

How a Roth IRA Conversion Can Potentially Maximize After-Tax Performance for Investors

Roth IRAs can be a powerful tool for investors to accumulate tax-free earnings and distributions, benefitting both their retirement and their heirs. However, many investors do not fully understand the benefits of a Roth IRA vs. a “Traditional IRA” or how they may be able to capitalize on these benefits by converting part or all of their Traditional IRA to a Roth IRA (“Roth Conversion”) as well as how some investments may provide a unique opportunity to execute this conversion in a way that minimizes the tax implications of doing so.

OVERVIEW OF ROTH IRAS

Tax-Free Withdrawals

Unlike a Traditional IRA, where investors are able to make pre-tax contributions but pay income tax on withdrawals, contributions to Roth IRAs are made with after-tax dollars and any withdrawals are tax-free.¹ In addition, when an investor passes away, their beneficiaries will not have to pay income tax on amounts withdrawn from a Roth IRA, but they will have to pay income tax on any amounts withdrawn from a Traditional IRA. For these reasons, a Roth IRA may be attractive for investors that anticipate their effective tax rates will increase in retirement, either due to changes in the tax code or because they expect to be in a higher tax bracket at such time or expect their beneficiaries to be subject to a higher income tax rate when they inherit the assets.

Income Limitation

While investors may be enticed by the benefits a Roth IRA provides, they may believe they are unable to take advantage of a Roth because the amount that can be contributed to a Roth IRA in a given year is limited based on your income. This is where the Roth conversion comes into play.

WHAT IS A ROTH CONVERSION?

A Roth Conversion is a strategy by which investors convert their assets in a Traditional IRA to a Roth IRA. Such conversion can occur at any time and consist of all or a portion of their Traditional IRA assets. To offset the fact that the converted assets will no longer be subject to income tax when funds are withdrawn, the tax code requires investors to pay income tax on the fair value of the assets at the time they are converted. This can be particularly attractive if investors are able to strategically time their conversion and minimize the tax liability by utilizing specific strategies.

1. Exception apply. Individuals that withdraw from a non-inherited Traditional or Roth IRA prior to the age of 59.5 may be subject to a 10% penalty on the amount withdrawn.

ROTH IRA CONVERSION STRATEGIES

Because investors that convert from a Traditional to a Roth IRA incur an income tax liability based on the fair value of the assets at the time upon which they converted, the lower the value of the assets at the time of conversion, the lower the tax liability that an investor will incur. This presents a potentially powerful benefit for investors that hold certain types of investments in their Traditional IRA, particularly those that have “J-Curve” return profiles and “private” investments that are not traded on a public exchange.

J-Curve

A “J-Curve” refers to investments whose returns or valuations initially decline and then rise in the future. Private equity investments are one of the best examples of such a return pattern, as these strategies entail investing in private companies, direct real estate, or other non-public assets with the goal of developing or improving the asset to enhance its value. Since such strategies incur management, due diligence, acquisition, development and other costs immediately, their value typically declines in the initial years of investment and then rises as the asset is developed/improved. As a result, an investor could potentially perform a Roth IRA conversion when the value is less than what they originally contributed and ultimately expect to realize, thereby reducing their tax liability on the conversion and eliminating tax liability on any future appreciation of the investment.

Hypothetical Real Estate Development Fund J-Curve



The chart above is hypothetical, provided for illustrative purposes only and should not be construed as a guarantee of the actual performance of any investment. An investment in an actual real estate development fund includes multiple risks, including the risk that investor’s may lose some or all of their investment.

Additional Tax Alpha in the Roth Conversion - Discount for Lack of Control and Marketability

Under the U.S. Tax Code, fair market value is defined as “the price at which 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.” For some private market investments, this presents a potential opportunity to generate tax alpha in the context of a Roth Conversion.

Assume an investor acquires interest in a private equity fund organized as a limited partnership. Such strategies typically have an investment horizon of several years with returns that follow the J-Curve discussed above. In addition, such investments are typically illiquid and provide limited control rights to investors as decisions about the fund's investment and operations either fall under the discretion of the fund's General Partner or require approval of at least a majority of all the limited partners. Therefore, a single limited partner does not have material "control" of the partnership. In addition, there typically is not an active trading market for such limited partnerships, so an investor's ability to sell their interest for cash in a given year may be limited (i.e. limited liquidity). Therefore, a potential buyer of such interest would reasonably seek a discount to the value of the underlying assets in light of the limited control rights and liquidity of the investment.

A discount to the underlying value of an investment for lack of control and marketability is more than just a theoretical valuation exercise. Both the IRS and tax courts have specifically affirmed the acceptability of this methodology, and it has been used by taxpayers for years to determine the appropriate value for a variety of purposes, including business sales, estate planning, and other tax-related matters. In addition, the IRS explicitly discusses the appropriateness of the methodology in their Real Property Valuation Guidelines, which state that an appraiser should consider factors such as "marketability, control or lack thereof" when determining the valuation of an asset for tax purposes. Therefore, if applied appropriately, this valuation methodology may potentially reduce the tax liability for a Roth Conversion beyond the J-Curve effect.

CONCLUSION

Tax minimization, financial planning and investments are key pillars of serving investors and maximizing investment and planning outcomes. For the appropriate investor, a Roth Conversion can be a highly effective tool and, when combined with an investment that has advantageous valuation and return characteristics, the outcome can potentially be even more additive.



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