the self-directed client? Some individuals think that financial advisors may disagree with self-direction, or because it's never been discussed by their brokers, feel that they have no alternative but to invest alone.

As a professional advisor, I certainly prefer that my clients discuss all of their investments with me as part of their overall wealth-management plan. I do not want my clients only discussing a portion of their strategy and then feeling they have to venture autonomously with their self-directed investments.

So, how can you get unbiased advice on self-directed retirement plans? In order to get unbiased advice that is truly in your best interest, seek a Fee-Only advisor. The Fee-Only advisor does not accept commissions from selling financial products; instead, they earn an income in the form of explicit fees charged directly to the client. Nothing is hidden. Therefore they do not have an ulterior agenda to sell you a mutual fund, annuity or insurance policy in order to earn a commission.

Also you should seek a "registered investment advisor" versus a registered representative. The advantage of using an independent registered investment advisor is that they are "fiduciary." A Fiduciary means that they have a legal and ethical obligation to act in your best interest. This is a higher standard of care than what a broker is required to provide. As a fiduciary, the advisor has a standard of care that is the same as your lawyer and your doctor. For more information on this, go to www.FocusOnFiduciary.com.

However, a different standard applies to a registered representative, (a.k.a. "stockbroker" or just "broker"). The broker does not have a fiduciary obligation. A broker only has a "suitability" standard of care. Their suitability standard means that the products that they recommend to you must be merely suitable but not necessarily in your best interest. If you can imagine, there are a myriad of products that may be suitable for you and your situation but very few - perhaps only one - is going to be the best product for your situation. Most of the time, the best solutions are products which do not have commissions or loads attached to them. Unfortunately, if you are working with a commissioned broker, you might not hear about them. Registered reps are most commonly employed at large brokerage firms with well known names.

So now that you understand the difference between an advisor and a broker, let's examine how the Fee-Only, registered investment advisor charges. There are three common methods:

1. flat fee annual retainer
2. percentage of assets under management (AUM)
3. hourly or project based

Each one has its own advantages and disadvantages.

The retainer model is generally a flat fee model where you hire the advisor for a set annual fee. In exchange, they will give you financial advice about your situation, regardless of the assets managed. If you are seeking advice about a self-directed IRA and self-directed real estate transactions it might make sense to work with a retainer advisor who charges a flat fee. A good place to find an advisor who works on a flat fee retainer is from the Alliance of Cambridge Advisors. You can find information and a planner at www.cambridgeadvisors.com.

The AUM model of charging as a percentage of assets under management is a common model, whereby the advisor works with you for a percentage of the assets that they advise on, typically 1 - 1.5% per year. They may be less willing to have you self-direct your IRA if it means losing AUM fees. But some AUM advisors will consolidate all held-away assets on which they advise, and charge a fee on them. A good place to find an AUM advisor is www.napfa.org.

The hourly model works very similarly to the way most lawyers operate. By this we mean that if you have financial questions, you engage the advisor to help you. Then you just pay for the hours of advice you receive or the hours that it takes for the advisor to complete that task. For example, you might have an investment in mind for your self-directed IRA and want your advisor to help you evaluate it for benefits and risks. A good place to find an hourly advisor is Garrett planning network at www.garrettplanningnetwork.com.

It is important to understand that you could receive biased and conflicted advice if you go to a financial product sales person. If you seek advice from a stockbroker or an insurance agent who has an agenda to sell you financial products, the advice may not be in your best interest. It likely contains sales advice in order for them to earn a transaction fee or a commission. If you have or are considering a self-directed investment, there is no incentive for the broker or agent to help you. For example, you

wouldn't go to a Chevy salesman and expect him to advise you that Honda is actually a more reliable product. The salesman has an agenda to sell you a Chevy so that is what you will hear about.

For unbiased advice, seek an advisor who can quote you a fee in advance and upfront. Seek a comprehensive advisor who can cover your total financial picture—not just your IRA or real estate investments—and will also provide help with other securities, risk management, insurance, estate planning, college planning and life planning.

Use these checklists and tools to gain comfort with the advisor. If they are unable or unwilling to answer questions on these forms, keep looking for an advisor who will openly share with you their qualifications, fees, credentials and experience. Also remember to ask each advisor you talk to for a copy of their Form ADV. This form provides complete disclosure of the advisory services and fees.

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TIP OF THE MONTH

CONDUCTING AN EFFECTIVE DUE DILIGENCE

Due diligence is probably the most critical stage in the buying process. Many prospective buyers incorrectly identify this period as strictly a financial review, but it goes far beyond that. Due diligence encompasses a far greater project -- the complete investigation and review of the business.

One of the keys to buying a good business comes from your ability to learn the intimate details of the business: to identify the strengths, weaknesses, pluses, minuses, growth opportunities and areas of concern. If you do not do a flawless job of gathering information, you will not be able to pull the trigger and complete the transaction since you'll be uncertain about too many components of the business.



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