SLASH THE TAX LIABILITY ON IRA DISTRIBUTIONS & ROTH CONVERSIONS BY APPLYING FAIR MARKET VALUE DISCOUNTING TECHNIQUES TO ALTERNATIVE ASSETS HELD IN *FULLY* SELF-DIRECTED ACCOUNTS

A little known, but highly effective, opportunity exists for IRA investors holding "assets subject to valuation adjustment" to substantially reduce tax liability by applying well-established fair market value (FMV) discounting methods to their holdings. The same valuation adjustment techniques are commonly applied in the gift and estate tax context, but are equally applicable to “alternative assets” held in self-directed retirement plans. When one considers that privately-held assets such as real estate and partnership interests are subject to valuation adjustments (discounting), where publicly-held Wall Street products like stocks, bonds and mutual funds generally are not, another compelling reason for building a *fully* self-directed IRA or 401(k) portfolio becomes clear. Retirement plan investors and their professional advisors are well-served to familiarize themselves with the pertinent strategies and techniques in order to maximize the tax benefits afforded by settled law.

The following is a brief overview of the asset valuation adjustment concept together with some illustrations as to how the methods actually work with IRA's. For a more comprehensive treatment of the subject, please refer to Joe Luby’s excellent work: “Keep It! Advanced Tax Strategies for IRA’s.”

The Fair Market Valuation Requirement. The tax code requires IRA custodians to report the December 31st fair market value (FMV) of the IRA accounts they administer to the IRS and the IRA Holder. [IRC §408(i); Treasury Reg. §1.408-5]. The reports are made annually on IRS Form 5498. The standard definition used for "fair market value" is:

> "The price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of the relevant facts."
> [Treasury Reg. §1.412(c)(2)-1(c)(1)]

The law also requires IRA custodians to report any distributions or withdrawals made from the IRA accounts on IRS Form 1099-R. Distributions typically include any withdrawal of cash or in-kind assets from the IRA account that are, for example, disbursed directly to the IRA Holder [such as Required Minimum Distributions (RMD's)] or made for the purpose of converting to a Roth IRA. The custodian must include the FMV of the assets as of the date of distribution on Form 1099-R. Keep in mind that the IRA Holder is primarily responsible for producing the FMV asset valuation to the IRA custodian in a timely manner.

Of course, the FMV set forth on Form 5498 or Form 1099-R will reflect the amount of income that must be reported by the IRA Holder (or beneficiary thereof) upon a taxable distribution. This income must be included along with other income realized during the given reporting period and will be taxed at ordinary income rates. The resulting tax liability may push the IRA Holder into the top federal tax bracket (currently at 35% for individuals). Accordingly, a well-documented valuation statement is most critical at the point when a taxable event occurs.

The FMV determination is rather straightforward for most conventional IRA's because their assets typically consist of publicly traded stocks, bonds and mutual funds that are sold on established markets at readily ascertainable unit values. Simply stated, the FMV of one's Microsoft stock is reported at the trading price as of the date of annual valuation (December 31st) or date of distribution. If the stock is liquidated and converted to cash prior to its distribution or the reporting deadline, then the resulting cash amount held in the IRA account constitutes its FMV. Accordingly, if one has 1000 shares of Microsoft stock trading at $30 per share, the FMV is $30,000.00 ($30 X 1000 = $30,000.00). Because the shares enjoy full liquidity via the public stock exchange, there is little, if any, room to argue that their FMV should differ from the contemporaneous trading price.

Valuation Adjustments. Not so, when it comes to determining FMV for the wide array of alternative assets held in *fully* self-directed IRA's and 401(k)'s. Because of their very nature, various valuation adjustment factors may offer substantial FMV discounting opportunities when applied to real estate or limited partnership interests, for example. The higher the applicable discount, the lower the income tax burden at the time it matters most: taxable distributions, withdrawals or Roth conversions.

Here is a sampling of common valuation adjustment factors that may be applied to discount the FMV of alternative assets:

1. Minority Interests. The IRA holds less than a controlling interest in the asset to be valued. For example, a ten percent (10%) interest in a privately-held limited liability company constitutes a minority interest because the interest holder does not have a controlling vote as concerns the affairs of the company. This lack of control affects the market value of this asset.

2. Lack of Marketability. Assets that are not traded on established exchanges (e.g.- the DOW; NASDAQ) have limited marketability in the sense that they aren't bought and sold daily via a given stock or commodities market. It may take awhile to sell a privately-held partnership

interest or rental real estate in order to convert to cash. This lack of liquidity also affects the market value of the asset.

3. Fractional Interests. Undivided fractional interests in real estate, even if controlling, are typically more difficult to sell than the entire real property interest (because they come with other undivided fractional interest holders that must be contended with). An investor considering the purchase of a 25% interest in an apartment building owned by strangers will often require a steep price reduction in order to make the investment appealing enough to select.

Appraisal Requirement. For purposes of FMV reporting, the value of an alternative asset held in an IRA or 401(k) must be determined by an independent third party qualified to make such an appraisal. There are many qualified appraisers who specialize in this area throughout the country. Estate and tax planning professionals will often have experienced resources close at hand to refer one to. As mentioned, the valuation adjustments/discounting methods have been extensively developed over the years in the gift, estate and tax planning context. When someone dies, their assets are generally appraised in order to determine the estate tax liability and/or the value thereof with respect to the stepped-up basis realized by the heirs. When one makes a gift to charity, an appraisal is required to determine the value of the gift and the corresponding tax write-off available to the donor.

Here's how the valuation adjustment process works in a typical context. Let's say Manny and Mona each hold a 20% interest in a limited liability company (LLC). The remaining 60% interest is held by three other family members. The LLC owns an office building with a book value of $3,800,000.00. Manny dies and Mona wants to gift her interest to charity. Manny's estate hires an appraiser to determine the value of the asset for estate tax purposes. Mona splits the cost of the appraisal in order to determine what valuation adjustment may apply to her intended charitable gift.

The appraiser determines that the FMV of the office building as a whole is $5,000,000.00. However, because both Manny's estate and Mona: 1) hold minority interests in the LLC, 2) there is no established exchange through which to sell such interests, and 3) their holdings constitute fractional interests in the LLC/office building, the appraiser will be on solid ground to apply substantial discounts to the FMV of such interests. The ultimate FMV determination should be upheld, if challenged, provided the valuation adjustments are well-supported by the professional appraisal.

So, when the appraiser concludes that a 40% valuation discount applies to the LLC/office building interests, Manny's estate would report an asset with a FMV of $600,000.00, rather than the $1,000,000.00 value that would otherwise show on the LLC's books. That translates into a $400,000.00 reduction in taxable income reported on the estate tax return [20% of $5,000,000.00 = $1,000,000.00; 40% of $1,000,000.00 = $400,000.00; $1,000,000.00 - $400,000.00 = $600,000.00]. Conversely, Mona would have a substantially reduced tax write-off for her charitable gift as a result of the FMV discount. She may decide not to make the gift at this time.

Imagine the IRS arguing out of both sides of its mouth should it challenge the valuation adjustments applied to Manny's and Mona's respective interests. On the one hand, Manny's estate asserts that the 40% discount is reasonable and supportable; hence the tax liability should be substantially reduced. If the IRS argues no, only a 20% discount should apply, then the agency will be hard-pressed to succeed on a claim that Mona's identical interest should be discounted by 40% and her corresponding tax write-off reduced accordingly. The IRS would be trapped in a classic Catch-22. The prospect of an IRS challenge to the discount claimed simply underscores the need to produce a well-supported appraisal for purposes of asset valuation adjustments.

FMV Discounts Applied to IRA Assets. Manny and Mona have siblings holding similar fractional interests in the LLC/office building, but their undivided 20% interests are held in their respective Traditional IRA's. Brother Melvin is now 72 years old and must obtain the FMV of his IRA account in order to calculate his annual required minimum distribution (RMD) amount and the corresponding tax liability. Sister Martha intends to convert her interest into a Roth IRA and must obtain the FMV to determine the income tax amount due on conversion. Both, of course, desire to minimize their ultimate tax liability.

Melvin and Martha may use the same appraiser who determined the FMV of $5,000,000.00 for the office building, with each 20% interest being worth $1,000,000.00. Utilizing the same valuation adjustment rationale as used for Manny's estate and Mona's charitable gift purposes, the appraiser discounts Melvin's and Martha's fractional interests by 40%. Accordingly, Melvin's RMD's will be based on a $600,000.00 FMV, allowing him to reduce his current tax liability significantly. Martha's Roth conversion will be taxed on a FMV of $600,000.00, rather than $1,000,000.00, reducing the corresponding tax liability by 40%. In Martha's situation, she stands to save $140,000.00 in federal income tax, assuming a tax rate of 35% ($400,000.00 Discount x 35% = $140,000.00). The resulting tax savings are substantial, and may otherwise have gone overlooked, had the valuation adjustment methods not been employed.

<u>Conclusion.</u> *Fully* self-directed IRA's and 401(k)'s offer a host of benefits, including real control over one's financial future, real choice over the assets one can invest in, real diversification of one's retirement portfolio, real asset protection and real tax advantages. When one considers that, at any moment, Congress could ring in a whole new round of federal income tax increases, positioning oneself to side-step the additional liability becomes that much more compelling. By coupling the many benefits available for self-directed IRA & 401(k)'s with the valuation adjustment techniques applicable to alternative assets held in such accounts, a real opportunity exists to preserve one's accrued wealth for posterity's sake.

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