

# 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. 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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## Message From the Editor

This issue of IRA & 401(k) Insights is dedicated to helping you understand the nuances of taxes and tax advantaged accounts. Also included in this issue is the answer to the most asked question—Real Estate or Notes.

We start by reviewing Health Savings Accounts with Bill Humphrey. Changes in the real estate market are discussed by Raymond Yu and we take a comical look at taxes with Clay B. Powell. I hope you enjoy the real estate vs. notes article by Lisa Moren Bromma as much as I did.

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## Understanding Health Savings Accounts

By: Bill Humphrey

Changes to the Health Savings Account rules effective January 1, 2007, are generating new interest in the plans. However, there is still a gap in knowledge with regard to the actual usage of the plans. A recent article on Health Savings Accounts appeared in the Wall Street Journal Online and posed questions about the option of using an HSA as a saving vehicle for future expenses verses using funds in the HSA to immediately reimburse medical expenses. The article implied that it was an either/or choice.

Many HSA users are unaware that the IRS allows HSA investors to be both Savers and Spenders. As a franchisee of the Entrust Group, we provide continuing education classes to employers, employees, and professional advisors, teaching about

the rules related to HSAs and HDHPs. Surprisingly, few advisors and even fewer users really understand how the HSA works

Contrary to common belief, there is no time requirement for taking HSA distributions for medical expenses. In other words, HSA owners who elect to pay their medical expenses out of their personal funds may, rather than immediately taking a reimbursement for those costs from their HSAs, defer the reimbursement until they really need the cash. In the meantime, the funds continue to grow tax free. The longer the funds remain under the shelter of the HSA, the more they can grow. Today's eye glasses can be paid for out of pocket, and subsequently reimbursed by the HSA, the next day, the next year, or 20 years

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from now. The choice is the up to the HSA owner. Thus, if an individual can comfortably pay the expense personally, then there is really no reason to take the money from the HSA. The taxpayer is not giving up the chance to take a reimbursement by delaying it. Thus, fueled by additional funds, the HSA may search for longer term, higher yield investments. Our clients, who tend to be longer term investors, favor this approach as it allows for more stability in the account balance and potential growth.

***“clients, who tend to be longer term investors, favor this approach as it allows for more stability”***

Similarly, many taxpayers don't realize that expenses incurred in excess of the HSA balance may be reimbursed in subsequent years. The one requirement is that the HSA had to have been established prior to the expense being incurred. Unfortunately, the IRS form 8889 doesn't show these "carry-forward expenses" nor are many tax preparers able to help clients track the expenses that have not yet been reimbursed.

As keeping track of these un-reimbursed expenses is critical to determining how much of the HSA balance is eligible for immediate tax free distribution, our firm has created an "Un-reimbursed Expense Tracking System" to help our clients organize and document their un-reimbursed expenses.

*Please contact us for details on the use of an HSA for long term investments or join us for a Webex seminar to introduce the basics of HSA/High Deductible Health Plan combinations. Bill Humphrey, one of the principals of Entrust New Direction IRA in Colorado, has been a crusader for Health Savings Accounts since their creation in 2004. Bill is a Colorado CPA and has worked on developing educational programs for CPAs and health plan users to clarify the understanding and use of the HSA. Entrust New Direction has programs available live and over the internet for HSA users and employers anticipating adopting High Deductible Health Plans for their companies.*

## The Best of Both Worlds

By: Raymond Yu

Investment in core real estate has long been the anchor for investors utilizing their self-directed retirement funds. But with the recent national media and national housing data clearly showing signs that the real estate market has cooled and in many markets, saw prices for both residential and commercial real estate decline, what is one to do?

The commodities market saw this as well and in 2006, the Chicago Mercantile Exchange (CME) launched the CME Housing Futures and Options contracts and at the beginning of 2007, launched the CME US Commercial Real Estate Futures and Options contracts. Both will give investors and developers an opportunity to help mitigate risks through futures to protect or gain exposure to the \$6 trillion U.S. commercial real estate market.

While most typical futures investors are institutional investors, such as pension funds and university endowments, the contracts allow anyone to gain real estate portfolio exposure and hedge core property types based on geographically determined markets.

The idea behind a futures contract is simple: The buyer agrees to purchase a specified amount of something -- say, a ton of pork bellies -- on or before a given date. If the price goes up in the interim, then the buyer gets that commodity at below-market cost. But if the price falls the buyer is stuck overpaying. Of course, most investors -- even the big institutional ones -- can't store a ton of pork bellies. So while some futures contracts conclude with the physical delivery of a commodity, the vast majority expire unexercised, are settled with cash or involve nonphysical financial instruments like the S & P 500 index.

As a hedging tool, the futures contracts could help protect developers of larger buildings who are vulnerable to price declines between the construction of the first and last home or apartment in a large project.

The CME's product aimed at the residential market debuted last May. The contracts are tied to price indices that track home prices in 10 major metropolitan areas. As of January of 2007, there were 6,300 contracts traded with an average of 45 a day. The city with the most contracts traded has been Los Angeles with 1,275, followed by Miami with 1,149 contracts. New York has traded 750 contracts to date.

The total dollar value of trades amounts to \$325 million. For more information about the CME Housing and CME US Commercial Real Estate futures and options contracts, go to [www.cme.com](http://www.cme.com).

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## Understanding Taxes

By: Clay B. Powell

This is a lesson about drinking or something bigger. Think about it the next time someone complains that the "rich people" get the lion's share of a tax cut. Let's put tax cuts in terms everyone can understand. Suppose that every day, ten men go out for beer and the bill for all ten comes to \$100. If they paid their bill the way we pay our taxes, it would go something like this:

- The first four men (the poorest) would pay nothing.
- The fifth would pay \$1.
- The sixth would pay \$3.
- The seventh would pay \$7.
- The eighth would pay \$12.
- The ninth would pay \$18.
- The tenth man (the richest) would pay \$59.

So, that's what they decided to do. The ten men drank in the bar every day and seemed quite happy with the arrangement, until one day, the owner threw them a curve. "Since you are all such good customers," he said, "I'm going to reduce the cost of your daily beer by \$20. "Drinks for the ten now cost just \$80. The group still wanted to pay their bill the way we pay our taxes so the first four men were unaffected. They would still drink for free. But what about the other six men - the paying customers? How could they divide the \$20 windfall so that everyone would get his 'fair share'? They realized that \$20 divided by six is \$3.33. But if they subtracted that from everybody's share, then the fifth man and the sixth man would each end up being paid to drink his beer. So, the bar owner suggested that it would be fair to reduce each man's bill by roughly the same amount, and he proceeded to work out the amounts each should pay.

And so:

The fifth man now paid nothing (100% savings).

The sixth now paid \$2 instead of \$3 (33% savings).

The seventh now paid \$5 instead of \$7 (28% savings).

The eighth now paid \$9 instead of \$12 (25% savings).

The ninth now paid \$14 instead of \$18 (22% savings).

The tenth now paid \$49 instead of \$59 (16% savings).

Each of the six was better off than before. And the first four continued to drink for free. But once outside the restaurant, the men began to compare their savings. "I only got a dollar out of the \$20," declared the sixth man. He pointed to the tenth man, "but he got \$10!"

"Yeah, that's right," exclaimed the fifth man. "I only saved a dollar, too. It's unfair that he got ten times more than I!"

"That's true!!" shouted the seventh man. "Why should he get \$10 back when I got only two? The wealthy get all the breaks!"

"Wait a minute," yelled the first four men in unison. "We didn't get anything at all. The system exploits the poor!"

The nine men surrounded the tenth and beat him up. The next night the tenth man didn't show up for drinks, so the nine sat down and had beers without him. But when it came time to pay the bill, they discovered something important. They didn't have enough money between all of them for even half of the bill! And that, boys and girls, journalists and college professors, is how our tax system works. The people who pay the highest taxes get the most benefit from a tax reduction. Tax them too much, attack them for being wealthy, and they just may not show up anymore. In fact, they might start drinking overseas where the atmosphere is somewhat friendlier. For those who understand, no explanation is needed. For those who do not understand, no explanation is possible.

*Clay B. Powell, Director, Rental Property Owners Association, Real Estate Investors of Michigan, 2004 & 2006 NAREIA MERIT AWARD, 2005 NAREIA AWARD OF EXCELLENCE, 1459 Michigan Street NE, Grand Rapids, MI 49503, 1-800-701-7762, 616-454-3385, [www.rpoaonline.org](http://www.rpoaonline.org), [www.reiofmi.org](http://www.reiofmi.org)*

# Real Estate or Notes: Which Is the Better Investment?

By: Lisa Moren Bromma

When someone asks you which is the better investment, real estate or notes, how do you answer them?

You already know that real estate is a good investment. It is safe because it is asset backed. It generally rises in value and creates profits that frequently can be tax deferred or even tax free. So why might someone consider real estate notes?

1. There are no tenants in the note business, only payors. Any problems with the improvements, the property, or the neighbors must be dealt with by the payor on the note, not the note holder.
2. Notes are, by definition, set up as income streams over time. It is rare to find a note with less than five years of payments remaining, so once the note is in existence, the holder can count on receiving regular payments for a long time.
3. Holding a note defers some taxable profits over the same long term. Notes generate taxable interest income similar to taxable rent. In addition, however, if a property is sold on installments instead of for cash, some of the profit often can be deferred. As principal is received one payment at a time, the percentage of it that represents profit is taxed but is spread out over multiple tax years.
4. If the payor defaults, you keep the down payment, all the payments made to date, foreclose, and resell the property to generate another down payment and a new note all over again.

Real estate and notes each have significant benefits. We recommend that most investors maintain a portfolio mix of both to take advantage of either one when a creative buying opportunity arises.

For instance, rehabbers make their properties easier to resell by financing the sale and creating paper to keep. If they need cash in the near or distant future, the remaining payments can be sold. For smaller cash needs, a deal can be tailored to sell just enough payments to raise the required cash. The rehabber can keep unsold payments that begin again once the investor has received his payments.

As you increase your portfolio of paper, opportunities will come to you to buy existing notes at a discount. You then can use discount purchased paper at full face value to buy real estate. It looks to the sellers as if you are paying full price for their property when instead you are using paper you bought at a discount. You are able to convert your discounted purchase into real estate.

Some people advertise that they buy notes. Frequently this is a second source of income for someone who spends most of their working time in a different field, such as real estate investing. These people either can hold the note to collect payments or resell it quickly to another investor, securing a cash profit at the same time.

*The next time someone asks you  
which is better, real estate or notes,  
now you know to answer,  
**BOTH!!!***

*Lisa Moren Bromma has been a real estate investor since 1978, a note investor since 1988, and a marketing consultant since 1984. She is President of The Entrust Group. Recently published "Real Estate Investing for the Utterly Confused" and "Wise Women Invest in Real Estate."*



## QUESTION OF THE MONTH

### **Question:**

I bought a piece of Land in December.2006. I took title in my personal name. After doing that, I realized I should have purchased it with my self-directed Roth IRA. Is it too late to transfer this into my Roth IRA? It only cost me 2k for the land.

### **Answer:**

Unfortunately, it is too late to place the land in your Roth IRA as any sale or exchange between your Roth IRA and property you own would be a prohibited transaction.

## INTERESTING INSIGHTS

### **Study Urges Individuals to Start Saving for Retirement No Later than 35**

April 6, 2007 (PLANSPONSOR.com) - Individuals should start saving no later than age 35, or be in danger of facing a significant drop in lifestyle when they retire, a recent study by several Ibbotson Associates researchers suggests.

According to the authors of the National Savings Rate Guidelines Study, those who start saving for retirement after age 35 face the challenge of needing to save at an increasingly higher rate to have enough. For example, the recommended savings rate for a person starting to save at age 25 typically more than doubles if he or she waits until age 45 to start saving and triples at age 55.

According to the study, someone making \$40,000 would:

- At a starting age of 25, have to save at a 6.8% rate to generate 80% income replacement for retirement and 1.4% if they wanted 60% income replacement;
- At a starting age of 35, have to save at a 16.4% rate to generate 80% income replacement for retirement and 7.4% if they wanted 60% income replacement;
- At a starting age of 45, have to save at a 29.4% rate to generate 80% income replacement for retirement and 13.4% if they wanted 60% income replacement;
- At a starting age of 55, have to save at a 79.8.4% rate to generate 80% income replacement for retirement and 48.8% if they wanted 60% income replacement.

The study also shows that Social Security benefits have a greater impact on low-and moderate-income individuals than they do on high-income individuals because benefits are capped at certain income levels, meaning that higher-income individuals have to save more to offset the lower proportional benefits



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### TIP OF THE MONTH

Review your existing health insurance policy to determine if it is a high deductible health plan. If your health plan is a high deductible plan or could be converted to a high deductible plan, you may have the ability to take advantage of a health savings account that could allow you to make tax deductible contributions and use the money tax free for health care costs.