

A Strategy for 2010 IRA to Roth Conversions

By Joe O. Luby, III

The author discusses the advantages of using a private mutual fund for IRA conversions.

Come January 2010, the principal barrier to converting traditional individual retirement accounts (IRAs) into Roth IRAs, the \$100,000 annual income cap, will be lifted.¹ Anyone will be able to make a 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. The 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.²

Approximately 25 percent of all retirement plan assets in the United States, representing over \$3.4 trillion (T), are currently held in IRA accounts. In the coming years, this figure will increase exponentially. As Americans change jobs and retire, another \$3.4T being held in defined contribution and other retirement plan iterations will be rolled over into IRAs.³ The combination of an income ceiling removal, an expectation of tax rate hikes, deferred taxes and uncertainty over the future disposition of Roth IRAs represents an historic planning opportunity for advisors, provided they have an investment vehicle for conversions that appeals to investors with larger IRA holdings.

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Today's investors 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. Investors are challenging the efficacy of traditional asset allocation strategies and products. 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.⁴

Given the lessons of the recent past, it is understandable that investors who wish to convert their IRAs may become more focused on any long-term effects associated with the investments therein. This focus is furthered as a result of investors seeking to recoup the tax that is paid at the time of a Roth conversion. Since investors have chosen to embrace a true long-term approach to investing, the challenge for financial advisors and fund managers is to find investment vehicles that are genuinely committed to a long-term investment strategy.

Earlier this year, the author attended a financial conference and heard two speakers who were fund managers respond to a question with remarkable similarity. When these fund managers were asked what they would do differently if they could go back in their careers and start over, they both indicated they would never manage another fund with daily

variety of investment objectives, asset allocations and risk tolerance preferences.

The first of these private funds is being managed by Nuveen. Its investment objective is pure capital appreciation by employing growth and value oriented equities (primarily large cap) in a ratio of approximately 75 percent U.S. issues and 25 percent 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 a more balanced approach could be adopted by 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 is dedicated to investment in the capital markets for obvious reasons. In a private fund structure, the distinct advantage to investors is that multi-year "sticky" dollars help to ensure that the portfolio garners a fund manager's best ideas. In addition, the manager is under no 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 a private fund 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 as well. For these reasons, and due to the fact the fund is privately held and cannot be sold on an open exchange, an investor who wants out of the fund must find another investor who is willing to purchase his or her ownership. Typically, a new buyer 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 percent 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

A private fund is required to have a qualified appraisal performed annually to report the fund's fair market value (FMV).⁷ Here, a second and vitally important benefit of the fund's structure emerges: a discounted valuation captured because the fund's FMV⁸ will be substantially less than its net asset value (NAV).⁹ Discount valuation has traditionally been employed as a tool in tax and estate planning. While a 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. A private fund structure 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 percent or more controlling interest.

So, while investment returns at the end of a 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 percent 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 (illustrated by the chart on Roth conversions shown 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.

The FMV of the private fund units will vary over time in response to gains or losses in a 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 percent discount in year one might only garner a five percent or 10 percent discount in the final year of the term.

attempts have been made to provide a discounting mechanism that would withstand IRS scrutiny, such as the family limited partnership, family limited liability company, restricted investment account, restricted management account, restricted limited partnership and restricted limited liability company. In many instances, IRS challenges have diminished the efficacy of these structures as discounting vehicles or rejected their use altogether (*i.e.*, restricted management accounts). While each method 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 his or her family.

The design of a private fund 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 the valuation field going back several decades. An indication of its depth and complexity is the fact that a research project on valuation methods took two years to complete. It was conducted by a group of prominent attorneys hired expressly for the purpose.¹⁰ Heading up the research effort was 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 research is the development of 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

that of a family limited partnership (FLP). In a typical FLP situation, assets are placed into the FLP and then its interest is sold or gifted to a partner's heirs (or a trust is created for the heirs). An appraiser reports a discounted FMV based on the FLP's illiquidity (being a privately held entity), minority interest, and lack of marketability or other factors.

Historically, the IRS has challenged two areas regarding the FLP structure: the validity of the entity and the 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. By its very structure, however, a private fund

eliminates the family control and personal spending account challenges. The private fund is not under family control and all investors are subject to identical redemption and liquidity provisions; some investor cannot force a cash distribution whenever they wish.

Another example of a discounted vehicle successfully challenged by the IRS is a restricted management account (RMA). While not widely publicized or utilized, the RMA was offered exclusively by banks and trust companies. This investment vehicle 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 the driving reasons for creating a private fund structure was the concern that the RMA might not hold up in tax court. While the author agrees with the discount principles that were being applied to RMAs, based on the overall account restrictions (lack of control, illiquidity, *etc.*), the client still directly owned the underlying portfolio assets held in the account. 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 2008.¹¹ It ruled the RMA was merely an investment agreement while the underlying assets to be valued were the

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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 in 2010. 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.

ENDNOTES

- ¹ Code Sec. 408A(c)(3), as amended by Act Sec. 512(a)(1) of the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222).
- ² Code Sec. 408A(d)(3)(A), as amended by Act Sec. 512(b)(1) of P.L. 109-222.
- ³ Investment Company Institute, *Research Fundamentals*, August 2009 (amounts are as of March, 2009).
- ⁴ Morningstar Advisor, Spring 2008.
- ⁵ New York Times, *Hedge Funds Anxious as Redemption Deadline Looms*, Nov. 14, 2008.
- ⁶ Reuters article, Lawrence Fletcher, Oct. 7, 2008.
- ⁷ In addition to the annual year-end appraisal required by IRA custodians, appraisals are