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### A Strategy for 2010 IRA to Roth Conversions

By Joe O. Luby III, CFP®

Come January 2010, the principal barrier to converting traditional IRAs into Roth IRAs, the \$100,000 annual income cap, will be lifted. Anyone will be able to make the conversion, regardless of income. Removal of this obstacle is likely to trigger an avalanche of conversions among those with higher incomes and significant holdings in traditional IRAs.

Approximately 25% of all retirement plan assets in the United States, representing over 3.4 trillion dollars, are currently held in IRA accounts. That figure will increase exponentially in coming years as Americans change jobs and retire, and another \$3.4 trillion held in defined contribution and other retirement plan iterations is rolled over into IRAs.<sup>1</sup>

Momentum for conversions is also being driven by an anticipated increase in income tax rates, particularly among higher wage earners. In addition, those who convert will have the option of deferring taxes on 2010 income until 2011 and 2012, a one-time accommodation from Congress.

The combination of the income ceiling removal, the expectation of tax rate hikes, deferred taxes and uncertainty over the future disposition of Roth IRAs represents an historic opportunity for advisors, provided they have an investment vehicle for conversion that appeals to investors with larger IRA holdings.

Investors today have a far different attitude about portfolio performance, largely the result of losses inflicted during the protracted economic tailspin. Apprehensive over market volatility, most now regard investment safety, not investment performance, as their first priority. Traditional asset allocation strategies and products are being challenged for their efficacy by investors. Stocks, bonds and open-end mutual funds comprise the lion's share of IRA holdings. The erosion of these assets has been compounded by their exposure to daily liquidations and redemptions, and investors have recognized this shortcoming.

Dramatic swings in cash flows can have disastrous consequences for managers and fund shareholders. Few things could be more dangerous than being forced to sell into a declining and illiquid market to meet shareholder redemptions.<sup>ii</sup> Given the lessons of the recent past, it's understandable that investors opting to convert are more attentive to the long-term effects associated with their holdings. This focus is furthered as a result of investors seeking to recoup the money paid in taxes at the time of their Roth conversion. Since investors have chosen to embrace a true long-term approach, the challenge for advisors and managers is to provide investment vehicles genuinely committed to a long-term strategy.

Earlier this year, I attended a financial conference and heard two of the smartest fund managers I know, Marty Whitman of Third Avenue Funds and Jean-Marie Eveillard of First Eagle Funds, respond with remarkable similarity when asked what they would do differently if they could go back and start over. Jean Marie said, "In my next life, I want to manage a closed end fund." Whitman replied, "I would never manage another fund with daily redemptions again. From 2008-2009 we were doing cash management, not investment management. This was the time I should have been buying."

Obviously, these highly regarded financial experts prefer managing "permanent" money to managing open-ended funds.

The hedge fund industry was smacked with heavy redemptions last year and their performance suffered as a result. Even outperforming funds could not escape the toxic effects of massive liquidations. Some funds, such as the Swiss-based Gottex Fund, saw fit to temporarily suspend redemptions.<sup>iii</sup> There were numerous other instances where anxious investors actually requested their funds cease redemptions because the added trading costs and potential tax consequences were quashing portfolio value.<sup>iv</sup> They also realized that money would not be available for reinvestment while market prices languished.

It seems only logical that high-income IRA converters would favor investment strategies with an extended time horizon that eschew short-term redemptions.

### **The Private Fund Entity**

One such option is a specifically designed private placement in an LLC structure, similar to a mutual fund and open to investment by unrelated but like-minded individuals. As a private fund, it is exempt from certain SEC registration requirements. Investors pool resources to gain economies of scale and access to the superior institutional managers of major investment houses who serve as sub advisors. The minimum requirement for an individual investor to gain similar access would typically be \$25-50 million.

Each structure has a specific investment objective and time horizon. The pooled investment capital amasses a fund with \$50-\$100 million or more in a single private entity, taxed as a partnership. The allure of that sized pool of capital opens doors to institutional level investment opportunities, portfolios, strategies, management styles and pricing structures otherwise unavailable to individual investors. These institutional advantages can be in stark contrast to the typical open-end mutual funds or smaller separately managed account products offered to investors with accounts of a few hundred thousand dollars.

In addition to institutional level investment opportunities, the large private entity may be able to negotiate cost savings with the acting appraisal and auditing firms, given the amount of capital involved. Partially offsetting these savings is the fact that an appraisal firm's services would not be required if not for the private entity's structural design.

An argument could be made that the availability of sophisticated products and platforms to individual investors has increased in recent times through separately managed accounts and other vehicles. But it remains irrefutable that smaller portfolios are unable to directly access institutional expertise and cost benefits. Just as valuable for private entity shareholders is the fact that top institutional managers are usually presented with investment opportunities in advance of other managers. Underwriters logically approach the institutional divisions of investment houses in order to move large blocks of new issues more efficiently and quickly. If a new issue has sufficient appeal, the institutional managers may subscribe the entire issue, with the result that most investors never see the offering, or only gain access through an open end fund when the issue eventually trickles down.

Finally, institutional managers are usually in a position to better negotiate pricing points. They have greater leverage than open-end mutual fund managers who are often relegated to buying the issue post-IPO, at street price on an open exchange.

The privately held fund is a long-term strategy, generally designed for a time horizon of five years or more, although there is sufficient flexibility in the structure to accommodate somewhat shorter (or even longer) life cycles. The long-term focus ensures advisors and fund managers that the dollars will remain under their management, and the investors have compatible investment objectives and are committed to a mutual time frame. The fund can be structured to a variety of investment objectives, asset allocation and risk tolerance preferences.

Nuveen is managing the first of these private funds. Its investment objective is pure capital appreciation employing growth and value oriented equities, primarily large cap, in a ratio of approximately 75% U.S. issues and 25% International. Unlike an open-ended mutual fund, the private fund has a specified time cycle, in this case, six years. The cycle could be longer or shorter, depending on the investment objectives, but the design is intended for a long-term investment approach, aligned with Roth IRA owners' intentions. Subsequent private funds could be similarly structured, or adopt a more balanced approach using a combined equity/fixed income strategy or other asset allocation.

The fund buys liquid, marketable securities and similar assets. The same structure could be used to buy a chain of pizza shops, but it's dedicated to investment in the capital markets for obvious reasons. The distinct advantage to investors is that multi-year "sticky" dollars help ensure the portfolio garners the fund manager's best ideas. In addition, the manager is not under pressure to generate quarterly performance in order to retain investors. These considerations are designed with an eye towards enhanced long-term total return.

In order to maintain the portfolio and avoid excessive trading costs and adverse tax ramifications, midstream redemptions from the fund by investors are generally prohibited. Substantial restrictions apply to sales and transfers of the private fund's units. Because of this and the fact the fund is privately held and cannot be sold on an open exchange, investors who want out must find another investor, willing to purchase their ownership. Typically, new buyers must adhere to stringent restrictions and procedures before being admitted as a full owner in the fund. No investor may own a controlling interest (51% or more) of the fund.

The provisions are designed to protect and preserve the fund's tax status and SEC exemptions, and to ensure that any new investors share a similar investment objective and time horizon as the other partners. While the tax and private fund status under SEC rules must be maintained, gifts, sales and transfers between family members, certain trusts and specific family business entities are authorized.

## **Discounted Valuation**

The private fund is required to have a qualified appraisal performed annually before year's end to report the fair market value (FMV).<sup>v</sup> Here, a second, and vitally important benefit of the fund's structure emerges: a discounted valuation, captured because the fund's FMV<sup>vi</sup> will be substantially less than its net asset value (NAV).<sup>vii</sup>

Discount valuation has traditionally been employed as a tool in tax and estate planning. While the private fund could be utilized in the estate planning process, the LLC unit structure was deliberately crafted to be IRA compliant in order to apply discount valuation principles to Roth conversions.

Discounted valuations are primarily governed by three principles: *illiquidity, lack of marketability and lack of control*. The private fund meets these three criteria.

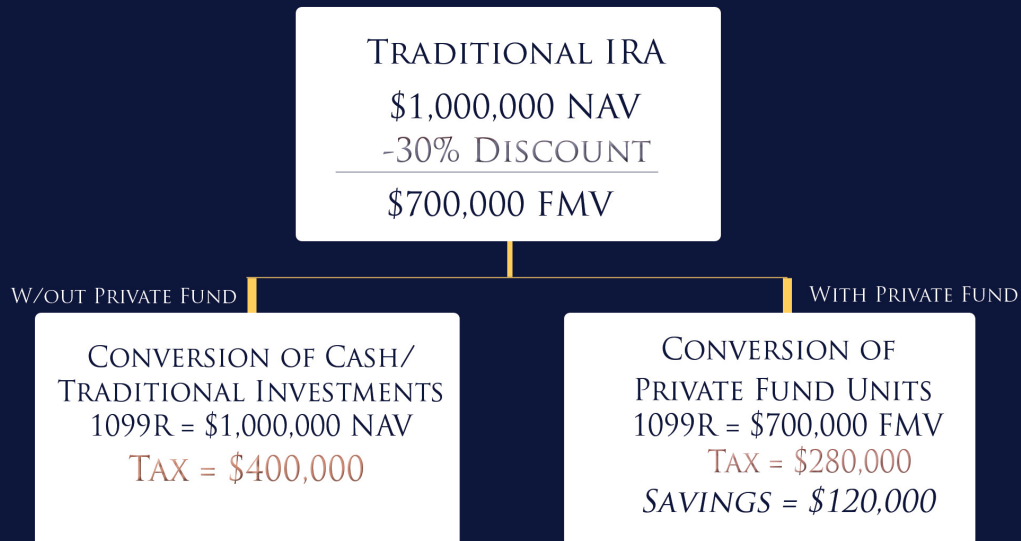
**Illiquidity:** Once the fund is subscribed, investors cannot access their money until the end of the term, in the case of the initial fund, six years. The longer the term of the structure, sans dividends or redemptions, the greater the potential volatility and investment risk, since there is more time for the portfolio to decline in value.

**Lack of marketability:** Investors are not able to easily find buyers for their fund units because no open exchange exists for such a transaction.

**Lack of control:** Also known as a minority discount, this refers to the fact that no investor can own a 51% or more controlling interest.

So while investment returns at the end of the fund cycle are based on each investor's original investment, the valuation conducted for tax purposes results in a discounted FMV that can be roughly 30% less than the NAV of the fund as a result of the three factors previously mentioned. The valuation has no effect on an individual's investment or returns, but it can have a dramatic effect on tax reporting. (See graphic below) The discounted FMV is used to report the value of private fund units owned by IRAs, as well as for gift transactions and estate tax valuations.

# ROTH CONVERSIONS-INCOME TAX



Hypothetical illustration assumes 40% combined state and federal income tax rate.

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The FMV of the private fund units will vary over time in response to gains or losses in the portfolio and the reduction of time before the term expires. Obviously, the closer to the end of the fund's term, the less liquidity risk appraisers have to take into account, hence less discount. A fund receiving a 30% discount in year one might only garner a 5 or 10% discount in the final year of the term.

One might question the assumption of a 30% discount from NAV to FMV for tax purposes, but comparable and even much larger discounts on a variety of assets is not out of the ordinary. The data in the table below, culled from tax court records, illustrates this point.

## Tax Court Discount Cases

Taxpayer	Asset(s)	Discount
Knight	Securities/Real Estate	15%
Dailey	Securities	40%
Adams	Securities/RE/Minerals	54%
Church	Securities/Real Estate	63%
McCord	Securities/Real Estate	32%
Lappo	Securities/Real Estate	35.4%
Peracchio	Securities	29.5%
Deputy	Boat Manufacturer	30%
Green	Bank stock	46%
Thompson	Publishing company	40.5%
Kelley	Cash	32%
Holman	Dell stock	16.5%/22.4%/25%
Bergquist/Kendric	Medical practice	64.25%
Litchfield 1	Securities/Real Estate	47.2%
Litchfield 2	Securities	46.2%

As the data indicates, assets held can be in the form of a portfolio of cash or pure marketable securities and still receive a 30% discount or more. Regardless of the entity's underlying holding --- cash, securities, operating companies, real estate --- what matters is the entity itself because that's the property interest being valued, whether in LLC units or as an ownership percentage.

Using the private fund structure, an investor converting a traditional IRA into a Roth could expect an approximate 30% tax reduction at the time of conversion. In addition, future distributions from the Roth are tax-free, assuming all other qualifications are met. The owner would never have to pay taxes on the 30% discounted difference, which would be \$300,000 on a \$1 million conversion.

Each aspect of the private fund structure that provides a discount also provides an investment advantage. For example, private fund units are subject to substantial restrictions on transferability, which gives rise to the lack of marketability issue (a discount factor), which in turn is in place to avoid violating SEC exemptions and subjecting the fund to filing costs and other expenses that would impair returns (an investment advantage). In other words, a unique secondary benefit - the valuation discount - results from the restrictions designed and included to protect the investment portfolio.

The same dual purpose applied to the fund's liquidity. Fund units were intentionally designed to be illiquid so as to protect the portfolio from experiencing a loss of capital at the worst possible time, and to prevent a single

investor from disrupting the plan or causing the fund to incur trading costs or unwanted tax consequences. The calculated illiquidity was in support of the fund's long-term objectives and to enhance returns, but it simultaneously contributes to a significant valuation discount.

The minority interest was established because the fund wanted to avoid a majority interest holder from altering the direction of the fund, its objectives, managers, timeline, or any other factor that could be detrimental to the fund's minority holders. But again, a great secondary discount benefit arrived as a result.

## **Alternatives**

There are other investment products that might be considered for larger IRA to Roth conversions, but none offer accredited investors the combination of institutional management access and tax advantages of discounted valuations.

The concept of discounting the NAV of a privately held entity is not uncommon. In the past, numerous attempts have been made to provide a discounting mechanism that would withstand IRS scrutiny, including the family limited partnership, family limited liability company, restricted investment account, restricted management account, restricted limited partnership and restricted limited liability company, among others.

In many instances, IRS challenges have diminished the efficacy of these structures as discounting vehicles and rejected their use altogether (i.e. restricted management accounts) in others. While each has certain planning or tax advantaged applications, these traditional discounting mechanisms are unsuitable for the unique requirements of investors making large IRA to Roth conversions, primarily because of the restrictions on certain types of transactions. For example, an IRA generally cannot be funded with an entity or company owned by the IRA owner or family.

The private fund's design is based on decades of tax law history, IRS rules and regulations and tax code provisions. What is new is how the fund is constructed and the new market it is being applied to, namely investors converting larger IRAs to Roths using traditional investment products such as stocks, bonds and mutual funds. The private fund structure is likely new for advisors as well.

There is an expansive field of law in this area going back several decades. An indication of the depth and complexity is the fact that the research took two years to complete. It was conducted by a group of the nation's foremost tax attorneys hired expressly for the purpose.<sup>viii</sup> Heading up the research effort was noted attorney Roy Adams, Managing Member, Roy M. Adams & Associates and Professor Emeritus of Estate Planning and Taxation at Northwestern University

School of Law. Included in the research was an extensive review of cases where the IRS had successfully challenged the FMV of a privately held entity so that appropriate accommodations could be made to remove that risk from the private fund structure.

The result of this effort is a discounting technique where the only arguable variable is the amount of the discount, which is always subject to challenge. There will always be a disparity among appraisers when valuing an asset.

An example of a discount vehicle open to frequent IRS challenge is the family limited partnership (FLP) where assets are placed into the FLP and interests are typically sold or gifted to heirs or a trust created for the heirs. An appraiser reports a discounted FMV based on the FLP's illiquidity (being a privately held entity), minority interest, lack of marketability, or other factors.

Historically, the IRS has challenged two areas of the FLP: The validity of the entity and amount of the discount. These challenges have successfully focused on the fact that there is no outside investment since the FLP is family owned, and where the family fails to run the FLP as a true business, instead treating it as a personal spending account.

The private fund eliminates the family control and personal spending account challenges by its very structure. The private fund is not under family control and all investors are subject to identical redemption and liquidity provisions such that one investor cannot force a cash distribution whenever they wish.

Another example of a discounted vehicle successfully challenged by the IRS is the Restricted Management Account (RMA). While not widely publicized or utilized, the RMA offered exclusively by banks and trust companies gave the institutions the right to manage an investor's IRA (or other nonqualified account) for a stated period of time. Terms included the owner giving up access to the funds during the specified period, providing unfettered investment options for the manager. The goal was to gain a discount for the IRA because of the illiquidity and investor lack of control.

One of driving reasons for creating the private fund structure was the concern that the RMA might not hold up in tax court. While we agreed with the discount principles applied, based on the overall account restrictions (lack of control, illiquidity, etc.), the client still ultimately owned the underlying portfolio assets directly. Thus when applying the willing buyer/willing seller rule, it seemed reasonable to assume the buyer would simply purchase the portfolio assets and not the "account" subject to the restrictions.

The IRS subsequently killed the RMA in 2008<sup>ix</sup>. It ruled the RMA was merely an investment agreement while the underlying assets to be valued were the stocks and other liquid assets in the portfolio. The private fund structure falls under property laws at the state level, with the assets owned by the investor being LLC units. Under willing seller/willing buyer rules, its value is based on the LLC interest and as such, the valuation must take into consideration any restrictions and provisions built into the operating agreement of that structure. That differential makes the private fund structure a completely different animal than a product like the RMA.

### **Investment Considerations Take Precedence**

Attorney Roy Adams, whose professional experience with discounted valuation vehicles is extensive, notes that IRA to Roth conversions by investors with larger accounts are expected to generate a substantial tax windfall for the government. The amount of tax paid at the time of conversion can be significantly reduced for those utilizing the private fund structure. "While investors may tend to focus on the tax reduction advantages of the private fund as a conversion discount vehicle, they would be wise to pay as much or more attention to the investment side of the equation, since Roth holdings are not subject to taxes and whatever rate of return is earned, the net return should be significantly magnified in a Roth as compared to a traditional IRA."

As for the private fund's valuation discount, Adams suggests that, "Valuation for retirement benefits is essentially the same as valuation for anything else. The overwhelming majority of court and litigation issues are centered on what an asset is worth. Traditionally, IRA holdings were simply reported as their FMV without much thought to a discount strategy. The private fund structure changes all that. Here, the investor cedes certain rights in exchange for meaningful discount benefits not otherwise available. That becomes critical in terms of valuation."

Partnerships involving real estate were quite common during the building boom of recent years. Typically, a real estate developer would put together a LLC and get 40 or 50 investors together to contribute, typically using their investment as a down payment and/or to cover the development's up-front cash costs, taking out a construction loan for the balance. The developer would then conduct the preparatory work, secure the building permits, and so forth so the parcel could be developed or sold off in pieces. Depending on the provisions in the agreements, these vehicles could be subject to the same kind of discounted valuations as the private fund. However, once the developer borrows money for the project, the percentage of the property that is in debt (usually 70-80%) causes Unrelated Business Income Tax (UBIT) on any income generated that flows back to the IRA. As such, the IRA must file a return (form 990T) and pay

taxes on that portion of income related to the debt. Worse, the IRA pays tax at the prevailing trust tax rates, which reach the top bracket at only about \$10,000 of income.

A similar situation exists when using hedge funds within an IRA. If properly valued, the investor may be entitled to a discount. However, most hedge funds have some form of quarterly or annual redemption built in so investors can exit the fund if they wish. That feature detracts from or offsets the discount. When investors can exit a strategy within a short time period, such as annually, the discount is severely limited because the liquidity risk is greatly reduced.

Another issue is that debt-financed income as described above is only one type of Unrelated Business Taxable Income (UBTI). If the IRA invests in an LLC that is an operating company, whether a chain of coffee shops, car dealerships or windmill farms, operating income from that entity triggers taxes within an IRA. To qualify for protection within an IRA, money flowing in must be in the form of dividends, interest, rental income (assuming there's no related debt) or similar.

Adams concurs that IRS challenges have hurt some discount valuation vehicles. "The RMA, for example, was thought to be a good idea for an IRA. Investors would put IRA holdings into an account from which there could be no withdrawals for a specified period of time in order to gain a discounted valuation. The prevailing thinking was since the strategy worked outside of an IRA it would work inside. In what I believe was an unfortunate and poorly worded Revenue Ruling, the IRS panned the idea, rejected the discount and refuses to revisit the issue. As such, the private fund structure now stands out as one of the only opportunities available to secure a discount."

As to other discount vehicles, Adams notes that, "While the family limited partnership remains viable, it is only in situations where there is a genuine business purpose. However, if someone is investing in marketable securities without real management or business purpose, they're headed for trouble. Under normal circumstances, the barrier is that an IRA cannot invest in a family limited partnership or family LLC. While cases have been favorable where active family management, participation and contributions exist, those circumstances do not exist for the majority of Roth conversions."

## **Summary**

Advisors have a singular opportunity to help high-income clients convert traditional IRAs into Roth IRAs come January. The collective impact of more accounts eligible for conversions, a two year deferral of taxes due and the specter of higher future income tax rates may trigger an avalanche of

conversions among wealthier investors planning for retirement and wealth transfers.

Advisors with a strategy that encapsulates the most important investment and tax considerations are best positioned to meet client needs during this transitory environment. The vital elements of a cohesive conversion strategy include access to established institutional management, a product with a long-term investment horizon that avoids short-term redemptions, and favorable valuations to help allay the conversion tax burden. The private entity fund can fulfill all these requirements for high-income Roth IRA conversions.

## Bio

Joe O. Luby III is founder and president of Jagen™ Investments, LLC, (<http://www.jagenfunds.com>) headquartered in Henderson, NV.

Mr Luby, CFP®, is a member of the Financial Planning Association of Nevada, the Southern Nevada Estate Planning Council, and serves on the Planned Giving Councils of Vegas PBS and the University of Nevada Las Vegas (UNLV).

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<sup>i</sup> Investment Company Institute, *Research Fundamentals*, August 2009 (amounts are as of March, 2009)

<sup>ii</sup> Morningstar Advisor, Spring 2008

<sup>iii</sup> New York Times, *Hedge Funds Anxious as Redemption Deadline Looms*, Nov 14, 2008

<sup>iv</sup> See:

[file://localhost/Users/michaeldubes/Library/Mail\\_Downloads/Hedgeworld\\_article\\_on\\_lock-ups\\_Oct\\_2008.htm](file://localhost/Users/michaeldubes/Library/Mail_Downloads/Hedgeworld_article_on_lock-ups_Oct_2008.htm)

<sup>v</sup> In addition to the annual year-end appraisal required by IRA custodians, appraisals are also conducted during the calendar year on an individual basis as needed. For example, an investor who completes a Roth conversion during mid-year, or a death valuation for the estate of a deceased investor.

<sup>vi</sup> Fair Market Value (FMV) is the price at which units would change hands between a willing buyer and willing seller, given all relevant data and restrictions.

<sup>vii</sup> Net Asset Value (NAV) is the total value of the underlying portfolio divided by the number of units outstanding.

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<sup>viii</sup> Roy M. Adams, Esq., Estate and Tax Planning & Administration, Managing Member, Roy M. Adams & Associates PLLC, a partner of Constantine Cannon LLP, New York, NY; Steven A. Gibson, Esq., Intellectual Property, Gibson Lowry Burris LLP, Las Vegas, NV; Amiram J Givon, Esq., Partner, GCA Law Partners, LLP, Mountain View, CA; Janis F. Kerns, Esq., Securities, Financial Services, Of Counsel, Nelson Mullins Riley & Scarborough, LLP, Washington, DC.; and S. Craig Stone II, Esq., Estate Planning, Business Organization & Tax, Fox Rothschild LLP, Las Vegas, NV.

<sup>ix</sup> RMA Revenue Ruling: 2008-35