“Real Estate Investments With Your Self-Directed IRA”

Take control of your financial future
with investments you understand.

The Entrust Group
Self-Directed Retirement Plan Services

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Table of Contents

Introduction

Creating your financial future comes down to the freedom to make choices: relying on your own knowledge, understanding the opportunities, getting expert help and enjoying the challenges of taking charge. With a self-directed IRA or real estate IRA, you can invest your retirement funds when, where and how you want.

Self-directed IRAs and real estate IRAs give you the ability to choose from a variety of investments, such as mortgages, notes, real estate, offshore real estate, private placements and more. And, by diversifying your investments, you may protect and enhance your retirement.

The Entrust Group is the world's premier provider of account administration services for self-directed retirement plans through a nationwide network of dedicated local offices. For more than 25 years we have been an acknowledged authority in the field of self-directed retirement accounts. Our commitment is to always be the knowledge leader in our field, and to deliver that knowledge to you through the highest level of service in the industry.

In this special report, The Entrust Group provides complete and accurate information on self-directed individual retirement accounts and real estate IRAs so that you can make the most of your self directed retirement plan. We do not promote any investments. Rather, Entrust provides the knowledge, tools and information you need to make self-direction easy.

Turn your IRA into a wealth-building machine and secure your future. Invest in what you know, understand, and control.

Self-Directed IRA Basics

What Is a Self-Directed IRA?

In 1975, as part of the Employee Retirement Income Security Act of 1974 (ERISA) and the creation of IRAs, self-directed IRAs were also permitted. At that time, qualified plans, such as Defined Benefit, Profit Sharing and Money Purchase Pension Plans, were self-directed. The investments of choice were most commonly real estate and notes.

The self directed portion of the retirement industry continues to evolve. Today it is an accepted investment diversification strategy. Investors are able to purchase a wide variety of assets that comply with the federal rules guiding permitted transactions through IRAs and 401(k) plans.

The term "self-directed" simply means that you, as an individual, have complete control over selecting and directing your own IRA or 401(k) investments. Once established, your account can buy real estate, notes, limited partnerships, commercial paper, foreign exchange, gold, commodities and many other types of assets.

In a self-directed transaction, you make all of the decisions regarding your investments. The self-directed IRA custodian or administrator completes the documents required to establish your account and purchase your investment.

Benefits of Self-Direction

You can invest in what you know. Period!

With the great tax advantages provided by all IRAs or 401(k)s, as well as the wider range of possible investments of a self-directed IRA or self directed 401(k), you can potentially build wealth and secure your future much more effectively than through traditional retirement plans.

With a self-directed IRA, you are not limited to the investment offerings of your custodian/trustee. By using Entrust as the administrator for your account, you get much greater flexibility in the number of investment choices you have. You are not limited by the parameters set up by the custodian.

Would you like more investment choices for your retirement funds?

It's a common misconception among Americans that the only investments allowed in a retirement account are stocks, CDs, and mutual funds. The truth is that broader investment options have been available to the public since 1975, the year contributions could first be made to IRAs.

How come my portfolio manager says I can't invest in real estate?

Why the confusion? It is because the retirement industry has been dominated by large transaction-driven custodians who have focused on a narrow universe of investments. While these kinds of accounts may be right for some, they don't offer the kind of freedom that a self-directed qualified retirement plan offers.

To fully maximize your investment options, you need to have a retirement plan that allows you to select your own self-directed investments. A fully self-directed retirement plan allows you the freedom to invest in many types of assets - assets that are not prohibited by the U.S. Treasury Department regulations and the Internal Revenue code.

Investments Allowed in a Self-Directed Retirement Plan

Here are some of the self-directed investment options that our current clients have taken advantage of:

- Apartment Buildings, Co-Ops and Condominiums
- Building Bonds
- Commercial Paper
- Commercial Property
- Contracts of Sale
- Factoring
- Improved or Unimproved Land (Leveraged or Un-Leveraged)
- Joint Ventures
- Leases
- Like and Unlike Exchanges
- Limited Liability Companies (LLCs)
- Limited Partnerships
- Palladium
- Private Placements
- Single Family and Multi-Unit Homes
- Tangible Asset Deeds
- Tax Lien Certificates
- Trust Deeds and Mortgage Notes
- U.S. Treasury Gold and Silver Coins

The new tax laws affecting retirement plans can be confusing and complicated. Depending on your financial situation, your future goals, and whether you might have an employee-sponsored plan available, you will need to choose between several alternatives.

Consult with your tax advisor or financial planner on the best course of action. If you decide that a self-directing your retirement investments is for you, Entrust is here to help.

Disallowed Investments in a Self-Directed Retirement Plan

Self-directed individual retirement accounts provide a great deal of freedom, flexibility, and choice of potential self-directed investments. However, they are also governed by a set of rules that self-directed investors must be aware of and follow.

Prohibited Transactions

Some types of self-directed transactions violate the basic intent of your IRA, and may subject your account to risks and penalties.

Your retirement plan is intended to benefit you when you retire and not before. Transactions that can be interpreted as providing immediate financial gain to the account holder or other disqualified persons holders are not allowed.

For example, an IRA holder may not:

- Borrow money from the IRA
- Sell, exchange or lease property to their IRA
- Receive unreasonable compensation for managing property held by the IRA
- Use their IRA as security for a loan
- Transfer plan income or assets to disqualified persons
- Lend IRA money to disqualified persons
- Extend credit on their IRA to disqualified persons
- Furnish goods, services, or facilities to disqualified persons
- Allow fiduciaries to obtain or use the plan's income or assets for their own interest

For IRAs or 401(k)s, a disqualified person is:

- The IRA holder and his or her spouse
- The IRA holder's lineal descendants, ascendants and their spouses
- Investment advisers and managers
- Any corporation, partnership, trust, or estate in which the IRA holder has a 50 percent or greater interest

- Anyone providing services to the IRA, such as the trustee or custodian (See IRS Section 4975 for a complete list of prohibited parties credentials)

Prohibited Holdings

In addition, direct investment of your self-directed IRA funds in life insurance, collectibles, which include works of art, rugs, antiques, metals other than gold and palladium bullion, gems, stamps, coins (except certain U.S.-minted coins), alcoholic beverages, and other tangible personal property as may be defined by the Secretary of the Treasury is prohibited.

What do I have to do to Self-Direct my Retirement Plan?

It's easy. Basically, there are three steps to self directing your IRA funds:

1. **Open an Account** – If you've already chosen a retirement plan, open a self-directed IRA account with Entrust. Our professionals are trained in all areas of self directed IRAs, and are ready to assist you.
2. **Fund your Account –** Fund your account by making a contribution or by transferring funds from another IRA. Your local Entrust office can assist you.
3. **Choose an Investment –** If you have an investment in mind, simply contact your local office. If you're looking for investment ideas, attend a seminar or workshop in your area. Visit the events page of our website at *www.TheEntrustGroup.com* for events near you.

Can IRAs Borrow Money?

IRAs (and Qualified Plans) may borrow funds but may not be used as collateral for loans for personal use. Debt financing a property in an IRA is for the benefit of the IRA and is therefore not prohibited. The most difficult issue is finding a lender as loans to purchase property must be non-recourse. Most institutional lenders do not lend to IRA plans because such loans are not sellable in the secondary market. Community banks and other portfolio lenders, such as hard money or private lenders are much more likely to lend to IRAs (or Qualified Plans).

Here is what you need to know about obtaining a loan for your plan:

- The loan to value ratio is important for any lender.

- The loan to your plan must not permit recourse to you as an individual.
- You may not guarantee a loan, but a third party who is not related to you may.
- You can use other or additional collateral for the loan.
- Follow the 10 requirements for purchasing a property with debt as outlined in this workbook.

Banks generally lend 80% of the appraised property value (loan to value or LTV) or less on single-family dwellings. The lower the LTV, the more appealing the transaction may be to a lender. Private lenders or motivated sellers may lend more to your plan than banks. Also, your IRA may purchase a property subject to an existing debt.

Ten Basic To Know About Non-Recourse Loans

1. Locate a lender/bank. Lender will lend to the retirement plan, not to you as an individual.
2. This lender may not have recourse to you. It may only have recourse to the asset being financed. This means the debt is secured by the subject property financed in the retirement plan and not by you personally.
3. Your personal credit may not be used to facilitate the loan.
4. A seller may carry-back financing.
5. If you are using your IRA, debt financing will be subject to Unrelated Debt Financed Income Tax (UDFI). Acquisition debt in a Qualified Plan is not subject to such tax in certain circumstances.
6. Any additional debt incurred in an IRA or Qualified Plan is subject to UDFI.
7. Factor in that even if your account paid UDFI tax, the account will be subject to tax again when withdrawals are made. An exception to this rule is the Roth IRA.
8. UDFI does not apply if the debt had been paid off for 12 months or more.
9. UDFI must be paid by the IRA or plan. The IRA or plan files IRS form 990T.
10. Debt may be paid by funds from other IRAs or plans provided that those funds are transferred or rolled over to the IRA plan with the debt. Debt paid from funds not in an IRA or plan will be considered an excess contribution and may be a prohibited transaction and subject to penalty.

What is UDFI?

UDFI is defined as Unrelated Debt Financed Income. It is the tax on the profit made from the borrowed funds. The IRA becomes a taxpayer and must file IRS form 990T. A tax is imposed by the IRS which applies to any profit exceeding $1,000 made on a debt financed transaction.

UDFI is imposed on the profits attributable to the debt financed portion of the transaction. For example, in Nancy's case approximately 57.14% of the profit could be attributed to the borrowed funds. There are other rules where UDFI does not apply, such as if the asset has not been debt financed for a previous twelve month period or if the debt is owed by certain types of Qualified Plans.

To find out more about UDFI/UBIT, please see IRS Publication 598 or your tax advisor.

Unrelated Business Income Tax on Debt Financed Property Involving a 401(k)

In some circumstances, UDFI does not apply to income from debt financed property in a 401(k) plan. There is a limited exception to the definition of acquisition indebtedness contained in section 514(c)(9) of the Internal Revenue Code for plans under section 401, including 401(k) plans. For more information on this exemption, please see your tax advisor.

Case Studies

Real Estate & Notes

Case Study 1 - "Linda's Purchase"

Before we discuss how the transaction took place, here is an overview on how self-directing an IRA works and how Linda was able to grow her retirement account.

Here are some tips from Linda:

- Put funds in an IRA.
- The amount you put away is not taxed in the year you make the contribution (unless it is contributed to a Roth IRA).

- If you convert a Traditional IRA to a Roth IRA, you may pay taxes due with funds outside of your IRA. You must qualify for a Traditional to Roth IRA conversion.

- If you qualify, contribute to a Roth IRA. A Roth IRA is generally preferable, as the gains are never taxed.

- If you do not qualify for a Roth IRA, a Traditional IRA can be used. However, gains are taxed when you start taking distributions later.

- If you already have an IRA and wish to self-direct it, all you need to do is complete a self-directed IRA application at Entrust. Then you may transfer the assets in the old IRA to your new self-directed IRA.

- If you had a 401(k), TSA, 403(b) or government sponsored 457 plan from any previous employers, you may roll these over to any Traditional IRA or Qualified Plan, if the plan allows it.

- The paperwork is easy and the process goes very quickly. It takes only two to four weeks to fund the new account by transferring or rolling over monies from your previous IRA and/or Qualified Plan.

Linda's Purchase of a Duplex

The transaction unfolded as follows:

1. Linda opened her first self-directed IRA. She employed a TPA that provided self-directed IRA services through a trustee bank. Linda's first real estate transaction involving her plan was the purchase of a duplex.
2. She was familiar with a property and knew that the tenants had been there for over five years and were not likely to move in the near future. She decided to make an all cash offer of $400,000.
3. The current owner needed cash, so the timing was ideal. She made an offer on the property in the name of the plan. Example:

   The Entrust Group, Inc. FBO Linda Chang IRA #12345

   The cash flow on the property was $9,600 per year gross and $6,000 net. This cash flow satisfied her plan's needs. The offer was accepted by the seller.
4. Linda completed a Buy Direction Letter for Real Estate for the purchase of the property and sent it to Entrust along with a copy of the contract which had been read and approved by her. Entrust signed the contract on behalf of her IRA and sent a $20,000 good faith deposit to the title company from her IRA in accordance with the instructions on the Buy Direction Letter.

5. A preliminary title report showed no prior liens or other conditions that would preclude the purchase. All closing documents were read and approved by Linda.

6. The title company / escrow agent sent the read and approved documents to Entrust. Entrust signed them on behalf of Linda's IRA.

7. Rental or lease agreements were assigned to the name of the IRA. Property management agreements were made between the IRA and the provider.

8. Entrust sent the funds from Linda's IRA and the completed documents to the title company / escrow agent.

9. The deal was closed. The deed was then recorded in the name of Entrust for the benefit of Linda's IRA (e.g., The Entrust Group, Inc. FBO Linda Chang IRA #12345) and was sent back to Entrust. Entrust maintained the deed in safekeeping. Linda's IRA now owns the property.

10. Tenants were instructed to make all payments to Entrust FBO Linda Chang IRA #12345. All income was then deposited into an FDIC insured cash account at the custodial bank.

Service providers such as utilities and insurance companies were instructed to bill the name of the IRA "*The Entrust Group FBO Linda Chang IRA#12345.*"

All expense bills, such as taxes, hazard insurance, maintenance, gas, electric and disposal services were sent directly to Entrust to be paid from IRA funds at the custodial bank.

As you can see, the purchase of a property in an IRA is as straightforward as making that purchase personally. The only difference is that there is an intermediary, such as Entrust, performing the transaction on behalf of the IRA.

What Happens if there is Shortage of Money in the IRA?

Here is what Linda can do:

1. **Making a contribution to her IRA.** This is the easiest option. However, it may only be used if she had not made a contribution at all that year or had the ability to contribute enough funds to cover expenses without exceeding her annual contribution limit. If those requirements were not met and Nancy contributed to her plan anyway, she would be making an excess contribution. Penalties of 6% of the amount she over-contributed (or 10% in the case of a SEP IRA) may be assessed for each year the excess contribution remained in her IRA.

2. **Transferring or rolling over funds from another IRA or qualified plan.** Provided that funds were available in another plan, this is another relatively easy solution.

3. **Increasing her "debt finance."** This requires the completion of additional paperwork with her banker. Nancy may incur additional points, more interest and some fees if she exercises this option.

4. **Selling another asset in her plan.** This is an easy way to raise funds. Nancy could sell all or part of a note in her IRA or Profit Sharing Plan and use the proceeds. She could also sell part of a stream of income from a note for a short period if the amount she needed to raise was small. Either way, this would result in a discount of a note she owned in her IRA or plan.

5. **Bringing in partners.** This is more complicated, as it would involve going through the sale process. As a part of that process her bank and her IRA would give up an undivided interest in the property and would suffer some profit loss. She could also do this using a Limited Partnership or a Limited Liability Corporation, but using either would add more expenses. She could not, after the original purchase, partner with herself or any other "disqualified persons" such as ascendants or descendants and spouses thereof.

6. **Selling the property as is.** This is an option, but is the least preferable as the IRA would likely suffer a loss of the profit interest.

Case Study 2 - Using an IRA to Buy Discounted Notes

"Property at 18 Main Street"

Recently a collection agency informed one of our real estate broker clients, Lee, about some problem loans. Lee had formerly sold the property in question, 18 Main Street.

The principal due on the note was $110,000. The borrowers were in danger of being foreclosed on. Lee was able to purchase the obligation from the lender prior to foreclosure. The financing was Lee's IRA along with her friend Eddie.

Lee was able to negotiate the purchase of the note for $100,000; a 9.09% discount. She had her IRA purchase 50% of the note and her friend Eddie the other 50%.

Lee's IRA	**50%**	**$50,000**
Eddie	**50%**	**$50,000**
NOTE		**$100,000**

Two years after the transaction, the borrowers began to have more problems and the loan payments were not made regularly. Eddie decided that he wanted to sell out his 50% ownership because of the collection problem.

Lee, who had originally sold the property, knew that there was a fair amount of equity in the property. She was also aware of the financial issue of the borrowers and the potential of foreclosure. Though the payments were slow, they were being made.

Lee recognized the opportunity she had with Eddie wanting to sell. Lee negotiated a 10% discount with Eddie. Lee's IRA purchased Eddie's 50% of the note for $44,505.

Lee directed the trustee of her IRA, Entrust, to purchase the note at a discount from Eddie on behalf of her IRA.

	Original Amount	**Current Balance**	**Lee's IRA Purchase 10% Discount**
NOTE	$110,000	$98,900	
Lee's IRA	50%	$49,450	
Eddie	50%	$49,450	$44,505
IRA Purchase Total			$44,505
Total Cost to Lee's IRA			**$93,955**

Lee's IRA ended up with a note paying 15% over 30 years with a value of $98,900.
Lee's IRA paid a total of $93,955.

All income Lee received on the note is tax-deferred.

Lee's intentions always included purchasing properties and holding them, so this transaction fit nicely into her financial plan. In addition to other properties, her IRA now owns a high yield note. If foreclosure should become necessary, the plan would then own the property and be able to sell it with or without a carry-back note. The plan would also have other options, including a lease option or lease purchase or the property could simply become a rental.

LLCs in an IRA

Case Study 3 - Using LLC and other Company Forms For Purchases in IRAs

LLC – Limited Liability Company The basic definition of an LLC is a legal form of company offering limited liability to its owners. It is similar to a corporation, but may be suitable for smaller companies with restricted numbers of owners. Its owners may be shielded from personal liability.

IRAs have invested in publicly traded stock as well as private, or closely held, stock since retirement plans and accounts began. Most of the issues regarding such ownership by IRAs center on percentages of ownership. It is necessary to ensure these percentages comply with tax provisions. In many cases, ownership means disqualification of an individual relative to an IRA. However, disqualification in and of itself does not mean that a taxable event has occurred. If a Limited Liability Corporation is owned by an IRA, the entire benefit of the LLC must go to the IRA. Once the disqualified person (the beneficial interest owner of the IRA) receives any personal benefit, the IRA ceases to be an IRA. This would be effective as of the end of the previous year in which the violation occurred. This is an abbreviated version of an IRA prohibited transaction. It is imperative to seek proper legal counsel and have an understanding of all requirements and potential problems involved in LLC ownership. Many individuals who follow this advice do not run into any problems. The most necessary part of any LLC is a carefully crafted document.

The majority of people who purchase closely held stock have no issues regarding ownership among themselves and disqualified persons. Generally, these purchases have a broad enough ownership base to ensure that a violation of percentage of ownership does not occur.

Checkbook control is often used by people doing transactions using an LLC. A good example of this is for purchases of real estate and notes. The IRA holder who self-directs his or her plan or IRA to purchase controlling interest in a new LLC (not previously owned by a disqualified person) can assume an official position such as managing member or president. By doing so, the IRA is directed to have the beneficial owner be responsible for the purchases and sales within the LLC. The custodial function of the IRA is only that of the LLC. The LLC must adhere to all rules and regulations of the regulatory authorities. The IRA custodian or trustee should have no part in the formation or operation of the LLC unless the custodian wishes to be potentially considered a fiduciary or active trustee/custodian. In addition, you need to ensure that no violation of the indirect rule occurs and that unrelated business issues are dealt with.

Basic Requirements to Buy Investment Property within an Entity such as an LLC or LP Owned by an IRA or Qualified Plan

1. The Plan or IRA may own 50% or more of the investment, but the entity will be a disqualified person.
2. No disqualified person may generally receive any current benefit from the investment.
3. The entity has the obligation to ensure that all IRS and DOL requirements are met, such as prohibited transaction and tax rules.
4. The entity may debt finance property. Unrelated Debt Financed Income or Unrelated Business Income Tax may be paid from the entity.
5. The entity must prorate dividends to owners based on percentage owned.
6. The entity must be constructed by competent legal counsel.

Private Letter Rulings not obtained by the instant case should not be relied on. See also Swanson vs. Commissioner at IRS website.

EntrustGroup

SPECIAL REPORT

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