

The Self-Directed Retirement Plan and Retirement Plan Types

“To Succeed, You Must Take Control”

By Gene Curry, Realtor, Certified Financial Planner

The IRS code does not include any official reference to a “self-directed” retirement plan. It is not an IRA account type, 401(k) plan or any other type of retirement plan. A self-directed retirement plan simply means that the owner of the retirement account(s) (usually an IRA, SEP, Simple or a Solo 401(k), either regular or Roth), has the ability to exercise much greater control over their investment decisions and what assets are ultimately held in the retirement account(s) by the trustee.

True Self-Directed Retirement Accounts

Tax-advantaged retirement account accounts issued and managed by institutions, such as banks, insurance companies and brokerage firms, only give the retirement account owner the ability to invest in what they consider “approved investments”, and do not allow the investor to truly self-direct their retirement investments. While some such institutions tout that their retirement plans are in fact self-directed, the truth is they typically permit the investors only to choose from a select group of financial products that they issue or at most, select among a group of other “traditional” IRA investments such as mutual funds over which they have an agreement with. Such institutions would never permit true self-direction of investments and would recommend to you that your retirement account invest in part in real estate or other non-traditional assets. Moreover, many advisors who work for such institutions would never recommend the inclusion of real estate or other non-traditional assets in a retirement portfolio, either because they are not in position to profit from a sale or they are simply uninformed about the process.

Self-Directed Retirement Account Asset Types

While the banks, insurance companies and brokerage firms do not permit self-directed retirement plans, fortunately there are institutions that do. Moreover, like the banks, insurance companies and brokerage firms these institutions or custodial firms do issue and manage retirement plan accounts, but the difference is they do permit your retirement plan accounts to invest in non-traditional retirement account assets. And while such investment assets can include traditional retirement plan assets such as securities, certificates of deposits (CDs), stocks, bonds, and mutual funds, ETFs, other non-traditional assets are permitted as well, such as:

- Accounts receivable financing
- Building bonds
- Commercial paper
- Commodities and futures accounts
- Contracts of sale
- Factoring
- Foreign sales corporation stock
- Gold bullion
- U.S. Treasury gold and silver coins
- Joint ventures

- Leases
- Like and unlike exchanges
- Limited-liability companies (LLCs)
- Limited partnerships
- Private placements
- Tangible asset deeds
- Tax lien certificates
- Trust deeds and mortgage notes

More importantly, such self-directed retirement plan administrators and custodians do permit retirement plan accounts to invest in real estate to include:

- Commercial real estate of all types
- Apartment buildings, co-ops, and condominiums
- Single-family and multiunit homes
- Improved or unimproved land, lots and home sites (financed or not)

Yes, there is considerable flexibility in asset types - but you still have to follow some rules on investments. It should be noted, the Internal Revenue Code does not approve any investment made inside a tax-advantaged retirement account; rather the code specifically outlines what types of investments are not permissible or prohibited. Prohibited Investments include artwork, rugs, antiques, metals, gems, stamps, coins and certain tangible personal property and most importantly, and with the exception of Solo401(k)s, investments in life insurance contracts.

Self-Directed Retirement Plan Control and Flexibility

Certainly the key difference between the banks, insurance companies and brokerage firms and the self-directed administrators or custodial firms is measured by the level of control, specifically control over what investments can be made by one's retirement plan account. And as such, control and likewise flexibility means that your retirement plan(s) can achieve greater asset allocation and diversity, which is vital to investment portfolio long-term success. Control also means that you are free to invest in asset classes that you know best. With a self-directed retirement plan investors can benefit from a variety of alternative investment opportunities and in turn leverage one's interest and knowledge in asset types they know best. And today, more than any time before, such control and flexibility is vitally needed to grow retirement savings. Only when you take control over your pension can you begin to take advantage of the new tax benefits that are available under the law and in doing so, maximize growth of your retirement savings.

Notably, with a self-directed retirement plan you have almost complete control over the investments in your retirement account(s), and only when you take control over your pension can you begin to take advantage of the new tax benefits that are available under the law and in doing so, maximize growth of your retirement funds.

Retirement Account Types

The commonly known non-institutional retirement plans include the Traditional IRA, Roth IRA, SEP-IRA, Simple IRA, Solo 401(k) and Roth Solo 401(k), all of which can be self-directed. As follows we will present a brief introduction to each.

Traditional IRA

The Traditional or “regular” IRA is the original individual retirement account and it is available to those who have compensation and are under age 70½. The primary goal of the traditional IRA is to build retirement income. Earnings within the traditional IRA grow tax-deferred until withdrawn, typically at retirement. Specific to the Traditional IRA, withdrawals of required minimum distribution amounts must begin when the account owner attains age 70½, and at that time, will be taxed at the account owner’s ordinary income tax rate. Should the required minimum distributions not begin at that age 70½, the IRS will impose a 50% penalty on any amount not taken.

Money may be withdrawn from a Traditional IRA at any time. However, upon withdrawal the amount withdrawn may be taxed and/or penalized by the IRS. Withdrawals from a Traditional IRA will always be taxed, either in whole or in part, at ordinary income tax rates. While there are specific IRS exceptions, withdrawals from a traditional IRA prior to age 59½ will result in a 10% penalty tax in addition to the ordinary income tax.

Contributions to Traditional IRAs reduce taxable income for the respective tax year. Contributions to IRAs can be made as late as the first due date of a tax return and can be considered retroactive to the previous tax year.

Roth IRA

The Roth IRA provides the same tax-free growth of earnings as the Traditional IRA but differs from a Traditional IRA in the following important ways:

- Contributions to the account are never deductible and contributions to a Roth IRA are always made with after-tax dollars.
- When "qualified" distributions are taken, they are tax-free and are not included in gross income for individual tax purposes.
- The earnings portion on the account is taxable and subject to an early withdrawal penalty only when a withdrawal is not a "qualified" distribution.

In effect, a qualified distribution from a Roth IRA is tax-free, no taxes due on the principal and no taxes due on the earnings, providing that distributions are:

- Made on or after the date you become age 59½; or
- Made to your beneficiary, or to your estate, after you die; or
- Made to you after you become disabled within the definition of the IRS code; or
- Used to pay for qualified first-time homebuyer expenses.

Note, even if one of the qualifications above is met, the distribution is still not qualified if it is made within the five-tax-year mandatory period beginning from the account's inception.

Annual contributions to a Roth IRA are subject to the same contribution limits as Traditional IRAs. However, unlike Traditional IRAs, contributions to a Roth IRA may be made even after the owner reaches age 70½. The annual contribution limit is phased out

as adjusted gross income (AGI) increases from \$150,000 to \$160,000 (married filing jointly) or \$95,000 to \$110,000 (single filer).

Together with contributions, transferring funds from IRA-to-IRA or rolling over funds from qualified retirement account to-IRA, can also fund an IRA account. A direct IRA transfer involves moving IRA assets from one custodian, such as a bank, insurance company or brokerage firm to another custodian. When a transfer is made, the new custodian typically prepares the needed documents. Keep in mind the original custodian may be in no hurry to complete the transfer, since they are effectively giving up funds under their management. Likewise, it is very important to remember that under no circumstances should the IRA owner ever accept a check for the IRA funds from the original custodian to be passed to the new custodian. Should the IRA owner accept a check for the IRA funds, the IRS will consider the individual in constructive receipt of the money and the transfer will now be deemed a rollover in the eyes of the IRS, and with a rollover different rules apply.

With an IRA rollover, funds are moved out of one tax advantaged investment vehicle such as a 401(k), IRA or other retirement account and into a new IRA. Unlike direct transfers, with rollovers you may take actual possession of the retirement plan assets. Unlike transfers, you are only permitted one tax-free rollover annually per each IRA account. When rolling over an IRA account, the same amount and type of investment from the old retirement plan to the new IRA must be transacted. Moreover, the rollover must be completed within sixty (60) calendar days; otherwise the IRS considers the IRA balance as income for that year.

When selecting an IRA account for real estate investment, most investors opt for the Roth because of its tax-free features. Again, while Roth contributions are made with after-tax dollars, Roth IRA accounts grow tax-free and upon retirement, all distributions are completely tax-free. If you expect to make a real estate investment in an IRA and hold it for a long period, the Roth IRA is probably your best option, particularly if real estate value appreciation works its magic and the property increases in value over the period.

Traditional IRAs can be converted in part or in total to a Roth IRA. Conversion of a Traditional IRA to a Roth is especially useful if the IRA owner expects to be in a higher tax bracket when they retire. If such a conversion is initiated, federal taxes on the deductible amount and earnings withdrawn from the Traditional IRA and no 10% early withdrawal penalty will apply. Currently, to be eligible to convert a Traditional IRA to a Roth IRA, the IRA owner's modified adjusted gross income (MAGI) must be less than \$100,000 in the tax year of the conversion. Because rollovers to IRAs from other retirement plans can be complex, it is highly recommended to seek professional advice concerning individual circumstances.

Under the current tax law for Roth IRA conversions, - there are only two stipulations that taxpayers have to be concerned about:

- Paying taxes on the converted money.
- Income limit which determined eligibility to convert.

If an individual converts from a traditional IRA to a Roth IRA they are required to pay federal income taxes on any pre-tax contributions as well as any growth in the

investment's value. Once converted to a Roth and taxes paid, all of the investment including earnings could now be withdrawn on a tax-free basis in retirement.

In regard to income limits, upper income taxpayers, those with adjusted gross incomes of more than \$100,000, whether single or married are not eligible to make a conversion from a traditional IRA to a Roth IRA. Moreover, earning \$110,000 or more as an individual (\$160,000 for married joint filers) makes you ineligible to contribute to a Roth IRA. These two tax laws effectively precluded upper income taxpayers from enjoying the benefits of a Roth IRA.

In 2006 President Bush signed into law a change in the eligibility rules for Roth IRA conversions. Beginning in 2010, taxpayers with modified adjusted gross income of more than \$100,000 will be allowed to convert a traditional IRA to a Roth IRA. This change applies for one year only - 2010 - and the income taxes due on conversions can be spread over two years. So the 2010 conversion amount may be included as taxable income in 2011 and 2012 - helping to spread out the tax bite. Conversions in subsequent years are included in income during the tax year in which the conversion is completed.

Note, removing the Roth IRA conversion cap however doesn't mean anyone can fund a Roth IRA, but it does mean that anyone can convert an existing IRA to a Roth IRA. Fortunately there is a way for all taxpayers - regardless of income - to take advantage of this change in the tax code:

Start Funding a Traditional IRA Right Now - Even if you don't qualify to make Roth IRA contributions or traditional IRA contributions on a before-tax basis, you can still make after-tax contributions to a traditional IRA. If you invest in a non-deductible IRA in the tax years 2006 through 2010, then you can convert those IRAs to Roth IRAs in 2010.

Traditional and Roth IRA Annual Contribution Limits

<u>Year</u>	<u>Normal Contribution</u>	<u>Allowable Catch-up Amount</u>
2001	\$2000	\$0
2002	\$2000	\$500
2003	\$3000	\$500
2004	\$3000	\$500
2005	\$4000	\$500
2006	\$4000	\$1000
2007	\$4000	\$1000
2008	\$5000	\$1000
2009 and going forward	Indexed for inflation	\$1000

SEP-IRA

Simplified employee pensions - referred to as SEPs or SEP-IRAs - are generic retirement plans that allow you to contribute and deduct up to 20% of self-employment income or up to 25% of salary if you're an employee of your own corporation. However, the percentage can be voluntarily varied each year, so lower amounts (or nothing at all) could be contributed in lean years when revenue is down. The maximum dollar contribution in 2008 is \$46,000.

For those who procrastinate, SEPs are great because they can be opened up as late as the date of your income tax return, including extensions. Moreover, SEPs are very easy to establish and administer compared to other business pension retirement plans. It takes only minutes to get one started and usually at no charge with a bank, brokerage firm, insurance company or self-directed IRA administrator. There are no annual government reports required or ongoing administrative expenses to pay. Essentially, SEPs are easy deductible traditional IRAs for the self-employed that allow much bigger contributions.

Retirement Plan Options*

Plan	Contribution Limits	Phaseout Limits	Comments
SEP	20%*/\$46,000	None	Simple to establish and administer
Keogh	20%*/\$46,000 (or more)	None	Can be designated a profit-sharing plan, or a defined benefit plan. Generally requires a professional to set up, especially if you want a defined benefit plan.
Solo 401(k)	\$46,000/\$51,000 if age 50 or older at year end	None	High contribution limits mean you can lower your tax bills and generate more tax-deferred earnings for your retirement stash.
Roth IRAs	\$5,000 for singles, \$10,000 for couples	\$101,000-116,000 for singles, \$159,000-169,000 for joint filers	Contributions are nondeductible, but earnings grow tax-free. You can contribute an extra \$1,000 if you will be 50 or older as of Dec. 31, 2008.
Spousal Deductible IRA	\$5,000	\$159,000 to \$169,000	If your spouse participates in a retirement plan at work but you do not, the joint AGI limits on a spousal IRA (for you) are \$159,000 to \$169,000. If you yourself already have another type of smText business retirement plan set up, such as a SEP or a 401(k), then your joint AGI phaseout is \$85,000 to \$105,000. An extra \$1,000 can be added to the account annually if you will be age 50 or older at year end.

Based on 2008 limits.

** 20% of self-employment income or 25% of compensation for employees.*

Solo 401(k)

The Solo 41(k), also known as a Self Employed 401(k), Individual(k) or Personal 401(k) self employed retirement plan, got a hefty makeover thanks to tax-law changes a few years ago and is expected to revolutionize the way successful self employed business

owners save for their retirement.

The Solo 401k is available to self-employed individuals and business owners with no full time W-2 employees other than themselves or a spouse. Businesses employing independent contractors (1099 employees) would not disqualify you from a Solo 401(k). Sole proprietorships, partnerships, LLCs and corporations (including both subchapter S and C corporations) would qualify.

With a Solo 401(k) you can contribute up to 100% of the first \$15,500 of your 2008 compensation or self-employment income (\$20,500 if you'll be 50 or older at year-end). On top of that, you can contribute and deduct an additional amount of up to 25% of your compensation income, or 20% of your self-employment income. So, for those who are looking to max out their contributions to a deductible retirement account, it's a major improvement. The reason - With a solo 401(k), annual contributions consist of two parts. And in this case, two is definitely better than one.

A much larger deductible annual contribution is by far the biggest improvement with the Solo 401(k). This means you can quickly build up a substantial tax-deferred retirement account balance, while cutting your annual income tax bills, at the same time.

Another important benefit of the Solo 401(k) versus other self employed retirement plans is the ability to receive a Solo 401(k) loan. Loans are permitted up to 1/2 of the total value of the Solo 401k up to a maximum of \$50,000. Solo 401(k) loans generally have a 5 year term. Principal and interest is repaid back to yourself into your Solo 401(k). A Solo 401(k) loan can be provided tax free, penalty free and without credit checks or income qualifications and the money can be used for any purpose. A Solo 401(k) loan is a key benefit and may be considered a valuable feature, especially for self employed business owners.

The bottom line - For those who hate to leave any tax break on the table, the solo 401(k) is a great deal. You won't be forced to contribute more than you can comfortably afford in years when cash is tight and you can always pay in less than the tax-law maximum or even nothing at all. In other words, the solo 401(k) lets you rack up major tax savings in the good years, while leaving you the option to contribute less (or zero) in the lean years, when conserving cash is your highest priority.

Solo Roth 401(k)

As a logical extension to Solo 401(k), the Solo Roth 401(k) was placed into law in January 2006 and collectively, and in our opinion, the two plans offer everything you ever needed in your retirement plan.

The Roth 401(k) is actually a Solo 401(k) plan with a Roth component. As such, all of the same Solo 401(k) requirements apply.

- You must be self-employed, receive 1099 income, or run a small business with only yourself and your spouse as full-time employees.
- You must set it up through an outside administrator

What you're really doing is setting up a Solo 401(k) plan and then adding a Roth component to it and as such, you can make contributions to one side or the other throughout the year. However, the Roth 401(k) contributions must be made irrevocably. In other words you can't change your mind down the road and swap Roth 401(k)

contributions for Solo 401(k) contributions. It will be the administrator's job to make sure the amounts being paid into each side are recorded properly and kept separately, and to prepare the required reports for the IRS.

Another thing to bear in mind is that the Solo Roth 401(k) plan can only be funded with the salary income element, and not the profit sharing element. So although you can sock away up to \$44,000 per year into your plan, only \$15,000 of that \$44,000 can go into the Roth 401 (k) side.

Once you've funded your Solo Roth 401 (k), make sure you keep the funds in place for a minimum of five years so that when it comes out, it comes out of the Solo Roth 401(k) plan comes out tax-free.

Setting Up Your Self-Directed Retirement Account

The first step in allowing a retirement account owner to invest in real estate is to setup or restructure the account to be self-directed. The process of setting up and funding the self-directed account can be quite simple. An individual opens a self-directed account with a specialized custodian and funds to the new self-directed account. Making a contribution and/or transferring or rolling over tax-advantaged funds from your current IRA account can accomplish funding your new self-directed account. The custodian is one that specializes in self-directed custodial services associated with real estate and real estate related investments. As per the IRS code, the account holder can't serve as the custodian of his or her own account.

Self-Directed Retirement Account Investing

Once the account is setup, the account owner is then free to purchase or invest in appropriate assets. Upon an investment selection and after an administrative review to determine if the particular asset can be administered, the custodian forwards the funds to purchase the asset to the necessary parties. Upon closing, the asset comes into the ownership of the individual's self-directed retirement account.

Note, your custodian and not you personally, must actually purchase the real estate investment property. For example, the title will reflect the name of your IRA custodian for your benefit (such as XYZ Trust Co., Custodian FBO Jane Doe IRA). In addition, if you put up earnest money with your personal funds, you'll need to make sure you include that amount in the total due so that the title company can reimburse you upon closing. While this part of the process may appear complicated, it really isn't, as the self-directed retirement account custodian handles just about everything. After all, this is what they get paid for.

A "true" self-directed retirement account custodian will allow you to select from virtually any type of investment, provided for under the IRS law. While clients can still have the option to invest in conventional financial investments such as stocks and mutual funds within their self-directed retirement account, they also have the freedom to truly diversify their portfolio by adding non-conventional assets such as real estate and real estate related assets.

While self-directed retirement accounts offer a number of benefits, as with everything that involves the IRS, there are some limitations. In order to stay within the rules set forth by the IRS, the investor should be familiar with prohibited investments, prohibited

transactions, disqualified persons and self-dealing. The following offers a general overview of these matters, but note our overview should not be construed as a substitute for professional advice.

Prohibited Transactions and Disqualified Persons

Understanding what constitutes a prohibited transaction is very important when it comes to making investments within your self-directed retirement account especially since a prohibited transaction can bring into question the tax-deferred status of the account. In addition, it can result in the disqualification of the retirement account together with possible tax consequences.

In general, a prohibited transaction is any improper use of a retirement account by the account owner, their beneficiary or any disqualified person. Disqualified persons include fiduciaries of the account owner and members of their family to include a spouse, ancestor, linear descendant, and any spouse of linear descendant. Note, a sibling is not considered a disqualified person. The retirement account owner together with any other disqualified person may not personally benefit from retirement account investments until qualified distributions of the investments are made.

Self-Dealing

Self-dealing is engaging the retirement account in transactions that in some way benefit disqualified persons. The purpose of the retirement account is to provide for your retirement and it is not intended to advantage you or any disqualified person until the property held in the account is properly distributed. Examples of Prohibited Transactions regarding Self Dealing:

- Self-dealing with oneself would arise if the retirement account purchased real estate that the account owner, member of their family or linear descendant currently holds in ownership.
- Personal use of retirement account owned real estate by the IRA owner, member of their family or linear descendant such as an office, personal residence, vacation home or retirement home.
- Receipt of personal benefits from the retirement account, such as paying retirement account owner or a company that is owned by the retirement account owner to do work on a real estate property purchased by the retirement account.

It is important to remember you cannot place a real estate property that you already own into your self-directed retirement account. Your spouse, your parents, or your children also couldn't have owned the property before it was purchased by your retirement account. However, property owned by siblings may be allowed, since IRS Code Section 4975 specifies that only "lineal descendants" be disqualified.

Also, the Internal Revenue Service regulations will not let you use the real estate owned by your retirement account as your residence or vacation home. Nor can your business lease space in your retirement account held property. You can't have any personal use or benefit of the property. To do so may cost you plenty in taxes and penalties if you are under 59 1/2. As long as IRS guidelines are followed, retirement account owners are

permitted to self-direct investments in their account in areas in which they have knowledge and expertise.

As said, when purchasing real estate with a self-directed retirement account, it is the account and not the owner of the account that owns the property and as such, it is the account that must pay all related expenses for the property. In fact, should any other party, including the account owner, pay the property expenses the IRS could disallow the status of the retirement account. Because all property expenses (i.e. property taxes, insurance, repairs, etc.) must be paid from funds in your retirement account, you'll need liquid funds available in your retirement account. Of course, any and all income generated from the property will be deposited directly in your retirement account so you can use that money to cover your costs. You also can make annual contributions within federal guidelines. If your retirement account doesn't have funds to cover property expenses, you will have to withdraw the property from your retirement account and pay taxes on the value of the property, as well as possible penalties for early withdrawal. It will be your responsibility as an account owner to insure that the self-directed retirement account is well funded to handle all associated costs.

It's also possible to sell properties while your retirement account holds them, so long as the purchaser is not a family member. Once a transaction closes, your retirement account now holds the cash proceeds, ready and available for you to make your next investment. An alternative is to sell retirement account -held property with seller financing so that all payments made by the buyers are paid to the retirement account.

Copyrighted, RealSmartRetirementInvestment.com. All rights reserved.