NAEPC was notified by Jagen Investments LLC that one of NAEPC's regional councils posted an article on its website purportedly written by Gary Powell of CenterG, Inc. and published by Cannon Financial Institute, Inc. (the "Powell Article") that allegedly infringes the copyright in the article 'Advanced Estate Planning with Alternative Investments' written by Joe O. Luby III, CFP, Founder and Manager of Jagen Investments LLC. Neither NAEPC nor its regional council were aware of Mr. Luby's article before the local council posted the Powell Article. Had NAEPC or its regional council been aware of Mr. Luby's article, serious questions or originality in the Powell Article would have been raised, questions of which NAEPC or its regional council would have vetted before publishing it. NAEPC herein publishes Mr. Luby's article for the readers of its Journal.

Advanced Estate Planning with Alternative Investments

Alternative investment products are more popular than ever according to a recent article from *Financial Advisor* magazine.[1] Quoting statistics gathered by Cogent Research, the article states roughly eight out of every ten advisors use alternative investments in their client portfolios. Alternative assets often provide portfolio diversification, steady income streams, easy access to institutional investment opportunities, and the ability to benefit from non-traditional investment sectors. For example, investors wanting direct exposure to opportunities within the current distressed U.S. mortgage and real estate market generally need to turn to alternatives to provide such access

The unique attributes of many alternative investment products provide the opportunity for significant benefits in addition to those listed above. These added benefits are a direct result of the delta that occurs between such assets' net asset value (NAV) and fair market value (FMV) at any given time. Examples of these added benefits include the following:

- The ability to substantially reduce the tax owed on Roth conversions.
- Reduction of required minimum distributions (RMDs) from IRAs.
- The ability to increase annual gifts exempt from gift tax and protect spendthrift beneficiaries.
- Reducing the size of a taxable estate and keeping more assets in the family.

Defining Alternatives

There are many types of alternative investments available to advisors and clients. These products often differ widely on areas such as fund design, underlying holdings, investment objectives, fee schedules, portfolio activity, and others. Alternative investing strategies have even been introduced in the form of mutual funds and exchange traded funds (ETFs).

Traditional alternative investments typically share many of the following characteristics: longer investment time horizons with minimum holding periods, not traded on an open exchange, investor qualifications, restrictions on transfers, and a spread between NAV and FMV. This creates a distinction between true alternative investment products and the newer mutual funds employing alternative investment *strategies*. True alternative investment products have additional benefits beyond those provided by the investment strategies they employ. These benefits are directly related to the typical alternative product design.

FMV vs. NAV

Recognizing the unique planning benefits offered by alternative investments requires an understanding of the difference between NAV and FMV. NAV is typically the valuation used for portfolio reporting on account statements and when calculating investment yield or total return. Per-share NAV is generally determined by totaling the value of an investment fund's underlying assets and dividing it by the number of fund shares outstanding. For example, a fund with $100

[1] http://www.fa-mag.com/fa-news/10056-four-fifths-of-advisors-use-alternative-investments.html

million in underlying portfolio assets and 10 million shares held by investors has a NAV per share of $10. This is the same process used to determine NAV of open-end mutual fund shares at the end of each trading day.[2]

FMV is an entirely different valuation and represents what a particular asset could be sold for in a hypothetical arms-length transaction between a buyer and seller. FMV is the valuation required to be used in most tax reporting instances where the value of an asset is used to determine the amount of income or deduction. Assume an individual donates a parcel of raw land to a favorite charity. The donor is entitled to a charitable contribution deduction equal to the FMV of the land at the time of donation.[3] A parcel of land shares many of the alternative asset characteristics shown above such as not being traded on an open exchange, etc. A qualified appraisal is required to determine the current FMV of the land and thereby the charitable tax deduction.[4] The FMV determined by the qualified appraiser must meet the following definition:

> "The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts."[5]

This is more commonly referred to as the "willing buyer-willing seller" rule. Qualified appraisers must consider both sides of a hypothetical transaction between two parties who are each acting in their own best interests.

Note the significant differences between NAV and FMV. NAV looks to the underlying assets of a fund without regard to what price the fund's own shares may bring in the marketplace. FMV, on the other hand, must consider many additional factors to determine a likely sale price for the fund's shares. Appraisers use NAV as the starting point for their calculations when determining the appropriate FMV.

The difference between NAV and FMV is most obvious in the closed-end fund market. Closed-end funds have a finite number of shares outstanding that trade daily like a stock. The NAV of the shares is determined exactly as described above. FMV of the shares is the current trading price on the exchange. This is the price willing buyers and willing sellers are agreeing to at any given moment. Closed-end funds almost always trade at prices different from their NAV. When trading for more than NAV, the shares are said to be at a premium. When trading for less than NAV, the shares are said to be at a discount. In either case, the shares will have two different valuations in effect at the same time. Specific examples can be seen by viewing price quotations for closed-end funds at ***www.nasdaq.com***, which show "last net asset value (NAV)" and "market price," where the latter is the trading price (FMV) of the shares. The Closed-End Fund Association (***www.closed-endfunds.com***) also provides daily updated lists of funds trading at significant premiums and discounts to their NAV.

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[2] Some adjustments are required for open-end mutual funds as outlined in Rule 2a-4 promulgated under the Investment Company Act of 1940.
[3] Treas. Reg. §1.170-1(c)(1)
[4] IRC §170(f)(11)(E)
[5] Treas. Reg. §1.170-1(c)(1); Rev. Rul. 59-60, 1959-1 CB 237; IRS Publication 561

Valuation Adjustments

Valuation adjustment factors are conditions, restrictions, or circumstances that affect the price willing buyers and sellers will agree to in the marketplace at any particular time. They have no impact on NAV, investment performance based on NAV, investment yields, or any other measure other than current FMV. Following are some factors common to alternative investments:

- ✓ Lack of control (minority interest)
- ✓ Lack of liquidity
- ✓ Fractional interests
- ✓ Lack of marketability
- ✓ SEC Restrictions
- ✓ Long time horizon to maturity

NAV and FMV of alternative investments are rarely the same. FMV will generally be less than NAV due to the types of factors shown above. For example, shares of alternative investments that do not trade on an exchange (lack of marketability), will not become liquid for several years (long time horizon), and have limitations on ownership (SEC restrictions) will generally have a FMV much lower than NAV. FMV is typically less than the true inherent value of the underlying assets because shareholders cannot access the full NAV until the factors described above have expired. For example, investments with a prescribed time horizon may become redeemable at NAV once the maturity date has passed, but not earlier in the investment cycle. The appraiser must take all these facts into account when determining what price a willing buyer is likely to offer and a willing seller likely to accept in the interim. Just as the tax reporting definition of FMV is provided by various rulings, regulations, and publications, so too are the factors such as those shown above that go into determining FMV.

Assume an alternative investment with a NAV of $9 per share and an FMV determined at $5.85 per share.[6] This represents a thirty-five percent valuation adjustment down from NAV. At first glance, it may appear the investor has lost money, which is not the case. A realized loss only occurs when someone sells an asset for less than he or she paid for it. Provided the investor does not sell the share, he or she still owns an asset with underlying intrinsic NAV of $9, which is the basis for any future investment return or yield. The FMV is merely a hypothetical value taking into account the applicable adjustment factors as required by IRS guidelines when valuing illiquid, non-traded assets for reporting purposes.[7]

Many advisors are familiar with valuation adjustments and differences between NAV and FMV due to the extensive use of these concepts in gift and estate tax planning scenarios. Common estate planning techniques involve the use of family limited partnerships, closely held private company stock, and fractional interests in family real estate, which are subject to many of the same valuation adjustment factors described above. For example, a ten percent interest (lack of control/minority interest) in a family-owned and controlled limited partnership (lack of marketability) with no specified liquidity date (long time horizon) will generally have a FMV that is substantially discounted from its NAV. The reduced FMV is used when reporting the

[6] These are hypothetical values and not indicative of any actual investment. Proper FMV can only be determined by means of a qualified appraisal.

[7] Rev. Rul. 59-60, 1959-1 CB 237

value of the asset for gift or estate tax purposes and serves to reduce the amount of tax owed on the specific transaction.

Taxable Events & Alternative Investments

The value of assets involved often determines the amount of tax owed or the amount of deduction allowed for a particular tax event. FMV is the required reporting value in all such cases including income tax, gift tax, and estate tax transactions.[8] Most of the time a lower FMV for tax reporting purposes is beneficial by serving to reduce the tax liability on the transaction.

The following list shows examples of transactions resulting in various financial and/or tax outcomes based on the valuation of the assets involved:

- Estate tax calculations
- Gift tax calculations
- Roth conversions
- In-kind Traditional IRA distributions
- Calculation of RMDs from an IRA
- Charitable gift deductions
- Capital gain calculations

In almost every case, a reduced FMV provides significant tax savings by reducing the amount of taxable value reported. The exception on the list above is charitable gift deductions whereby a reduced FMV serves to limit the favorable tax deduction resulting from the gift.

REITs Provide Added Planning Value

Non-listed real estate investment trusts (REITs) are perfect examples of the types of alternative investments that may provide these unique and powerful planning benefits to advisors and their clients. The typical non-listed REIT has an initial offering price of $10 per share, and the subsequent estimated per-share value is updated over time. Non-listed REITs generally have multiyear time horizons before the investment sponsor anticipates a liquidity event such as listing the shares on an exchange. There is often limited opportunity for investors to cash out during that time. These design features create the opportunity for an adjustment between NAV and FMV of non-listed REIT shares.

Example #1 – Individual Retirement Accounts (IRAs)

Many advisors recommend that clients convert Traditional IRAs into Roth IRAs. The benefits include tax-free treatment on qualified distributions from the Roth IRA, no required distributions at any age, and the opportunity to lock in current tax rates. The main drawback is that any amount converted, excluding prior non-deductible IRA contributions, is taxed as

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[8] Treasury Regulations §20.2031-1(b), §25.2512-1, §1.170-1(c)(1); Rev. Rul. 59-60, 1959-1 CB 237; Rev. Rul. 68-609, 1968-2 CB 327; Note: this is not an exhaustive list of references.

ordinary income in the year of conversion. Alternative investments such as non-listed REITs can help mitigate this tax impact when their FMV is less than NAV for reporting purposes.

For example, an investor holds 10,000 shares of a non-listed REIT inside a Traditional IRA. The NAV is $9 per share, and the discounted FMV is $5.85 per share as determined by a qualified independent appraiser.[9] Thus, the entire account has a NAV of $90,000 and FMV of only $58,500. The investor completes a Roth conversion, which is required to be reported at FMV to determine the resultant amount of taxable income.[10] The proper amount of taxable income in this scenario is $58,500 rather than $90,000. Assuming a hypothetical combined state and federal tax rate of forty percent, the investor would owe $23,400 in tax versus $36,000 if the transaction were valued at NAV. Proper valuation and reporting saved the investor $12,600 of tax.

The reduced FMV also serves to minimize the amount of any RMDs to be taken from an IRA. RMDs apply to owners of Traditional IRAs aged 70½ and older as well as many beneficiaries of inherited IRAs. Required distributions are calculated annually based on the FMV of the IRA as of December 31st. A lower valuation results in a lower required distribution the following year.

Example #2 – Estate and Gift Tax

There are many complex strategies to reduce the impact of gift and estate taxes that go beyond the scope of this report. However, please note that many of those strategies are amplified in their effect when utilizing reduced FMV alternative assets such as those described herein. A simple example of how investors may use alternative assets in this arena is by making gifts intended to qualify for the annual gift tax exclusion.[11] Such a gift is money or property with an FMV less than or equal to the current annual exclusion amount ($13,000 in 2012). Consider the same non-listed REIT valuations described above where NAV is $9 and FMV is $5.85. An investor gifting shares with FMV of $13,000 to qualify for the annual gift tax exclusion is actually moving $20,000 of underlying NAV to the gift recipient. The $7,000 valuation adjustment amount is transferred tax-free.

Conclusion

The alternative investment arena offers incredible opportunities for portfolio diversification, access, and exposure to unique asset classes, institutional management, and performance based on measures other than those associated with traditional stocks and bonds. Advisors and their clients continue to broaden portfolio exposure to such asset classes and often find that alternatives fill needs and niches unmet by traditional securities.

As outlined in this report, alternative investments also have significant potential to add value to client portfolios in other ways apart from their investment performance. The unique

[9] These are hypothetical values and not indicative of any actual investment. Proper FMV can only be determined by means of a qualified appraisal.
[10] IRS *2012 Instructions for Forms 1099-R and 5498*
[11] IRC §2503(b)

characteristics of many alternative investment fund structures open the door to multiple tax and financial planning opportunities. This represents a major opportunity and advantage for proactive advisors to bring these solutions and benefits to their clients. Advisors can also use this knowledge to gain additional clients through referrals from allied professionals such as CPAs and attorneys by positioning themselves as the advisors of choice for clients considering alternative investments for a portion of their portfolios.

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