Prisoner: There's a message through the grapevine, Johnny.
Johnny Dangerously: Yeah? What is it?
Prisoner: Johnny and the Mothers are playing "Stompin' at the Savoy" in Vermont tonight.
Johnny: Vermin's going to kill my brother at the Savoy theater tonight!
Prisoner: I didn't say that.
Johnny: No, but I know this grapevine.

From the Edgewood/20th Century fox film *Johnny Dangerously*

Every month, I get asked about some unique way that someone has found to save taxes. Usually these questions start like this:

"A friend/coworker/neighbor of mine told me…"

When I hear this phrase, I immediately know that I'm going to spend the next few minutes refuting tax 'advice' given out by someone's cousin's neighbor's best friend…eh, you know the chain.

Like the grapevine in *Johnny Dangerously*, the 'advice' usually starts out as true and practical – for the person it's given to. But by the time it gets to the 5th person on the list, it's become something entirely different…and often downright wrong, if not illegal.

And 'highly questionable' if not outright illegal can be used to describe the latest 'tax strategy' to cross my desk.

Here's how it works:

Let's say that you have a traditional IRA at a traditional third-party provider, like Fidelity, with a fair market value of $99,000. You've been told that a Roth IRA is the way to go (not always, but that's not the point here), and that for this year only, you can convert a traditional IRA to a Roth IRA without regard to income limits, and pay the tax over a two year period. You want in. Your friend tells you he/she has a 'foolproof' way to do it, and pay less in tax, too (always a red flag, but people hear what they want to hear).

Step 1 is to change the IRA to a self-directed IRA. This is pretty simple, and permitted.

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Step 2 is to have the self-directed IRA invest into an LLC. Again, a permissible event depending on a few other factors. For this example, we'll assume the factors that would negate this aren't present.

Step 3 is to have a non-related person invest in the LLC as well (since related parties would be one of those negating factors). The non-related person invests a small amount ($1,000) and has a tiny (1%) interest, while your IRA has a significant (99%) interest. However, your IRA does not have any voting interest or control, while the non-related party has complete control (another red flag, but what could possibly go wrong?). This is a tricky area (easy to become involved in a prohibited transaction) but isn't outright impermissible.

So at this point, you'd have an LLC with a total capitalization of $100,000 – your $99,000 plus the non-related person's $1,000.

Step 4 is valuation. This is where it gets tricky. Because you don't have control, you argue that the investment isn't worth $99,000 – it is worth less, say, $80,000. Discounted valuations are permitted for such vehicles as Family Limited Partnerships, so this isn't unusual.

Step 5 is the Roth Conversion. You convert the investment in the LLC from a self-directed Traditional IRA to a Roth IRA, claim the discounted value of $80,000 as the taxable value, and save yourself the tax on $19,000.

I know what your first question will be – is that legal? Well, that's why these things perpetuate: there's no clear-cut prohibition on such a transaction, probably because Congress can't foresee every permutation of a strategy. But…if it sounds too good to be true…

Here's a few problems with this strategy:

1. *<u>The non-related party just got a $19,000 boost in the value of their 1% share</u>*. If we assume that the LLC is worth $100,000, and that your share is only worth $80,000, then that must mean the other share is worth $20,000. If that share is transferable, the other investor can now sell it for $20,000, pay the tax on the gain, and walk away with over $16,000 in profit. And you? Well, you're left with a $19,000 loss, which you can't recognize (because it was in a traditional IRA when it 'occurred'), and an LLC over which someone else – not you – has complete control.
2. *<u>You have no control over the money</u>*. That's right – you ceded control to save on tax, so you cannot direct where the funds are invested. And if the funds are invested into a vehicle which is later found to be self-dealing (and thus a prohibited transaction), you will have a nice $80,000 distribution. Better yet, what's to stop the non-related party from investing in their grandiose scheme with your money? You could wind up with nothing.
3. *<u>You aren't avoiding tax at all, merely deferring it</u>*. The point of this exercise is to get the $99,000 out of the LLC while only paying tax on $80,000. But since Roth IRAs are taxed on the earnings, the additional $19,000 will be taxed when the funds are distributed. Only the corpus of the Roth will not be taxed.
4. *<u>The IRS has rules against these kinds of transactions</u>*. Notice 2004-8 deals with abusive Roth transactions, and includes prohibitions on transferring undervalued assets into a Roth. Such transactions are considered 'listed' transactions, and must be reported. Failure to do so will subject the individual to additional penalties. Given that the investment in the LLC is greater

than the claimed value, the transaction above is subject to challenge by the IRS as an undervalued asset, and subjecting you to those very penalties.

So the operative question then becomes: is the purported tax ‘savings’ worth the risk?

I’ll take ‘What, are you crazy?’ for $400, Alex.