Articles on Self-Directed IRAs, 401(k)s and Other Qualified Accounts

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Table of Contents

Top 10 Self-Directed IRA Myths Debunked ... 3
Either a Lender or a Borrower Be ... 7
The Saver's Tax Credit – How to get up to $2,000 FREE from the U.S. Government ... 10
What's in a Name? – Why It's Important to Name a Beneficiary for Your IRA ... 12
Self-Directed Health Savings Accounts – Building Wealth through Health ... 14
Self-Directed Health Savings Accounts – The Best of Both Worlds ... 16
How to Pay for Education Expenses With Tax-Free Dollars ... 18
How Can My Minor Child Have a Roth IRA? ... 21
How to Analyze a Roth Conversion ... 24
How to Stretch a Roth IRA to Last More Than 150 Years ... 27
How Do I Invest Thee? Let Me Count the Ways! ... 30
To Pay or Not to Pay – That is the Question Unrelated Business Income Tax in Retirement Plans ... 34
Frequently Asked Questions About Buying Debt Financed Real Estate in an IRA ... 36
Prohibited Transactions in Self-Directed Retirement and Other Plans ... 39
Option Strategies for Your IRA ... 58
Wealth Building Options for Your IRA ... 61
Entity Investments in Your IRA - Advantages, Cautions and Legal Considerations ... 64
Entity Investments in Your IRA - Is Your Investment Income Taxable to the IRA? ... 67
Entity Investments in Your IRA - Prohibited Transactions and Disqualified Persons ... 70
Entity Investments in Your IRA - Who Cares About the Plan Asset Regulations? ... 73
Entity Investments in Your IRA - *Swanson v. Commissioner* and the "Checkbook Control" IRA-Owned LLC ... 76
Top Ten Mistakes I See People Make With Their Self-Directed IRAs ... 79
Ten Things You Need to Know About Self-Directed IRAs ... 83
Top Ten Things You Need to Know When Investing in Real Estate Notes in Your IRA ... 87

Top 10 Self-Directed IRA Myths Debunked

By H. Quincy Long

There is a lot of confusion over self-directed IRAs and what is and is not possible. In this article we will disprove some of the more common self-directed IRA myths.

1) Purchasing anything other than CDs, stocks, mutual funds or annuities is illegal in an IRA.

False. The only prohibitions contained in the Internal Revenue Code for IRAs are investments in life insurance contracts and in "collectibles", which are defined to include any work of art, any rug or antique, any metal or gem (with certain exceptions for gold, silver, platinum or palladium bullion), any stamp or coin (with certain exceptions for gold, silver, or platinum coins issued by the United States or under the laws of any State), any alcoholic beverage, or any other tangible personal property specified by the Secretary of the Treasury (no other property has been specified as of this date).

Since there are so few restrictions contained in the law, almost anything else which can be documented can be purchased in your IRA. A "self-directed" IRA allows any investment not expressly prohibited by law. Common investment choices include real estate, both domestic and foreign, options, secured and unsecured notes, including first and second liens against real estate, C corporation stock, limited liability companies, limited partnerships, trusts and a whole lot more.

2) Only Roth IRAs can be self-directed.

False. Because of the power of tax free wealth accumulation in a self-directed Roth IRA, many articles are written on how to use a Roth IRA to invest in non-traditional investments. As a result, it is a surprisingly common misconception that a Roth IRA is the only account which can be self-directed. In fact, there are seven different types of accounts which can be self-directed. They are the 1) Roth IRA, 2) the Traditional IRA, 3) the SEP IRA, 4) the SIMPLE IRA, 5) the Individual 401(k), including the Roth 401(k), 6) the Coverdell Education Savings Account (ESA, formerly known as the Education IRA), and 7) the Health Savings Account (HSA). Not only can all of these accounts invest in non-traditional investments as indicated in Myth 1, but they can be combined together to purchase a single investment.

3) I don't qualify for a self-directed Roth or Traditional IRA because I am covered by a retirement plan at work or because I make too much money.

False. Almost anyone can have a self-directed account of some type! Although there are income limits for contributing to a Roth IRA (in 2008 the income limits are $169,000 for a married couple filing jointly and $116,000 for a single person or head of household), having a plan at work does not affect your ability to contribute to a Roth IRA, and there is no age limit either. With a Traditional IRA, you or your spouse having a retirement plan at work does affect the deductibility of your contribution, but anyone with earned income who is under age 70 1/2 can contribute to a Traditional IRA. There are no upper income limits for contributing to a Traditional IRA. Also, a Traditional IRA can receive funds from a prior employer's 401(k) or other qualified plan. Additionally, you may be able to contribute to a Coverdell ESA for your children or grandchildren, nieces, nephews or even my children, if you are so inclined. If you have the right type of health insurance, called a High Deductible Health Plan, you can contribute to an HSA regardless of your income level. With an HSA, you may deduct your contributions to the account and qualified distributions are tax free forever! It's the best of both worlds. All of this is in addition to any retirement plan you have at your job or for your self-employed business.

4) **I can't have a self-directed 401(k) plan for my business because I am self-employed and file a Schedule C for my income.**

False. You can have a self-directed SEP IRA, a SIMPLE IRA or a 401(k) plan even if you are self-employed and file your income on Schedule C of your personal tax return. With a SEP IRA, you can contribute up to 20% of your net Schedule C income (or 25% of your wages from an employer), up to a maximum of $46,000 for 2008. With the SIMPLE IRA, you can defer up to the first $10,500 of your income, plus an additional $2,500 of your income if you are age 50 by the end of the year, plus you can contribute an additional 3% of your income as an employer contribution. Beginning in 2002 even self-employed persons are entitled to have their own 401(k) plan. Better yet, in 2006 the Roth 401(k) was added, allowing even high income earners to contribute after tax dollars into an account where qualified distributions are tax free forever! With an Individual 401(k) you can defer up to $15,500 of your earnings, plus an additional $5,000 if you reach age 50 by the end of the year, plus you can contribute up to an additional $30,500 based on up to 20% of your net Schedule C income for 2008 (or 25% of your wages from an employer). This means that a 50 plus year old self-employed person can contribute up to $51,000 for 2008!

5) **Because I have a small IRA and can only contribute $4,000, it's not worth having a self-directed IRA.**

False. Even small balance accounts can participate in non-traditional investing. Small balance accounts can be co-invested with larger accounts owned by you or even other people. For example, one recent hard money loan we funded had 10 different accounts participating. The smallest account to participate was for only $1,827.00! There are at least 4 ways you can participate in real estate investment even with a small IRA. First, you can wholesale property. You simply put the contract in the name of your IRA instead of your name. The earnest money comes from the IRA. When you assign the contract, the assignment fee goes back into your IRA. If using a Roth IRA, this profit is *tax-free forever!* Second, you can purchase an option on real estate, which then can be either exercised, assigned to a third party, or canceled for a fee. Third, you can purchase property in your IRA subject to existing financing or with a non-recourse loan from a bank, a hard money lender, a financial friend or a motivated seller. Profits from debt-financed property in your IRA may incur unrelated business income tax (UBIT), however. Finally, as mentioned above, your IRA can be a partner with other IRA or non-IRA investors.

6) If I want to purchase non-traditional investments in an IRA, I must first establish an LLC which will be owned by my IRA.

False. A very popular idea in the marketplace right now is that you can invest your IRA in an LLC where you (the IRA owner) are the manager of the LLC. Effectively you have “checkbook control” of your IRA funds. Providers generally charge thousands of dollars to set up these LLCs and sometimes mislead people into thinking that this is necessary to invest in real estate or other non-traditional investments. This is simply not true. Not only can an IRA hold title to real estate and other non-traditional investments directly with companies such as Entrust Retirement Services, Inc., but having “checkbook control” of your IRA funds through an LLC can lead to many traps for the unwary. Far from protecting your IRA from the prohibited transaction rules, these setups may in fact lead to an inadvertent prohibited transaction, which may cause your IRA to be distributed to you, sometimes with substantial penalties. This is not to say that there are not times when having your IRA make an investment through an LLC is a good idea, especially for asset protection purposes. Nonetheless, you must educate yourself completely as to the rules before deciding on this route. Having a “checkbook control” IRA owned LLC is kind of like skydiving without a parachute – it may be fun on the way down, but eventually you are likely to go SPLAT!

7) I can borrow money from my IRA to purchase a vacation home for myself.

False. Although the Internal Revenue Code lists very few investment restrictions, certain transactions (as opposed to investments) are considered to be prohibited. If your IRA enters into a prohibited transaction, there are severe consequences, so it is important to understand what constitutes a prohibited transaction.

Essentially, the prohibited transaction rules were made 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 owner (other than as a beneficiary of the IRA) or any other disqualified person. Investment transactions are supposed to be on an arms length basis.

As a result of these legal restrictions, a loan from your IRA or staying at a vacation home owned by your IRA, even if fair market rates are paid for interest or rent, would be prohibited.

8) With a self-directed IRA, I can borrow my IRA funds to purchase real estate and then put all the profits back into the IRA.

False. When real estate or any other asset is purchased within a self-directed IRA, the money never leaves the IRA at all. Instead, the IRA exchanges cash for the asset, in the same way that an IRA at a brokerage house exchanges cash for shares of stock or a mutual fund. Therefore, the asset must be held in the name of the IRA. For example, if Ira N. Vestor were to purchase an investment house in his self-directed IRA, the title would be held as "Entrust Retirement Services, Inc. FBO Ira N. Vestor IRA #12345-11." Since the IRA owns the asset, all expenses associated with the asset must be paid by the IRA and all profit resulting from that investment belongs to the IRA, including rents received and gains from the sale of the asset.

9) If my IRA buys real estate, it must pay all cash for the property. An IRA cannot buy real estate with debt.

False. An IRA can own debt-financed property, either directly or indirectly through a non-taxed entity such as an LLC or partnership. Any debt must be non-recourse to the IRA and to any disqualified person. An IRA may have to pay Unrelated Debt Financed Income Tax (UDFIT) on its profits from debt-financed property. In general, taxes must be paid on profits from an IRA-owned property that is debt-financed, including profits from the sale or disposition of the property, in the same proportion that it had debt. For a simplified example, if the IRA puts 50% down, then 50% of its profits above $1,000 will be taxable. Although at first this sounds terrible, in fact leverage can be an extremely powerful tool in building your retirement wealth. The same leverage principle applies inside or outside of your IRA – you can do more with debt-financing than you can without it. One client was able to build her Roth IRA from $3,000 to over $33,000 in less than 4 months even after paying the taxes due by taking over a property subject to a debt and selling the property to another investor!

10) An IRA cannot own a business.

False. A self-directed IRA is an amazingly flexible wealth building tool and can own almost anything, including a business. However, due to the conflict of interest rules you cannot work for a business owned by your IRA and get paid. Some companies have a plan to start a C corporation, adopt a 401(k) plan, roll an IRA into the 401(k) plan and purchase employer securities to effectively start a new business, but this is not a direct investment by the IRA in the business and is fairly expensive to set up. Also, if your IRA owns an interest in a business, either directly or indirectly through a non-taxed entity such as an LLC or partnership, the IRA may owe Unrelated Business Income Tax (UBIT) on its profits from the business. A solution to this problem may be to have the business owned by a C corporation or another taxable entity.

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Either a Lender or a Borrower Be

By H. Quincy Long

Personally, I think Shakespeare had it wrong when he penned this advice in Hamlet: "Neither a borrower nor a lender be; For loan oft loses both itself and friend, And borrowing dulls the edge of husbandry." Perhaps he may be forgiven for his error, however, since Shakespeare suffered from a lack of the tremendous benefits of a truly self-directed IRA.

Money in self-directed IRAs can be loaned out to any person who is not a "disqualified person." While this means that you cannot loan yourself or other related disqualified persons money from your self-directed IRA, you can loan the money to anyone else. Loans can be secured by real estate, mobile homes, equipment or anything you like. If you are really a trusting soul, you can even make a loan from your IRA unsecured (although in that case I personally would tend to support Shakespeare's advice).

First, let's look at it from the borrower's perspective. At our office we offer a seminar entitled "Make Money Now With Self-Directed IRAs." One of the ways you can make money for yourself right now with your knowledge of self-directed IRAs is by creating your own "private bank." To do this, simply share the news that an IRA can be a private lender, refer people with IRA money to Entrust to open a self-directed IRA, and then borrow their IRA money for your own financing needs.

With private financing the loan terms can be whatever the borrower and the lender agree to within the legal limits. If you know a person who is getting 5% in a "safe" IRA at a bank, and you can offer them 9% secured by a first lien on real estate with only a 70% loan to value, would they be happy with that? Even with a higher interest rate, private financing can work for you. IRA loans can be done quickly and without a lot of fees or fuss, which may mean you can get a deal which might be lost if you had to wait on the bank. This is especially true in distressed sale situations, such as a pre-foreclosure purchase.

From a lending perspective, your IRA can grow at a nice rate while someone else does all the work. In a typical hard money loan, the borrower even pays all of Entrust's modest fees as well as any legal fees for preparation of the loan documents. True, you won't hit a home run with lending, unless you are fortunate enough to foreclose on the collateral. But the returns can be quite solid. For example, by making very conservative hard money loans my Mom's IRA has grown by about 10.5% in one year. This is much better than the amount she was earning in her money market fund before she moved her IRA to an Entrust self-directed IRA.

Even small IRAs can combine with other self-directed accounts to make a hard money loan. My brother recently combined his Roth IRA, his traditional IRA, his wife's Roth IRA, his son's Roth IRA, his Health Savings Account (HSA), and 5 other IRAs to make a hard money loan. The smallest IRA participating in this loan was for $1,827.00! Each IRA made 2% up front and 12% interest on an 18 month loan, secured by a first lien on real estate with no more than 70% loan to value.

One thing to avoid in hard money lending is usury. Usury is defined as contracting for or receiving interest above the legal limit. The usury limit varies from state to state, with a few lucky states having no usury limit at all on commercial loans. Some people have the theory of "What's a little usury among friends?" However, if the investment goes bad and your IRA has made a usurious loan, the consequences of the borrower making a claim of usury could include the loss of all the principal of the loan plus damages equal to 3 times the interest. Some states even have *criminal* usury statutes. It is best to consult with a competent attorney prior to making a hard money loan to make sure your IRA does not violate any usury laws.

To see how well hard money lending can work, let me give you an actual example. One of our clients made a hard money loan from his IRA to an investor who purchased a property needing rehab. The terms of the loan were 15% interest with no points or other fees except for the attorney who drew up the loan documents. The loan included not only the purchase price but also the estimated rehab costs. The minimum interest due on the loan was 3 months, or 3.75%. The investor began the rehab by having the slab repaired, and before he could take the next step in the rehab process, a person offered him a fair price for the property as is. The investor accepted the offer, and they closed about 6 weeks after the loan was initiated.

From the investor's perspective, was this a good deal? Yes, it certainly was! True, he was paying a relatively high interest rate for the time he borrowed the money. However, he was able to purchase a property with substantial equity which a bank most likely would not have loaned him money to buy due to the condition of the property. Also, while the interest rate was high, the cost of financing was actually comparatively low. With a normal bank or mortgage company there are fees and expenses incurred in obtaining the loan. Common fees include origination fees, discount points, processing fees, underwriting fees, appraisal fees and various other expenses relating to the loan. On the surface an interest rate may be 8%, but the cost of the financing is actually higher than 8% since a borrower has to pay the lender's fees in addition to the interest on the loan. Spread out over a lengthy loan term these additional fees do not add much to the cost of the financing. However, if an investor has to pay all of these fees up front and then pays the loan off in only 6 weeks, the cost of the financing goes way up.

In this case the investor's total loan costs were limited to 3 months minimum interest at 3.75% plus $300 in attorney's fees for preparing the loan documents. Best of all, the investor walked away from closing with $20,000 profit and *no money out of his pocket!* Far from "dulling the edge of husbandry" this loan actually made the "husbandry" (ie. the purchase and resale of the property) possible. Incidentally, the purchaser of the property was absolutely thrilled to get the property at less than full market value so that they could fix it up the way that they wanted it.

What about the lender in this case? The lender was also quite happy with this loan. His IRA received 3 months of interest at 15% while only having his money loaned out for 6 weeks.

For the 6 week period of the investment, his IRA grew at a rate of approximately 30% per annum! Although his yield was above the legal limit for interest in Texas on loans secured by real estate, prepayment penalties are generally not included in the calculation of usury here, so there was no problem. The investor was happy, the new homeowner was happy, and the lender was happy. Anytime you can create an investment opportunity with a win-win-win scenario, you should.

When I lecture about hard money lending, I ask the audience what they think is the worst thing that happens if you are a hard money lender. Invariably, most people in the audience answer that you have to foreclose on the property. Nonsense! If you are doing hard money lending correctly, the worst thing that can happen is that *the borrower pays you back!* Unfortunately, this is a common risk of hard money lending. Most hard money loans are made at 70% or less of the fair market value of the property. If you are fortunate enough to foreclose on a hard money loan, your IRA will have acquired a property with substantial equity while the investor did all the work of finding and rehabbing the property!

While it is true that foreclosing on a property owned by a friend may cause an end to that friendship, a properly secured hard money loan will at least not "lose itself" as Shakespeare asserts. In fact, it may lead to substantial profit for your IRA! To avoid losing a friend, simply don't loan money from your IRA to someone you would feel bad foreclosing on. In order to be a successful hard money lender, you do have to be prepared to foreclose on the property if necessary.

In modern times I believe the proper advice, at least in the right circumstances, is "Either a lender or a borrower be!" You can make more money for yourself right now by borrowing OPI (Other People's IRAs). Borrowing from someone else's IRA can even lower the total cost of your financing compared to a conventional loan from a bank or mortgage company, especially on short term financing. From a lending perspective, your IRA can make great returns by being a hard money lender, either through higher than average interest rates or, better yet, through foreclosing on property with equity. You may find that hard money lending from your self-directed IRA is a great way to boost your retirement savings without a lot of time and energy invested on your part.

The Saver's Tax Credit – How to get up to $2,000 FREE from the U.S. Government

By H. Quincy Long

Tax time is coming, and many of you are considering whether or not to make a 2008 contribution to your Traditional or Roth IRA. I have good news! If you are at least 18 years old, you are not a full-time student, you are not claimed as a dependent on another person's tax return and you meet the income requirements listed below, you are entitled to a tax credit of up to 50% of your contribution to almost any type of retirement plan, including a Roth IRA! If you then take your refund from the government and put it back into your IRA, your retirement savings will increase by as much as 50%!

Begun in 2002 as a temporary provision, the saver's credit was made a permanent part of the tax code as part of the Pension Protection Act of 2006. To help preserve the value of the credit, income limits are now adjusted annually to keep pace with inflation. To qualify for the Saver's Tax Credit, you must have Modified Adjusted Gross Income (MAGI) within the following limits for 2008 and 2009:

Filing Status	Tax Year	Credit is 50% of Contribution	Credit is 20% of Contribution	Credit is 10% of Contribution	No Credit
Married Filing Jointly	2008	≤ $32,000	$32,001-$34,500	$34,501-$53,000	≥ $53,001
	2009	≤ $33,000	$33,001-$36,000	$36,001-$55,500	≥ $55,501
Head of Household	2008	≤ $24,000	$24,001-$25,875	$25,876-$39,750	≥ $39,751
	2009	≤ $24,750	$24,751-$27,000	$27,001-$41,625	≥ $41,626
All Other Filers	2008	≤ $16,000	$16,001-$17,250	$17,251-$26,500	≥ $26,501
	2009	≤ $16,500	$16,501-$18,000	$18,001-$27,750	≥ $27,751

The maximum tax credit allowed for 2008 is $1,000 (with a $2,000 contribution), or up to $2,000 if married filing jointly and each spouse makes a contribution. Simply attach Form 8880, Credit for Qualified Retirement Savings Contributions, to your income tax return, and you will receive up to a $2,000 tax credit. A tax credit is a dollar for dollar reduction in your tax bill, as opposed to a tax deduction, which only reduces the amount of money on which you pay income taxes. You may get more information on this credit from IRS Publication 590.

To prevent abuse, the IRS has rules which will reduce the amount of contribution which qualifies for the saver's tax credit if the IRA owner has taken distributions from any eligible employer plan or IRA during a specified testing period. The testing period includes the two taxable years prior to the year the credit is claimed, plus the taxable year the credit is claimed and the following year up until the tax filing deadline for the year the credit is taken, including extensions. For example, if Josh contributes $2,000 to his Roth IRA for 2007 but had previously removed $500 from his IRA in 2006 and removes an additional $500 in 2008 before October 15, only $1,000 of his $2,000 Roth IRA contribution for 2007 may be used toward the saver's tax credit on his 2007 tax return.

Let me give you an example. Lucky Larry, a married man, was downsized from his job in the corporate world in December, 2006. Larry decided that he wanted to be a real estate investor instead of looking for another j-o-b. Things went fine in 2007, but Larry's modified adjusted gross income after all of his expenses will be $30,000 due to his various write-offs, and his taxable income after the standard deduction and 2 exemptions will be $13,500. Therefore his taxes before the tax credit will be $1,353 (see instructions for Form 1040, page 65). He and his wife contribute $1,353 each to a self-directed Roth IRA at Entrust, which they can use to purchase real estate options, debt-leveraged real estate, and many other things. Larry and his wife will receive a tax credit of $1,353 (50% of each of their contributions).

Although the maximum contribution for purposes of the tax credit is $2,000 each, the tax credit is non-refundable. This means that the maximum tax credit Larry and his wife can receive is equal to the taxes they would otherwise pay. With the tax credit, Larry's income tax for 2007 is ZERO! Larry and his wife wisely decide to contribute the tax refund back into their Entrust self-directed Roth IRAs. Each Roth IRA grows by 50% to $2,029.50 absolutely FREE, courtesy of the United States government!

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 IRAs were 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 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.

Self-Directed Health Savings Accounts – Building Wealth through Health

By H. Quincy Long

By now you have probably heard of the Health Savings Account (HSA). What you may not know is just how amazing this type of account actually is, in terms of premium savings, tax savings, and, most importantly, what you can invest in with your HSA.

Qualification Requirements. In order to have a Health Savings Account, you must be an "eligible individual." To be an eligible individual, you must 1) have a High Deductible Health Plan (HDHP); 2) have no other health coverage, with certain exceptions; 3) not be enrolled in Medicare; and 4) not be claimed as a dependent on another person's tax return. More complete information of the requirements may be found in IRS Publication 969, which is freely available at www.irs.gov.

While a full description of a HDHP is beyond the scope of this article, its key features are a higher deductible than many insurance policies and a maximum limit on the out-of-pocket expenses (including the deductible and co-payments, but excluding the premium payments). For 2011, the minimum deductible is $1,200 for self-only coverage and $2,400 for family coverage, and the maximum out-of-pocket expense is $5,950 for self-only coverage and $11,900 for family coverage. All major insurance companies offer HSA compliant plans. Employers may also offer an HSA compliant plan, since these policies tend to be less expensive. If the employer makes contributions to your HSA it is excluded from your income.

Premium Savings. Because of the higher deductibles and plan features, HSA compliant plans tend to cost less. When I switched from a policy with a $2,000 general deductible and a $200 drug deductible to an overall deductible of $2,200, the premiums for my family were reduced from $754 per month to $450 per month. That's a total premium savings of $3,648 per year!

Tax Savings. One of the best features of an HSA is the tax savings for contributing to the account. Beginning in 2007, the contribution limit is no longer tied to the deductible. The contribution limit for 2011 is $3,050 for self-only coverage and $6,150 for family coverage. To the extent you make the contribution (as opposed to your employer), these amounts are fully tax deductible, no matter what your income level. If you are age 55 or older, you may contribute an additional $1,000 for 2011. There is even a one time ability to take a distribution from your IRA to fund your HSA with no taxes or penalty.

In my tax bracket, the ability to deduct my contributions is significant. I contributed $6,150 for 2011 and will save approximately $2,030 on my taxes. If you add the premium savings over a traditional health plan to the tax savings from contributing to an HSA, the total benefit to me goes a long way towards covering the cost of my contribution.

Distributions from an HSA for “qualified medical expenses”, which are broadly defined and include expenses for yourself, your spouse and your dependents, are tax free forever! Because the expenses only have to occur after the HSA has been established, virtually everyone will end up with qualified medical expenses at some point in their life. You can take a qualified distribution at any point after the expense is incurred, even in later years, provided you keep track of the expenses.

Investment Opportunities. Even better than the premium and tax savings is the ability to invest your HSA funds in non-traditional investments, just as you would in a self-directed IRA. Many banks and other companies offer the convenience of an HSA account with a debit card for you to pay medical bills with. However, if you are healthy and don’t have a lot of expenses or you can fund the expenses out of pocket, you can make your HSA account grow much faster with investments other than mutual funds or savings accounts which may pay very little.

With a self-directed HSA, you choose your HSA’s investments. Common investment choices made by self-directed HSA participants at Entrust Retirement Services Inc. in Houston, Texas include real estate, both domestic and foreign, options, secured and unsecured notes, including first and second liens against real estate, C corporation stock, limited liability companies, limited partnerships, trusts and much more. In my own HSA I have a portion of two hard money loans generating yields of 12%, a portion of a shared appreciation mortgage which generates 10% in addition to a share of profits when the property is eventually sold, and a membership interest in an LLC owning a debt-fee rental unit.

The Health Savings Account is truly the best of all worlds. It can significantly reduce your health care premiums, reduce your taxes, and produce tax free wealth through non-traditional investments in a self-directed HSA. With a self-directed HSA (or IRA), you don’t have to “think outside the box” when it comes to your HSA’s investments. You just have to realize that the investment box is much larger than you think!

Self-Directed Health Savings Accounts – The Best of Both Worlds

By Nathan W. Long

By now most people have heard of using self-directed IRAs to make purchases other than stocks, bonds, and mutual funds. Companies like Quest IRA Inc., operating out of Houston and Dallas, Texas as well as Mason, Michigan, have been doing a good job, through a series of free education seminars, of teaching people about using self-directed IRAs to buy real estate, foreclosures, foreign property, invest in notes, deeds of trust, private stock, limited partnerships, LLCs, and other non-traditional assets. In examining some of the other government sponsored savings vehicles available for investing in non-traditional assets I discovered the highly under-utilized Health Savings Account (HSA). Before my recent employment with Quest IRA I did not know that you could purchase non-traditional assets with a Health Savings Account (HSA). A Health Savings Account is a powerful investing tool that many people overlook. Because it is the only account where contributions are tax deductible and qualified distributions are tax free, it is the best of both worlds. Furthermore, the definition of "qualified medical expenses" is fairly broad. IRS Publication 502 has an available list of qualified medical expenses. These include a broad range of medical, dental and vision expenses, but generally do not include the cost of health insurance premiums. You can, however, treat premiums for long-term care coverage, health care coverage while you receive unemployment benefits, or health care continuation coverage required under any federal law (COBRA) as qualified medical expenses for HSAs. If you are age 65 or older, you can treat insurance premiums (other than premiums for a Medicare supplemental policy, such as Medigap) as quailed medical expenses for HSAs.

In order to be an eligible individual and qualify for a Heath Savings Account you must have a High Deductible Health Plan (HDHP), you cannot be enrolled in Medicare, and you cannot be claimed as a dependent on someone else's tax return. Recent changes in HSA rules allow you to contribute the maximum amount to your HSA even if your deductible is less than that amount. If you are an individual the amount you can contribute for the year 2007 is $2,850 and for a family it is $5,650. In addition, if you are over the age of 55 you are allowed an $800 catch up contribution. Unlike other plans you may have heard about, the amount you put into a Health Savings Account is allowed to rollover from year to year and the profits on any investments with the money are tax deferred. When the money is used to pay or reimburse for qualified medical expenses the distributions are tax free.

The knowledge of how to invest with a self-directed Health Savings Account from Quest IRA Inc. allowed me to do some amazing investments this year. I have a High Deductible Health Plan (HDHP) for my family. This health plan works well for me. I personally like high deductible insurance policies. My family rarely turns in a claim on most of our insurance policies. Because my family is financially stable, in the event of an accident or major illness paying a few thousand dollars would not be a problem. Over the years I have saved a lot of money by using high deductible insurance policies. When I discovered that Quest IRA offered self-directed Health Savings Accounts I saw a great opportunity.

This year my wife needed extensive dental procedures. The cost went well over $5,650. The insurance company did not pay because it was a dental procedure and I don't carry any dental insurance. I opened an HSA with Quest IRA Inc. with a maximum deposit of $5,650. I could have immediately taken a distribution for my wife's dental expenses, effectively negotiating a discount on the dental bill equal to my marginal tax rate. Instead I chose to leave the money in the HSA and invest the money in partnership with my son's Roth IRA and my wife's Roth IRA to purchase a note secured by a first lien on real estate. The note was for 12% with a 2% origination fee and all costs were paid by the borrower, including Quest's fees, with an 18 month balloon.

I can add $5,800 again to the HSA in January of 2008. As the money grows I can take any amount of money out of the account as long as I have qualified medical expenses, including dental or vision expenses, to be reimbursed. Since I already have a large amount of dental bills I just keep these bills along with any others in a file. When I want to withdraw some money for any reason I just request a reimbursement for the expenses regardless of the year the expenses were incurred, as long as the expense was incurred after opening my HSA. That being said, don't make the same mistake I made. I opened my HDHP at the first of the year but waited to fund my Quest HSA until I could fund it fully. My wife had some of the dental work done before I opened the HSA. The work done before the HSA was opened will not qualify for a tax free reimbursement. If I would have simply opened the account with a small amount then funded the rest later in the year I could have used those expenses as well.

If in the future we decide that a HDHP is not good for our family we can switch to another plan. We will not be able to continue to contribute to the HSA, but we can keep the HSA open and withdraw the money out as needed tax free for qualified medical expenses.

If I had just paid for the dental expenses out of my pocket like I originally planned to, I would have lost the opportunity for a $5,650 deduction on my taxes and the opportunity to make a great investment. Remember, I can take the money out as my investments mature and gains on the investments can be withdrawn tax free. Like we always say here at Quest IRA, Inc., "You don't have to think outside the box, just realize the box is bigger than you think!"
Happy Investing!

How to Pay for Education Expenses With Tax-Free Dollars

By H. Quincy Long

Many people are under the mistaken impression that a Roth IRA is the only type of self-directed account from which tax free distributions can be taken. However, distributions from Health Savings Accounts (HSAs) and Coverdell Education Savings Accounts (ESAs) can be tax free if they are for qualified expenses. In this article we will discuss the benefits of the Coverdell Education Savings Account and, more importantly, what investments you can make with a self-directed ESA.

Contributions. Contributions to a Coverdell ESA may be made until the designated beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary. The maximum contribution is $2,000 per year per beneficiary (no matter how many different contributors or accounts) and may be made until the contributor's tax filing deadline, not including extensions (for individuals, generally April 15 of the following year). The contribution is not tax deductible, but distributions can be tax free, as discussed below. Contributions may be made to both a Coverdell ESA and a Qualified Tuition Program (a 529 plan) in the same year for the same beneficiary without penalty.

To make a full contribution to a Coverdell ESA, the contributor must have Modified Adjusted Gross Income (MAGI) of less than $95,000 for a single individual or $190,000 for a married couple filing jointly. Partial contributions may be made with MAGI as high as $110,000 for an individual and $220,000 for a married couple filing jointly. Since there is no limit on who can contribute to a Coverdell ESA, if your MAGI is too high consider making a gift to an individual whose income is less than the limits, and they can make the contribution. Organizations can make contributions to a Coverdell ESA without any limitation on income.

Tax Free Distributions. The good news is that distributions from a Coverdell ESA for "qualified education expenses" are tax free. Qualified education expenses are broadly defined and include qualified elementary and secondary education expenses (K-12) as well as qualified higher education expenses.

Qualified elementary and secondary education expenses can include tuition, fees, books, supplies, equipment, academic tutoring and special needs services for special needs beneficiaries. If required or provided by the school, it can also include room and board, uniforms, transportation and supplementary items and services, including extended day programs. Even the purchase of computer technology, equipment or internet access and related services are included if they are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school.

Qualified higher education expenses include required expenses for tuition, fees, books, supplies and equipment and special needs services. If the beneficiary is enrolled at least half-time, some room and board may qualify for tax free reimbursement. Most interestingly, a

Qualified Tuition Program (a 529 plan) can be considered a qualified education expense. If you believe that contributing to a 529 plan is a good deal, then contributing that money with pre-tax dollars is a great deal!

One thing to be aware of is that the money must be distributed by the time the beneficiary reaches age 30. If not previously distributed for qualified education expenses, distributions from the account may be both taxable and subject to a 10% additional tax. Fortunately, if it looks like the money will not be used up or if the child does not attend an eligible educational institution, the money may be rolled over to a member of the beneficiary's family who is under age 30. For this purpose, the beneficiary's family includes, among others, the beneficiary's spouse, children, parents, brothers or sisters, aunts or uncles, and even first cousins.

Investment Opportunities. Many people question why a Coverdell ESA is so beneficial when so little can be contributed to it. For one thing, the gift of education is a major improvement over typical gifts given by relatives to children. Over a long period of time, investing a Coverdell ESA in mutual funds or similar investments will certainly help towards paying for the beneficiary's education. However, clearly the best way to pay for your child's education is through a self-directed Coverdell ESA.

With a self-directed Coverdell ESA, you choose your ESA's investments. Common investment choices for self-directed accounts of all types include real estate, both domestic and foreign, options, secured and unsecured notes, including first and second liens against real estate, C corporation stock, limited liability companies, limited partnerships, trusts and much more.

With the small contribution limits for Coverdell ESAs, you might wonder how these investments can be made. Often these accounts are combined with other self-directed accounts, including Traditional, Roth, SEP and SIMPLE IRAs, Health Savings Accounts (HSAs) and Individual 401(k) plans, to make a single investment. For example, I combined my daughters' Coverdell ESAs with our Roth IRAs to fund a hard money loan with 2 points up front and 12% interest per year.

One client supercharged his daughter's Coverdell ESA by placing a burned down house under contract in the ESA. The contract price was for $5,500 and the earnest money deposit was $100. Since the ESA was the buyer on the contract, the earnest money came from that account. After depositing the contract with the title company, the client located another investor who specialized in rehabbing burned out houses. The new investor agreed to pay $14,000 for the property. At closing approximately one month later, the ESA received a check for $8,500 on its $100 investment. That is an astounding 8,400% return in only one month! How many people have done that well in the stock market or with a mutual fund?

But the story gets even better. Shortly after closing, the client took a TAX FREE distribution of $3,315 to pay for his 10 year old daughter's private school tuition. Later that same year he took an additional $4,000 distribution. Assuming a marginal tax rate of 28%, this means that the client saved more than $2,048 in taxes. In effect, this is the same thing as achieving a 28% discount on his daughter's private school tuition which he had to pay anyway!

The Coverdell ESA may be analogized to a Roth IRA, but for qualified education expenses only, in that you receive no tax deduction for contributing the money but qualified distributions are tax free forever. Investing through a Coverdell ESA can significantly reduce the effective cost of your child or grandchild's education. As education costs continue to skyrocket, using the Coverdell ESA as part of your overall investment strategy can be a wise move. With a self-directed ESA (or a self-directed IRA, 401(k) or HSA for that matter), you don't have to "think outside the box" when it comes to your ESA's investments. You just have to realize that the investment box is much larger than you think!

How Can My Minor Child Have a Roth IRA?

By H. Quincy Long

"How can my minor child have a Roth IRA?" If I only had a million dollars for every time I have been asked this question, I would be a very rich person! When entrepreneurial people learn of the myriad of possibilities for non-traditional investments within a self-directed IRA, they usually immediately see the benefit of starting on their child's retirement now in addition to utilizing their own IRAs. In this article I will discuss the benefits of starting an IRA early, how a minor can qualify for a Roth IRA, the tax filing requirements for a minor with earned income, and what can be done with the IRA once the money is deposited in the account.

First, let me briefly discuss the benefits of starting early on retirement savings. Assume your 15 year old daughter starts off her Roth IRA with $1,000 from her earnings and adds $1,000 per year until she retires at age 67. If she can earn an average return of just 10% per year, her tax free Roth IRA will be worth $1,552,472 at retirement – not bad for only investing a total of $52,000 over 52 years. Contrast this with an individual who starts saving at age 35 and puts $5,000 in for 32 years with the same annual return of 10%. His Roth IRA will be worth approximately $1,111,253 when he retires at age 67, and his contributions will total $160,000. No matter what your age and annual return assumptions are, one thing is very clear – the earlier you start saving the better!

Before you get too excited and start writing your IRA custodian or administrator checks to open Roth IRAs for your minor children, you must make sure that they qualify to make a contribution. In order to contribute to a Roth IRA, a single individual must have earned income (compensation) at least in the amount of the contribution and Adjusted Gross Income of no more than $122,000 (for 2011). For example, if your daughter earns $1,000 babysitting in 2011, she can contribute a maximum of only $1,000 to her Roth IRA, even though the contribution limit for individuals under age 50 is $5,000.

How can a minor earn money so they qualify to contribute to a Roth IRA? The younger your child is, the more difficult it will be to justify compensation if the IRS questions the contribution. I have heard of parents hiring their minor children as a model for advertising purposes in the parents' trade or business, but if you intend to do this make sure that you actually use the photos in your advertising. Keep track of how and when you use the photos, and have adequate documentation in your file as to what reasonable compensation would be for a model doing an advertising shoot with unlimited use of the photos. By the age of 8 or 9 children can be of some use to their parents' businesses by doing things like cleaning up trash in the yard of rent houses, collating materials if the parent teaches classes, stuffing and stamping envelopes, or other menial tasks. At age 7 my daughter helped me with artwork to put on t-shirts by carefully writing in crayon "Do you have a self-directed IRA? I do!" I then had her wonderful artwork turned into a silk screen for the back of t-shirts with my company logo on the front. I gave away hundreds of the shirts to my clients. With the unusual writing on the back of the shirts, people asked a lot of questions about self-directed IRAs and it turned out to be one of my most effective advertising campaigns! Other ways for minors to earn money include cutting grass, babysitting, or working at restaurants and offices when they are a little older. If you are hiring your minor children in your own business, be sure that you always document the time spent working and pay them a reasonable wage. The importance of good records cannot be overstated.

The next questions I get asked when discussing Roth IRAs for minors are "What is the tax effect of my child earning compensation?" and "Does my child have to file a tax return?" I will briefly summarize the rules here, but always check with your CPA or tax professional. More information may also be found in IRS Publication 929, Tax Rules for Children and Dependents. A minor child who is a dependent on someone else's tax return cannot claim a dependency exemption, but can still claim the standard deduction on their tax return if they are required to file. The standard deduction for a single dependent minor varies between $950 and $5,700 for 2010, depending on the type and amount of income. In general, for 2010 a dependent minor must file a tax return if 1) unearned income, such as interest and dividends, was over $950, 2) earned income was over $5,700, or 3) if the minor has both earned income and unearned income, the gross income was more than the larger of $950 or the earned income (up to $5,400) plus $300. If the dependent minor worked at an employer who withheld income taxes from their paycheck, in most cases they will want to file a return to collect a refund of this amount, even if there was no filing requirement.

There are situations where a dependent minor has to file a tax return regardless of the above filing requirements. One of the more common circumstances is when the dependent minor has net earnings from self-employment (such as from babysitting or cutting grass) of $400 or more. Net earnings from self-employment for IRA contribution purposes are calculated by taking the net Schedule C income and subtracting one-half of the self-employment taxes due and the contribution to any self-employment retirement plan such as a SEP IRA. If this amount is $400 or more, the dependent minor will owe Social Security and Medicare tax on that income and will have to file a tax return to pay the tax. For example, a recent tax client of mine who was 18 years old and still a dependent on her mother's tax return earned $3,183 doing clerical work, for which she received a 1099-MISC. She was not treated as an employee by the person who hired her, and she was required to file a dependent tax return to report this income. Because her Adjusted Gross Income was below $5,700 she owed no federal income tax. Unfortunately, she still owed $487 in Social Security and Medicare taxes. If she had been treated as an employee, the employer would have paid its portion and withheld her portion of the Social Security and Medicare tax from her paycheck. In that case she would not have had to file a federal tax return, unless she wanted to claim a refund for any federal income taxes withheld.

There is an interesting exception to the requirement that a dependent minor pay Social Security and Medicare tax on their earned income. If a child under age 18 works in their parent's trade or business and their parent's business is either a sole proprietorship or a partnership in which the parents are the only partners, the income is exempt from Social Security and Medicare taxes, as well as federal unemployment taxes (FUTA). This exception does not apply if the business is incorporated or if the partnership includes persons other than parents. The exemption is extended to those under age 21 for work other than in a trade or business, such as domestic work in the parent's private home. So if a minor earns compensation of less than

$5,700 working in their parent's trade or business or for domestic work in the parent's private home and they have no other income, no federal income tax or Social Security and Medicare taxes would be due. This means that no tax return would have to be filed, but they would still qualify to contribute to a Roth IRA up to the amount of their earned income, subject to the $5,000 maximum contribution! However, just to be safe it may be advisable to go ahead and file a zero tax due return for documentation purposes. Always check with your CPA or tax advisor to find out if your child will owe state or local income taxes on this income. More information on the family employee exception to Social Security and Medicare taxes may be found in IRS Publication 15, Circular E, Employer's Tax Guide, Chapter 3.

What you can do with the money once in a Roth IRA? The beauty of a self-directed IRA is that even small amounts can be invested in non-traditional investments. There are at least four ways a small Roth IRA can be invested. The Roth IRA may be combined with IRAs of other people to make a single investment. The most IRAs I have seen participate in a single note investment was 10 different accounts, with the smallest IRA investor contributing only $2,000. That note had a yield of 12% per year! Another investment which is common in small IRA accounts is an option to buy real estate. Once you have an option, you may let it lapse, exercise the option and close on the property, sell the option to a third party for a fee if the option agreement allows this, or even release the option for a cancellation fee from the property owner. Another variation on this idea is for the Roth IRA to enter into a sales contract, then assign that contract to a third party for a fee. Finally, the IRA could buy a property with a loan, either from taking over the property subject to the seller's existing financing, negotiating non-recourse seller financing, or obtaining a non-recourse loan from a private party or another non-disqualified IRA. However, if the IRA either owns debt-financed property or operates a business of any type (including a real estate dealer business), it may be required to file IRS Form 990T and pay Unrelated Business Income Tax (UBIT). Always be sure and have your child's IRA pay the taxes if they are due. It is great to use the tax law to your advantage, but do not abuse the law, because the IRS has what it takes to take what you have.

If your child qualifies, there is no doubt that one of the best things you can do for them is to open a Roth IRA. Perhaps the best part of this strategy is the time you will spend with your child teaching them the benefits of saving early and the methods of investing their money wisely. This is truly a win-win situation for both you and your child. Happy investing!

How to Analyze a Roth Conversion

By H. Quincy Long

How would you like to have tax free income when you retire? Would you like to have the ability to leave a legacy of tax free income to your heirs when you die? The great news is that there is a way to achieve these goals – it is through a Roth IRA.

Historically, because of income limits for contributions to a Roth IRA and for converting a Traditional IRA into a Roth IRA, high income earners have not been able to utilize this incredible wealth building tool. Fortunately, the conversion rules are changing so that almost anyone, regardless of their income level, can have a Roth IRA. But is it really worth converting your Traditional IRA into a Roth IRA and paying taxes on the amount of your conversion if you are in a high tax bracket? For me, the answer is a resounding yes. I firmly believe it is worth the pain of conversion for the tremendous benefits of a large Roth IRA, especially given the flexibility of investing through a self-directed IRA.

For Traditional to Roth IRA conversions in tax year 2009, the Modified Adjusted Gross Income (MAGI) limit for converting to a Roth IRA is $100,000, whether you are single or married filing jointly. However, the Tax Increase Prevention and Reconciliation Act (TIPRA) removed the $100,000 MAGI limit for converting to a Roth IRA for tax years after 2009. This means that beginning in 2010 virtually anyone who either has a Traditional IRA or a former employer's retirement plan or who is eligible to contribute to a Traditional IRA will be entitled to convert that pre-tax account into a Roth IRA, regardless of income level.

Even better, for conversions done in tax year 2010 only you are given the choice of paying all of the taxes in tax year 2010 or dividing the conversion income into tax years 2011 and 2012. If you convert on January 2, 2010, you would not have to finish paying the taxes on your conversion until you filed your 2012 tax return in 2013 – more than 3 years after you converted your Traditional IRA! One consideration in deciding whether to pay taxes on the conversion in 2010 or dividing the conversion income into 2011 and 2012 is that 2010 is the last tax year in which the tax rates are at a maximum of 35%. Tax rates are scheduled to return to a maximum tax rate of 39.6% in 2011, and other tax brackets are scheduled to increase as well, so delaying the payment of taxes on the conversion will cost you some additional taxes in 2011 and 2012. The benefit of delaying payment of the taxes is that you have longer to invest the money before the taxes need to be paid, whether the payment comes from the Roth IRA or from funds outside of the Roth IRA.

The analysis of whether or not to convert your Traditional IRA to a Roth IRA is a complex one for most people, because it depends so much on your personal tax situation and your assumptions about what might happen in the future to your income and to tax rates, as well as how you invest your money. From my own personal perspective, I make the simple assumption that tax free income in retirement is better than taxable income. I can afford to pay my taxes now (not that I like it), and I would like to worry less about taxes when I retire. I also don't believe that tax rates will be going down in the future. For me, the decision comes down to whether I want to pay taxes on the "acorn" (my Traditional IRA balance now) or the "oak tree" (my much higher IRA balance years in the future as I make withdrawals).

The way I analyze whether or not to convert to a Roth IRA is to calculate my "recovery period" – that is, the time it takes before my overall wealth recovers from the additional taxes I have to pay on the conversion. If I can recover the cost of the taxes on the conversion before I might need the money in the Roth IRA, then I say it is worth doing, especially since the gains after the conversion are tax free forever. Fortunately, with a self-directed IRA you are in total control of your investments, and the recovery period can be quite short. There may also be a benefit if you are able to convert an asset now that may have a substantial increase in value later.

Using my own situation as an example, I have been planning on doing a conversion in 2010 ever since the passage of TIPRA was announced in 2006. My first step was to immediately begin making non-deductible Traditional IRA contributions. Even though I am covered by a 401(k) plan at my company and earn more than the limits for making a deductible Traditional IRA contribution, this does not prevent me from making a *non-deductible* contribution since I am under age 70 ½. The main reason I have been making non-deductible contributions to my Traditional IRA is to have more money to convert into a Roth IRA in 2010. The best thing about this plan is that only the gains I make on the non-deductible contributions to the Traditional IRA will be taxed when I convert to a Roth IRA, since I have already paid taxes on that amount by not taking the deduction.

I plan on converting approximately $100,000 in pre-tax Traditional IRA money in 2010. The actual amount converted will be more like $150,000, but as I noted above my wife and I have been making non-deductible contributions to our Traditional IRAs since 2006, so the actual amount we pay taxes on will be less than the total conversion amount. This means that my tax bill on the conversion will be $35,000 if I pay it all in tax year 2010 or $39,600 divided evenly between tax years 2011 and 2012, assuming I remain in the same tax bracket and Congress doesn't make other changes to the tax code.

To help analyze the conversion, I made some calculations of how long it would take me to recover the money I had to pay out in taxes at various rates of return, assuming a taxable conversion of $100,000 and a tax bite of $35,000. I calculated my recovery period based on paying the taxes with funds outside of the IRA (which is my preference) and by paying taxes from funds withdrawn from the Roth IRA, including the early withdrawal penalty I would have to pay since I am under age 59 ½.

If I pay taxes with funds outside of my Roth IRA and can achieve a 12% return compounded monthly, my Roth IRA will grow to $135,000 in only 30 months, at which point I will have fully recovered the cost of the conversion. A 6% yield on my investments will cause my recovery period to stretch to 60 months, while an 18% yield will result in a recovery period of only 20 months! Of course paying taxes with funds outside of the IRA reduces my ability to invest that money in other assets for current income or to spend it on living expenses. But if I have to withdraw the money from the Roth IRA to pay taxes and the early withdrawal penalty, the recovery period for my Roth IRA to achieve a $39,000 increase ($35,000 in taxes and a $3,900 premature distribution penalty) increases to 50 months at a 12% yield and 99 months for a 6% yield. Paying the taxes from funds outside of my Roth IRA will result in a much larger account in the future also since the full $100,000 can be invested if taxes are paid with outside funds, while only $61,000 remains in the Roth IRA after withdrawal of sufficient funds to pay the taxes and penalties.

I believe that since my IRAs are all self-directed I can easily recover the cost of the conversion (i.e. the taxes paid) in less than 3 years based on my investment strategy. From that point forward I am building tax free wealth for me and my heirs. How can I recover the taxes so quickly? It's easy! Self-directed IRAs can invest in all types of non-traditional investments, including real estate, notes (both secured and unsecured), options, LLCs, limited partnerships and non-publicly traded stock in C corporations. With a self-directed IRA you can take control of your retirement assets and invest in what you know best.

In my retirement plan I invest in a lot of real estate secured notes, mostly at 12% interest with anywhere from 2-6% up front in points and fees. I also own some stock in a 2 year old start up bank in Houston, Texas which is doing very well, and a small amount of stock in a Colorado bank. As the notes mature I plan on purchasing real estate with my accounts, because I believe now is the best time to buy. In some cases I may purchase the real estate itself and in other cases I will probably just purchase an option on real estate. The bank stock will be converted at the market price in 2010, but when the banks sell in a few years I expect to receive a substantial boost in my retirement savings since banks most often sell at a multiple of their book value. In the meantime, the notes and the real estate will produce cash flow for the IRA, and if I have done my investing correctly the real estate will also result in a substantial increase in my Roth IRA when it sells in a few years.

Note that I have written this article from the perspective of someone who is in a high tax bracket. A lower tax bracket will reduce the recovery period and is an even better bargain, especially if you can afford to pay the taxes from funds outside of the Roth IRA. If you take advantage of the opportunities afforded to you by investing in non-traditional assets with your self-directed Roth IRA, you can truly retire wealthy with a pot of tax free gold at the end of the rainbow.

How to Stretch a Roth IRA to Last More Than 150 Years

By H. Quincy Long

I have a philosophy, which is that if you can create win-win situations you should always do so. My daughter, Briana, is 12 years old and has been invited to travel to Europe next summer to be a Student Ambassador through the People to People program (www.studentambassadors.org). One of the requirements I am making for Briana to go is that she must raise one-half of the funds for the trip. Since Briana needs funds for her trip, and my company, Quest IRA, Inc. needed help stuffing envelopes to send out our quarterly statements, Briana came to work for us to help stuff envelopes. This earned her money for her trip and at the same time reduced my taxable income – a definite win-win scenario.

You may be asking, "What does this have to do with IRAs?" As her father and as a professional in the area of self-directed IRAs, of course it immediately struck me that Briana now has earned income and is therefore eligible for a Roth IRA, even at age 12. This got me thinking about how long a Roth IRA could last under a certain set of circumstances.

The original owner of a Roth IRA never has to take distributions from that Roth IRA. Briana can therefore accumulate funds in her Roth IRA for her entire life without ever having to take a distribution. This is one of the benefits of a Roth IRA over a traditional IRA. With a traditional IRA distributions must begin no later than April 1 of the year following the year the IRA owner reaches age 70 1/2. When she dies, Briana can leave the Roth IRA to anyone she wants (although she may need her spouse's consent in certain circumstances if she lives in a community property state). An IRA inherited by someone is sometimes referred to as a "Beneficiary IRA" or a "Stretch IRA," especially if the person is very young.

Unlike Briana, who never has to take distributions during her lifetime, if a non-spouse beneficiary inherits her Roth IRA they must take required minimum distributions (RMDs) based on the beneficiary's life expectancy as determined by the IRS. The good news is that if Briana has had a Roth IRA for at least 5 tax years when she dies, required minimum distributions from the inherited Stretch Roth IRA to the beneficiary who inherits the account will be tax free, even if they are under age 59 1/2 at the time of the distributions.

So how might this work out in Briana's situation? Let's assume Briana makes exactly $1,000 in earned income for tax year 2008. Roth IRA contributions can be made based on the amount of her *earned income* (her investment income, if any, doesn't count), up to a maximum of $5,000 for people under age 50 by the end of the year for 2008. In Briana's case, since she earned less than the $5,000 contribution limit, she can only contribute $1,000.

If we assume that Briana will live to age 87, and she never makes another contribution to that Roth IRA, the value of the Roth IRA upon her death (75 years from the start of the Roth IRA) would be as follows:

Initial Contribution	Annualized Yield	Result After 75 Years
$1,000	6%	$ 89,013.00
$1,000	12%	$ 7,748,834.00
$1,000	18%	$659,839,065.00

For purposes of our discussion, I will assume an annualized yield of 12%. Some may argue that this isn't realistic, but in fact at Entrust we see much higher yields in self-directed IRAs than just 12%. For example, my Mom's self-directed IRA has achieved a yield of more than 13% per year over the last couple of years by simply doing hard money lending (but that is the topic of a different article). If your calculator holds enough numbers, multiply the appropriate amount from the above chart times 5 or 6 for a full single year contribution depending on the age of the contributor (ie. $5,000 for those under age 50, and $6,000 for those age 50 or older). Of course the results on the chart above do not even account for continuous contributions during Briana's lifetime, which she will almost certainly make based on the financial education she is going to get from me!

If Briana has a daughter at age 31 (although how she is going to have a child before she's ever allowed to date I'm not sure), and her daughter delivers her granddaughter at age 31, who in turn gives birth to her great granddaughter at age 31, Briana will be age 81 when her great granddaughter is born (we'll call her Samantha). If Briana updates her beneficiary designation to leave Samantha her huge Roth IRA, Samantha will be age 6 when Briana dies at age 87. By December 31 of the following year, when Samantha is age 7, required minimum distributions must begin from the inherited Stretch Roth IRA.

To calculate Samantha's required minimum distributions, her life expectancy must be determined from the IRS Single Life Expectancy Table (Table 1 in the back of IRS Publication 590). Once the appropriate Life Expectancy Factor is found on the table, Samantha must take the value of the account as of December 31 of the prior year and divide it by the factor. For a beneficiary who must begin distributions from an inherited IRA at age 7 the Life Expectancy Factor from the IRS table is 75.8. Samantha's first year distribution is calculated as follows:

$$\frac{\text{Prior Year End Balance (\$7,748,834)}}{\text{Life Expectancy Factor (75.8)}} = \text{Required Minimum Distribution (\$102,227.36)}$$

In subsequent years the factor is reduced by 1, and in each year the balance on December 31 of the prior year is divided by the new factor (ie. the Life Expectancy Factor is 74.8 in year 2, 73.8 in year 3, etc.). Since the original Life Expectancy Factor was 75.8, after a total of 76 years the inherited Stretch Roth IRA must be completely distributed, either to Samantha or to Samantha's heirs if she doesn't live that long.

The best part is that Samantha is not required to just let the money sit there earning nothing for the 76 years of required minimum distributions. As long as there is sufficient funds in the account to meet the annual required minimum distributions, the account can continue to be invested in real estate, notes, private company stock and limited partnerships, among many other choices, so that it continues to grow. In Samantha's inherited Stretch Roth IRA, for example, during the first year of distributions if the account earns a 12% annualized yield, the income will be $929,860, while Samantha's required minimum distribution would only be $102,227, resulting in an *increase* in the account balance of $827,633.

The following chart shows how powerful an inherited Stretch Roth IRA of just $100,000 can be if distributed over a long period of time:

Starting Principal	Beginning Life Expectancy Factor	Yield	Total Distributions
$100,000.00	75.8	6%	$ 2,033,743
$100,000.00	75.8	12%	$ 80,496,367
$100,000.00	75.8	18%	$3,420,454,810

If an annualized yield of 12% can be maintained for the entire life of Briana and Samantha so that the beginning balance of Samantha's inherited Stretch Roth IRA is $7,748,834.00, total distributions from the account for Samantha and her heirs would be a staggering $6,237,497,033 – and under current law it is all TAX FREE! This is obviously an incredible estate planning tool. A lifetime of tax free income is quite a gift to leave to your heirs.

It should be noted that I have ignored for the purposes of this article the estate tax and generation skipping tax issues in order to illustrate the power of an inherited Stretch Roth IRA. No one can predict what tax law changes will take place over the next 75 years, or what the estate tax and generation skipping tax limitations will be if they continue to exist for that long. However, you should never avoid estate and tax planning simply because the law might change. We can only plan based on what we know right now. One thing is for sure – to fail to plan is to plan to fail.

How Do I Invest Thee? Let Me Count the Ways!

By H. Quincy Long

Many people find it very easy to see the benefits of self-directing their Roth and Traditional IRAs, SEP IRAs, SIMPLE IRAs, Individual 401(k)s, Coverdell Education Savings Accounts (ESAs) and Health Savings Accounts (HSAs) into something other than the same old boring stocks, bonds, annuities and mutual funds. The central idea of a self-directed IRA is that it gives you total control of your retirement assets. With a self-directed account you can invest your IRA funds in whatever you know best.

When I spoke recently at John Schaub's Real Estate All Stars conference in Las Vegas, Nevada, I outlined some of the top strategies our clients have actually used to build their retirement wealth. A brief description of these strategies is included in this article. This shows the tremendous flexibility of investing through a self-directed account.

Strategy #1 – Purchasing Rental Real Estate for Cash. Even the IRS acknowledges on its website that real estate is an acceptable investment for an IRA. In answering the question "Are there any restrictions on the things I can invest my IRA in?" the IRS includes in its response that "IRA law does not prohibit investing in real estate but trustees are not required to offer real estate as an option." One of our clients purchased a 10 unit apartment complex for $330,000 cash. In April, 2008 his total rent collection was $5,235. Even after payment of taxes and insurance, his cash on cash return is excellent, and the client believes that the value of the property will increase significantly over time. A discussion of the relative benefits and disadvantages of owning real estate directly in an IRA is beyond the scope of this article, but for those who know how to successfully invest in real estate it is great to know that real estate is an option for your self-directed account.

Strategy #2 – Purchase, Rehab and Resale of Real Estate. In this case study, our client decided not to hold onto the real estate purchased with his IRA. The client received a phone call one evening from an elderly gentleman who said he needed to sell his home quickly because he wanted to move to Dallas with his son. After a quick phone conversation, it was clear that the price the seller wanted was a bargain even considering the needed repairs. Our client dropped what he was doing and immediately headed over to the seller's house with a contract. The buyer on the contract was our client's IRA, and of course the earnest money came from the IRA after the client read and approved the contract and submitted it with a buy direction letter to Entrust. They agreed on a sales price of $101,000. Approximately $30,000 was spent rehabbing the property with all funds coming from the IRA. The property was sold 6 months later for $239,000, with a net profit after sales and holding expenses of $94,000!

Strategy #3 – Purchase and Immediate Resale of Real Estate (Flipping). The previous two examples show the tremendous power of buying real estate for cash with a self-directed IRA. However, both of these strategies require a significant amount of cash in your account. How else can you invest in real estate if you have little cash? One of our clients was able to put a commercial piece of vacant land under contract in his Roth IRA. The sales price was $503,553.60 after acreage adjustments. Using his knowledge of what was attractive for a building site, our client was able to negotiate a sales price to a major home improvement store chain for $650,000. On the day of closing Entrust received two sets of documents, one for the purchase of the property for $503,553.60 and the other for the sale of the same property for $650,000. After sales expenses, the IRA netted $146,281.40 from the sale with only the earnest money coming from the account! A word of caution in this case is that if property is flipped inside of an IRA the IRS may consider this to be Unrelated Business Taxable Income (UBTI), causing the IRA (not the IRA owner) to owe some taxes on the gain. Even if taxes had to be paid, it is hard to argue that this transaction was not beneficial to the IRA and ultimately the client! It should also be noted that in this situation everyone involved in the transaction was aware of what everyone else was doing, so there was no "under the table" dealings.

Strategy #4 – Assignments and Options – Getting Paid NOT to Buy! Another favorite strategy for building tremendous wealth without a significant amount of cash is the use of options and assignments. One of our clients put a property under contract in his daughter's Coverdell Education Savings Account for $100. The sales price was a total of $5,500 because the house had burned down. The seller was just getting rid of the property for its lot value since he had already received a settlement from the insurance company and had purchased another house. Our client then used his contacts to find a person who specialized in rehabbing burned out houses. The new buyer was willing to purchase the property for $14,000 cash. At closing one month after the contract was signed, the seller received his $5,500 and the Coverdell ESA received an assignment fee of $8,500 right on the settlement statement. That is an astounding 8,400% return on the $100 investment in only 30 days! Even better, our client was then able to take a TAX FREE distribution from the account of $3,300 to pay for his 10 year old daughter's private school tuition. In a similar transaction, another client's Roth IRA recently received an assignment fee of $21,000 plus reimbursement of earnest money for a contract.

Strategy #5 – Using the Power of Debt Leveraging. One of my favorite true stories of building wealth in a Roth IRA involves purchasing property subject to a debt. If an IRA owns debt-financed property either directly or indirectly through a non-taxed entity such as a partnership or LLC taxed as a partnership, profits from that investment are taxable to the same extent there is debt on the property. One of our clients used her knowledge of real estate investing and what she learned from a free Entrust educational seminar to tremendously boost her retirement savings. After noticing a large house in downtown Houston which was in bad shape but in a great location, our client tracked down the owner in California who was being sued for approximately $97,000 in delinquent taxes on the property. She negotiated a deal with the seller for her Roth IRA to purchase the property for $75 cash subject to the delinquent taxes. With closing costs her Roth IRA's total cash in the transaction was only around $3,000. Within 4 months she was able to sell the property for a profit to her Roth IRA of $43,500! Because the property had debt on it and because her Roth IRA sold the property for a short term capital gain, the taxes on the profit were approximately $13,500. Still, using the power of debt leveraging her Roth IRA was able to achieve a 1,000% return in less than 4 months even after paying Uncle Sam his share of the profits!

Strategy #6 – Hard Money Lending. Another excellent strategy for building your retirement wealth is through lending. Loans from IRAs can be made secured by real estate, mobile homes or anything else. Some people even choose to loan money from their IRAs on an unsecured basis. As long as the borrower is not a disqualified person to the lending IRA, almost any terms agreed to by the parties are acceptable. In many states there are limits to the amount of interest that can be charged, and loans must be properly documented, but IRA law does not impose any limits other than the prohibited transaction rules. For those wanting to avoid the direct ownership of real estate within their IRA, a loan with an equity participation agreement is often used. Several of my own self-directed accounts combined together recently to make a $25,000, 7 1/2 year, 12% first lien loan against real estate with 6% in points up front. True, this is not exactly setting the world on fire as far as return on investment goes, but I was very pleased with a safe return on a relatively small amount of cash. If I get to foreclose on the collateral my accounts should be able to make a substantial profit, since the land securing the loan was appraised at $45,000. At my office we routinely see hard money loans secured by first liens against real estate with interest at 12%-18% for terms ranging from 3 months to 3 years.

Strategy #7 – Private Placements. Many of the best opportunities for passive growth of IRAs include the purchase of private limited partnership shares, LLC membership units and private stock which does not trade on the stock market. Let me give you two examples from my own retirement account investments. In one case my 401(k) plan invested in a limited partnership which purchased a shopping center in northern Louisiana. The initial investment was $50,000, and in a little over 2 years the partnership has returned $59,321. The plan's remaining equity is estimated as of 12/31/2007 at $31,598 and the return on investment will be around 82%. Even though the property is debt-financed the taxes on the profit have been almost nothing since the plan has taken advantage of depreciation and all of the normal deductions. Once your IRA or other plan owes taxes due to debt financing, it gets to deduct a pro rata share of all normal expenses. Another of my 401(k) plan investments is bank stock of a community bank in Houston, Texas. The initial shares were sold at $10 per share in February, 2007. The book value after less than 1 year of operations was $11 per share, and shares have recently been selling to other private investors for as much as $14.25 per share! That is a great return for a completely passive investment, and when the bank finally sells the shares are expected to sell for well above these amounts.

Strategy #8 – Owning a Business in Your IRA. One of the most innovative strategies we have seen is the ownership of a business by an IRA. Although neither you nor any other disqualified person may provide services to or get paid for working at a business owned by your IRA or other self-directed account, this does not mean that your IRA cannot own a business. Some companies do market the ability for you to start a C corporation, adopt a 401(k) plan, roll your IRA into the plan, and purchase "qualifying employer securities," but this is different than an IRA owning a business directly. For example, my Health Savings Account invested $500 for 100% of the shares of a corporation which arranges for hard money loans to investors. The company is fully licensed as a Texas mortgage broker. The structure of the company is a C corporation. Since being a mortgage broker is a business operation, profits from the venture would have been taxable to my HSA if the entity formed to own the business was not taxable itself, and the tax rates for trusts such as IRAs and HSAs are much higher than for corporations. While normally dividends from C corporations are taxable a second time to the shareholder, dividends paid to an IRA or HSA are tax free as investment income. The corporation is run by non-disqualified persons who handle the due diligence on the loans and the legal work, as well as by a licensed Texas mortgage broker who sponsors the corporation's mortgage broker license.

Strategy #9 – Using OPI (Other People's IRAs) to Make Money Now. Even if you have not found the investment strategy of your dreams among the strategies discussed in this article, or if you have no IRA or if you are more focused on making money now to live on, your time spent reading this article can still be of great use to you. For each of the above strategies I have focused on the possibility that your IRA could be the investor. But what if you are the recipient of the IRA's investment money? Are you a real estate investor having a hard time finding funding for your transactions? If you know people with self-directed IRAs or people who would move their money to a self-directed account, you can borrow their IRA money and virtually create your own private bank! You can also partner with OPI where the IRA puts up the money and you share in the equity for finding the deal and managing the project. Simply by explaining to people that they can own real estate in their IRAs you may be able to sell more property, either as a real estate broker or as the seller. You can even provide financing for your sales by having OPI make loans to your buyers. Finally, OPI can be a great way to raise capital for your business venture, although you must be aware of and comply with all securities laws. One bank I know of told me that 42% of their initial capital came from retirement accounts! Although you cannot use your own retirement account to benefit yourself at present unless you are over age 59 1/2, these are just some of the ways you can use OPI to make money for yourself right now. A good network is the key to your success.

What I have discussed in this article have been some of the more common investment strategies actually used by our clients. The only restrictions contained in the Internal Revenue Code are that IRAs cannot invest in life insurance contracts or collectibles. Almost any other investment that can be documented can be held in a self-directed IRA. As long as you follow the rules and do not invest in prohibited investments, your only real limitation is your imagination!

To Pay or Not to Pay – That is the Question
Unrelated Business Income Tax in Retirement Plans

By H. Quincy Long

Most people understand that an IRA is normally not a taxable trust and its income is not taxed until the income is distributed (or not at all, if it is a qualifying distribution from a Roth IRA). However, there are 2 circumstances when an IRA may owe tax on its income. First, if the IRA is engaged in an unrelated trade or business, either directly or indirectly through a non-taxable entity such as an LLC or a limited partnership, the IRA will owe tax on its share of Unrelated Business Income (UBI). Second, if the IRA owns, either directly or indirectly, property subject to debt, it will owe tax only on the portion of its income derived from the debt, which is sometimes referred to as Unrelated Debt Financed Income (UDFI). I will refer to either tax as Unrelated Business Income Tax (UBIT) in this article.

From a financial planning perspective, the question becomes "Should I avoid doing something in my IRA which may incur UBIT?" Many people just say "Forget it!" when they learn a certain investment may subject the IRA to UBIT. Or worse yet, they ignore the issue and hope they won't get caught. However, being afraid of UBIT is short sighted and ignores the opportunity it presents for building massive wealth in your retirement plan. Remember, making an investment which may subject the IRA to UBIT is not a prohibited transaction, it just means the IRA has to pay a tax. The best financial advice on UBIT is simple: "Don't mess with the IRS!" If the IRA owes UBIT, make sure it is paid.

"But," you object, "doesn't this mean I am paying double taxation?" Unless your IRA is a Roth IRA, it is true that in these 2 circumstances the tax will be paid by the IRA and again by the IRA holder when the income is distributed. However, in my view this is the incorrect focus. Is the IRA glass 1/3 empty or 2/3 full? At least the IRS is a silent partner. The double taxation issue is no different when investing in stocks traded on the stock exchange, since corporations pay tax on income before issuing dividends to shareholders, and the value of the stock takes into account that the company must pay income taxes.

Two key questions arise when analyzing a "UBIT investment." The first question to ask in UBIT analysis is "What tax would I pay if I did the same transaction outside of my IRA?" The only "penalty" is the amount of tax the IRA would pay above the amount that you would pay individually. If you make the investment personally, you not only will pay tax on the income from the investment, but also from the next investment, and the next one after that. At least within the IRA you have the choice of making investments with your proceeds which do not incur UBIT. A second question to ask is this: "Will my after UBIT return exceed what I could make on other IRA investments?" Why should you turn away from an investment in your IRA which will give you an incredible return even after paying the tax?

Let me give you one powerful example of how paying UBIT might make a lot of sense. One Entrust client purchased a property in her Roth IRA subject to approximately $97,000 in delinquent taxes (this is the same as a mortgage for UBIT purposes). The owner was willing to walk away from the property for $75 just to get rid of the headache and the lawsuit pending against him by the taxing authorities. With closing costs the IRA spent around $3,000 to acquire the property. Only 4 months later the property was sold to another investor, and the Roth IRA netted around $46,500 from the sale after paying delinquent taxes and sales expenses. Because the IRA purchased the property subject to debt (the delinquent taxes), it owed UBIT in the amount of approximately $13,500 on its short term capital gain. This meant that even after paying UBIT the IRA went from $3,000 to approximately $33,000. That is a return of over 1,000% in under 4 months, or an annualized return of over 4,000%! This client will obviously have an easier time making money with her $33,000 Roth IRA than she could have with her $3,000 IRA. Since this was a Roth IRA, no more tax will be owed on this income if it is distributed as a qualified distribution after age 59 ½ or from any other income generated in this IRA from investments that are not subject to UBIT.

Ignorance of the tax law is no excuse. You can find out more on this topic by reviewing IRS Publication 598, or by visiting with your tax advisor. After analyzing a transaction, you may come to the conclusion that paying UBIT now in your IRA may be the way to financial freedom in your retirement. Like I often say, “UBIT? You bet!” The information contained in this article is not intended to be tax or investment advice.

Frequently Asked Questions
About Buying Debt Financed Real Estate in an IRA

By H. Quincy Long

Good news! You can buy real estate in your traditional, Roth, SEP, or SIMPLE IRA, your 401(k), your Coverdell Education Savings Account for the kids, and even in your Health Savings Account. Even better, your IRA can borrow the money for the purchase or even take over a property subject to existing financing. What could be better than building your retirement wealth using OPM (Other People's Money)? However, there are some restrictions which you must be aware of when using your IRA to purchase debt financed real estate. Below I answer a series of frequently asked questions regarding the purchase of debt financed real estate in an IRA.

Q. Is it really legal to buy real estate in an IRA?

A. Yes. Even the IRS agrees that real estate is a permitted investment. In its answer to the question "Are there any restrictions on the things I can invest my IRA in?" the Internal Revenue Service states "IRA law does not prohibit investing in real estate but trustees are not required to offer real estate as an option."

Q. Can my IRA buy real estate with a loan or take over a property subject to an existing loan?

A. Yes. An IRA may borrow money to acquire real estate or take over a property subject to an existing loan, provided that the loan is non-recourse to the IRA and to any "disqualified person." This means that typically the lender may only foreclose on the property in the event of a default. Even if there is a deficiency, the lender cannot come after the rest of the IRA's assets, nor can the lender come after the IRA owner or any other disqualified person. Neither the IRA holder nor any other disqualified person is permitted to sign a personal guarantee of the debt.

Q. Where can I get a non-recourse loan for my IRA?

A. There are at least four sources for financing which do not violate the non-recourse requirements for IRA's. First, there is seller financing. Most sellers understand that if the loan goes into default they get the property back anyway, so asking for the loan to be non-recourse should not be too difficult to negotiate. Second, there is private financing from financial friends. If you cultivate a reputation as a professional real estate investor, there should be no reason that your financial friends would not loan your IRA money on a non-recourse basis, either from their own funds or from their own IRA's. I have seen IRA's borrow the money for both the purchase and the rehab on a non-recourse loan! Third, there are banks and hard money lenders. Non-recourse loans are not the norm, so many banks will turn you down. However, there is at least one bank that lends in all 50 states, and in Houston I have had at least 3 local banks and 2 hard money lenders make non-recourse loans to IRA's. Finally, as mentioned above, you could take over a property subject to an existing loan, provided the originator of the loan is not you or another disqualified person.

Q. Is there any tax effect of having an IRA own debt financed real estate?

A. Yes. Income and gains from investments in an IRA, including real estate, are normally not taxed until the income is distributed (unless the distribution is a qualifying distribution from a Roth IRA, a Coverdell Education Savings Account, or a Health Savings Account, in which case the distribution is tax free). However, if the IRA owns property subject to debt, either directly or indirectly through an LLC or a partnership, it may owe tax on the net income from the property or partnership.

Q. If the profits from an investment are taxable to an IRA, does that mean it is prohibited?

A. Absolutely not! There is nothing prohibited at all about making investments in your IRA which will cause the IRA to owe taxes.

Q. But if an investment is taxable, why do it in the IRA?

A. That is a good question. To figure out if this makes sense, ask yourself the following key questions. First, what would you pay in taxes if you made the same investment outside of the IRA? The "penalty" for making the investment inside your IRA, if any, is only the amount of tax your IRA would pay which exceeds what you would pay personally outside of your IRA. Unlike personal investments, the IRA owes tax only on the portion of the net income related to the debt, so depending on how heavily leveraged the property is the IRA may actually owe less tax than you would personally on the same investment. Second, does the return you expect from this investment even after paying the tax exceed the return you could achieve in other non-taxable investments within the IRA? For example, one client was able to grow her Roth IRA from $3,000 to over $33,000 using debt financed real estate in under 4 months *even after the IRA paid taxes on the gain!* Third, do you have plans for re-investing the profits from the investment? If you re-invest your profits from an investment made outside of your IRA you pay taxes again on the profits from the next investment, and the one after that, etc. At least within the IRA you have the choice of making future investments which will be tax free or tax deferred, depending on the type of account you have.

Q. If the IRA pays a tax, and then it is distributed to me and taxed again, isn't that double taxation?

A. Yes, unless it is a qualified tax free distribution from a Roth IRA, a Health Savings Account (HSA) or a Coverdell Education Savings Account (ESA). The fact is that you still want your IRA to grow, and sometimes the best way to accomplish that goal is to make investments which will cause the IRA to pay taxes. Keep in mind that companies which are publicly traded already have paid taxes before dividends are distributed, and the value of the stock takes into consideration the profits after the payment of income taxes. In that sense, even stock and mutual funds are subject to "double taxation."

Q. If the IRA makes an investment subject to tax, who pays the tax?

A. The IRA must pay the tax.

Q. What form does the IRA file if it owes taxes?

A. IRS Form 990-T, Exempt Organization Business Income Tax Return.

Q. What is the tax rate that IRA's must pay?

A. The IRA is taxed at the rate for trusts. Refer to the instructions for IRS Form 990-T for current rates. For 2005, the marginal tax rate for ordinary income above $9,750 was 35%. Capital gain income is taxed according to the usual rules for short term and long term capital gains.

Q. Is there any way to get around paying this tax?

A. Yes. In some ways it may be considered a "voluntary" tax, since investments can often be structured in such a way as to avoid taxation. Some ways to structure your IRA investment to avoid taxation include loaning money instead of acquiring the real estate directly or purchasing an option on the real estate, then assigning or canceling the option for a fee. These techniques have a disadvantage in that they may not result in as much profit to the IRA, but will generally be free of tax. There is also an exemption from this tax for 401(k)'s and other qualified plans in certain circumstances.

Q. Where can I find out more information?

A. Visit our website at www.entrustsdira.com for more information. Also, Unrelated Business Taxable Income and Unrelated Debt Financed Income are covered in IRS Publication 598, which is freely available on the IRS website at www.irs.gov. The actual statutes may be found in Internal Revenue Code §511-514.

There is one general truth that applies both inside and outside of an IRA - you can do more with debt than you can without it. Despite the increased risk from debt and the taxes due on income from debt financed property, a careful analysis may lead to the conclusion that having your IRA pay taxes now may be the way to financial freedom in your retirement. Be sure to have your IRA pay the tax if it owes it, though. As I always say, "Don't mess with the IRS, because they have what it takes to take what you have!"

Prohibited Transactions in Self-Directed Retirement and Other Plans

By H. Quincy Long

Definition of a Truly Self-Directed Plan

1) A self-directed IRA or other retirement plan means that the beneficial owner (i.e. the IRA holder) has total control over the investments he or she wants to make in the retirement plan. IRAs and other retirement plans all have an investment section in their respective trust and plan documents. The investment section specifies what types of investments are permitted and under what circumstances. Truly self-directed plans have investment language which permits the beneficial owner to direct the trustee, custodian or administrator of the retirement plan to make any investment permitted by law. Companies like Quest IRA, Inc. provide administration services for self-directed plans to hold primarily non-traditional assets, such as real estate, real estate options, secured and unsecured loans, tax lien certificates, foreclosure property, non-publicly traded stock, limited partnership interests, limited liability company shares and many other types of investments. **Quest IRA, Inc. does not provide any investment, legal or tax advice, nor do we sell or promote any investments.**

Types of Self-Directed Plans Offered by Quest IRA Inc.

1) All of Quest IRA's plans are 100% self-directed and all types of plans we administer may invest in any type of permitted traditional or non-traditional investment. Quest IRA, Inc. provides administration services for the following types of plans:

A) Roth IRA's
B) Traditional IRA's
C) SEP IRA's (Simplified Employee Pension)
D) SIMPLE IRA's (Savings Incentive Match Plan for Employees)
E) Individual 401(k)'s
F) Coverdell Education Savings Accounts (ESA's, formerly Education IRA's)
G) Health Savings Accounts (HSA's)

Basic Concepts of Prohibited Transaction Analysis

1) What is prohibited under Section 4975 of the Internal Revenue Code is the d*irect 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[1];

(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.

There are various exemptions and exceptions to the definition of a prohibited transaction, but unless you know of a specific exception, the wisest course is to stay away from a transaction involving one of the above situations.

One of the most misunderstood of the exemptions to the above rules is found in 4975(d)(2) – the "reasonable compensation" exemption. *Subject to the exceptions contained in section 4975(f)(6)*, the prohibitions do not apply to, among other things, any contract, or reasonable arrangement, made with a disqualified person for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid (4975(d)(2)) and receipt by a disqualified person of any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan (4975(d)(10)). The "(d)(2)" exemption is often quoted in arguing that the IRA owner may receive reasonable compensation for managing the assets of your plan, even by people who should know better. It doesn't help at all that IRS Publication 590 lists prohibited transactions as including "receiving unreasonable

[1] For an example of how easy this is to violate, see Addendum A, a tax court memo on the case of Rollins v. Commissioner.

compensation for managing it,"[2] which people interpret to mean that receiving reasonable compensation for managing it is okay. ***It is my position that this is wrong!***

There are 2 reasons why you cannot receive any compensation for managing the assets of your own self-directed IRA. First, section 4975(d) starts off with the phrase "*Except as provided in subsection (f)(6), the prohibitions provided in subsection (c) shall not apply to…"* Therefore, before we even get to the exemptions contained in sections 4975(d)(2) and 4975(d)(10), we have to look and see what section 4975(f)(6) says. Section 4975(f)(6) voids most of the exemptions contained in section 4975(d) (including (d)(2) and (d)(10)) for transactions with "owner-employees" in which the plan directly or indirectly lends any part of the corpus or income of the plan to, *pays any compensation for personal services rendered to the plan to*, or acquires for the plan any property from, or sells any property to any such owner-employee, a member of the family of any such owner-employee, or any corporation in which such owner-employee owns, directly or indirectly, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation. The definition of an "owner-employee" includes a shareholder-employee and *a participant or beneficiary of an individual retirement plan* (4975(f)(6)(B)(i)(II)). Therefore, the IRA plan itself cannot compensate a participant or beneficiary of that individual retirement plan.

Second, an IRA beneficiary, at least in a self-directed IRA, is considered a fiduciary to the plan. As fiduciaries, IRA beneficiaries have a duty of undivided loyalty to the plans for which they act. The prohibitions of 4975(c)(1)(E) and (F) are imposed on disqualified persons who are also 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. These prohibitions also include a person who is a disqualified person by reason of a relationship to a fiduciary, since the fiduciary has an interest which may affect the exercise of such fiduciary's best judgment. The Treasury Regulations make it clear that "section 4975(d)(2) does not contain an exemption for acts described in section 4975(c)(1)(E) (relating to fiduciaries dealing with the income or assets of plans in their own interest or for their own account) or acts described in section 4975(c)(1)(F) (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan). Such acts are separate transactions not described in section 4975(d)(2)." (Treasury Regulation §54.4975-6(a)) Therefore, an IRA beneficiary cannot receive "consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan."

[2] See page 41 of the 2005 IRS Publication 590.

These rules are complex and confusing, to say the least. As you might suspect, there are exceptions to the exceptions to the exemptions also, but unless you know of a specific ruling allowing compensation, the wisest course is simply to forget receiving any compensation for a transaction involving your IRA. Besides, why would you want to take taxable compensation out of your IRA?

2) The prohibited transaction rules are intended to ensure that the assets of a retirement plan are invested in a manner which benefits the plan itself and not the IRA holder (other than as a beneficiary of the retirement plan) or another disqualified person, either *directly or indirectly*.

3) 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.

4) There are 2 separate and distinct ways in which any given transaction may violate the prohibited transaction rules. First, there is the transaction itself, such as the sale of property or the making of a loan. Second, there is the decision by the fiduciary to have the plan enter into the transaction. The fiduciary conflict of interest provisions of Section 4975 (IRC 4975(c)(1)(E) & (F)) are the ones that get most people into trouble. The classic example of this is contained in CFR §54.4975-6(a)(6), example 6, which reads:

"*Example (6).* F, a fiduciary of plan P with discretionary authority respecting the management of P, retains S, the son of F, to provide for a fee various kinds of administrative services necessary for the operation of the plan. F has engaged in an act described in section 4975(c)(1)(E), because S is a person in whom F has an interest which may affect the exercise of F's best judgment as a fiduciary. *Such act is not exempt under section 4975(d)(2) irrespective of whether the provision of the services by S is exempt.*" (emphasis added)

5) Transactions done in an IRA are intended to be for investment purposes only and must be on an arms-length basis. Any investment which is not made on an arms-length basis is likely to get you into trouble.

6) All prohibited transactions involve a plan and a disqualified person,[3] which can be either a person who enters into the transaction with the plan or a fiduciary of the plan who makes the decision. Therefore, in order to properly analyze a

[3] A detailed description of disqualified persons is attached as Addendum B.

transaction for potential problems with the prohibited transactions rules you must understand both what is prohibited under Section 4975(c)(1) and who is a disqualified person, as defined in 4975(e)(2). Disqualified persons include, *but are not limited to*, the following:

the IRA holder (who is considered to be a fiduciary of the plan);
the IRA holder's spouse;
the IRA holder's parents and lineal ascendants;
the IRA holder's children and lineal descendants and their spouses;
any other fiduciary of the IRA or a person providing services to the IRA (e.g. the custodian or third party administrator);
an entity at least 50% of which is owned (or at least 50% of the beneficial interests are held) by a combination of certain disqualified persons; and
a 10% owner, officer, director or highly compensated employee of such an entity.

Prohibited Transaction Issues When Retirement Plans Invest in Entities

1) Special issues arise when investments in certain entities are contemplated by a plan. This is because of the plan assets regulations issued by the Department of Labor under 29 C.F.R. §2510.3-101 apply. Additionally, Interpretive Bulletin 75-2 (29 C.F.R. §2509.75-2) may apply.[4] Therefore, a basic understanding of these rules is crucial when advising clients on investments in non-publicly traded stock, limited partnership interests, and limited liability company shares.

2) Generally, when a plan invests in another entity, the plan's assets include its investment, but do not, solely by reason of such investment, include any of the underlying assets of the entity. **However**, in the case of a plan's investment in an equity interest of an entity that is neither a publicly-offered security nor a security issued by an investment company registered under the Investment Company Act of 1940 (meaning, in general, a mutual fund company) its assets include both the equity interest and an undivided interest in each of the underlying assets of the entity, **unless** it is established that –

   1) the entity is an operating company, which can include –

      a) a real estate operating company or
      b) a venture capital operating company; or

   2) equity participation in the entity by benefit plan investors is not significant (meaning total retirement plan investors own less than 25% of each class of securities).

[4] For an example of how these rules interact with the prohibited transaction rules of IRC §4975, see Advisory Opinion 2006-01A, which is attached as Addendum C.

3) The most critical point to remember about this issue is that, unless the entity fits within one of the above exceptions to the plan assets rule, any person who exercises authority or control respecting the management or disposition of such underlying assets (including, presumably, the officers, directors, general partners and/or managers of the entity), and any person who provides investment advice with respect to such assets for a fee (direct or indirect), **is a fiduciary of the investing plan**. This means that all of the usual prohibited transaction rules now apply to these fiduciaries.

4) Another important point is that if the company does not fit into one of the exceptions, if a transaction between a disqualified person and a plan would be a prohibited transaction, then such a transaction between a disqualified person and an entity subject to the plan assets regulations will ordinarily be a prohibited transaction also.

Swanson v. Commissioner and Ethical Considerations in the Formation of IRA Owned Entities

1) One case counsel should be very familiar with when advising clients is *Swanson v. Commissioner*. In a nutshell, Mr. Swanson had two entities formed in which he was the President and sole director. He then instructed the bank holding his IRA to subscribe to 100% of the shares of the entities. After the entities were funded, Mr. Swanson proceeded to do business with a corporation owned by him. The IRS argued that what Mr. Swanson did violated IRC 4975 in several ways. However, the court found that the position of the IRS was so unreasonable that they awarded Mr. Swanson several thousand dollars in attorneys' fees against the IRS! *However, the court completely ignored the transactions between Mr. Swanson's IRA owned corporation and Mr. Swanson's personally owned corporation*. Had they properly considered these transactions, the case probably would have gone the other way.

2) As a result of the Swanson decision, which is apparently still good law for the proposition that it is not a prohibited transaction for an IRA to purchase *original issue* shares of an entity where the IRA owner is an officer and director, there are many companies and lawyers selling "checkbook control" entities to IRA owners. Some of these companies or lawyers charge thousands of dollars for what amounts to a regular entity with the only exception being that the IRA owner is an officer and director of the entity.

3) There are at least 2 potential ethical problems with setting up a "checkbook control" entity for a client. First, the fees charged by most of these companies far exceed the value of the service rendered. Some of the companies do the articles and just "have a lawyer check them over," yet fees range up to $7,500. Second, even if the fees charged are reasonable, it is highly unlikely that anyone not fully knowledgeable of all of the rules discussed here can run a Swanson-type entity

without running afoul of the prohibited transaction rules. The transaction may in fact not be a prohibited transaction initially, but is it ethical to set up an entity which you have reason to believe will lead to a prohibited transaction and the disqualification of the client's IRA? Some companies have gone so far as to say "Well, we expect our clients to be knowledgeable of the rules." In other words, they wash their hands of all responsibility for what happens after the fact.

4) The IRS is aware that abusive Roth transactions are occurring[5]. If the IRS begins attacking these types of transactions, it is likely that IRA owned entities will be examined first. This is when the problems may begin for those who have set up these types of entities, even if they have done so in good faith.

5) Another area of ethical concern is in advising clients on what to do to avoid a prohibited transaction. Unfortunately, much of the advice being given by the "gurus" involves not how to avoid prohibited transactions but rather how to hide the fact that prohibited transactions are occurring by using entities and trusts. In other words, many advisers have the theory that "it is legal until you are caught."

6) Once a prohibited transaction has occurred, there is no "cure." There is no way for a client to undo a prohibited transaction, and the penalties include disqualification of the IRA as of January 1 of the year in which the prohibited transaction took place, as well as penalties for other persons involved in the transaction. There may be ethical concerns about how to advise a client when he comes to you and you discover he has done a prohibited transaction. Do you tell him to undo the transaction and hope for the best, or do you advise him to "fess up" to the IRS, knowing the implications? At a minimum, the client should be advised to immediately separate that IRA from other IRA funds to avoid the "taint" on the other funds. Also, if the client wishes to do something that may end up being prohibited, it is wise to advise the client to set up a separate IRA for that transaction "just in case."

Prohibited Transaction Exemptions

1) The Department of Labor has been given the authority to grant prohibited transaction exemptions. The DOL grants individual exemptions which apply only to those who obtain them and also grants class exemptions which apply on an industry wide basis.

2) A listing of all class exemptions, as well as copies of more recent exemptions themselves, is available on DOL's website at: http://www.dol.gov/ebsa/Regs/ClassExemptions/main.html

[5] See IRS Notice 2004-8 for examples of abusive Roth transactions where a Roth IRA corporation is used to avoid the limitations on contributions to Roth IRA's. The transactions described in this notice are now "listed transactions."

3) Information on obtaining an individual exemption may be found on DOL's website at:
http://www.dol.gov/ebsa/regs/ind_exemptionsmain.html

4) DOL also has a special class of expedited individual exemptions where it can be shown that DOL has granted similar exemptions within the recent past. These are called EXPRO Exemptions. Information can be obtained on DOL's website at:
http://www.dol.gov/ebsa/Regs/expro_exemptions.html

5) You can get an advisory opinion from DOL as to whether a transaction would violate the prohibited transaction rules. However, you should not ask for an opinion if your client is not willing to accept the answer. Information on Advisory Opinions from 1992 forward may be found on DOL's website at:
http://www.dol.gov/ebsa/Regs/AOs/main.html

6) DOL publishes information letters which are answers to inquiries made about issues relating to DOL regulations. Information on information letters may be found on DOL's website at:
http://www.dol.gov/ebsa/Regs/ILs/main.html

Useful Websites

www.questira.com – Quest IRA, Inc. website
www.dol.gov/ebsa - Department of Labor, Employee Benefits Security Administration
http://frwebgate.access.gpo.gov – US Code online
http://ecfr.gpoaccess.gov – Code of Federal Regulations online
www.irs.gov – Internal Revenue Service website

ADDENDUM "A"

Plan sponsor's owner had to pay prohibited transaction excise taxes for his role in lending plan assets to other companies that he owned

Joseph R. Rollins, TC Memo 2004-260.

The owner of a company that sponsored a 401(k) plan had to pay excise taxes for his participation in a prohibited transaction for which he was found to have personally benefited, where he approved a series of plan loans to other companies in which he owned a part-interest.

Background. Joseph Rollins was a CPA, registered investment adviser, and a certified employee benefits specialist. He was also the sole owner of Rollins & Associates, P.C. (the company), a public accounting firm. The company maintained a 401(k) plan, and functioned as both its sole trustee and administrator. As trustee, the company was responsible for investing, managing, and controlling the plan's assets. All of the company's investment decisions were made by Rollins.

Between 1996 and 1999, Rollins made a series of decisions permitting the plan to lend a total of $700,000 to three companies, in each of which he owned a minority interest. Rollins not only signed all of the loan checks on behalf of the plan, but he also signed the promissory notes *to* the plan on behalf of each borrower. All of the loans were eventually repaid to the plan, with 12% interest.

IRS asserted that Rollins had engaged in a Code Sec. 4975 prohibited transaction and thus owed excise taxes totalling about $208,000, plus additional taxes equalling about $11,000 for failing to file excise tax returns. Rollins petitioned the Tax Court to reverse the IRS deficiencies against him for the taxes that it had determined he owed.

Prohibited transactions. Under Code Sec. 4975, a tax is imposed on a disqualified person (e.g., a plan fiduciary or a 50% or more owner of the plan sponsor) who participates in a prohibited transaction between a plan and a disqualified person. Under Code Sec. 4975(c)(1)(D), any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan is a prohibited transaction.

IRS contended that the loans here constituted a use of the plan's assets for Rollins' benefit, in violation of Code Sec. 4975(c)(1)(D). IRS argued that Rollins was a disqualified person with respect to the plan in two capacities: (1) he was a plan fiduciary, and (2) he was the 100% owner of the employer sponsoring the plan. IRS further argued that the plan's loans to the companies in which Rollins had an interest were prohibited transactions because the loans were transfers of the plan's assets that benefited Rollins. The loans enabled the borrowers-all companies in which Rollins owned an interest-to operate without having to borrow funds at arm's length from other sources.

Rollins argued that with respect to all of the loans, the interest rate was above-market, the principal was repaid, and the plan's assets were diversified. Rollins acknowledged that he was a disqualified person with regard to the plan because he owned the company, but he contended that (a) none of the borrowers was a disqualified person, (b) none of the loans was a transaction between him and the plan, and (c) he did not benefit from the loans, either in income or in his own account.

The Tax Court sided with IRS in holding that each of the loans constituted a use of the plan's assets for Rollins' benefit, in violation of Code Sec. 4975(c)(1)(D). The plan loan proceeds here were used by Rollins, or for Rollins' benefit. **Although the assets weren't transferred to Rollins, the Tax Court concluded that he "sat on both sides of the table." Rollins both made the decisions to lend the plans' funds, and signed the promissory notes on behalf of the borrowers. And that, the court said, violated the purpose of the prohibited transaction rules, which is to stop disqualified persons from dealing with plan assets.**

According to the court, Rollins had the burden of proving by a preponderance of the evidence that the loans did not constitute uses of the plan's assets for his own benefit. Based on the evidence presented, however, he failed to persuade the court that he did not benefit from the transactions. Thus, the court held, each of the loans constituted a use of the plan's assets for Rollins' own benefit, in violation of Code Sec. 4975(c)(1)(D).

Excise Taxes. The court held that Rollins was liable for prohibited transaction excise taxes under both Code Sec. 4975(a) and Code Sec. 4975(b). Under Code Sec. 4975(a), an excise tax is imposed on a disqualified person for his participation in a prohibited transaction. The tax is equal to 15% of the amount involved for each year in the taxable period. Under Code Sec. 4975(b) , an additional tax equal to 100% of the amount involved is imposed on a prohibited transaction if the transaction is not corrected within the taxable period. The court said that investment prudence and actual benefit to the plan are not sufficient to excuse imposition of those taxes.

The court also held that Rollins was liable for additions to tax under Code Sec. 6651(a)(1), for failing to file excise tax returns. Rollins was obligated to file tax returns for payment of the excise taxes, but failed to do so, and did not have reasonable cause for that failure.

ADDENDUM "B"

DISQUALIFIED PERSONS

Since all of the prohibited transaction rules refer to a transaction involving the plan and a *disqualified person*, in order to understand what is prohibited you must understand who is a disqualified person. A "disqualified person" is defined in section 4975(e)(2) as a person who is –

(A) a fiduciary, which is defined to include any person who -

(1) 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;

(2) 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

(3) has any discretionary authority or discretionary responsibility in the administration of such plan.

Because you are self-directing the IRA, it is clear that you are a fiduciary to your IRA. This means that you, the IRA beneficiary, are a disqualified person and cannot do any prohibited transaction described in section 4975(c)(1), unless an exemption applies.

(B) a person providing services to the plan;

(C) an employer any of whose employees are covered by the plan;

(D) an employee organization any of whose members are covered by the plan;

(E) an owner, direct or indirect, of 50 percent or more of –

(1) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;

(2) the capital interest or the profits interest of a partnership; or

(3) the beneficial interest of a trust or unincorporated enterprise,

which is an employer any of whose employees are covered by the plan or an employee organization any of whose members are covered by the plan;

(F) a member of the family of any individual who is –

(1) a fiduciary;

(2) a person providing services to the plan;

(3) an employer any of whose employees are covered by the plan; or

(4) an owner, direct or indirect, of 50 percent or more of –

(a) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;

(b) the capital interest or the profits interest of a partnership; or

(c) the beneficial interest of a trust or unincorporated enterprise,

which is an employer any of whose employees are covered by the plan or an employee organization any of whose members are covered by the plan.

A "member of the family" is defined to include only a spouse, ancestor, lineal descendant, and any spouse of a lineal descendant. Note that brothers and sisters, in-laws, aunts, uncles and cousins are not defined as disqualified persons. Therefore, *as long as you are receiving no current benefit as a result of dealing with them*, you can conduct legitimate investment activity with your family members who are not your spouse, ancestor, lineal descendant, or any spouse of a lineal descendant.

(G) a corporation, partnership, trust, or estate in which 50 percent or more of –

(1) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;

(2) the capital interest or the profits interest of a partnership; or

(3) the beneficial interest of such trust or estate,

is owned, directly or indirectly, or held by persons who are –

(1) a fiduciary;

(2) a person providing services to the plan;

(3) an employer any of whose employees are covered by the plan;

(4) an employee organization any of whose members are covered by the plan; or

(5) an owner, direct or indirect, of 50 percent or more of –

(a) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;

(b) the capital interest or the profits interest of a partnership; or

(c) the beneficial interest of a trust or unincorporated enterprise,

which is an employer any of whose employees are covered by the plan or an employee organization any of whose members are covered by the plan.

(H) 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 –

(1) an employer any of whose employees are covered by the plan;

(2) an employee organization any of whose members are covered by the plan;

(3) an owner, direct or indirect, of 50 percent or more of –

(a) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;

(b) the capital interest or the profits interest of a partnership; or

(c) the beneficial interest of a trust or unincorporated enterprise,

which is an employer any of whose employees are covered by the plan or an employee organization any of whose members are covered by the plan; or

(4) a corporation, partnership, trust, or estate in which 50 percent or more of –

(a) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;

(b) the capital interest or the profits interest of a partnership; or

(c) the beneficial interest of such trust or estate,

is owned, directly or indirectly, or held by persons who are –

(a) a fiduciary;

(b) a person providing services to the plan;

(c) an employer any of whose employees are covered by the plan;

(d) an employee organization any of whose members are covered by the plan; or

(e) an owner, direct or indirect, of 50 percent or more of –

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;

(ii) the capital interest or the profits interest of a partnership; or

(iii) the beneficial interest of a trust or unincorporated enterprise,

which is an employer any of whose employees are covered by the plan or an employee organization any of whose members are covered by the plan.

(I) a 10 percent or more (in capital or profits) partner or joint venturer of a person who is –

(1) an employer any of whose employees are covered by the plan;

(2) an employee organization any of whose members are covered by the plan;

(3) an owner, direct or indirect, of 50 percent or more of –

(a) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;

(b) the capital interest or the profits interest of a partnership; or

(c) the beneficial interest of a trust or unincorporated enterprise,

which is an employer any of whose employees are covered by the plan or an employee organization any of whose members are covered by the plan; or

(4) a corporation, partnership, trust, or estate in which 50 percent or more of –

(a) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;

(b) the capital interest or the profits interest of a partnership; or

(c) the beneficial interest of such trust or estate,

is owned, directly or indirectly, or held by persons who are –

(a) a fiduciary;

(b) a person providing services to the plan;

(c) an employer any of whose employees are covered by the plan;

(d) an employee organization any of whose members are covered by the plan; or

(e) an owner, direct or indirect, of 50 percent or more of –

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation;

(ii) the capital interest or the profits interest of a partnership; or

(iii) the beneficial interest of a trust or unincorporated enterprise, which is an employer any of whose employees are covered by the plan or an employee organization any of whose members are covered by the plan.

ADDENDUM "C"

Advisory Opinion 2006-01A[6]

January 6, 2006

Debra C. Buchanan, Esq.
Guidant Legal Group, PLLC
225 Commerce Street, Suite 450
Tacoma, WA 98402

2006-01A
ERISA Sec. 29 CFR 2509.75-2

Dear Ms. Buchanan,

This is in response to your request for an advisory opinion as to whether the following proposed transaction would be prohibited under section 4975 of the Internal Revenue Code (the "Code"), 26 U.S.C. § 4975.

You represent that Salon Services and Supplies, Inc. is a Washington state "S" Corporation ("S Company") which is 68% owned by Miles and Sydney Berry, a marital community (M). The other 32% is owned by a third-party, George Learned ("G"). Miles Berry (Berry) proposes to create a limited liability corporation ("LLC") that will purchase land, build a warehouse and lease the property to S Company. The investors in the LLC would be Berry's individual retirement account ("IRA") (49%), Robert Payne's ("R") IRA (31%) and G (20%). R is the comptroller of S Company. R and G will manage the LLC. You represent that S Company is a disqualified person with respect to Berry's IRA under section 4975(e)(2) of the Code. You represent that R and G are independent of Berry. You also represent that the LLC does not contain plan assets because it is a "real estate operating company" (REOC) as defined by 29 C.F.R. § 2510.3-101(e).

You state that an independent qualified commercial real estate appraiser has appraised the rental value of the lease and has found that the terms of the lease are not less favorable to the LLC and its IRA investors than those obtainable in an arm's length transaction between unrelated parties. Finally, the custodian for Berry's and R's IRAs has reviewed the LLC operating agreement and has approved the investment for those two self-directed IRAs.

Section 4975(c)(1)(A) of the Code prohibits any direct or indirect sale, exchange or leasing of any property between a plan and a "disqualified person." Section 4975(c)(1)(D) of the Code prohibits any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan. A "disqualified person" is defined under section 4975(e)(2)(A) of

[6] Footnotes omitted.

the Code to include a person who is a fiduciary. Code section 4975(e)(3) defines the term "fiduciary" to include, in pertinent part, 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. Section 4975(c)(1)(E) prohibits a fiduciary from dealing with the
income or assets of a plan in the fiduciary's own interest or for his or her own account. Section 4975(e)(1)(B) of the Code defines the term "plan" to include an individual retirement account described in Code section 408(a).

We first address the proposed lease as it relates to Berry's IRA. Berry is a fiduciary to his own IRA because he exercises authority or control over its assets and management. 26 U.S.C. § 4975(e)(3). As a fiduciary, Berry is a disqualified person under section 4975(e)(2)(A) of the Code. You represent that S Company is a disqualified person under section 4975(e)(2) of the Code. R, the comptroller of S Company, is a disqualified person with respect to Berry's IRA under section 4975(e)(2)(H) as an officer of S Company. R, as an employee of S Company, a company 68% owned by M, cannot be considered independent of Berry.

Based upon your representations, it is the opinion of the Department that a lease of property between the LLC and S Company would be a prohibited transaction under Code section 4975, at least as to Berry's IRA. The lease constitutes a prohibited transaction regardless of whether the LLC qualifies as a REOC under the Department's plan assets regulation. 29 C.F.R. § 2510.3-101.

The Department's regulation at 29 C.F.R. § 2509.75-2(a) (Interpretative Bulletin 75-2), explains that a transaction between a party in interest under ERISA (or disqualified person under the Code, in this case S Company) and a corporation in which a plan has invested (i.e., the LLC) does not generally give rise to a prohibited transaction. However, in some cases it can give rise to a prohibited transaction. Regulation section 2509.75-2(c) and Department opinions interpreting it have made clear that a prohibited transaction occurs when a plan invests in a corporation as part of an arrangement or understanding under which it is expected that the corporation will engage in a transaction with a party in interest (or disqualified person).

According to your representations, it appears that Berry's IRA will invest in the LLC under an arrangement or understanding that anticipates that the LLC will engage in a lease with S Company, a disqualified person. Therefore, the lease would amount to a transaction between Berry's IRA and S Company that Code section 4975(c)(1)(A) and (D) prohibits. Additionally, the proposed lease, if consummated, may also constitute a violation by Berry, a fiduciary, of Code section 4975(c)(1)(D) and (E).

Finally, we note the express emphasis in 29 C.F.R. § 2509.75-2(c) that the Department considers "a fiduciary who makes or retains an investment in a corporation or partnership for the purpose of avoiding the application of the fiduciary responsibility provisions of the Act to be in contravention of the provisions of section 404(a) of the Act."

Thus, the proposed lease, which would violate section 4975(c)(1) of the Code, would also have to be referred to the Internal Revenue Service for a determination as to whether it would consider the transaction a violation of the exclusive benefit rule of section 401(a)(2) of the Code, which is the Code's analogue to the fiduciary responsibility provisions of section 404(a) of ERISA.

Because we have concluded that the proposed lease would constitute a prohibited transaction with respect to Berry's IRA, the issue of whether the Code prohibits the lease as it relates to R's IRA is moot, and does not need to be addressed.

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (1976). Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,

Louis J. Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Option Strategies for Your IRA

Many people would like to buy real estate in their IRAs but have a mistaken belief that they do not have enough money to do so. Nothing could be further from the truth! You may invest in real estate with your IRA without a lot of money in several ways, including partnering with other IRAs or non-IRA money, buying property with debt, or by using one of the most powerful and under utilized tools in real estate investing today – the option.

In this article we will focus on some option basics. First, what is an option? Once consideration for the option is paid, it is the owner's irrevocable offer to sell the property to a buyer under the terms of the option for a certain period of time. The buyer has the *right* but not the *obligation* to buy.

You might wonder why an owner would agree to tie up his property with an option. Advantages to a property owner include: 1) the owner may be able to time his income for tax purposes, since option fees are generally taxable when the option is either exercised or expires (always check with your tax advisor); 2) if the owner needs money, an option may be a way to get money that he doesn't have to repay, unlike a loan; 3) options are very flexible, and the owner may be able to negotiate an option which allows him to keep the property until a more opportune time – this is especially true of an owner in a pre-foreclosure situation.

Do the paperwork right! Options are extremely powerful and very easy to mess up. Be very specific, clear and complete about all the details. *Remember, with options, you have to negotiate for both the option and for the purchase of the property.* With a well written option, the following must be, as my old law professor was fond of saying, "patently obvious to the most casual observer":

a) Who is granting the option? Does it include heirs, successors and assigns?
b) Who is receiving the option? Does it include assignees of the buyer, or is it an exclusive option to purchase by the buyer only?
c) What property is being optioned? Property can be anything, including real estate, a beneficial interest in a land trust, a real estate note or nearly anything else.
d) What is the consideration for the option? Remember, there must be some consideration for the option in the form of money, services or other obligations.
e) How is the option exercised by the buyer? This is one of the easiest things to mess up in an option. If the procedure is not clear for exercising the option, it is an *invitation to litigation!*
f) What will be the purchase price of the property if the option is exercised?
g) How will the purchase price be paid when the option is exercised? Will it be for cash? Seller financing? Subject to the owner's existing mortgage?
h) Will the option consideration be credited to the option price or not?
i) When can the option be exercised? For example, does the option holder have the right to exercise the option at any time during the option period, or can the option only be exercised after a specified amount of time?

j) When will the option expire, and under what circumstances? The option should have a definite termination date, but might also include other circumstances under which the option terminates, such as a default under a lease.

k) When it comes time to close, what are each party's obligations? For example, who pays for title insurance, closing costs, etc? Are taxes prorated?

So what forms do you use? The answer is my favorite as a lawyer - *it depends!* There is not and cannot be a "standard" option for all purposes. They are simply too flexible. You must decide on a specific use for the option and then, as Shakespeare said, "Get thee to a lawyer!" (Okay, it was "Get thee to a nunnery" but I like it better as revised!).

When you have negotiated an option agreement for your IRA, you have several choices. First, you can let the option expire on its own terms. Sometimes this is the best course of action if the deal is not what you expected, especially if you only paid a small amount for the option.

Another choice is that your IRA could exercise the option and buy the property. Since there are ways to finance property being purchased by your IRA, including seller financing, bank financing, private party financing or even taking over property subject to a loan, this may be a good strategy for your IRA, even if the IRA does not have the cash to complete the purchase. Be aware that if your IRA owns debt financed property, either directly or indirectly through an LLC or partnership, its profits from that investment will be subject to Unrelated Business Income Tax (UBIT). This is not necessarily a bad way to build your retirement wealth, but it does require some understanding of the tax implications.

A third choice which is often employed in the context of self directed retirement accounts is to assign your option to a third party for a fee. Your option agreement should specifically allow for an assignment to make sure that there are no problems with the property owner. This is a great technique for building a small IRA into a large IRA quickly. I had one client who put a contract on a burned house for $100 earnest money in his daughter's Coverdell Education Savings Account, then sold his contract to a third party who specialized in repairing burned houses for $8,500. In under 1 month the account made a profit of 8,400%, and all parties were happy with the deal! The account holder then immediately took a TAX FREE distribution to pay for his daughter's private school tuition.

A fourth choice that sometimes is overlooked is the ability to release the option back to the property owner for a cancellation fee. In other words, this is a way for your IRA to *get paid not to buy!* Let me give you an example of how this might work. Suppose you want to offer the seller what he would consider to be a ridiculously low offer. When the seller balks, you say "I'll tell you what. You sign this option agreement for my IRA to purchase this property at my price, and we'll put in the option agreement that I cannot exercise my option for 30 days. If you find a buyer willing to offer you more money within that 30 day period, just reimburse my IRA the option fee plus a cancellation fee of $2,500." Either way, your IRA wins!

The creative use of options can make your IRA grow astronomically if done correctly. In future articles I will be discussing different types of option strategies.

Wealth Building Options for Your IRA

By H. Quincy Long

In my last article on Option Strategies for Your IRA, I discussed option basics. In this article I will expand on the uses of options and how these strategies might be used to turn small amounts of cash into tremendous wealth in your IRA.

Simple Options. The most basic type of option is simply to have an option to purchase a piece of property for a specified price within a certain period of time. This is much better than a loan because it is similar to zero percent interest financing. For example, if a Health Savings Account (HSA) has a five year option to buy a piece of property for $50,000.00, then the HSA does not owe any more for the property at the end of the five years than it did at the beginning, yet the HSA effectively controls the property. This amounts to a five year, zero percent interest loan, but with no unrelated business income tax (UBIT)! You could even structure the option to have monthly or yearly renewal fees, so that it feels similar to a regular seller-financed loan for the property owner. With options all the burdens of owning the property, such as property taxes, insurance, and maintenance, continue to be on the property owner, thereby reducing your IRA's risk!

Fix Up and Sell Options. Many investors are familiar with the typical buy, rehab and resell strategy for real estate. Suppose you created a deal in your Roth IRA where the repairs to be done are the consideration for the option? You and the property owner would agree on a specific list of repairs to be done, and the money for the repairs would come from your IRA. The option price would be based on the value of the property in its current condition. When the repairs are done the value of the property will have substantially increased, but your IRA has an option to purchase the property at the lower price. The value of your Roth IRA's option is equal to the difference between the current, after repair fair market value and the original option price. As discussed in the prior article, your Roth IRA may, among other choices, 1) exercise its option and purchase the property, 2) assign the option for a fee to a retail buyer and let him purchase the property directly from the property owner, or 3) allow the property owner to sell directly to a retail buyer at a higher price while *paying your Roth IRA a substantial fee to cancel the option!*

Options on Ugly Property. What do you do if you locate a property that you think could probably be sold for a profit, but it is such a trashy piece of property or has so little equity that you are nervous about your IRA taking title to it? The solution is simple: have your IRA purchase an option from the property owner, stick a sign on the property, and try to find a buyer for the property which will give your IRA a profit. Options under these circumstances can often be purchased with very little money from your IRA. Even if your IRA ends up not exercising its option sometimes, overall this can be an incredibly powerful wealth building strategy.

Options on Partial Interests. What if there were several heirs owning a property you wanted your IRA to buy, but the heirs did not get along or did not agree to a certain price? Rather than giving up, have your IRA buy an option to purchase each heir's interest separately.

The price would not have to be equal to each heir. Once you have negotiated options with all the heirs, you could add up the price and see if your IRA could market the property for a profit.

Low Ball Offers and the Right to Cancel. Suppose you want to make a low ball offer on a piece of property. The seller wants too much for the property, and you think he won't get his price. On the other hand, he has to sell by a certain date for whatever reason (foreclosure, closing on a new house, moving out of town, etc.). Tell the seller this: "If you sell my daughter's Coverdell Education Savings Account (ESA) an option to purchase the property for my price, I will give you the right to cancel the option within the next 30 days if you return the option fee plus $2,500.00. That way, if you find someone to pay you more than you would get from me who can close quickly enough you can sell the property to them and cancel the option, but you know you have a guaranteed sale if you can't sell it to someone else on time." How's that for overcoming objections to a low ball offer? Your daughter's ESA either gets the property at a bargain price or the seller *pays her ESA not to buy!*

Long Term Options. Long term options can be particularly powerful within an IRA, especially if your retirement is not imminent. Although many options used by IRAs are for shorter time periods, a long term option can turn out to be a fantastic investment. For example, in Houston, Texas there is an area called the Heights. This is close to downtown and many urban professionals are purchasing property in the area to avoid the horrible commute. Old properties are being purchased by individuals and developers who knock the houses down and build new homes on the lots. It is an area in transition. Prices have skyrocketed. Wouldn't it be great if your IRA had 5 or 10 year options on several pieces of property in a redeveloping area such as the Heights or in the growth path of a city? Even if the option was to purchase the property for full fair market value or higher in today's market, the longer term of the option may allow for a natural increase in the fair market value of the property

Rights of First Refusal. Another technique that can be used either alone or in conjunction with an option is a right of first refusal. A right of first refusal by itself is not an option to buy. It only means that the seller agrees not to sell the property to anyone else before first offering it to the holder of the right of first refusal. This is commonly used in business transactions, and can be used in real estate as well. Sales price and other terms are not typically negotiated in a pure right of first refusal, since it is only the right to buy the property at whatever price and on whatever terms the owner wants to sell.

When combined with a long term option, this strategy can pay off even if the option price is as high or higher than the current fair market value. For example, what if your IRA has an option to purchase a property in a growth path area for $100,000.00, and the option has a right of first refusal clause in it. In other words, any time the property owner wants to sell the property to a third party he would have to offer it to your IRA under the same terms. If the property owner wants to sell the property to a third party for $80,000.00, your IRA will also have the option to purchase it for that price because your IRA's option has a right of first refusal clause. But suppose $80,000 is at or near the current fair market price and so exercising the option is not a good deal for your IRA. Assuming your option agreement is structured in a way that the option does not expire merely because of a transfer of ownership, the new owner of the property will have to take the property subject to that option. This of course limits his ability to sell the property in the future for more than your option price. Also, if a notice of option is filed in the real property records the buyer's lender may require that the option be released. What is the value of your option under these circumstances, even though it is at a higher price than the current fair market value? *The answer is however much the owner and buyer are willing to pay your IRA to cancel the option if that's what you want!*

Options and Shared Appreciation Mortgages. Has your IRA ever made a hard money loan and you thought, "I'd sure like my IRA to have a piece of that property! What a great deal!" Here is an interesting concept: loan the money to the investor at a low interest rate in exchange for an option to purchase a certain percentage of the property at the initial purchase price. One investor I know was able to use this method to purchase a property at a discount with a tenant in the property. Because the tenant was already in the property with a long term lease, he could not make the deal work using regular hard money rates. His solution was to borrow the money for the purchase and rehab from a friend's IRA. The IRA received 6% interest plus an option to purchase a 50% interest in the property at one-half original purchase price. The investor walked away from closing with $3,000 in his pocket, a rental property with cash flow, and 50% of the future appreciation! Another possible structure is a loan with an option to convert from debt to equity.

Options on Personal Property. Options are most commonly discussed in terms of real estate. However, there is nothing which says you cannot purchase an option on personal property. For example, in many states the beneficial interest in a land trust is considered to be personal property. You may want to have your IRA purchase an option on a discounted note to see if it can be sold for a profit. I have even heard of people having an option in their IRA on automobiles being purchased by an investor at car auctions.

Options can be purchased in all types of Entrust self-directed accounts, including Roth, traditional, SEP and SIMPLE IRAs, Individual 401(k)s, Coverdell Education Savings Accounts (ESAs), and even Health Savings Accounts (HSAs). Options are so incredibly powerful and flexible that I cannot discuss all the opportunities in one short article. I hope this article has opened your mind to new possibilities for your IRA. As I always say in the context of self-directed IRAs, "I don't think outside the box, the box is just bigger than you think!"

Entity Investments in Your IRA - Advantages, Cautions and Legal Considerations

By: H. 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. Other articles in this series include prohibited transactions and disqualified person, unrelated business income (UBI) and unrelated debt-financed income (UDFI) as it relates to entity investments, the plan asset 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.

There are advantages, cautions, and legal considerations when investing in an entity within your IRA. Advantages of having your IRA own an entity include:

1) Your IRA's funds may be held in the entity's name at a local bank. This can be an advantage when getting cashier's checks for the foreclosure or tax lien auction, paying earnest money or option fees, or paying contractors who prefer local checks, among other things.

2) Certain types of investments, such as real estate closings or investments at foreclosure auctions, may in some circumstances be easier to facilitate through an entity.

3) Investing your IRA's funds through an entity may give your IRA some asset protection. Always check with local legal counsel!

4) In certain limited circumstances, you may be able to act as a manager, director or officer of your IRA-owned entity *without compensation*.

5) If the entity's shares are all that the IRA owns, administration fees may be lower.

6) If the director, officer or manager is a trusted friend, you may more easily control what happens with your IRA's funds.

Cautions when investing your IRA through an entity include:

1) Check with your CPA or tax advisor on the local, state and federal tax implications of the entity you want your IRA to invest in.

2) Select competent legal counsel to guide you who is familiar with the restrictions imposed by the Internal Revenue Code, including the prohibited transaction rules of Section 4975, as well as the plan asset regulations. Otherwise, you may

inadvertently engage in a prohibited transaction. Make sure that the investment in the entity is not prohibited in itself and also that the company is not structured in a way that the operations of the company will lead to a prohibited transaction.

3) All fees for the formation of the entity and for the preparation of any necessary tax returns as well as any taxes due must be paid from funds belonging to the IRA.

4) Unless the entity is taxable itself, to the extent it owns debt-financed property or operates as a business, unrelated business income tax (UBIT) may attach to the profits from the entity. Remember, there is no distinction between general and limited partners.

5) Your third party administrator generally does not review the formation document or the by-laws, operating agreement or partnership agreement. The nature of a self-directed IRA is that the IRA holder is responsible for the contents of the agreement, and usually must read and approve the subscription agreement and operating or partnership agreement prior to the administrator signing. Typically, the only review that is undertaken is to make sure that the ownership of the asset is correctly listed in the name of the IRA. Also, bear in mind that the administrator does not review any investment for compliance with IRS guidelines, so the IRA holder and his or her advisers should be very familiar with any restrictions.

Other things for you and your legal counsel to consider include:

1) You should review the entity agreements to make sure that an IRA or qualified plan is permitted to be a shareholder, member or partner. The agreement should specify the voting procedure for shares held by an IRA or qualified plan.

2) There should be no transfer or buy-sell restrictions that would restrict the shares if the IRA is distributed either because the IRA holder dies or because the shares are distributed as part of a Required Minimum Distribution (RMD), or if the IRA holder decides to move the shares to a different custodian or administrator.

3) The IRA holder and other related disqualified persons generally cannot receive compensation from the company.

4) Depending on the ownership percentage by the IRA and other disqualified persons, it may be a prohibited transaction to fund additional capital calls. If so, only the amount of the initial commitment can be funded. Many administrators or custodians have restrictions on future capital calls. The concern is that if the IRA and other disqualified persons fund more than 50% of the entity the entity will become a disqualified person to the owning IRA and future capital contributions

might be considered a "transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the plan" in violation of Internal Revenue Code §4975(c)(1)(D).

5) If the IRA holder is or may soon be subject to required minimum distributions, either the IRA holder must have sufficient resources left in the subscribing IRA or other traditional IRA's to cover the RMD, unless there will be guaranteed sufficient distributions from the entity to fund the RMD. Otherwise, shares of the entity may have to be distributed. This would cause significant difficulties both for the IRA holder and for the entity.

6) Because of the limited review by the custodian or administrator of the formation documents and the investment, the IRA holder and his or her advisor should do the normal due diligence on the company, including investigating all of the principals involved, reviewing the financial strength of the company, verifying with the Secretary of State that the company is in good standing, and checking with the Securities and Exchange Commission, the Better Business Bureau and any other governmental or non-governmental agency to see if any complaints have been filed against the company. The IRA holder is 100% responsible for evaluating the company and the investment.

Entity Investments in Your IRA -
Is Your Investment Income Taxable to the IRA?

By: H. 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.

Many people are surprised to learn that, as discussed below, there are 2 ways in which an IRA's investment in an entity may cause the IRA to owe tax on its income from that investment. This does not necessarily mean that you should not make the investment in the IRA. It does mean that you must evaluate the return on the investment in light of the tax implications.

The first situation in which an IRA might owe tax on its entity investment is if the entity invested in is non-taxable, such as a limited partnership or an LLC treated as a partnership for tax purposes, and the entity operates a business. Although investment in an entity which is formed for the purpose of capital investment, such as the purchase and holding of real estate, should not generate taxable income for the IRA (unless there is debt financing), any income from business operations would be considered Unrelated Business Income (UBI) for the IRA. UBI is the income from a trade or business that is regularly carried on by an exempt organization and that is not substantially related to the performance by the organization of its exempt purpose, with the exception that the organization uses the profits derived from this activity. Exclusions from UBI include dividends, interest, annuities and other investment income, royalties, rents from real property (but not personal property), income from certain types of research, and gains and losses from disposition of property (except property which is considered to be inventory).

> *Example.* Ira N. Vestor has a large rollover IRA from a former employer and wants to help out his friend, Will B. Richer, who is starting a new restaurant business. Will offers Ira a 25% ownership interest in his new business, Eat Richer Restaurants, LLC. Ira believes Will is going to be a huge success, and wants to grow his IRA. The LLC will be taxed as a partnership. Ira will not be paid and will have no part in the management or operation of the business. Because the LLC is taxed as a partnership, the IRA must pay taxes on its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business less its share of the partnership deductions directly connected with such gross income.

A second situation in which an IRA may owe tax is when the entity invested in owns debt financed property. Anytime an IRA owns debt financed real estate, either directly or indirectly through a non-taxable entity, the income from that investment is taxable to the IRA as Unrelated Debt Financed Income (UDFI). Some key points to remember about UDFI include: 1) the IRA is only taxed on the debt financed portion of the investment income (see example below), 2) the

IRA is allowed most of the normal expenses, depreciation (on a straight line basis) and similar items which are directly connected to the debt financed income in calculating its UDFI, 3) the tax on the gain or loss is determined according to the usual rules for capital gains and losses, and 4) there is no tax if the debt has been paid off for at least 12 months prior to the sale.

> *Example.* Ira N. Vestor wants to use his IRA to invest in a limited partnership, Pay or Go, L.P., which will purchase an apartment complex. The lender requires a 20% cash down payment, and will not permit subordinate financing. Because the property is 80% debt financed, Mr. Vestor's IRA will owe a tax on approximately 80% of its net profits from the limited partnership (the percentage subject to tax changes as the debt is paid down and the basis is adjusted). When the property sells, Mr. Vestor's IRA will have to pay capital gains tax on the debt financed portion of the profits. Only the profits from the rents or capital gains from the sale that are attributable to the debt financing are taxable to the IRA. For example, if the gain on the sale of the apartment complex is $100,000, and the highest acquisition indebtedness in the 12 months prior to the sale divided by the average adjusted basis is 75%, then $25,000 of the gain is tax deferred or tax free as is normal with IRA's, while the IRA would owe tax (not Mr. Vestor personally) on $75,000.

"But," you ask, "if an investment is taxable, why make it in the IRA?" That is a good question. To figure out if this makes sense, ask yourself the following key questions. First, does the return you expect from this investment even after paying the tax exceed the return you could achieve in other non-taxable investments within the IRA? Second, do you have plans for re-investing the profits from the investment? If you re-invest your profits from an investment made outside of your IRA you pay taxes again on the profits from the next investment, and the one after that, etc. At least within the IRA you have the choice of making future investments which will be tax free or tax deferred, depending on the type of account you have.

Is there any way to get around paying this tax? The short answer is yes. Investments can often be structured in such a way as to avoid taxation. Dividends, interest, investment income, royalties, rents from real property (but not personal property), and gains and losses from disposition of property (unless the property is debt financed or is considered "inventory") are all excluded from the calculation of UBI. There are many ways to structure your IRA investment to avoid taxation. Some examples of how you might structure a transaction in ways that are not taxable to the IRA include:

> *Example.* Suppose in the Eat Richer Restaurants, LLC example above the LLC elected to be treated as a corporation instead of a partnership, or a C corporation was formed instead (IRA's may not own shares of an S corporation). Because the entity has already paid the tax, the dividend to the IRA would be tax free or tax deferred. This may not be acceptable to other shareholders, however.

> *Example.* Instead of his IRA investing directly in Pay or Go, LP, Ira N. Vestor could have made a loan instead. The loan could have been secured by a second lien on the

property (which may not be permitted by the first lienholder, however). The loan could even be secured by shares of the LP itself, possibly with a feature allowing the loan to be converted at a later point to an equity position in the LP (a "convertible debenture"). *Caution:* With lending there may be state or federal usury limits on how much interest may be charged, and if the debt is converted into equity the IRA may then owe taxes at that time.

Example. Another choice for investing without the IRA paying taxes is to purchase an option instead. When your IRA owns an option to purchase anything, it can 1) let it lapse, 2) exercise the option, 3) sell or assign the option (provided the option agreement allows this) or 4) release the owner from the option for a fee (in other words, getting paid not to buy!)

A careful analysis of an investment which causes the IRA to owe tax will often lead to the conclusion that having your IRA pay taxes now may be the way to financial freedom in your retirement. Be sure to have your IRA pay the tax if it owes it, though. As I always say, "Don't mess with the IRS, because they have what it takes to take what you have!"

Entity Investments in Your IRA - Prohibited Transactions and Disqualified Persons

By: H. 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. 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 asset 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 IRA's. 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 that 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, CPA's and your third party administrator.

3) An employer any of whose employees are covered by the plan.

4) An employee organization any of whose members are 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 judgement (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 IRA's. 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.

Entity Investments in Your IRA - Who Cares About the Plan Asset Regulations?

By: H. 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 this article we discuss the plan asset regulations and how they may impact your investment in an entity.

What are the plan asset regulations and why should you care about them if you are investing your IRA through an entity? If the plan asset regulations apply to your entity investment, there are two major effects. First, your IRA is deemed to own not only the equity interest in the entity but also an undivided interest in the underlying assets of the entity for purposes of the prohibited transaction rules of Section 4975. To see how this works, suppose you want to sell a piece of real estate to your IRA. Unfortunately, the prohibited transaction rules say you cannot sell any property to your IRA. So can you form an LLC owned by your IRA and sell the property to that LLC instead? The answer is no, because under the plan asset regulations selling the property to your IRA-owned LLC is the same as selling it directly to your IRA, which is prohibited.

Second, if the plan asset regulations apply, the officers, directors and managers of an entity may be considered fiduciaries of the investing IRA, which means the prohibited transaction rules apply to them and other disqualified persons related to them. This is a critical issue and has many implications. Basically all of the prohibited transaction restrictions which are imposed on the IRA owner now also apply to the managers of the LLC. As fiduciaries they are responsible for making decisions in the best interests of the IRA as opposed to their own best interests or the interests of parties related to them. For example, suppose an LLC is formed which is subject to the plan asset regulations. Because the manager of the LLC is now a fiduciary of the investing IRA, neither the manager nor any other disqualified person related to the manager may sell property to, exchange property with, or lease property from the LLC.

Because of the serious implications of these regulations, when investing your IRA through an entity you should evaluate whether or not they apply. If you are forming an entity or advising clients as an attorney, knowing when these rules apply is crucial since it may affect how the entity is structured and whether or not you agree to accept retirement plan money.

When do the plan asset regulations apply? The plan asset regulations apply to any investment which is not a publicly offered security or a mutual fund **unless** either 1) the entity is an operating company (essentially, a business), which can include a real estate operating company or a venture capital operating company or 2) equity participation in the entity by benefit plan investors is not significant (meaning total retirement plan investors own less than 25% of each class of securities). This means that the plan asset regulations will apply unless the entity either is running a business (in which case the unrelated business income tax rules apply) or unless all retirement plan investors together own less than 25% of each class of securities. Even if the entity meets the requirements for an operating company, the regulations still apply if an IRA or a related group of IRA's own all of the outstanding shares of the entity.

According to an additional set of regulations which stem from the Department of Labor's Interpretive Bulletin 75-2, even the investment in the entity itself may be a prohibited transaction if a fiduciary (including the IRA owner) causes the plan to invest in an entity and as a result of that investment the fiduciary or another disqualified person derives a current benefit. For example, if the IRA invests in or retains its investment in an entity and as part of the arrangement it is expected that the entity will hire the fiduciary or a related disqualified person, such arrangement is a prohibited transaction. Under those same regulations, if a transaction between a disqualified person and an IRA would be a prohibited transaction, then it will ordinarily be a prohibited transaction if the IRA and other disqualified persons collectively have voting control in the entity.

There is no doubt that this is a complex topic which is hard to explore in a short article. In most cases, the plan asset regulations will apply to your IRA's entity investment. If so, you should be aware of the following implications:

1) Your IRA's assets include a proportionate interest in each company asset.

2) Company managers, directors, officers and advisers are likely fiduciaries of the IRA.

3) Because they are likely fiduciaries, certain compensation and indemnification plans for officers and directors may give rise to prohibited transactions.

4) Prohibited transactions may result if the company engages in business transactions with disqualified persons, including the company's managers, directors, officers, advisers and related parties to them.

If you hire an attorney or a company to assist you in setting up an IRA-owned LLC or other entity, including the "checkbook control" LLC, make sure they have a complete understanding of the prohibited transaction rules of Section 4975 and the associated regulations, the plan asset regulations, and the regulations from Department of Labor's Interpretive Bulletin 75-2. Sadly, there is a perception that investing an IRA through an entity is somehow a "prohibited transaction washing machine" which will protect the IRA from all the pesky rules of Section 4975. In fact, the opposite is true, since the additional layers of complexity make it more likely that an inadvertent prohibited transaction may occur.

For those who want to know more, the prohibited transaction rules may be found in Internal Revenue Code (26 U.S.C.) Section 4975. The regulations for Section 4975 are in 26

C.F.R. 54.4975-6. The plan asset regulations are in 29 C.F.R. 2510.3-101. The regulations relating to Department of Labor Interpretive Bulletin 75-2 are found in 29 C.F.R. 2509.75-2.

<u>Entity Investments in Your IRA - *Swanson v. Commissioner* and the "Checkbook Control" IRA-Owned LLC</u>

By: H. Quincy Long

One of the most popular ideas in the self-directed IRA industry today is the "checkbook control" IRA. You may have wondered what exactly it means to have "checkbook control" over your IRA's funds. In this article we will examine the celebrated case of *Swanson v. Commissioner*, on which the idea of "checkbook control" is based. The entire text of the *Swanson* case is available on our website at www.EntrustTexas.com.

The essential facts of *Swanson* are as follows:

1) Mr. Swanson was the sole shareholder of H & S Swansons' Tool Company (Swansons' Tool).

2) Mr. Swanson arranged for the organization of Swansons' Worldwide, Inc. (Worldwide). Mr. Swanson was named as president and director of Worldwide. Mr. Swanson also arranged for the formation of an individual retirement account (IRA #1).

3) Mr. Swanson directed the custodian of his IRA to execute a subscription agreement for 2,500 shares of Worldwide *original issue stock*. The shares were subsequently issued to IRA #1, which became the sole shareholder of Worldwide.

4) Swansons' Tool paid commissions to Worldwide with respect to the sale by Swansons' Tool of export property. Mr. Swanson, who had been named president of Worldwide, directed, with the IRA custodian's consent, that Worldwide pay dividends to IRA #1.

5) A similar arrangement was set up with regards to IRA #2 and a second corporation called Swansons' Trading Company.

6) Mr. Swanson received *no compensation* for his services as president and director of Swansons' Worldwide, Inc. and Swansons' Trading Company.

The IRS attacked Mr. Swanson's setup on two fronts. First, the IRS argued that the payment of dividends from Worldwide to IRA #1 was a prohibited transaction within the meaning of Internal Revenue Code (IRC) Section 4975(c)(1)(E) as an act of self-dealing, where a disqualified person who is a fiduciary deals with the assets of the plan in his own interest. Mr. Swanson argued that he engaged in no activities on behalf of Worldwide which benefited him other than as a beneficiary of IRA #1.

The court agreed with Mr. Swanson, and found that the IRS was not substantially justified in its position. The court said that section 4975(c)(1)(E) addresses itself only to acts of disqualified persons who, as fiduciaries, deal directly or indirectly with the income or assets of a plan for their own benefit or account. In Mr. Swanson's case the court found that there was no such direct or indirect dealing with the income or assets of the IRA. The IRS never suggested that Mr. Swanson, acting as a "fiduciary" or otherwise, ever dealt with the corpus of IRA #1 for his own benefit. According to the court, the only direct or indirect benefit that Mr. Swanson realized from the payments of dividends by Worldwide related solely to his status as a participant of IRA #1. In this regard, Mr. Swanson benefited only insofar as IRA #1 accumulated assets for future distribution.

The second issue the IRS raised was that the sale of stock by Swansons' Worldwide to Mr. Swanson's IRA was a prohibited transaction within the meaning of section 4975(c)(1)(A) of the Code, which prohibits the direct or indirect sale or exchange, or leasing, of any property between an IRA and a disqualified person. Mr. Swanson argued that at all pertinent times IRA #1 was the sole shareholder of Worldwide, and that since the 2,500 shares of Worldwide issued to IRA #1 were *original issue*, no sale or exchange of the stock occurred.

Once again, the court sided with Mr. Swanson. The critical factor was that the stock acquired in that transaction was *newly issued* - prior to that point in time, Worldwide had no shares or shareholders. The court found that a corporation without shares or shareholders does not fit within the definition of a disqualified person under section 4975(e)(2)(G). It was only after Worldwide issued its stock to IRA #1 that petitioner held a beneficial interest in Worldwide's stock, *thereby causing Worldwide to become a disqualified person*. Accordingly, the issuance of stock to IRA #1 did not, within the plain meaning of section 4975(c)(1)(A), qualify as a "sale or exchange, or leasing, of any property between a plan and a disqualified person".

On the surface it seems like the court endorsed the idea of an IRA holder being the sole director and officer of an entity owned by his IRA. In other words, by having the IRA invested in an entity such as an LLC of which the IRA owner is the manager, the IRA owner gets to have "checkbook control" over his or her IRA's funds. This sounds like a great idea. However, before jumping too fast into this area, there are some issues to consider.

One thing to remember is that the LLC does not insulate the IRA from the prohibited transaction rules. Amazingly, the IRS and the court in *Swanson v. Commissioner* ignored completely the fact that Mr. Swanson's non-IRA owned corporation, Swansons' Tools, paid commissions to Worldwide, thereby reducing Swansons' Tools' taxable income and indirectly benefiting Mr. Swanson. Especially after the recent case of *Rollins v. Commissioner*, it seems clear that this would be a prohibited transaction. In the Rollins case, Mr. Rollins loaned money from his 401(k) plan to corporations in which he served as president but of which he owned only a minority interest. The corporations were clearly not disqualified persons, but the court nonetheless held that there was an indirect benefit to Mr. Rollins, who was the largest shareholder and an officer of each corporation.

The IRS also might have argued that Mr. Swanson's service as the president and sole director of Worldwide was a prohibited transaction as described in 4975(c)(1)(C), which prohibits the furnishing of goods, *services* or facilities between an IRA and a disqualified person. Although Mr. Swanson stated that Worldwide had no "active" employees, one has to wonder at what point the services rendered to an IRA-owned entity become a problem. Another question which was not raised in the *Swanson* case was whether or not an IRA owner having checkbook control over his IRA funds through a 100% IRA-owned entity violates IRC Section 408(a)(2), which requires that the custodian of an IRA be a bank or other qualified institution. Why have that requirement at all if the IRA owner can get around it merely by having his or her IRA own 100% of an LLC managed by the IRA owner?

Although the *Swanson* case appears to be good case law, a great deal of care is merited when relying on this case. Several questions which were not raised in the *Swanson* case remain unanswered. As noted by the court, Mr. Swanson was "following the advice of experienced counsel." Even then, Mr. Swanson had to fight the IRS in tax court to win his case. For most people, even getting into a battle with the IRS is a losing proposition. Some people, perhaps through ignorance of the rules, appear to be abusing Swanson-type entities. For example, in IRS Notice 2004-8 on abusive Roth transactions, the IRS states that it is aware of situations where taxpayers are using a Roth IRA-owned corporation which deals with a pre-existing business owned by the same taxpayer to shift otherwise taxable income into the Roth IRA. If the IRS has become aware of the problem, there may come a day when they decide to go after these types of arrangements more actively.

When relying on the *Swanson* case to set up a checkbook control LLC or other entity, always use experienced legal counsel who is very familiar with how to set up this type of entity and who will be there to guide you on issues such as the prohibited transaction rules, the plan assets regulations, unrelated business income tax issues and the other rules and regulations which may apply. What happens after the LLC is formed is just as important as the initial setup and can get you into just as much trouble. To attempt a "checkbook control" entity without knowledge of all the rules and regulations or competent counsel to guide you is sort of like jumping out of an airplane without a parachute – it may be fun on the way down, but eventually you're going to go SPLAT!

Top Ten Mistakes I See People Make With Their Self-Directed IRAs

By H. Quincy Long

1) Not understanding the "self-directed" part of self-directed IRAs.

   Unlike more traditional brokerage style IRAs, self-directed IRAs do not come with any tax, legal or investment advice, nor do self-directed custodians and third party administrators offer or endorse investment products. Self-directed means just that – it is self-directed and you must find your own investments and decide how you want to structure those investments. If you make a million dollars in your self-directed IRA all the glory belongs to you, but if you lose everything you have there is no one to blame but yourself.

2) Not investing in what they know best, but rather investing in something they know nothing whatsoever about.

   One of the primary benefits of a self-directed IRA is that it allows you to invest in what you know best, especially if that is not the more traditional IRA investments like stocks, bonds, mutual funds or annuities. Some people get very excited about the idea of self-direction and invest in something they know nothing about, which often leads to an investment disaster. Most of my mistakes in investing have been because I have strayed from what I know how to do best.

3) Not understanding the disqualified persons and prohibited transaction rules.

   Disqualified persons are those persons who are deemed to be too close to make a transaction within your IRA an arms-length transaction, which means these persons cannot enter into transactions with your IRA nor can they benefit from those transactions, *either directly or indirectly*. Prohibited transactions are what your IRA cannot do with any disqualified person. The penalty for entering into a prohibited transaction is DEATH (of the IRA that is) along with taxes and penalties. If you have a self-directed IRA you must have a good basic understanding of these rules as they apply to your investing strategy.

4) Not vesting assets correctly – all assets in self-directed IRAs should be vested as follows: "Entrust Retirement Services, Inc. FBO *Your Name* IRA #*Your IRA Number*."

   A lot of time is spent in attempting to get clients, title companies, and investment providers to understand that all assets must be vested in a specific way in order to be held within a self-directed IRA. Common errors include failing to vest in the name of the custodian or administrator at all, or only putting the client name after the "FBO" so that it appears we are holding the asset on behalf of the individual instead of the individual's IRA. Another common mistake is where the client attempts to use their own Social

Security Number instead of that of the IRA or the administrator or custodian's trust tax identification number.

5) Failing to submit proper paperwork to allow smooth opening of IRAs and processing of transactions.

Another large time waster is chasing down paperwork from improperly completed documents for opening the IRAs, for transferring money into the IRAs and for transactions. This leads to a frustrated client and frustrated staff. Taking the time to learn how to properly submit paperwork and allowing yourself enough time to do so is critical in successfully navigating the self-directed IRA world. Remember, it is better to ask questions in advance than to submit incorrect paperwork and cause a delay.

6) Not understanding what they are investing in.

This is a big one. It is almost incomprehensible to me how some people don't have any understanding of what they are investing in at all. For example, a person called the other day and thought she had a note and an option agreement. Instead, she had a simple option where she had paid $28,000 for an option to buy 50% of the property for $10. This was meant to help the owner out of foreclosure. The homeowner had the right to buy back the option at a profit to the IRA of about $5,000. The good news is that it worked for a time period and the homeowner got to stay in the house for an extra two years. The bad news is that the homeowner still wasn't fiscally responsible and the IRA lost every dime when the lien holder foreclosed. Since all the IRA had was an option (not a note as she thought) she could not even sue to recover some of her money, and even if she had exercised her option her IRA would have only owned half of the house.

7) Not understanding Unrelated Business Income Tax and how it may affect your IRA.

IRAs may be taxed in three circumstances. First, if it runs a business, either directly in the IRA or indirectly through a non-taxed entity such as a partnership or LLC. Second, if the IRA owns and rents out personal property (rents from real property are exempt from this tax). Third, if the IRA owns debt-financed property, again either directly in the IRA or indirectly through a non-taxed entity such as a partnership or LLC. Just to be clear, it is not necessarily all bad to make investments which cause your IRA to pay tax, especially within a Roth IRA or other tax free account, but it is something you should understand up front.

8) Trusting someone with your hard earned IRA money without doing proper due diligence and proper paperwork.

Let me give you a hint – con men are very good at what they do. Make sure you understand what you are investing in, and do your due diligence on the investment and on the person you are investing with before making an investment decision. Also, make sure you have proper paperwork. I wouldn't loan money to my own mother without proper documentation! Proper paperwork protects both your IRA and the person your IRA is investing with. Think about what would happen if either you died or the person you invested with died. Would either party's heirs understand what the investment was all about? Even if you trusted the person you invested with absolutely, would their heirs know about your handshake deal and honor it? Probably not! An excellent rule of thumb in investing is that if it sounds too good to be true it probably is. Also, a common thread in scams is that it must be done NOW or you will miss out on this incredible opportunity! This is an attempt to draw you in without allowing you time to think about or due diligence on the investment.

9) Failing to follow proper strategy when loaning your IRA to other investors.

There are at least 10 simple rules to follow when lending your IRA money out (or even your personal money). They are:

a) Do not loan on something you wouldn't be excited to own if the borrower defaults.

b) Generally, do not advance money for repairs until the repairs are done, and then inspect the repairs before advancing the funds.

c) Do not loan to someone you would feel uncomfortable foreclosing on!

d) If the loan goes into default, do not delay – take action immediately!

e) Collect interest monthly so you will know if the borrower is getting into trouble.

f) If you are unsure about a loan, hire a professional to help you evaluate the deal (at the borrower's cost, of course!).

g) Get title insurance on your loan. If done at closing the incremental cost to the borrower is very small.

h) Verify that hazard and, if necessary, flood and wind insurance are in place naming your IRA as an additional insured.

i) Insist on evidence that taxes, homeowners association dues and hazard insurance are paid when they come due during the term of the loan.

j) Get a personal guarantee when lending to a non-individual borrower or a weak borrower.

10) Attempting to figure out how to get around the rules to get a benefit for themselves or other disqualified persons rather than simply investing within the rules.

It seems to be very tempting for people to want to use their own IRAs to make money or obtain some other benefit for themselves or other disqualified persons right now instead of letting all the benefits go to the IRA so that they have a nice retirement. To make matters worse, a lot of gurus are teaching how to hide the fact that you are violating the rules instead of teaching people how to use the rules properly to their advantage. My personal motto is, use the law to your advantage but don't abuse the law. After all, the "R" in IRA stands for Retirement. It is not an INA (or Individual NOW Account)! To make money now, use OPI (Other People's IRAs), and to make money for your retirement, use your own self-directed IRA.

Quest IRA, Inc.

Ten Things You Need to Know About Self-Directed IRAs

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There is a lot of confusion over self-directed IRAs and what is and is not possible. In this article I will discuss some of the most important things you need to know about self-directed IRAs. We will explore these issues and a whole lot more when I speak at Central Ohio Real Estate Entrepreneurs Association on July 3, 2012. I look forward to seeing you there!

1) **IRAs Can Purchase Almost Anything.** A common misconception about IRAs is that purchasing anything other than CDs, stocks, mutual funds or annuities is illegal in an IRA. This is false. The only prohibitions contained in the Internal Revenue Code for IRAs are investments in life insurance contracts and in "collectibles." Since there are so few restrictions contained in the law, almost anything else which can be documented can be purchased in your IRA. A "self-directed" IRA allows any investment not expressly prohibited by law. Common investment choices include real estate, both domestic and foreign, options, secured and unsecured notes, including first and second liens against real estate, C corporation stock, limited liability companies, limited partnerships, trusts and a whole lot more.

2) **Seven Types of Accounts Can Be Self-Directed, Not Just Roth IRAs.** There are seven different types of accounts which can be self-directed. They are the 1) Roth IRA, 2) the Traditional IRA, 3) the SEP IRA, 4) the SIMPLE IRA, 5) the Individual 401(k), including the Roth 401(k), 6) the Coverdell Education Savings Account (ESA, formerly known as the Education IRA), and 7) the Health Savings Account (HSA). Not only can all of these accounts invest in non-traditional investments as indicated above, but they can be combined together to purchase a single investment.

3) **Almost Anyone Can Have a Self-Directed Account of Some Type.** Although there are income limits for contributing to a Roth IRA, having a retirement plan at work does not affect your ability to contribute to a Roth IRA, and there is no age limit either. With a Traditional IRA, the fact that you or your spouse has a retirement plan at work may affect the deductibility of your contribution, but anyone with earned income who is under age 70 1/2 can contribute to a Traditional IRA. There are *no upper income limits* for contributing to a Traditional IRA. A Traditional IRA can also receive funds from a prior employer's 401(k) or other qualified plan. Additionally, you may be able to contribute to a Coverdell ESA for your children or grandchildren, nieces, nephews or even my children, if you are so inclined. If you have the right type of health insurance, called a High Deductible Health Plan, you can contribute to an HSA regardless of your income level. With an HSA, you may deduct your contributions to the account and qualified distributions are tax free forever! All of this is *in addition to* any retirement plan you have at your job or for your self-employed business, including a SEP IRA, a SIMPLE IRA or a qualified plan such as a 401(k) plan or a 403(b) plan.

4) **Even Small Balance Accounts Can Participate in Non-Traditional Investing.** There are at least 4 ways you can participate in real estate investment even with a small IRA. First, you can wholesale property. You simply put the contract in the name of your IRA instead of your name. The earnest money comes from the IRA. When you assign the contract, the assignment fee goes back into your IRA. If using a Roth IRA, a Roth 401(k), an HSA, or a Coverdell ESA, this profit can be *tax-free forever* as long as you take the money out as a qualified distribution. Second, you can purchase an option on real estate, which then can be either exercised, assigned to a third party, or canceled for a fee. Third, you can purchase property in your IRA subject to existing financing or with a non-recourse loan from a bank, a hard money lender, a financial friend or a motivated seller. Profits from debt-financed property in your IRA may incur unrelated business income tax (UBIT), however. Finally, your IRA can be a partner with other IRA or non-IRA investors. For example, one recent hard money loan we funded had 10 different accounts participating. The smallest account to participate was for only $1,827.00!

5) **Caution: There Are Restrictions on What You Can Do With Your IRA.** Although as noted above in paragraph 1 the Internal Revenue Code lists very few investment restrictions, certain transactions (as opposed to investments) are considered to be prohibited. If your IRA enters into a prohibited transaction, there are severe consequences, so it is important to understand what constitutes a prohibited transaction. Essentially, the prohibited transaction rules were made to discourage certain persons, called disqualified persons, from dealing with the income and assets of the plan in a *self-dealing* manner. As a result, disqualified persons are prohibited from directly or indirectly entering into or benefitting from your IRA's investments. The assets of a plan are to be invested in a manner which benefits the plan itself and not the IRA owner (other than as a beneficiary of the IRA) or any other disqualified person. Investment transactions are supposed to be on an arms-length basis. Disqualified persons to your IRA include, among others, yourself, your spouse, your parents and other lineal ascendants, your kids and other lineal descendants and their spouses, and any corporation, partnership trust or estate which is owned or controlled by any combination of these persons. It is essential when choosing a custodian or administrator that the company you choose is very knowledgeable in this area. Even though no self-directed IRA custodian or administrator will give you tax, legal or investment advice, the education they provide will be critical to your success as a self-directed IRA investor.

6) **Some IRA Investments May Cause Your IRA to Owe Taxes – But That May Be Okay.** Normally an IRA's income and profits are exempt from taxation until a distribution is taken (or not at all, if it is a qualified distribution from a Roth IRA). However, there are three circumstances when an IRA may owe tax on its profits. First, if the IRA is engaged in an unrelated trade or business, either directly or indirectly through

a non-taxable entity such as an LLC or a limited partnership, the IRA will owe tax on its share of Unrelated Business Income (UBI). Second, the IRA will owe taxes if it has rental income from personal property, such as a mobile home not treated as real estate under state law (but rents from real property are exempt from tax if the property is debt-free). Finally, if the IRA owns, either directly or indirectly, property subject to debt, it will owe tax only on the portion of its income derived from the debt, which is sometimes referred to as Unrelated Debt Financed Income (UDFI). This may sound like something you never would want to do, but a more careful analysis may lead you to the conclusion that paying tax now in your IRA may be the way to financial freedom in your retirement. For example, one client made a net gain of over 1,000% in less than four months *after her IRA paid this tax.* This is definitely a topic you will want to learn more about, but it is not something you should shut your mind to before investigating whether the after tax returns on your investment would exceed the return you might otherwise be able to achieve in your IRA.

7) **An Inherited Roth IRA Can Give You Tax Free Income Now No Matter What Your Age.** Many people know that a qualified distribution from a Roth IRA is tax free. To make the distribution qualify as tax free, it must be distributed after the IRA owner has had a Roth IRA for at least 5 tax years and after one of four events occurs – 1) the IRA owner is over age 59 ½, 2) the IRA owner becomes disabled, 3) the IRA owner dies and the distribution is to his or her beneficiary, or 4) the distribution is for a first-time home purchase, either for the IRA owner or certain close family members. Although the neither the original Roth IRA owner nor his or her spouse has to take a distribution (assuming the spouse elects to treat the IRA as their own), non-spouse beneficiaries of a Roth IRA do have to take distributions, normally over their expected lifetimes. However, once the five year test is met, those distributions are tax free, *regardless of the age of the IRA beneficiary*! Even a $100,000 Roth IRA left to a 6 year old beneficiary may generate as much as $80,496,367 in lifetime tax free distributions if the IRA can sustain a yield of 12%, which is very possible with a self-directed IRA.

8) **Tax Avoidance With Permission of the U.S. Government.** Most people who understand the benefits of a Roth IRA really want one, but many people have not been able to qualify for this incredible wealth building tool because of income limitations which restrict the eligibility of a person to contribute to a Roth IRA or to convert pre-tax accounts like Traditional IRAs into a Roth IRA. In 2010 the rules for conversions changed so that anyone, *regardless of income level*, is now eligible to do a Roth conversion. Beginning in 2010 anyone who has a Traditional IRA (including a SEP IRA), a SIMPLE IRA which has been in existence for at least two years, or a former employer retirement plan such as a 401(k) or a 403(b) can convert those into a Roth IRA and can then begin to create tax free wealth for their retirement. In certain situations you can even do a Roth conversion within the 401(k) plan itself. Even if you do not currently have an IRA but are eligible to contribute to a Traditional IRA, the contribution can be made and immediately converted into a Roth IRA. This truly is one of the most exciting tax planning opportunities to come along in a very long time!

9) There Are Millions of Dollars Available to Finance Your Real Estate Deals Right Now. We are in a very exciting time for wise real estate investors. There are a lot of super real estate bargains out there right now, but it can be very difficult for investors to get financing – unless they know the secret of private financing. There are billions of dollars of lazy IRA money sitting on the sidelines waiting for the right investment, because many people are very afraid of the stock market. Included among the many things people can invest in with a self-directed IRA are real estate secured loans or even unsecured loans. Shakespeare wrote in his play Hamlet, "Neither a lender nor a borrower be, for a loan oft loses both itself and friend, and borrowing dulls the edge of husbandry." I believe Shakespeare was *wrong*, but he might be forgiven since he did not have the advantage of knowing about self-directed IRAs. You can benefit from your knowledge of self-directed IRAs either by having your IRA be a private lender or by borrowing OPI – Other People's IRAs – for your real estate transactions. Networking is the key to success in the area of private lending or borrowing, but there are things you must know to do it properly.

10) Use Options to Dramatically Boost Your Small IRA. Options are one of the most powerful and under-utilized tools in real estate investing today, and they work beautifully within a self-directed IRA. The consideration for the option and the property being optioned can be almost anything, not just real estate. Once an IRA owns an option, it can 1) let the option lapse (which at times is the right answer), 2) exercise the option and acquire the property, 3) assign the option for a fee (assuming the option agreement allows for assignment) or 4) agree to cancel the option for a fee with the property owner, thereby getting paid not to buy the property! Options are very flexible and can be designed to fit almost any situation. One client paid $5,000 from his Roth IRA for an option which he later canceled for a fee of over $35,000. Then he took that money, bought a property at a foreclosure auction for cash, and later sold the property for $70,000 with $5,000 down and a $65,000 seller-financed note. By using the option he was able to take his $5,000 Roth IRA and turn it into a $70,000 Roth in less than a year!

Truthfully there are many more things that you should know about self-directed IRAs. To learn more, attend one or more of Quest IRA's many free networking and educational events. You can get the entire schedule of events by going to our new website at www.QuestIRA.com. Happy investing!

<u>Top Ten Things You Need to Know</u>
<u>When Investing in Real Estate Notes in Your IRA</u>

Many self-directed IRA clients, including me, invest in notes within their IRAs, mostly secured by real estate. In my years of experience as a hard money lender personally and as a third party administrator for self-directed IRAs, I have seen some common mistakes made. As a result, I have developed some guidelines for lending your IRA (and non-IRA) money out secured by liens on real estate. I wish someone had shared these ground rules with me before I made some of the loans in my portfolio, although fortunately I have not been hurt too much by my mistakes.

1) Do not loan on something you wouldn't be excited for your IRA to own if the borrower defaults. Loaning money out of your IRA at relatively high interest rates secured by real estate is inherently more risky than leaving the money in a bank certificate of deposit, but it is also more profitable. We routinely see yields from these loans at 12% and higher. However, if you would be upset if the borrower defaulted and you had to take the property in foreclosure you probably should not make the loan. With a properly secured hard money loan the worst thing that can happen is that the borrower pays you back!

2) Generally, do not advance money for repairs until the repairs are done, and then have the repairs inspected before advancing the money. This is one of the biggest mistakes I see clients make with their IRAs. They fund the full loan amount expecting the repairs to be done on the property, but the borrower just needs a little more money on another project and diverts some of the loan proceeds to that project. When the loan goes bad, the IRA can end up with a property which has not had the repairs completed on it.

3) Do not loan money to someone you would feel uncomfortable foreclosing on. William Shakespeare wrote in Hamlet, "Neither a lender nor a borrower be; For loan oft loses both itself and friend, And borrowing dulls the edge of husbandry." For the most part I cannot agree with this advice, because lending and borrowing money drives our economy and increases economic activity. However, the part about a loan losing a friend is absolutely correct, in my opinion. If foreclosing on your borrower would cause you heartache, it is best not to make the loan. I have seen friendships destroyed over a loan gone bad.

4) If the loan goes into default, take action immediately. No one wants to admit they have made a mistake, but delaying action can be costly. You can always stop the foreclosure process once it has begun, but you cannot complete the process unless you start it.

5) Collect interest monthly so you will know if the borrower is getting into trouble. Many borrowers, especially investors, would love to just pay interest at the end of the loan, but this can expose the lender to additional risk. The purpose of collecting payments monthly is both to make sure the borrower remembers he has to do something with that property in order to avoid the pain of the payment and to let you know if the borrower is

in trouble because he starts missing his payments. Also, unless you have contracted for monthly payments, you may not be able to foreclose even if you find out through other means that the borrower is in financial trouble because the loan may not be in default. This actually happened to some of our clients.

6) If you are unsure about how to evaluate the loan, hire a professional to help you. Although a hallmark of the self-directed IRA is that it is "self-directed," meaning that you make your own decisions and find your own investments, most IRA owners either do not possess sufficient knowledge or, in my case, sufficient time to properly evaluate a loan transaction. My solution is to hire a professional to help me with the deals. He checks out the borrower, coordinates with the title company, orders the appraisal and usually a survey, makes sure insurance is in place, and generally evaluates the loan. Naturally he charges a fee for this service, which is passed through to the borrower, on top of any interest and fees that my retirement plan may charge. This increases the cost of the loan, but in this case the non-Biblical version of the golden rule applies, which is "He who has the gold makes the rules."

7) Get title insurance for the loan. The purpose of title insurance is to shift risk away from you and to the title company. In Texas, where my office is, the incremental cost of title insurance is very small when issued in conjunction with an owner's title policy. Regardless of the cost, making sure that your IRA is protected from title flaws is very important.

8) Verify that hazard and, if necessary, flood insurance is in place naming your IRA as an additional insured. It is very easy to miss this issue when you are trying to get everything done right before a closing. Borrowers may get insurance at the last moment and simply forget to add your IRA as an insured. But if something goes wrong, you will want to make sure your IRA is named on the check.

9) Insist that the borrower provide you evidence of payment when property taxes and homeowners association fees become due. The same thing would apply to hazard and flood insurance premiums, although normally you would receive notice of cancellation for non-payment of those bills. Depending on where you live, property tax bills can increase quickly due to penalties and court costs, which reduces your equity position in the property.

10) Get a personal guarantee if lending to an entity or to an individual with some weakness. When things are going well, you might be tempted not to insist on a personal guarantee, and indeed many borrowers will resist this. However, as we all have discovered recently, circumstances do change, and a personal guarantee may be helpful in collecting the debt. I collected on a note once where the property had decreased substantially in value due to vandalism and market conditions. Instead of foreclosing, I had my lawyer send a letter explaining to the guarantor, who had a significant amount of assets, that he was personally liable on the debt and that if he was unable to satisfy the note I would pursue

legal action against him and the borrower. A week later a cashier's check showed up satisfying the lien.

This list of suggestions is not meant to be exclusive. Other issues you will need to understand include your lien position (personally I only invest in first lien loans), any state usury laws that might apply to the loan, and at least a general idea of what the foreclosure process is in your state in case the loan goes into default. Always get good legal counsel to assist you with loan documentation. Especially since the borrower traditionally pays for all expenses including legal fees, there is no reason not to have an attorney draw up loan documents.

Lending can be an excellent investment in an IRA. It is relatively easy to do and if done correctly has a comparatively low risk. Getting to know successful real estate entrepreneurs who borrow your IRA money may also lead to other, intangible benefits as well.