AI Sponsors Will Pay Client's Advisory Fees

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Most RIA firms charge advisory fees to clients in the general range of one percent of assets under management annually. Thus, a $1 million account would incur fee expenses of $10,000 annually. Is it really possible to get an alternative investment sponsor to cover this expense on behalf of your clients? In a roundabout way, yes.

Shane has an IRA valued at $1 million and total investable assets of $10 million. Your asset allocation model calls for ten percent of the portfolio to be allocated to alternative investments such as hedge funds, non-listed REITs, etc. These assets are often inefficient vehicles for income tax purposes (K-1s, high taxable yields, high turnover, etc.) and are generally designed to be longer term holdings (illiquid, lock-ups, no trading market, etc.). So you allocate this portion of the portfolio to the IRA which avoids the tax issues and is itself designed as a long term holding vessel.

Shane's wealth management and transfer planning indicate that a Roth conversion will be very beneficial and ultimately maximize his estate for his beneficiaries. As you know, the fair market value (FMV) of the assets converted to the Roth IRA is taxable as ordinary income in the year of the conversion. Luckily (or wisely), you allocated all of the alternative investments in Shane's portfolio to his IRA. Why is this lucky or wise? As described above, alternative investments are typically illiquid, non-traded, minority interests. When these features exist, there is generally a discount between net asset value (NAV) and FMV. The tax reporting rules require FMV be used when reporting the value of an asset involved in a taxable transaction.

For example, Shane's $1 million NAV portfolio of alternative assets may have a FMV for tax reporting of only $650,000 when adjusted by taking into account the fact that the holdings are illiquid, non-traded and so on. The actual adjustment, if applicable, is determined by an appraisal. Now consider the net result of the Roth conversion:

	IRA w/out Alternative Assets	IRA w/ Alternative Assets
IRA NAV	$1,000,000	$1,000,000
Adjustment	N/A	35%
IRA FMV	$1,000,000	$650,000
Tax on conversion	$400,000	$260,000
Net advantage	---	$140,000
Effective tax rate	40%	26%

Hypothetical adjustment of 35%. Actual adjustment, if applicable, will vary. Assumes hypothetical combined state & federal income tax of 40%.

By virtue of holding the alternative asset portion of the overall portfolio in the IRA and properly valuing said assets for tax reporting purposes, Shane saved $140,000 in tax on his Roth conversion. Interestingly, this also dropped the effective tax rate on the transaction to only twenty-six percent when you compare the actual tax owed with the account NAV.

Back to the original assertion that alternative investment sponsors will cover your client's advisory fees. We already determined that Shane's annual fee for his IRA is $10,000, and we just learned that he saved $140,000 in tax by owning alternative investments in his account. Assuming no change in NAV, Shane just saved fourteen years of advisory fees in the form of tax mitigation. Put another way, you just earned fourteen years of advisory fees in one transaction by properly allocating and valuing your client's portfolio prior to a taxable event. Note that while this example used a Roth conversion as the applicable event, the same type of result occurs when using alternative assets in many other taxable transactions including estate and gift tax planning arrangements.

While the alternative investment sponsors didn't actually write a check to the RIA firm to cover the client's advisory fees, it was the design of their products that provided the ultimate tax benefit. Most firms use an asset allocation model that includes some alternative investments already. Now you know how to use them to provide even more benefit and help pay your advisory fees…in a roundabout way.