

Utilizing Roth IRA Conversions and Valuation Discounts to Optimize Tax and Planning Efficiency

Converting all or a portion of a traditional individual retirement account (“IRA”) to a Roth IRA (a “Roth Conversion”) may offer high-income earners a strategic opportunity to benefit from the long-term tax advantages of Roth accounts. These tax and planning benefits may be enhanced by investing traditional IRA funds in private market assets—whose fair market value (“FMV”) reflects applicable discounts for control and marketability—in connection with a planned Roth Conversion.

This overview explores the precedent for executing a Roth Conversion and outlines practical strategies for minimizing the associated tax burden, particularly when investing traditional IRA savings in private investment funds that are not readily marketable, and provides investors with limited control rights prior to effectuating a Roth Conversion. These investments in private funds are referred to in this article as “Private Market Investments.”

Potential Benefits of a Roth Conversion

1. Tax-Free Growth

Once funds are invested in a Roth IRA, qualified withdrawals are tax-free.¹ This feature may provide significant tax savings for individuals expecting higher tax rates in the future.

2. No Required Minimum Distributions (“RMDs”)

Unlike traditional IRAs, Roth IRAs are not subject to required minimum distributions during the account holder’s lifetime, allowing for extended tax-free growth.

3. Estate Planning Advantages

Roth IRAs may be an effective estate planning tool, enabling beneficiaries to receive distributions tax-free over time.

4. Income Diversification in Retirement

Having both taxable and tax-free sources of income can provide flexibility and optimize tax planning in retirement.

1. Taxpayers under the age of 59½ are generally subject to a 10% early withdrawal penalty on Roth IRA distributions. In addition, taxes and/or penalties may apply if earnings are withdrawn within five years of the taxpayer’s first Roth Conversion, or if converted principal is withdrawn within five years of the specific conversion date.



Risks and Considerations of a Roth Conversion

1. Immediate Tax Consequences

Pre-tax funds converted to a Roth IRA are subject to income tax in the year of the conversion. This can create substantial tax liability if not planned carefully.

2. Pro-Rata Rules

If a taxpayer holds both pre-tax and after-tax funds in any traditional IRA, Simplified Employee Pension IRA, or Savings Incentive Match Plan for Employees IRA, the Internal Revenue Service ("IRS") requires conversions to be treated proportionally, which can reduce the intended benefits.

3. Five-Year Rule

If funds that are converted to a Roth IRA are withdrawn within five years of conversion, they may be subject to penalties unless specific exceptions apply.

4. Legislative Risk

As is the case with any legislation, future legislation may alter or eliminate the ability to effectuate a Roth Conversion.

Potential Strategies to Minimize Tax Liability on Roth Conversions

1. Convert Investments When Their Value is Temporarily Depressed

Moving investments from a traditional IRA to a Roth IRA when their value is temporarily depressed can reduce the tax liability of a Roth Conversion and maximize the after-tax growth of the investment. This strategy is particularly impactful when holding Private Market Investments that are valued inclusive of discounts for lack of control and/or marketability.

2. Staggered Conversions

Moving Private Market Investments from a traditional IRA to a Roth IRA over multiple years, otherwise known as a "creeping conversion", can reduce annual taxable income and avoid higher tax brackets.

3. Utilize Deductions or Offset Income

Coordinating Roth Conversions in years in which eligible deductions or losses (e.g., charitable giving, business losses, etc.) are high can reduce taxable income.

4. Isolate Basis Before Conversion

Rolling pre-tax funds into a 401(k) can isolate after-tax contributions in the traditional IRA before executing the conversion.



Valuing Private Market Investments and Applying Discounts

When converting Private Market Investments held by a traditional IRA to a Roth IRA, determining the fair market value of these investments is a necessary component of the conversion process. In performing such valuations, discounts for lack of control and marketability, as applicable, may meaningfully impact the fair market value of the Private Market Investment at the time of conversion (depending on the specific terms of the particular investment) and, consequently, the tax impact of the conversion.

1. Discount for Lack of Control (“DLOC”)

Investment funds rarely grant minority holders the right to participate in fund management. To account for this lack of control over fund operations, any sale of a minority holder’s Private Market Investment to a third party in an arm’s length transaction will typically be at a discount. Accordingly, the application of a DLOC to the fair market value of Private Market Investments is broadly acknowledged for tax and estate planning purposes.

2. Discount for Lack of Marketability (“DLOM”)

Many Private Market Investments are not readily marketable because they are not traded on a public exchange—a dynamic which is particularly apparent when observing the secondary market valuations for smaller limited partnership interests. Similar to DLOCs, the sale price of an investor’s interest in a Private Market Investment to a third party in an arm’s length transaction will typically reflect a discount, or DLOM, to account for this illiquidity.

3. Appraisal Requirements

IRS regulations require a qualified independent appraisal when converting Private Market Investments. This appraisal must be documented and defensible. At Griffin Capital, we utilize a third party valuation expert to conduct these valuations, consistent with IRS requirements.

Legal and Regulatory Basis for Roth IRA Conversions

Roth Conversions are permissible under the U.S. tax code without regard to income limitations pursuant to statutes and legislative actions.

1. Internal Revenue Code §408A(d)(3)

This statute allows for the conversion of amounts from a traditional IRA (or other eligible retirement accounts) into a Roth IRA. Importantly, there is no income limit on conversions. The Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”) permanently removed the income cap on Roth Conversions starting in calendar year 2010.

2. Congressional Acknowledgment

The Joint Committee on Taxation and the Congressional Research Service have issued reports related to Roth Conversions, which provide additional legitimacy to their continued use and highlight the accessibility of Roth Conversions following the repeal of income limitations. The Congressional Research Service report on Rollovers and Conversions to Roth IRAs and designated



Roth accounts, dated November 5, 2021, acknowledges that individuals can preserve the tax benefits of their retirement savings through a transfer from a traditional IRA to a Roth IRA or designated Roth account. In addition, guidance on the present law and analysis by the Joint Committee on Taxation, dated June 24, 2008, describes the impact of the repeal of the income tax limitation on Roth Conversions, stating that after December 31, 2009, any taxpayer may make nondeductible contributions to a traditional IRA and then immediately convert that amount to a Roth contribution.

Legal and Regulatory Basis for DLOC and DLOM

The application of DLOC and DLOM is supported by established U.S. tax law and recognized by the IRS.

1. Internal Revenue Code §25.2512-1 and §25.2512-2

These regulations define fair market value and clarify that the value of property is the price a willing buyer would pay to a willing seller in an arm's length transaction. This framework supports the application of discounts in valuations where there is a lack of control or marketability.

2. IRS Revenue Ruling 77-287

This ruling addresses the valuation of restricted securities and acknowledges that a DLOM may be appropriately applied to account for the illiquidity of the securities.

3. Internal Revenue Manual

This manual is published by the IRS and serves as a set of internal guidelines to be utilized by IRS personnel. Section 4.48.6.2.4 specifically states that when valuing real property, IRS appraisers should consider the "marketability, control, or lack thereof" of an asset in reaching a final conclusion of value.

4. Case Law

The following cases collectively reinforce the legitimacy and necessity of DLOC and DLOM in properly valuing Private Market Investments for tax purposes.

- **Estate of Weinberg v. Commissioner (2000 T.C. Memo 2000-51):** The Tax Court applied both DLOC and DLOM in valuing a non-controlling interest in a limited liability company, reinforcing the standard for applying these discounts in a wide range of valuation scenarios.
- **Estate of Nelson v. Commissioner (T.C. Memo 2020-81):** While the court ultimately ruled that some of the discounts determined by the taxpayer's valuation expert in this case were excessive, it upheld the application of DLOC and DLOM, reinforcing that such discounts are legitimate tools when supported by detailed facts, valuation principles, and thorough analysis.
- **Estate of Gallagher v. Commissioner (T.C. Memo 2011-148):** The court accepted both DLOC and DLOM in determining the value of shares in a closely held limited liability company, underscoring the need for credible market-based evidence in discount assessments.



- **Estate of Giustina v. Commissioner (586 Fed. Appx. 417, 9th Cir. 2014):** The court acknowledged the appropriateness of applying an expertly determined marketability discount to valuations of limited partnership interests in timberland assets.
- **Estate of Jones v. Commissioner (T.C. Memo 2019-101):** The court concluded that DLOM was an appropriate factor in determining fair value under an income-based approach, even for partnerships holding publicly traded stocks.

Applications for Valuation Discounts in Financial Planning

When determining the FMV of ownership interests that lack a robust exchange or marketplace, especially partial non-controlling or illiquid interests, it's often appropriate to apply valuation discounts that reflect what a willing buyer would pay for that interest in an arm's-length transaction. When appropriate and reasonable, the IRS and U.S. Tax Courts have accepted the application of these discounts when determining the fair value of interests in a taxable transaction.

Potential Use Cases

An objective and reasonable fair market valuation of minority interests has a variety of use cases. In performing such valuations, DLOC and DLOM, as applicable, may have meaningful tax implications for the underlying investor. The thoughtful implementation and/or management of certain types of DLOC- and DLOM-eligible investments may improve tax planning outcomes and enhance the long-term after-tax returns of an investment portfolio.

1. Business Valuations

When determining the FMV of minority interests in private businesses, appraisers apply discounts to reflect factors that make the ownership interest less valuable than a proportional share of the total company's net assets. Discounts recognize the lack of control or marketability associated with certain ownership interests, as well as additional factors. While DLOC and DLOM are generally the most impactful components of these valuations, other potential adjustments include Key Person Discounts if the company's value depends heavily on one or a few individuals, and Built-in Gains Discount to account for deferred tax liabilities in appreciated assets.

These discounts are useful and widely utilized for tax-related valuations, such as estate and gift tax planning, charitable contributions, and buy-sell agreements.

2. Overfunded Defined Benefit Plans

A defined benefit ("DB") plan becomes overfunded when the value of its assets exceeds the value of its projected benefit obligations. In other words, the plan has more money than needed to pay all promised benefits to participants based on current actuarial assumptions.



A DB plan's funded status is calculated as:

$$\text{Plan Assets} + \text{Projected Benefit Obligation ("PBO")} = \text{Funding Surplus (or Deficit)}$$

If the result is positive, the plan is overfunded; if negative, the plan is underfunded.

How a Plan Becomes Overfunded

- **Performance:** If a plan's investments perform better than expected, the plan's asset value grows faster than its liabilities.
- **Declining Liabilities (Benefit Obligations):** A DB plan's liabilities are typically valued using discount rates tied to high-grade corporate bond yields. When interest rates rise, the present value of future obligations falls, which can turn an underfunded plan into an overfunded one.
- **Employer Contributions Overshooting Needs:** Employers sometimes contribute aggressively to avoid penalties or capture tax deductions. If market conditions later improve, these prior contributions can create a surplus.
- **Demographic or Actuarial Changes:** If retirees live shorter lives than projected or fewer employees qualify for benefits, liabilities decrease. Updated mortality tables or early retirements can improve funding status.

3. Reducing the Tax Impacts of Roth Conversions

Converting all or a portion of a traditional IRA to a Roth IRA may offer high-income earners a strategic opportunity to benefit from the long-term tax advantages of Roth accounts. These tax and planning benefits may be enhanced by investing traditional IRA funds in assets whose fair market value reflects applicable discounts for control and marketability.

Take, for example, an IRA that owns a non-controlling illiquid interest in a real estate partnership. In light of the lack of marketability and control with respect to such interests, a reasonable DLOC and DLDM may be applied when determining its FMV. These discounts often result in a valuation that is lower than the investor's original contribution, particularly in the early years of the investment. When the fund ultimately sells its investments and returns the proceeds to investors, the DLOCs and DLDMs no longer apply. If the investment performs as expected, then the realized value from the investment is likely to be meaningfully higher than prior valuations of such interests that did include DLOCs and DLDMs. Pre-tax funds converted to a Roth IRA are subject to income tax in the year of conversion based on the value of the asset at the time of conversion. Therefore, moving investments from a traditional IRA to a Roth IRA when their value is temporarily depressed can reduce the tax liability of a Roth Conversion and maximize the after-tax growth of the investment.



Conclusion

Investing in Private Market Investments within a traditional IRA and converting them to a Roth IRA may present a compelling opportunity for high-income taxpayers to minimize tax liability and improve the after-tax performance of such investments. Discounted valuations connect estate, retirement, and tax planning strategies. By accounting for limitations in liquidity and control, investors and advisors may be able to achieve meaningful estate planning and tax efficiency, and position assets for long-term generational growth. The strategy requires careful planning, particularly when investing in private investment funds. Utilizing professional valuations, strategic timing, and income management may substantially enhance the net benefit of a Roth Conversion.

This material does not constitute tax advice to any person. A person must consult with his or her own tax advisors regarding the tax consequences.

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Griffin Capital Company
266 Kansas Street
El Segundo, CA 90245

424.367.4250
www.griffincapital.com