

# How Real Estate Investors Can Benefit from the New Tax Law

By William A. Shopoff

In May of 2006, President George W. Bush signed into law the Tax Increase Prevention and Reconciliation Act of 2005, and among the voluminous paperwork that accompanies any new tax bill is a break for high-income taxpayers as they prepare for retirement. Beginning in 2010, all taxpayers, without regard to income limits, will be eligible to convert traditional IRAs to Roth IRAs. The Roth IRA is considered the "gold standard" for retirement accounts.

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*The properties pictured here are not owned by Shopoff Properties Trust.*



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Currently, investors with traditional IRAs may convert any or all of their balances into Roth IRAs if their modified Adjusted Gross Income is under \$100,000. This conversion is treated as a qualifying distribution, and income tax must be paid on the taxable amount converted. Despite

these costs, converting should appeal to many people since a new Roth IRA has three huge advantages to the holder:

- No taxes are owed on withdrawals made after age 59 – and at least 5 years after the initial contribution or conversion.
- There are no mandatory withdrawals required by the account holder or spousal beneficiary.
- The account passes income tax-free to beneficiaries.

The tax cut bill signed by President Bush in May relaxes the conversion rules considerably beginning in 2010, when all income restrictions on conversions will be totally removed. This means that anyone will be able to convert their traditional IRA into a Roth IRA regardless of income. As an added benefit, any conversion taking place in 2010 would have the conversion taxes split into two equal installments to be paid in 2011 and 2012. This feature will make conversions even more financially attractive to many IRA holders.

This bill provides a tremendous opportunity for investors to immediately begin planning how to benefit from this dramatic change. Moreover, there are several additional points regarding taxes to consider.

**Lock in current tax rates by converting.** Even if rates do not increase in the future, many taxpayers will enjoy eliminating the uncertainty of this expense. If they are planning on taking retirement withdrawals from their Roth IRA, they will be able to calculate the precise after-tax amount available at various rates of return.

**Save on Estate Tax.** Investors who are likely to have taxable estates may reduce the size of their estates by making the tax payment now. Depending on the Estate Tax rate at time of death, this may be tantamount to having the government pay 50% or more of conversion taxes.

**Get a "back door" path into Roth.** This new law provides a back door entry into the Roth IRA for anyone under age 70 1/2 who earns income. Even if their income makes them ineligible for a deductible contribution to a traditional IRA, they can make nondeductible contributions each year beginning immediately, and then convert to a Roth IRA in 2010.

For example: If a married couple begins making these nondeductible contributions in 2006, they will be able to save \$18,000 each through 2009. If this couple were both over age 50, they could contribute an additional \$1,000 each per year, and by the end of 2009, at 8% annual growth, their combined accounts would already total \$53,158! Then beginning in 2010, they can continue to make their maximum contribution to a nondeductible traditional IRA each year, and immediately convert it to a Roth IRA, essentially giving them an indirect avenue to a Roth IRA each year.

**Convert 401(k) funds to traditional IRA and then to Roth IRA regardless of income in 2010 and beyond.**

This is a tremendous opportunity for people contemplating retirement in the next few years and who have 401(k) accounts. This will allow investors an opportunity to move even large amounts into their Roth IRAs, potentially growing them tax-free forever and providing financial freedom for themselves and their heirs.

## **Consult with a Team of Advisors**

As with any financial opportunity, there are various factors to be considered prior to making a decision. Among other variables, investors will need to consider inflation, future tax rates, anticipated investment returns, and individual life expectancy prior to making a decision to convert traditional IRAs to Roth IRAs. It is always recommended to consult with a team of advisors before making any significant financial decision.

# Hypothetical Case Study

## How to Profit from the New IRA Conversion Provision

Jack, who turns 50 in 2008, has made deductible contributions to his traditional IRA each year since 1982. He saw a terrific benefit from the impending change in the tax law that would permit conversions to a Roth IRA beginning in 2010 without income limitations.

In early 2008, he had the opportunity to make a \$100,000 investment through a self-directed IRA that he had established with his IRA custodian. Let's see what happens to Jack's investment based upon the following assumptions:

- A 10-year life of the investment.
- A 10% annual return for the first two or three years
- A 20% overall annual return on his investment over the full ten year period.

With the 10% annual increases, Jack calculated that his \$100,000 investment would grow to \$121,000 by year-end 2009. Jack then planned to convert the \$121,000 to a Roth IRA in early 2010. He determined that all of the conversion would likely be taxed at the 35% rate, and that he would owe \$42,350 in taxes on the conversion. However, one of the features of the new IRA conversion provision allows Jack to spread his taxes due for a 2010 conversion across his 2011 and 2012 tax bills. So, Jack would owe \$21,175 in taxes in 2011 and 2012. Based on the preceding assumptions, his annual cash flows would be as follows: (Figure 1)

Here is a summary of Jack's 10-year investment.

- Jack would have an annual return of 17.80%, after taxes, on his investment. Jack's initial \$100,000 investment, plus \$42,350 in taxes, grows to \$619,174 in 10 years!
- Jack (and beneficiaries of his IRA) would never have taxes on this Roth IRA investment, if withdrawals were not made during the first five years after conversion.
- Jack has reduced his taxable estate by \$42,350 based on the income taxes paid on the conversion.

|                           | YEAR | CASH FLOW   |
|---------------------------|------|-------------|
| Initial Investment        | 2008 | (\$100,000) |
|                           | 2009 | \$0         |
| Year of Roth Conversion   | 2010 | \$0         |
| 1/2 tax bill              | 2011 | (\$21,175)  |
| 1/2 tax bill              | 2012 | (\$21,175)  |
|                           | 2013 | \$0         |
|                           | 2014 | \$0         |
|                           | 2015 | \$0         |
|                           | 2016 | \$0         |
|                           | 2017 | \$0         |
| Beginning of Year Balance | 2018 | \$619,174   |

FIGURE 1

Now, as impressive as Jack's story looks after 10 years, here is the great news. Since he will be over age 59 1/2, he can make tax free withdrawals (if he desires) from his Roth IRA. We could assume that Jack now earns 10% on his IRA after liquidating his prior 10-year investment. Even by reducing his growth rate by 50%, he could withdraw \$50,000 per year for the next 20 years. That is \$1,000,000 in retirement

income from a \$100,000 initial investment and it is entirely income tax-free. Now if that is not good enough, there will still be \$1,015,366 in Jack's Roth IRA after 20 years of withdrawals. (Figure 2) This money will provide for years of continued withdrawals for Jack, and upon his death, he can pass on this tax-free money machine to his heirs.

| 2017 End of Year Balance from Prior Table: \$619,174. |             |                     |      |             |                     |
|---|-------------|---------------------|------|-------------|---------------------|
| Year  | Withdrawals | End of Year Balance | Year | Withdrawals | End of Year Balance |
| 2018  | (\$50,000)  | \$626,091           | 2028 | (\$50,000)  | \$747,360           |
| 2019  | (\$50,000)  | \$633,700           | 2029 | (\$50,000)  | \$767,097           |
| 2020  | (\$50,000)  | \$642,070           | 2030 | (\$50,000)  | \$788,806           |
| 2021  | (\$50,000)  | \$651,277           | 2031 | (\$50,000)  | \$812,687           |
| 2022  | (\$50,000)  | \$661,405           | 2032 | (\$50,000)  | \$838,955           |
| 2023  | (\$50,000)  | \$672,545           | 2033 | (\$50,000)  | \$867,851           |
| 2024  | (\$50,000)  | \$684,800           | 2034 | (\$50,000)  | \$899,636           |
| 2025  | (\$50,000)  | \$698,280           | 2035 | (\$50,000)  | \$934,600           |
| 2026  | (\$50,000)  | \$713,108           | 2036 | (\$50,000)  | \$973,060           |
| 2027  | (\$50,000)  | \$729,419           | 2037 | (\$50,000)  | \$1,015,366         |

FIGURE 2

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## Roth IRA Growth

Example: \$100,000 Initial Investment

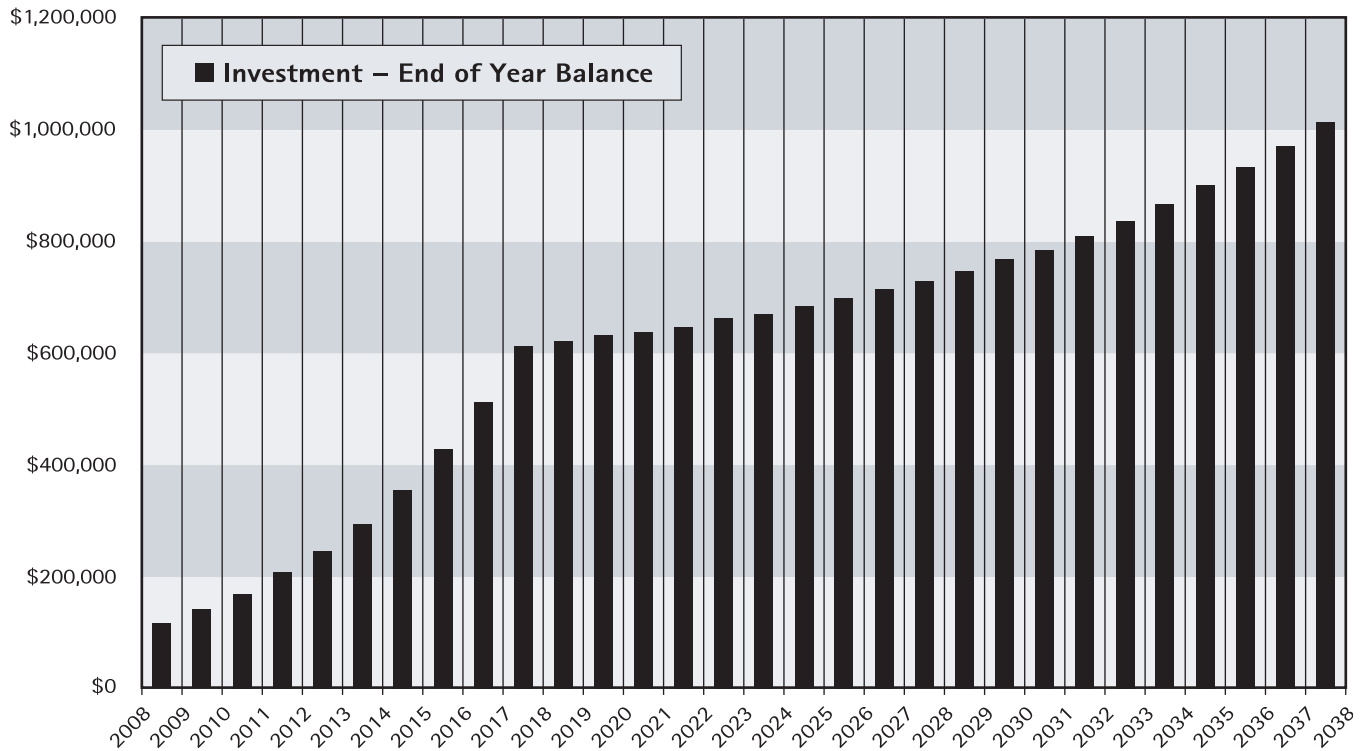


FIGURE 3

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Shopoff Properties Trust believes this graph (Figure 3) illustrates why the Roth IRA is the "gold standard" for retirement plans. By utilizing a self-directed Roth IRA, investors are able to invest in real estate and take advantage of the opportunity to generate superior returns while reducing risk in a diversified portfolio.

Investor Relations personnel at Shopoff Securities, Inc. are available to answer any questions investors may have about this article, real estate investing, and the use of self-directed IRAs to participate in investments with The Shopoff Group of Companies. Please feel free to contact one of the following representatives directly:

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