**Course Objective**

This course was created to teach advisors (CPAs, EAs, accountants, attorneys, financial planners, and insurance advisors) about how to best use IRAs to help clients maximize their long-term investments.

Most advisors see IRAs as a way for moderate income clients to put a few dollars away income taxed deferred for retirement. Most advisors do not understand that they can be used as a terrific tool to differentiate advisors from one another through knowledge on the various ways clients can invest in IRAs. This material will focus on the different types of investments in IRAs with an emphasis on how to use tax deferred IRA money to invest in real estate (which is a "hot" topic right now in the investment world).

# Advanced Investment Planning with IRAs

# Introduction

At the end of the year 2001, 42%, or 44.3 million, of U.S. households owned an IRA, with the total value of those assets being 2.4 trillion dollars. In recent testimony in front of the Senate Finance Committee, The Employee Benefit Research Institute said that this wealth represented nearly one-half (49.5 percent) of all the financial assets for those households.

According to a study by the Federal Reserve Bank, 5 trillion dollars has been lost in the stock market in recent years, a sizable amount of which was retirement money. Because of the devastating results of the stock market in recent years, individuals are desperate for alternative investments to use to actually build up their retirement plans.

## Could Real Estate be the Answer?

A significant portion of this material will focus on the rules surrounding how to purchase real estate in an IRA. While the rules are somewhat complex, the rewards can be sizable. Advisors can use strategy to attract new clients by showing them they could potentially use their IRA as a funding source for new investments. How? By showing clients how important diversification is, and presenting the following statistics:

 

**-Over the past three years, REITs averaged annual total returns of 15%, while the S&P declined by 13%** ***FORTUNE, March 17, 2003***

# Investment Limitations of IRAs

For some reason, a lot of people think that IRAs, both traditional and Roth, are some sort of mysterious creature that must be offered by a brokerage house, insurance company, or bank.

While an IRA does need to have a large institution be the trustee, the key concept to keep in mind is that an IRA **is merely a trust** given certain tax benefits so long as the trust contains key provisions. Since this is a very key concept, it is worth repeating again – an IRA is merely a trust that must meet certain conditions.

**408(a)** "individual retirement account" **means a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries but only if the written governing instrument creating the trust meets the following requirements**:

> **(1)** Except in the case of a rollover contribution described in subsection (d)(3) in section 402(c), 403(a)(4), or 403(b)(8), **no contribution will be accepted unless it is in cash**, and contributions will not be accepted for the taxable year in excess of $4,000 on behalf of any individual.
>
> **(2) The trustee is a bank** (as defined in subsection (n)) or such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust will be consistent with the requirements of this section.
>
> **(3)** No part of the trust funds will be invested in life insurance contracts.
>
> **(4)**The interest of an individual in the balance in his account is non-forfeitable.
>
> **(5)**The assets of the trust will not be commingled with other property except in a common trust fund or common investment fund.
>
> **(6)**Under regulations prescribed by the Secretary, rules similar to the rules of section 401(a)(9) and the incidental death benefit requirements of section 401(a) shall apply to the distribution

of the entire interest of an individual for whose benefit the trust is maintained.

So long as these key conditions are met, an IRA can do anything that a trust can do. Can a trust:

- Loan money?
- Borrow money?
- Buy real estate – for no money down?
- Buy options on real estate?
- Sell real estate?
- Sell options on real estate?
- Lease property?
  - Cars?
  - Machinery?
  - Office Equipment?
- Invest in a start-up business?
- Buy mortgage notes?
- Purchase tax lien certificates?
- Invest in pre-IPO stock?
- Invest in a limited partnership?

An IRA can make all of the above investments. In fact, the only asset classes that an IRA is not allowed to invest in are life insurance contracts and collectibles, with collectibles being defined as:

Collectibles

(2) Collectible defined

(A) any work of art,
(B) any rug or antique,
(C) any metal or gem,
(D) any stamp or coin,
(E) any alcoholic beverage, or
(F) any other tangible personal property specified by the Secretary for purposes of this subsection.

(3) Exception for certain coins and bullion. For purposes of this subsection, the term "collectible" shall not include –

(A)any coin which is –

(i) a gold coin described in paragraph (7), (8), (9), or (10) of section 5112(a) of title 31, United States Code,
(ii) a silver coin described in section 5112(e) of title 31, United States Code,
(iii)a platinum coin described in section 5112(k) of title 31, United States Code, or
(iv) a coin issued under the laws of any State, or

(B) any gold, silver, platinum, or palladium bullion of a fineness equal to or exceeding the minimum fineness that a contract market (as described in section 7 of the Commodity Exchange Act, 7 U.S.C.7) [2] requires for metals which may be delivered in satisfaction of a regulated futures contract, if such bullion is in the physical possession of a trustee described under subsection (a) of this section.

**Bottom Line: Anything a trust can do, an IRA can do, so long as it does not violate one of the above rules.**

Examples of investments that have been allowed in the past are trust deeds, loans to "private" corporations, the IRA owner's mortgage, and real estate, to just name a few. Here is an IRS Private Letter Ruling which allowed an individual to have their IRA make a loan to a real estate developer. The loan would be secured by a deed of trust on some of the developer's property. The IRS said there would be no problem with the investment.

## LTR 8723082

Section 408 -- Individual Retirement Accounts
UIL Number(s) 0408.07-00
Summary

INVESTMENT OF IRA IN BUILDING FIRM IS NOT A PROHIBITED TRANSACTION.

An individual who maintains an IRA will direct the IRA to lend money to a building company. The loan will be at 11 percent and will be secured by a deed of trust on a single family home. The loan will be repaid at the end of two years. Interest payments are monthly and will flow directly to the IRA. The note will be repaid to the order of the IRA trustee for deposit in the IRA. The builder is not the individual's employer or related to the employer. Neither the individual nor the IRA has an interest in the builder.

The Service has held that the transaction described above is not a prohibited transaction under section 4975 that would cause the IRA to cease to qualify under section 408(e)(2)(A).

Full Text

Date: March 13, 1987
Dear * * *

This is in response to your ruling request dated August 31, 1986, supplemented by correspondence dated September 13, 1986, September 24, 1986, and December 24, 1986.

You state that you have a self-directed individual retirement arrangement (IRA). You state that you wish to direct your IRA to make an investment in the form of a loan to Company M. Company M owns and manages residential buildings and shopping centers. You wish to direct your IRA to loan Company M $50,000. The IRA will receive a two year promissory note with interest at 11 percent. You state that the note will be secured by a deed of trust on a single family home with a market value of $500,000. The loan will be repaid at the end of two years. You state that interest payments are monthly and will flow directly to the IRA. Repayment of the note will be to the order of the IRA trustee and will go to the IRA. You state that Company M is not your employer nor is it related to your employer. You state that neither you nor your IRA have an existing interest in Company M.

Based on the above facts, you request a ruling that the above described transaction is not a prohibited transaction within the meaning of section 4975 of the Internal Revenue Code such that the IRA would cease to be an IRA under section 408(e)(2)(A) of the Code.

Section 408(e)(2)(A) of the Code provides, in part, that if an individual for whose benefit an IRA is established, or his beneficiary, engages in a transaction prohibited by section 4975 of the Code in connection with the IRA at any time during the individual's taxable year, the account ceases to be an IRA as of the first day of such taxable year. In any case in which any account ceases to be an IRA as of the first day of any taxable year, the account will be treated as having distributed all of the assets of such account.

Section 4975(c)(1)(B) of the Code provides that any direct or indirect lending of money or other extension of credit between a plan and a disqualified person is a prohibited transaction. Section 4975(e)(1) provides, in part, that the term "plan" includes an IRA described in section 408. In addition, section 4975(e)(2) defines the term "disqualified person."

In the instant case, the investment you propose directing your IRA to make is a loan to a company that is not a disqualified person in regard to your IRA. Furthermore, an investment loan of the type you describe is not listed among the investments an IRA is prohibited from making under section 408 of the Code.

Accordingly, we conclude that the above described transaction is not a prohibited transaction within the meaning of section 4975 of the Code such that the IRA would cease to be an IRA under section 408(e)(2)(A) of the Code.

The above ruling assumes that your IRA is otherwise qualified under section 408 of the Code.

Sincerely yours,
Allen Katz
Chief, Employee Plans
Rulings Branch

## S-Corporation Stock

While IRAs can invest in an LLC, FLP, LLP, and C-Corporation, it is important to remember that an IRA cannot purchase or become an investor in an S-Corporation.

Rev. Rul. 92-73, 1992-2 C.B. 224 provides that a trust that qualifies as an IRA under 408(a) is not a permitted shareholder of an S-Corporation under 1361. In addition, Rev. Rul. 92-73 notes that, when an S-Corporation inadvertently terminates due to the transfer of S stock to an IRA, relief may be requested pursuant to 1362(f).

IRS Letter Ruling 199929029, April 27, 1999, reiterates what Rev. Rul. 92-73 stated in that S-Corporations cannot be owned by an IRA; and that if an IRA does purchase S-Corporation stock, the company will lose its S-Corporation status. Again, however, the IRS stated that a waiver may be obtained to get around any adverse consequences if the purchase was inadvertent (i.e., the seller had no knowledge of the consequences of selling S-Corporation stock to an IRA).

## Annuities

An IRA can invest in individual retirement annuities pursuant to IRC §408(h).

There seems to be a running debate on annuities between licensed insurance advisors and security brokers; and non-insurance or security licensed advisors such as attorneys, accountants, and CPAs, over whether clients should use variable annuities or fixed annuities in IRAs.

The argument for NOT using an annuity in an IRA is simple and has been used for years by advisors who do not understand the value of principal protection. The argument is, “There is no need for a tax-deferred annuity inside a tax-deferred IRA” (or profit sharing plan or 401(k) plans). It is typical to hear an advisor say to a client:

> “Whoever is telling you to buy an annuity in your IRA is just trying to make an insurance or securities commission.”

While there is some truth to the above statement for younger clients, for those 55 and older there is a significant value to having an annuity inside an IRA as an investment.

**Principal protection**

Anyone who predicted the stock market crash in 2001 and advised their clients to get out of stocks and mutual funds was a genius. Unfortunately, few did predict the crash; and, therefore, millions of people lost billions of dollars. That is not the end of the world for a 30-50 year old client who still has 10+ years to work and recoup that investment, but what about those clients who were retired or nearly retired? Most retired clients live on fixed incomes that are based, in some part, on how much can be taken out of their IRAs. When the stock market crashed, many had to go back to work to accumulate more money to re-retire, or those who stayed retired had to significantly change their lifestyle.

Shouldn't a CPA, accountant, attorney, insurance, or financial advisor help protect a client's retirement money when they are close to or in retirement? How can that be accomplished? Most clients only know how to invest in mutual funds and stocks; and if they do pick a fixed investment, it is typically a CD or low yield bond.

Again, what about annuities as an investment inside an IRA (or qualified plan)? Clients who want a guaranteed fixed rate of return on their IRA money for life and a fixed payout could look to "fixed" annuities. The client could have a fixed deferred annuity growing at a better rate than CDs, or an immediate annuity with a guaranteed paycheck for life.

It would be much better for a client to get a guaranteed rate of return of between 3-6% with a fixed annuity at age 55+ on a significant amount of the money in an IRA than to have the client continue to roll the dice on stocks and mutual funds that could lose 30-50% in another stock market crash. The 55+ year old client cannot afford to have that kind of loss. The saying goes "It's better to get a return of principal than stretch for high returns on principal."

**Equity indexed annuities**

A better option for clients is to use an equity indexed annuity (EIA). EIAs have principal guaranteed and have their growth pegged to the S&P 500. Most EIAs have annual investment caps that vary from 5-15% depending on several variables, but as the products evolve, so has the ability of the products to give higher returns. EIAs should return to the client between 5-10+% depending on how well the S&P does over time. EIAs can also be used for conservative younger clients who still want to see market returns while knowing that their money is protected from downturns in the stock market.

Lastly, most EIAs are "no load" annuities with no annual administration fees. In addition to being no load (except for a diminishing surrender charge), many annuities have bonuses when money is deposited. Some annuities will pay upwards of a 10% bonus upon their deposit. This would turn a $100,000 deposit into an $110,000 account balance for growth purposes.

**Variable annuities**

Variable annuities are a little bit of a different story than fixed annuities. Most variable annuities have significant annual fees (1.5-2.5%) and are seen as a way to actively trade a mutual fund account without dividend or capital gains taxes. IRAs already have no capital gains or dividend taxes and so using a variable annuity to avoid such taxes makes little sense.

The only variable annuities that make much sense to use in IRAs for clients over the age of 55 are the few that have guarantees (but those are expensive with extra internal fees) or ones that guarantee a minimum rate of return. There are a few out there; but for the most part, clients over 55+ years of age can get what they need from EIAs.

**Conclusion on annuities**

It is true that clients do not need to buy annuities in IRAs for tax deferred growth (since the IRA already has tax deferred growth). However, clients who are nearing retirement or are in retirement should have a substantial amount of their money protected from downturns in the stock market. The best way to do that is through a true fixed annuity or through an indexed equity annuity.

Therefore, when discussing a client's IRA and how the money should be invested, it is strongly recommended that a client over the age of 55 years old have some amount of their money in an IRA invested in a principally guaranteed annuity.

(Later you will read about real estate investments which do not have principal protection but are an investment which over time typically does not lose value).

# Basics of Roth and Traditional IRAs

## Contributions

The first step in determining the amount of a contribution is to make sure that the individual is even qualified for establishing an IRA. In order to establish an IRA, the individual must be under the age of 70 ½ and have earned income (generally speaking income that was subject to employment taxes). If a spouse is under 70 ½ but does not have earned income, so long as his/her spouse did have earned income he/she should be able to establish an IRA. Even alimony payments will be considered earned income for the purposes of establishing an IRA.

Another interesting note is that there is not a minimum age for making contributions to IRAs. Thus, as long as children have earned income, they, too, can contribute to an IRA. With Roth IRAs in particular, this could be a great way to build a future nest egg.

By the way, the rules regarding IRAs say nothing about the individual having to be a U.S. citizen. This is a giant loophole that allows non-U.S. citizens to open up a tax haven in the states. Many countries, including Canada, will recognize the tax deferred growth of assets inside IRAs for their citizens.

Due to the massive changes in the tax code, probably one of the more confusing areas in IRAs in how much you can contribute each year. In the past, the rules were very straightforward, $2,000 a year, no matter what your age was. However, due to the tax code changes of 2002, the allowable contribution depends upon what year it is and the age of the client:

**Traditional and Roth IRA**
**Annual Contribution Limits**

| Year | Normal Amount | Catch up contribution (only allowed for those over 50 years old) |
|---|---|---|
| 2005 | $4,000.00 | $500.00 |
| 2006 | $4,000.00 | $1,000.00 |
| 2007 | $4,000.00 | $1,000.00 |
| 2008 | $5,000.00 | $1,000.00 |

All contributions for both traditional and Roth IRAs are due by April 15th. Even if you do file your tax return before April 15th, you can claim the deduction (if allowed); and you have until April 15th to actually contribute the money to the IRA. (SEP contributions can be delayed until October 15, so long as the proper extension requests are filed and granted.)

**Roth contribution** rules have a couple of unique twists to them. Due to the powerful nature of a Roth IRA, Congress in all of its infinite wisdom has decided that those who could most benefit from its completely tax-free build up and distribution are not allowed to utilize Roths.

 

**Roth Income Limits**

| Filing Status | Income Range for full contributions | Phase out ranges | No Contributions allowed |
|---|---|---|---|
| Single | $95,000 or less | $95,000- $110,000 | Over $110,000.00 |
| Married Filing Jointly | $150,000 or less | $150,000 - $160, 000 | Over $160,000.00 |
| Married Filing Separate | N/A | 0 - $10,000 | Over $10,000.00 |

One beneficial quirk of Roth IRAs is that, so long as individuals have earned income, they can make contributions to the Roth even past the age of 70½.

## Deductibility

While almost anybody can make a contribution to a traditional IRA, only a few are allowed to actually deduct the amount contributed to the IRA. If you are eligible to participate in a pension, your ability to deduct your IRA contributions is phased out based upon your income.

**AGI Phase-Out**
**Limits for Deductible Traditional IRA**

| Year | Single | Married Filing Joint |
|---|---|---|
| 2005 | $50,000 - $60,000 | $70,000 - $80,000 |
| 2006 | $50,000 - $60,000 | $75,000 - $85,000 |
| 2007 | $50,000 - $60,000 | $80,000 - $100,000 |

Roth contributions are never deductible.

## Tax Credits

A lucky few may be able to receive both a tax deduction **and a tax credit** for their IRA contributions. In order to encourage individuals to save for their retirement, Congress really sweetened the pot by giving tax credits for eligible individuals who make contributions to either their IRA or retirement plan.

Just as with everything else, there are a number of requirements to be met to be eligible for these tax credits.

An eligible individual is:

- Over 18 years old
- Not a full-time student
- Not claimed as a dependent on someone else's tax return

The amount of the credit allowed depends upon the individual's adjusted gross income and the amount of the contribution they make to the IRA or retirement plan.

**Credit allowed by Adjusted Gross Income and filing Status**

| Married Filing Joint | Head of Household | Others | Percent of Credit |
|---|---|---|---|
| $0-30,000 | $0-22,500 | $0-15,000 | 50% |
| $30,000-32,500 | $22,500-24,375 | $15,000-16,250 | 20% |
| 32,500-50,000 | $24,375-37,500 | $16,250-25,000 | 10% |

The maximum amount of credit any one individual can receive is $1,000. Since the credit is per individual, if both husband and wife are eligible individuals, they could potentially receive $2,000 in tax credits. One amazing feature of this credit is that it applies for contributions made to Roth IRAs as well. So now not only could the client receive completely tax free growth, but the IRS would pay them to do so.

## Withdrawals

The reason for the tax benefits of IRAs is that the government wants to encourage people to save for their retirement. After all, the more funds taxpayers build up in their retirement accounts, the less the government is going to have to help them. With that in mind, most distributions of assets before retirement age (generally 59½) will be subject to an early withdrawal tax of 10% on the distributed principal (unless it was a non-deductible contribution) and earnings.

Once again there are a number of exceptions to the 10% early withdrawal penalty. The following types of distributions are not subject to the early withdrawal penalty:

1. **Distributions upon the disability of the IRA owner**. The tax code's definition of disabled is very stringent. The individual must be "*unable*

*to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require."*

Keep in mind this only avoids the 10% early withdrawal penalty. The distributions will still be subject to income taxes.

2. **Distributions upon the death of the IRA owner.** Once again, income taxes will be paid on the actual distributions. However, with proper the distributions, the payments can probably be stretched over the lives of the named beneficiaries, thereby delaying the income taxes for a number of years. This does not solve the problem of estate taxes owed when an IRA is passed to a non-spouse heir when there is an estate tax problem.

3. **Substantially equal periodic payments.** Under this method of distribution, the IRA owner takes distributions based upon three different formulas, with the payments lasting for five years or until they reach age 59½, whichever is later. The three formulas are:

    a. *Life Expectancy* - The IRA owner takes distributions over his or her single or joint life expectancy, recalculated or not recalculated
    b. *Amortization* - The IRA owner amortizes his or her IRA balance over a term equal to his or her single life expectancy at a reasonable rate of return
    c. *Annuity* - The IRA owner divides his or her IRA balance by an annuity factor.

4. **Un-reimbursed medical expenses that exceed 7½ % of your adjusted gross income**

5. **Medical insurance premiums after having received unemployment for more than 12 weeks.**

6. **Distributions used to pay for qualified educational expenses for the IRA owner and eligible family members.** Educational expenses would include tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible higher education institution

7. **Distributions used to pay back taxes owed to the IRS**. It's best not to talk about this one.

8. **First-time home purchase (subject to a lifetime limit of $10,000).** While at first this seems self-explanatory, the rules can get really complex. First, the definition of a first-time home buyer is anyone who has not owned a home in the last two years. Additionally, the distributions can be used for a home purchase by not just the IRA owner, but his/her immediately family as well. Finally, the dollar maximum that can be distributed in this manner is $10,000 for the IRA owner's lifetime.

In the event that the IRA owner resists the urge to take withdrawals before the age of 59½, all withdrawals will be taxed as ordinary income. However, if nondeductible contributions were also made, a portion of each withdrawal will be considered a return of principal and not subject to taxes.

Once the IRA owner reaches age 70½, they will then have to start making required minimum distributions, a subject that could be a course unto itself and will not be covered here.

## Roth IRA Withdrawals

This is the area where the Roth area really starts to shine. So long as the Roth IRA account has been open for five years, qualified distributions come out **tax free**. While any new *contributions* to a Roth do not restart the clock, any *conversions* into a Roth will require a new five-year waiting period. Once the five-year requirement is met, any distributions that are "qualified" distributions will not be subject to taxes.

Qualified distributions are:

- Distributions made after the IRA owner turns 59½
- Distributions made to a beneficiary after the IRA owner's death
- Distributions made due to the IRA owner being disabled – yes, this is subject to the same stringent requirements as for the regular IRA.
- Distributions used by a first-time homebuyer to acquire a principal residence.

If a distribution is taken before the five-year waiting period, and is not a qualified distribution, there is a good chance that the distribution will be subject to regular income taxes as well as the 10% early withdrawal penalty taxes. In the case of early withdrawal penalties, Roth owners receive the same exceptions as regular IRA owners receive.

## IRA Rollovers and Transfers

If instead of distributing funds from an IRA, the IRA owner instead just wishes to move the funds to a different IRA custodian, this will not be considered a distribution, but will instead be either a rollover or a transfer. If done properly, there are no taxes consequences to a rollover or transfer.

The difference between a rollover or a transfer depends upon if the IRA assets were actually available to the IRA owner. If the IRA owner had use of the funds, this would be a rollover. The assets would have to be deposited into another IRA account within 60 days, or the amount would be subject to income taxes, and early withdrawal penalties if the IRA owner was under age 59½. An IRA owner can only engage in one rollover each year.

In a transfer, on the other hand, the IRA assets are moved directly from one IRA custodian to another IRA custodian. The IRA owner never receives the funds. There is no limit to the number of transfers that can be made each year.

## IRA to Roth IRA Conversions

There are some people who believe that the entire reason that Roth IRAs were created was to generate revenue for the government. The reason behind this thinking is that the government wanted to create an investment vehicle that was "too good to be true," an investment vehicle that everybody would want to utilize. Then, if the government made it a taxable event to move their funds into this wonderful investment vehicle, voila, the government could generate some additional revenue.

Well, that is exactly what happened with the Roth. The government was right that a lot of people would want to take full advantage of the Roth, and thus would want to move their traditional IRA money into a Roth IRA. So, in order to move funds from their traditional IRA to their Roth IRA, amounts that would have been taxable upon distribution are now taxed during the conversion process. Since most taxpayers IRA funds were solely from deductible contributions, the entire amount of their IRA would be subject to ordinary income taxes upon conversion and the government could fatten its coffers. Luckily, the 10% early withdrawal does not apply to conversion.

Unfortunately for higher income earners, if your adjusted gross income is greater than $100,000 (for both married filing joint and single taxpayers), you are not allowed to convert your IRA funds to a Roth IRA.

 

# Educational IRAs

What if one of your clients called you up and asked if you could establish a completely tax exempt trust for them; a trust that was not subject to income taxes, estate taxes, generation skipping taxes, or gift taxes, and would not be subject to the claims of creditors as well.

What would you say to your client? You might ask him if he had a screw loose.

As it turns our, your can actually do that for your client.

Educational IRAs, now called Coverdell Education Savings Accounts, have each of those attributes. The first sentence of Section 530 says it all, "A Coverdell Education Savings Account shall be exempt from taxation under this subtitle." (With the reference to "this subtitle" being the income tax code.) Additionally, by statute, the Educational IRA is exempt from estate, gift, and generation-skipping taxes as well.

> **(3)** Special rules for applying estate and gift taxes with respect to account.
>
> Rules similar to the rules of paragraphs (2), (4), and (5) of section 529(c) shall apply for purposes of this section.

There it is, in black and white, no income taxes, estate taxes, generation-skipping taxes, and/or gift taxes. In short, they are one of the most powerful financial savings tool available to people today.

Then, when it comes time to take money out of the E-IRA, so long as the distribution is used for educational purposes, the money comes out completely tax free. Educational purposes would include:

(A) In General—

The term `qualified elementary and secondary education expenses' means—

(i) tuition, fees, academic tutoring, special needs services in the case of a special needs beneficiary, books, supplies, and other equipment which are incurred in connection with the enrollment or attendance of the designated beneficiary of the trust as an elementary or secondary school student at a public, private, or religious school,

(ii) expenses for room and board, uniforms, transportation, and supplementary items and services (including extended day programs) which are required or provided by a public, private, or religious school in connection with such enrollment or attendance, and

(iii) expenses for the purchase of any computer technology or equipment (as defined in section 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school.

Clause (iii) shall not include expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature.

## Contributions

One of the perceived weaknesses is the fact that the maximum contribution to an E-IRA is $2,000 a year per child (**Section 529 plans allow contributions of $11,000 per spouse per child each year without gift taxes**). Once again, this is based upon the adjusted gross income of the contributor, with the tables being:

**Adjusted Gross Incomes and contributions**

| Single | Married Filing Joint | Max Contribution |
|---|---|---|
| $95,000 & under | $190,000 & under | $2,000 |
| $96,500 | $193,000 | $1,800 |
| $98,000 | $196,000 | $1,600 |
| $99,500 | $199,000 | $1,400 |
| $101,000 | $202,000 | $1,200 |
| $102,500 | $205,000 | $1,000 |
| $104,000 | $208,000 | $800 |
| $105,500 | $211,000 | $600 |
| $107,000 | $214,000 | $400 |
| $108,500 | $217,000 | $200 |
| $110,000 & over | $220,000 & over | $0 |

A couple of key points regarding the contribution limits. The first is that a number of people think that since they make too much they cannot contribute to an E-IRA. While at first glance that may appear to be a problem, the tax code says anybody can create the account, even the child who is the beneficiary.

The other concern is that $2,000 still isn't much to be putting into the account. That's an issue that will be addressed later regarding prohibited transactions and unrelated business income.

## Requirements to Open an E-IRA Account

The initial requirements to open up an E-IRA account are very simple. The initial beneficiary of the account must be under 18 years old, and the contributor's adjusted gross income has to be below $220,000 if married filing jointly or $110,000 if single.

## Distributions

The rules also say that if and when the **beneficiary of the account turns 30** years old, the **account must be distributed** at that point in time. If a distribution does occur due to age, then the beneficiary will be taxed on the distribution as ordinary income, plus a 10% penalty tax. Money contributed to a Section 529 plan has no similar forced distribution.

In order to avoid a taxable distribution due to age, the funds could be shifted in the form of a rollover or a transfer to another account with another beneficiary who is under the age of 30. Remember, transfers of E-IRA funds do not create gift taxes. The new beneficiary could be anyone who is considered a family member of the old beneficiary. Family members would be:

- Children, grandchildren, and stepchildren
- Brothers, sisters, stepbrothers, and stepsisters
- Nephews and nieces
- Parents, step-parents, and grandparents
- Uncles and aunts
- Spouses of all the family members listed above
- Cousins

Then, once the new beneficiary turns 30, they, in turn, could name a new family member as the beneficiary.

In the event a distribution is taken out of the E-IRA and the distribution isn't for qualified educational expenses, then the distribution will be subject to ordinary income taxes plus a 10% penalty.

One intriguing loophole is that any distributions taken out of the E-IRA account for the benefit of a beneficiary who is disabled (same definition as for IRAs and Roth IRAs), will only be subject to the disabled beneficiary's tax bracket, no 10% penalty for the withdrawal. Seemingly, an E-IRA could be a tax-exempt "special needs trust".

## Prohibited Transaction Rules

The final benefit of the E-IRA rules is the major loophole created upon their drafting by Congress. Under the current laws, there is no "true" owner to the E-IRA. The beneficiary can be changed at any time, as well as the investment trustee. Due to this situation, E-IRAs **are not** as constrained by the prohibited transaction rules, which will be discussed later, as other IRAs.

In closing, the E-IRA is a truly tax-exempt perpetual dynasty trust. If you have a client who wants to build up a legacy for generations to come and wants to do so in a tax-free manner, the E-IRA is a tool you should definitely consider.

# Prohibited Transactions

The next key section regarding IRAs and their investments is Section 4975, Tax on Prohibited Transactions. While there are a limited number of investment restrictions regarding IRAs, there are a number of restrictions on the type of transactions in which an IRA can engage with a related party to the IRA. These parties are considered disqualified persons.

A disqualified person is defined as:

(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;
(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 or an employee organization described in subparagraph (C) or (D);
(F) a **member of the family** (as defined in paragraph (6)) of any individual described in subparagraph (A), (B), (C), or (E);
(G) a corporation, partnership, or trust or estate of which (or in which) 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 such corporation,
   (ii) the capital interest or profits interest of such partnership, or

(iii) the beneficial interest of such trust or estate, is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);

(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 described in subparagraph (C), (D), (E), or (G); or

(I) a 10 percent or more (in capital or profits) partner or joint venturer of a person described in subparagraph (C), (D), (E), or (G).

The Secretary, after consultation and coordination with the Secretary of Labor or his delegate, may by regulation prescribe a percentage lower than 50 percent for subparagraphs (E) and (G) and lower than 10 percent for subparagraphs (H) and (I).

In a nutshell, a related party is the owner of the IRA, an ancestor, spouse, descendant, spouse of any of the above, and any **business entity owned 50%** or more by one of the above. Interestingly enough <u>left out</u> of the definition of related party are **brothers**, **sisters**, **"step" relations**, **nieces**, and **nephews**.

Section 4975(c) prohibits the following actions with a disqualified person:

(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 a 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 interests 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.

After all that, what is the penalty for engaging in a prohibited transaction? Under the rules, your IRA will be considered fully distributed at any time that your IRA engages in a prohibited transaction.

So if your IRA had $100,000 in assets, and loaned that money to you, that would be considered a prohibited transaction. The IRS would consider that IRA fully distributed and would charge you taxes on the value of the IRA. A loan to an entity owned 50% or more by you, or a related party, would be considered a prohibited transaction as well.

Alternatively, if your IRA loaned the $100,000 to your brother, the transaction would not be considered a prohibited transaction since your brother is not considered related to you by this section of the tax code. Also, a loan to a corporation or partnership that he owns 50% or more of would not be considered a prohibited transaction. Taking this a step further, if you are in a long-term relationship with someone and you are not married, transactions between your significant other and your IRA would not be prohibited.

One interesting note is that the IRS will only consider the IRA that engages in the prohibited transaction as distributed. For example, let's say you have two separate IRAs, one with $100,000 in assets, and one with $2,000 in assets. You personally loan $50,000 to the IRA with $2,000. Since a loan between you and your IRA is considered a prohibited transaction, the IRS would consider your $2,000 IRA fully distributed. Your IRA with $100,000 would be left untouched and still have favorable tax status since it did not engage in the prohibited transaction.

As you can see, there is a lot of wiggle room in these rules to structure some transactions that could be **beneficial to your clients** without running afoul of the prohibited transaction rules.

Probably the loophole that generates the largest amount of wiggle room is:

4975(c)(2) Special exemption

> The Secretary shall establish an exemption procedure for purposes of this subsection. Pursuant to such procedure, he may grant a conditional or unconditional exemption of any disqualified person or transaction, orders of disqualified persons or transactions, from all or part of the restrictions imposed by paragraph (1) of this subsection. Action under this subparagraph may be taken only after consultation and coordination with the Secretary of Labor. The Secretary may not grant an exemption under this paragraph unless he finds that such exemption is –
>
> (A) administratively feasible,
> (B) in the interests of the plan and of its participants and beneficiaries, and
> (C) protective of the rights of participants and beneficiaries of the plan.

This fairly small section of the code has allowed for some rather large transactions that would otherwise run afoul of the prohibited transactions rules and create rather large tax bills. Below are just two examples of exemptions that have been granted. One is allowed an IRA to purchase the IRA owner's mortgage; the other allowed the IRA to sell real estate owned by the IRA to the IRA owner.

## Educational IRAs and Prohibited Transactions

We previously discussed that one of the biggest benefits of the E-IRA is its possible insulation from the prohibited transaction rules. If structured correctly, with a non-related party as the investment advisor, it appears that E-IRAs may not be subject to the prohibited transaction rules.

In order to fully understand the ramifications of this, let's go step by step over the definition of related party in the prohibited transaction rules. For example, let's say I establish an E-IRA for my child, but my brother is the investment trustee.

**(A) a fiduciary;**

4975 goes on to define a fiduciary as:

> For purposes of this section, the term "fiduciary" means any person who -
>
> (A) 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,
>
> (B) 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
>
> (C) has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 405(c)(1)(B) of the Employee Retirement Income Security Act of 1974.

So long as I do not retain any of the above powers, I would not be considered a fiduciary of the plan, rather it would be my brother.

**(B) a person providing services to the plan;**

Once again, it doesn't appear that I would be considered related under this section.

 

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

Since there are no employees and no employer, I should not fall into this category.

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

Same as above.

**(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 or an employee organization described in subparagraph (C) or (D);**

Since these rules only apply to subparagraphs (C) or (D), they would not apply to me.

**(F) a member of the family (as defined in paragraph (6)) of any individual described in subparagraph (A), (B), (C), or (E);**

Paragraph 6 goes on to define family members as:

**(6) Member of family**

For purposes of paragraph (2)(F), the family of any individual shall include his spouse, ancestor, lineal descendant, and any spouse of a lineal descendant.

Remember in subparagraph (A), a brother was appointed as the fiduciary and he is not described here.

**(G) a corporation, partnership, or trust or estate of which (or in which) 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 such corporation,**
**(ii) the capital interest or profits interest of such partnership, or**

 

**(iii) the beneficial interest of such trust or estate, is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);**

Since (B), (C), (D), and (E) do not apply to the business owner, the only area of concern is if the fiduciary is engaging in a transaction with an entity of which they had some ownership.

**(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 described in subparagraph (C), (D), (E), or (G); or**

**(I) a 10 percent or more (in capital or profits) partner or joint venturer of a person described in subparagraph (C), (D), (E), or (G).**

**The Secretary, after consultation and coordination with the Secretary of Labor or his delegate, may by regulation prescribe a percentage lower than 50 percent for subparagraphs (E) and (G) and lower than 10 percent for subparagraphs (H) and (I).**

Notice the above only applies to subparagraphs (C), (D), (E), or (G). Since we already ruled those sections out, these rules also will not apply.

In conclusion, while the penalties for running afoul of the prohibited transaction rules are somewhat draconian, with a little bit of foresight and planning, they shouldn't be an insurmountable challenge.

# Unrelated Business Income Taxes (UBIT)

It comes as quite a shock to people that in many circumstances their IRA could actually have to pay taxes on the income it generates. When this does occur, it is normally due to the imposition of something called unrelated business income taxes.

Legend has it that the UBIT rules were implemented in response to New York University receiving the gift of a macaroni factory. As soon as the other macaroni producers found out about this, they were positive that NYU was going to take over the macaroni world due to its ability to sell its product at a lower price because NYU was a tax-exempt entity.

Thus in 1950, the UBIT rules were created. Under these rules, if your IRA generates more than $1,000 in unrelated business income, it will have to pay taxes on that income as per the trust tax brackets.

By the way, trusts are subject to **a 39% tax rate on any UB income over $8,900.**

What types of income generate unrelated business income taxes? There are two main culprits. The first is active business income; that is to say, income generated from a trade or business that is regularly carried on. The other type of income that generates UBIT is debt-financed income. This is pretty much exactly the way it sounds—income that is generated from borrowed money.

## Active Business Income

Any income that your IRA receives from a trade or business will be subject to UBIT. The term "trade or business" generally includes any activity carried on for the production of income from selling goods or performing services. However, the income is not taxable unless it is generated from a "trade or business" as defined in IRC Section 162. Thus it has been regularly carried on, as opposed to commercial transactions which are sporadic or infrequent.

At this point, you may be wondering why more people don't have to pay taxes on the profits generated inside their IRAs. The reason is that even if the activity is regularly carried on, there are a **number of exceptions from UBIT**. These exceptions would include, dividends, interest, certain investment income, royalties, certain rental income, and gains or losses from the disposition of capital assets.

Probably the biggest exception from UBIT is rental income**. So long as the rental income is not debt financed**, additional services are not provided, and the rental income is not dependent on a percentage of profits, your clients can build their own real estate empire within their tax-exempt IRA, or better yet, Roth IRA.

## Debt Financed Income

While passive income does not generally create UBIT, if the IRA borrowed money to purchase an asset or investment and that asset or investment generated income, the IRA will probably be subject to taxes on its debt-financed income. Probably the greatest examples of an IRA generating debt-financed income would be trading on margin or buying real estate with the use of a mortgage. In the event the IRA does generate debt-financed income, not all the income generated by the asset is taxable, rather the taxable income amount is equal to the amount of debt incurred to purchase the investment divided by the basis of the investment.

The topic of debt financed income is complicated, and will not be covered in detail in this material. For advisors who would like more information on debt financed income, please contact the Wealth Preservation Institute at info@thewpi.org.

## IRA Protection: Controlling IRA assets from the Grave

**Help your clients protect IRA assets from their children's poor decisions**

More and more wealth over the coming years will transfer between generations as our population ages. Those that know say there will be more wealth transferred from one generation to the next over the next 20 years than in anytime in our country's history. Much of the assets transferred will be IRA money.

Many readers of this material will have clients who will pass IRAs with balances of $100,000+ to their children. Many of those clients will have balances of $1,000,000+. So what's the big deal?

What will your clients' children do with $100,000 - $1,000,000+ cash in an IRA after the client has passed?

What many of your clients should fear is the reality that their children will do things with that money that they would not approve of or would make them roll over in their grave. Should we tell client not to worry about it, just because it took them 30+ yeas to accumulate the money, shouldn't their children have the right to burn through that money in a weekend in Vegas? The WPI thinks not.

If your clients' children do not blow it all at once (and don't forget there will be income taxes due on that money and potentially estate taxes), maybe they will slowly burn through it over a several year period by taking trips around the world, buying expensive cars, throwing lavish parties and otherwise living well above their normal standard of living. Heck, why would they want to use that money for the grandkid's education when they can buy a new Hummer to drive around in and schedule a month long trip to Europe?

Question: if your clients had the ability to control the IRA assets from the grave would they?

The WPI believes that well over 80% of clients with sizable IRA balances will say yes.

How can IRA assets be controlled from the grave?

By using a simple LLC (Limited Liability Company).

As you have read, IRAs can invest in all sorts of interesting assets including an interest in an LLC.

Why have an IRA transfer all of it's assets to an LLC? The reason is simple and powerful. Once the money is funded into the LLC, the manager of the LLC will control what happens to the LLC assets NOT the IRA owner. In fact, the IRA owner can not be the manager of the LLC.

Think about that for a second. It makes sense doesn't it?

You may be saying to yourself, this does not prohibit a son or daughter in the above example from distributing the IRA and getting the money does it? It does. When the IRA distributes assets what is it distributing? It is distributing the LLC interest. An IRA distribution DOES NOT remove the money from the LLC.

So a son or daughter in the above example now has ownership of the LLC interest and the manager of the LLC still controls the money (including distributions to pay estate and income taxes). If the LLC manager has enough discretion in the LLC operating agreement, the manager does not have to take money out of the LLC for any reason he/she does not believe is appropriate.

What's not appropriate? The list is long and would probably include a week long bender to Vegas, a Ferrari, a new 60 foot speed boat, diamonds for a part time girlfriend, etc.

Hopefully you are getting the point of this part of the material. The LLC structure acts similar to an irrevocable trust (IT) after a client dies. All CWPP™ and CAPP™ advisors are familiar with how ITs are used to make sure children spend inherited money wisely (per the trust agreement and with the watchful/discretionary eye of a trusted trustee). The LLC structure with an IRA basically does the same thing. A client will setup this structure inside their IRA and have a trusted person or institution act as the managing member of the LLC. Direction will be given to the manager of the LLC through a well written operating agreement. The manager, not the child/heir, controls the money in the LLC.

The WPI believes this topic is very powerful and can help CWPP™ and CAPP™ advisors differentiate themselves from their competitors while providing the best service possible to their clients.

# Conclusion

While traditionally most retirement plan assets are invested in the stock market, mutual funds, bonds, or annuities, they can be invested in real estate as well. Since there are literally trillions of dollars "locked" away in these plans, this represents a significant amount of money that can be utilized by investors to purchase investment real estate, as well as for individuals to purchase their retirement homes under certain circumstances.

Also, marketing the simple concept of controlling assets from the grave will help you market your services to clients and will be a door opener to other way to help new clients.

 