

Maximizing IRA Returns Using FLP/LLC Discounting Techniques

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Abstract

The purpose of this paper is to demonstrate the potential investment benefits of holding real estate inside an IRA and utilizing Family Limited Partnership (FLP) or family Limited Liability Company (LLC) discounting techniques. Statutory authority, administrative authority, and judicial authority was researched to support the conclusion that an IRA may own real estate and the Individual Retirement Account (IRA) value may be discounted for tax and minimum required distribution (MRD) purposes by using properly structured techniques.

I. Introduction

Total IRA assets within the United States continue to grow in value and the importance of IRA assets in retirement planning and living also continues to expand. U.S. Retirement Assets totaled \$14.0 trillion at the end of 2008, with IRAs being the largest component at \$3.6 trillion. Direct investments in IRAs and roll-over of assets in 401k and 403b IRA employer plans into self-directed IRAs may create substantial assets within an IRA. IRA assets normally consist of debt and equity investments such as publicly traded companies (or mutual funds) and bonds. IRA owners and financial planners continue to look for ways to maximize after-tax returns as they consider alternative investments that may be utilized within an IRA. Real estate is normally viewed as an investment to be made outside of an IRA. This paper reviews primary sources of authority supporting the ability to hold real estate inside an IRA and the potential pitfalls of holding real estate. Unrelated Business Taxable Income (UBTI) and “prohibited transaction” rules further complicate holding real estate within an IRA.

Planning techniques that historically were used in estate planning to reduce gift and estate taxes are researched in the context of IRAs. Discounting may not be applied to traditional IRA investments; however, when real estate is properly owned by an IRA, discounting techniques may be applied to maximize after-tax returns of IRAs using income tax deferral and if applicable, estate tax reduction.

II. Literature Review

Prior research has explored bits and pieces of the comprehensive approach taken to the research within this paper. (Guglielmo, Ware and Hamilton 2003) look at reducing taxation of large IRAs with a focus on using charitable remainder unitrusts, irrevocable life insurance trusts, and a strategy utilizing company-owned profit sharing plans to purchase life insurance. There are a few companies such as Equity Trust Company (<http://www.trustetc.com/>) and Pensco Trust Company (<http://www.penscotrust.com/investing/realEstate.aspx>) that promote utilizing IRA's to hold real estate and have various articles related thereto. The paper briefly considers use of an FLP without fully developing the concept or determining an appropriate asset to obtain

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discounts, stating such planning is in “its nascent stage.” (Oshins, Fox, Hirschey, Keebler and Kess 2008) reviews issues of FLP/LLC valuation (discounts) in the estate planning context, and the importance of having non-tax reasons for a FLP/LLC.

III. Maximizing IRA Returns Using Discounting Techniques

As IRA owners look to maximize their retirement assets and/or diversify their holdings, some owners are focusing on holding real estate inside an Individual Retirement Account (IRA). Assets qualifying to be held inside an IRA are defined as much by what is not allowed as by specific allowance. In general, investments in collectibles as a practical matter are not allowed since such an acquisition is deemed a distribution. IRC 408(m)(1-2). There is an exception for certain coins and bullion. IRC 408(m)(3). An IRA may not invest in insurance contracts. IRC 408(a)(3). An IRA may invest in real estate although there are traps for the unwary.

Traps include the rules for Unrelated Business Taxable Income (UBTI) and prohibited transactions. Investing in real estate may subject the IRA to UBTI. IRC 511 Triggering a tax liability through UBTI defeats the goal of tax deferral for traditional IRAs and tax exemption of Roth IRAs. Any IRA (Traditional or Roth) that is exempt from taxation may be subject to UBTI. IRC 408(e)(1) The term “unrelated trade or business” means any trade or business regularly carried on by such trust or by a partnership of which it is a member. IRC 511(a)(1), 512, 513(b).

UBTI may apply when real estate inside an IRA is financed (mortgaged) and generates rental income. IRC 514(a)(1). Publication 548 states that IRA’s are subject to tax on unrelated business income if the IRA incurs debt to acquire property within the IRA. Therefore, an IRA should have enough cash to acquire the real estate debt free, and then the rental income would be excluded from UBTI.

“Prohibited transaction” (prohibited by IRC 4975) rules are designed to prevent IRA owners from engaging in self-dealing transactions. If the rules are broken an IRA may lose tax exemption and cease to be an IRA. IRC 408(e)(2) An example of a prohibited transaction occurred when an IRA purchased a home for the IRA owner to reside in. Harris, Gerald M., et ux. v. Commissioner (T.C. 1994). The entire IRA value will be deemed to be distributed, triggering income tax consequences and may be subject to the 10% penalty on early distributions. IRC 72(t) This will also trigger state income tax and penalties. The same rules on prohibited transactions apply to Roth IRAs Reg 1.408A-1, Q-1, A-1,(b) A disqualified person includes not only the IRA owner, but also the owner’s family. IRC 4975(e)(2) Prohibited transactions may include the IRA buying, selling, leasing, or lending assets from or to the individual owner of the IRA. The IRA owner may not receive compensation for operating a business or managing rental property that is an asset of the owner’s IRA. IRC 4975 (c)(1)(C) and (F). If an owner is contemplating a transaction that may violate the prohibited transaction rules, the owner may request a ruling from the Department of Labor (which also has jurisdiction over IRAs). IRC 4975(c)(2)

Liquidity may create issues for IRAs holding real estate. The investor also faces annual expenses such as real estate taxes and maintenance needs, and risks associated with unforeseen expenses, such as emergency property repairs or tenant defaults, that could put the IRA investment in jeopardy if the IRA doesn't have the cash to cover them. Therefore it is important

to have some cash inside the IRA that is purchasing the real estate.

For purposes of the MRD (Minimum Required Distribution), a taxpayer may want to leave sufficient assets outside of real estate to have the liquidity required to make MRD in cash rather than using in-kind distributions of the real estate. An IRA owner that has multiple IRA's may take distributions in a disproportionate fashion, as long as the total MRD is met. This may allow a taxpayer with multiple IRAs to leave the IRA holding real estate intact for a longer period of time, while the initial MRD is taken from an IRA that holds mutual funds or other assets that may be easily converted to cash prior to distribution from the IRA. The IRS can levy a penalty equal to 50% of the difference between what you should have withdrawn from your account each year and what you actually withdrew, by filing IRS form 5329. Thus, a forced sale of the real estate could occur if liquidity needs are not addressed.

A trustee that is willing to hold real estate is needed to act as custodian. Many IRA trustees (ie. banks and brokerage companies) will not hold assets other than cash, fixed investments, and equities. The IRA fees will be higher when real estate is held, due to more frequent and involved transactions such as collecting rents and paying expenses such as real estate taxes.

No depreciation deduction is available on real estate held inside an IRA; however, the deduction may not be that important as there is no tax until subsequent distribution of the real estate or proceeds from the sale of the real estate. Holding a capital asset (real estate) inside an IRA will transform what otherwise would be capital gain (currently subject to lower income tax rates) into ordinary income inside a traditional IRA. All gain is taxed at ordinary rates rather than capital gain rates; however this is the same with stock gains and dividends from investment such as mutual funds held inside the IRA. A Roth IRA may offer additional planning opportunities with the purchase of real estate; however, since there is no tax on distribution or MRD the discounting techniques discussed here may not be useful.

Discounts are less likely to be attacked by the IRS if there are non-tax reasons for formation of the FLP/LLC. Assets may be exempt from creditor claims in bankruptcy or under applicable state law. Referring to its opinion in *Patterson v. Shumate*, the U.S. Supreme Court held that IRA assets are exempt from the debtor's bankruptcy estate under Bankruptcy Code §522(d)(10)(E) because an IRA confers a right to receive payment on account of age and is a similar plan or contract to those listed in Bankruptcy Code §522(d)(10)(E). Noting that, under Code §408(a)(4), the accountholders have a nonforfeitable right to the IRA assets, the Court reasoned that, under Code §72(t), that right is restricted by a 10% penalty tax on any withdrawal before age 59^{1/2}. Thus, the penalty tax prevents access to the entire IRA balance and limits the right to payment. Because the restriction is removed when the accountholder reaches age 59^{1/2}, the right to the IRA balance is a right to payment on account of age, the Court concluded.

Significantly, the Court noted that although the right to receive payment under an IRA is on account of age and is a similar plan or contract to those listed in Bankruptcy Code §522(d)(10)(E), the IRA assets are exempted under Bankruptcy Code §522(d)(10)(E) only to the extent that the assets are reasonably necessary for the support of the accountholder and any dependents. However, the IRA exemption under the Bankruptcy Code as amended by the 2005

Bankruptcy Act allows a debtor to claim an exemption for funds in an IRA up to the \$1 million cap without regard to the reasonably necessary standard.

A plaintiff injured on the real estate may file a lawsuit against the property owner or entity holding the asset, in this case the IRA if the real estate is titled in the name of the IRA, or the LLC if the IRA instead owns an interest in the LLC with the real estate titled in the name of the LLC. Since an IRA owner would not want to file bankruptcy to obtain protection of some or all of the IRA assets, a critical additional protection would be to place the real estate inside an LLC or multiple LLCs if multiple real estate properties are owned, and then IRA ownership interests in the LLCs. This creates a nontax reason (limited liability for other IRA assets) for creating the LLC, which may be important so the IRS respects the FLP/LLC. The FLP/LLC in turn becomes the mechanism supporting discounting the value of the IRA assets (real estate) for tax purposes.

Large discounts are often taken by GRATs (Grantor Retained Annuity Trusts), FLP (Family Limited Partnerships) or Family LLCs (Limited Liability Companies) for lack of marketability and lack of control. Fractional interest discounts are analogous to FLP discounts, for real estate directly held by the IRA rather than indirectly held using an FLP or LLC. The IRS has litigated the issue of discounts, and the taxpayer normally wins, as demonstrated in the following cases:

In *Mooneyham v. Commissioner*, 1991 T.C. Memo 178, the Tax Court allowed a 15 percent discount on a gift of a 50 percent interest in real estate to the taxpayer's brother based on a demonstrated lack of marketability, problems with control, and costs of partition relating to a fractional undivided interest. The court noted that the taxpayer's experts were unprepared and unqualified, but allowed the discount for the reason that the Internal Revenue Service "presented no evidence from which the Court could conclude that, under the facts of this case, no discount or a lesser discount was appropriate." The taxpayer had originally asked for a 25 percent discount.

In *Astleford v. Commissioner*, T.C. Memo 2008-128 (May 5, 2008), involving a gift of a limited partnership interest, the Tax Court applied cascading discounts on many different layers of assets. The taxpayer gifted an interest in a newly created limited partnership which owned a 50 percent interest in a general partnership which owned 1,187 acres of Minnesota farmland valued at \$3,500 an acre. The Tax Court first applied a 20 percent "absorption" discount to the farmland owned by the general partnership. The Tax Court said that an absorption discount is a discount in the value of real estate if the sale of such real estate within a short period of time would reduce the price for which real estate otherwise would sell. A short period of time was considered to be a year.

Essentially, the court said that flooding the local real estate market with 1,187 acres of farmland all in one year would require a price reduction of 20 percent to accomplish the sale. After applying a 20 percent absorption discount to the farmland owned by the general partnership, the Tax Court then applied a combined 30 percent minority and marketability discount to the one-half general partnership interest owned by the limited partnership. The Tax Court then applied a combined 39 percent minority and marketability discount to three gifts of 30 percent blocks of the limited partnership to the taxpayer's children. The end result of all the

cascading discounts is that the farmland originally valued at \$3,500 per acre was reduced to \$1,269 per acre with an effective discount rate of nearly 64 percent.

In *McCord v. Commissioner*, 120 T.C. 358 (2003) the Tax Court extensively analyzed the testimony and opinions of both the Government's and the taxpayer's appraisers to arrive at a discount of 15% for minority interest and 20% for lack of marketability interest for the transferred interests.

In *Knight v. Commissioner*, 115 T.C. 506 (2000), although the IRS raised the legitimacy of the family limited partnership for tax purposes, the Tax Court found that under Texas law the partnership had properly been created and was recognizable for federal gift tax purposes. The family limited partnership had been funded primarily with cash, municipal bonds, and real property. However, the Court allowed only a 15% overall discount for lack of marketability and minority interest from the underlying value of the property.

In *Lappo v. Commissioner*, T.C. Memo. 2003-258 the Tax Court, after considering the testimony of both taxpayer's and Government's expert witnesses, allowed an overall 15% minority interest discount and an overall 24% marketability discount in determining the fair market value of transfers of a family limited partnership with both active and passive assets. In *Lappo*, both parties agreed that the marketable securities portion of the family limited partnership should be valued using the net asset value of the partnership. The petitioner's expert used a minority interest discount of 7.5%, while the respondent's expert used a minority interest discount of 8.5%. Since the difference between the experts was not significant, the Tax Court adopted the 8.5% minority interest discount for the marketable securities.

In the recently decided case, *Estate of Webster E. Kelley v. Commissioner*, T. C. Memo. 2005-235, the Tax Court allowed a 12% minority discount and a 23% marketability discount for a family limited partnership that consisted solely of cash and certificates of deposit. In allowing this large discount, the Tax Court relied upon appraisals by both the petitioner and respondent that used general equity closed-end funds as comparables. The use of general equity funds as comparable to cash by both the petitioner and the respondent could be criticized, since cash is a more liquid investment than securities. This case was an anomaly for various reasons and should not be considered valuable guidance.

Fractional ownership interests in real estate may also receive discounts. An example would be three different IRA owners acquiring a fractional share interest (1/3, 1/3, 1/3) in a single apartment complex. The following court case, although unusual in the large size of the discount, demonstrates fraction share discount concepts.

The Tax Court again awarded a steep discount (60%) to the estate value of an undivided interest in timberland property in the *Estate of Della Walker van Loben Sels v. Commissioner*, 1986 T.C. Memo 501. The parcels of timberland ranged from 26 acres to 26,000 acres and the undivided interests ranged from 2.5 percent to 26 percent. The court cited lack of marketability, lack of management, lack of general control, lack of liquidity and potential partitionment expenses. An important consideration of this case was the disclosure by the Internal Revenue Service's experts that they were not directed by the I.R.S. to value the property to account for a

discount. At trial, all the I.R.S.'s experts agreed that had they been so instructed, they would have applied a discount. Thus, the Tax Court focused primarily on the taxpayer's experts whose discounts ranged from 50 to 78 percent. The court took special consideration of a minority sale of a tract of similar timber property at a 50 to 60 percent discount.

Although fraction interest discounts are available, for non-tax reasons there may be greater liability in lawsuits, and problems if one IRA owner wants to liquidate his or her fractional interest and the other IRA owners do not want to dispose of their interest, or a buyer is not found to acquire the fractional interest of one IRA owner. Discounts are fact specific. Consequently, each case needs to be individually assessed to determine the appropriate discounts.

The above cases did not involve IRAs. Discounting principals may also be applied in the context of valuing assets with IRAs. IRM 4.72.8.4(1) states that "although Rev. Rul. 59-60, 1959-1 C.B. 237 provides methods for valuing shares of stock of closely held corporations for estate and gift tax purposes, the factors may be used to determine values of assets in qualified plans." And where appropriate, stock values should be discounted due to a lack of marketability and, if appropriate, a control premium should be added to the stock value. IRM (09-01-2006) 4.72.8.4(3). In the FLP/LLC context, the IRA would need a fractional share ownership interest in the FLP/LLC with other IRA owners to effectuate the discounts. The FLP/LLC may have title to all or a fractional interest of the real estate.

One of the issues related to executing this valuation strategy is the administrative duties related to obtaining a valuation, including of course paying for the valuation. Business valuations can cost anywhere from \$5,000 to \$20,000, and more. And even though the asset involved is real estate, a valuation expert not a real estate appraiser is necessary since this individual is responsible for establishing the amount of your discount.

And of course paying for the valuation expert certainly does not guaranty (nor does the expert) the discount percentage (and hence the amount of your discount) that they have derived. If the valuation is challenged by the IRS, the fair market value determined by the IRS may be higher resulting in greater tax liability, and potentially interest and penalty. Depending upon the value of the asset, and hence the amount of tax, valuation has become a hotly contested issue - especially with the proliferation of family limited partnerships and limited liability companies. Therefore if the asset value involved has a high dollar-value, and therefore the tax savings/costs involved are significant, the IRS is more likely to challenge the discount.

There are indeed countless court cases involving success by the taxpayer as well as the IRS. The court cases reveal that the court usually makes a judgment call that relies upon the opinion of experts. Often the Judge will determine which expert presented a better position and side more in favor of that expert. Although in many instances, the courts "determine" their own opinion as to fair market value, siding with neither the taxpayer's nor the IRS's experts.

The "loss of value" using valuation discounts for lack of marketability and control would decrease the MRD. A 75 year-old retiree has a minimum required distribution pursuant to the IRS tables of an amount equal to 4.37%. Applying a discount to the value of the IRA assets of

35% reduces the effective MRD to 2.84%, resulting in a greater amount of assets left inside the IRA and greater tax deferral.

Assuming an annual investment rate of return on the assets held inside the IRA of 7% the MRD would not exceed the return until a taxpayer turned age 85. Applying a 35% discount to the IRA asset value effectively extends to age 94, the point at which the MRD percentage exceeds the return percentage. Therefore, the IRA owner utilizing discounting techniques gets an extra nine years in which the IRA balance continues to grow after MRD begins, resulting in greater tax deferral and after-tax returns. The discounts may continue to the heirs of a deceased IRA owner, resulting in further tax deferral in a “stretch IRA” scenario.

A taxpayer’s IRA is included in his or her gross estate on death. Depending on the size of a decedent’s estate and estate tax laws, the discounts applied to the IRA may also reduce the taxable estate for estate tax purposes providing additional financial planning opportunities. Table I gives an example assuming an IRA owner has real estate with a fair market value (absent discounts) of \$1,000,000 inside their estate and the estate is large enough to be subject to a 45% marginal estate tax rate. The discount techniques result in a tax savings of \$157,500 based on the assumptions used.

An IRA may invest in a closely held business entity without creating a prohibited transaction or self-dealing issue by staying within the constraints of the IRA rules. See: J.H. Swanson, 106 TC 76, Dec. 51,155 (1996), IRS FSA (Field Service Advice) 200128011, July 13, 2001, and Department of Labor Advisory Opinion 2000-10A. The IRS also recognizes the concept in its qualified plan audit manual, IRM 4.72.8, Employee Plans Technical Guidance, Valuation of Assets.

An issue that may arise during the MRD period, is determining the value of the real estate and FLP/LLC on an annual basis to determine what the MRD is each year. IRM 4.72.8.1.2. states that whether a formal valuation is required will depend on the transactions that occur with the plan and form of the plan. “The reasonableness of the method for valuing plan assets is based on the surrounding facts and circumstances...there is no absolute requirement the annual valuation be based on an independent appraisal.” Therefore, to reduce costs of administration the IRA custodian should consistently use a method that utilizes a ratio of an initial FMV appraisal by a certified appraiser, relative to the assessed fair market value on the real estate tax bill, multiplied by the FLP/LLC discount. Future real estate tax bills may then be used for annual valuations.

IV. Conclusion

Investing IRA assets in real estate and applying FLP/LLC discounting concepts to the IRA creates opportunities for IRA owners to increase after-tax returns that some individuals and financial planners may want to utilize. Under the right circumstances, a direct land investment through an IRA utilizing FLP/LLC discounting techniques provides an opportunity to maximize returns by minimizing taxes.

IRA owners interested in these opportunities should consult with their financial planner, tax, and legal advisors to review both tax and nontax issues. Upon determining such an

investment is appropriate, the transaction must be structured properly.

Table I

	Traditional IRA no discount	Traditional IRA with 35% discount
IRA value before discount	\$1,000,000	\$1,000,000
Discount	N/A	35%
Value after discount	\$1,000,000	\$650,000
Estate Tax Rate	45%	45%
Tax Liability	\$450,000	\$292,500

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