Wealth Preservation For The Affluent

A Practical Guide to Help High Income and/or High Net Worth Clients with:

Asset Protection
Income Tax Reduction
Estate Planning
Financial Planning
Business Management (cost reduction)
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Business Management (cost reduction)

By: Cindy Fields, MBA, CWPP™
Roccy DeFrancesco, Jr., JD, CWPP™
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# Wealth Preservation For The Affluent

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- Asset Protection
- Income Tax Reduction
- Estate Planning
- Financial Planning
- Business Management

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Forward

This book is dedicated to high income and/or net worth individuals who wonder if:

1) Their personal and/or business assets are properly asset protected from personal or business creditors;

2) There are viable income tax reduction plans that will allow deductions between $25,000-$250,000 per year in addition to a traditional 401(k)/profit sharing plan;

3) Their estate is set up so as to minimize, defer, or eliminate estate taxes and take care of the family in the event of death;

4) Their personal finances are invested correctly and if there are ways to mitigate investment risk/volatility and reduce or defer capital gains on investments. Additionally, if there are ways to mitigate or eliminate capital gains taxes on the sale of appreciated real estate or stocks.

5) Their businesses are run in the most financially efficient manner.

6) And how they can reach “Critical Capital Mass” (CCM).

In the following 300+ pages, you will not only read information on the general topics covered by the above six sections, you will be reading about many specific sub-topics that to the authors’ knowledge have never been printed in an educational book of any kind. Further, many of the topics covered in this book have not been heard of by your local advisors (CPAs, accountants, EAs, attorneys, financial planners, or stockbrokers) unless they have taken the Certified Wealth Preservation Planner (CWPP™) certification course (www.thewpi.org).

Why your advisors will not know many of the topics covered in this book

That is the number one question received when educating clients on the “advanced” topics covered in this book. The main reason local advisors do not know many of the topics covered in this book is lack of time to research topics that only apply to a small percentage of their client base. Do not blame local advisors for not knowing many of the topics covered in this book—blame the educational entities that do not cover many topics covered in this book (with the exception of the Wealth Preservation Institute which offers the CWPP™ program).

Whether hourly advisors (CPAs and attorneys) or commission-based advisors (financial planners, insurance agents, stockbrokers, fee based planners and, increasingly, CPAs), few of them choose to take the needed time off to simply research one advanced
topic let alone the twenty four plus topics covered in the CWPP™ program (many of which are covered in this book). Further, many of the topics in this book apply only to clients who make in excess of $150,000 a year and/or have estates in excess of $2,000,000. For the average advisor, that type of client might only make up 5% or less of their client base. With that said, it is difficult for the “average” advisor from a financial standpoint to justify the research needed to learn and know many of the topics covered in this book.

**About the authors**

Insert other authors’ bio and contact information.
Roccy DeFrancesco, JD, CWPP™ is the Founder of the Asset Protection Society, the Founder of the Wealth Preservation Institute, and the creator of the Certified Wealth Preservation Planner (CWPP™) designation (www.thewpi.org; www.apsociety.org).

Roccy received his B.S. degree from Embry Riddle Aeronautical University (where he also received his commercial pilot's license) and his J.D. from Valparaiso University School of Law. Roccy is licensed to practice law in both Indiana and Michigan and is "of counsel" for DeFrancesco Law Offices.

Roccy is the Author of The Doctor’s Wealth Preservation Guide© and Editor of a book titled: Wealth Preservation Planning: A “Team” Approach©, by The National Society of Accountants. He has also authored a number of advanced asset protection and wealth preservation articles in numerous legal, accounting, financial planning, banking, and other professional journals.

What lies ahead?

This book will teach you in plain English many topics that are close to your heart. You will learn why anyone with any amount of wealth needs an asset protection plan and how to get it accomplished. You will learn how to reduce your income taxes by sometimes over a hundred thousand dollars a year. You will learn if your estate plan is in order and, if not, exactly how to fix that in order to accomplish your long-term goals. You will learn the various options available to you when trying to have the most aggressive post-tax investments while, at the same time, protecting those investments from downside risk and avoiding partially or completely the capital gains and, eventually, the estate taxes on that money. And, lastly, you will learn many practical tips for how to save time and money while running a business.

Your goal by reading this book should be to reach Critical Capital Mass (CCM). What is CCM and how to achieve it is covered starting on page xii.

After you read this book, you will be absolutely shocked by the fact that you will now know as much as or more about the basics of many of the topics than several of your closest advisors. On the topics you do not know more than your local advisors, you will know enough to ask the advisors why they have not brought some of the topics to your attention and then be able to converse with them on a technical level so you do not have to take their advice without any real knowledge on the topics.

After reading this book, you will no longer be able to have the wool pulled over your eyes by a scam artist looking to have you invest money in plans that seem legal on their face but, in reality, are going to cause you significant grief with the IRS or when you find out that your money in whatever plan was not really asset protected.
Help from the authors

On many of the topics in this book, there might not be an advisor within 300 miles who will have even heard of the topic, let alone know enough about the topic to give you advice. The exception, of course, are the authors of this book.

Any person who reads this book has the ability to contact one of the authors for help. In the back of the book, you will find a five-page questionnaire you can fill out and fax or send in e-mail format to the one of the authors. Within a few minutes of reviewing your questionnaire, a summary can be created to let you know the areas of need in your asset protection, financial, and estate plan and how to fix them.

Please turn to page ix of the book for the author’s contact information.

Enjoy the book; and if you take nothing else from it, take away enough motivation (if you need it) so that you become proactive when trying to protect your assets, save on income, estate, and capital gains taxes, and when trying to save money while running your business.
Critical Capital Mass (CCM)

The term Critical Capital Mass (hereinafter CCM) will mean different things to different people.

To a school teacher, it might mean that he/she has enough money to pay all the bills and live a life in a financially comfortable manner (i.e., living paycheck to paycheck).

To a young professional (38-years old or younger), CCM might mean that all the student loans are paid off; and now the professional and spouse can finally buy that big house and car they always wanted.

To an older small business owner over the age of 50, CCM might mean that the family has no debt; and the client has enough money to put the children through college and, eventually, will have enough money to retire.

The following is the definition of CCM for purposes of this book and should be your definition for while reading this book and beyond.

A client reaches CCM when:

He/she has accumulated enough money/assets to retire and live in a financially comfortable manner for life.

It sounds simple, but most clients do not reach CCM until far later in life than they originally planned.

When do you want to retire?

The answers vary from clients depending on their profession and annual income. Most readers of this book will be in a higher income tax bracket and/or have already accumulated a sizable amount of assets. As a rule of thumb for small-to-medium size business owners, most 35-year-olds want to retire when they are 50. Most 45-50-year-olds want to retire when they are 60, and most 60-65-year-olds want to keep working for as long as they can (because they simply enjoy the business).

We are poking fun at the answers we get from clients when we ask them that question; but for the most part, business owners over the age of 60 like to work but do not want to be forced to work because of financial considerations.

That’s the real rub of the situation. Most clients want to have the financial means to retire at 55-60 years old even though most will continue to work because of the personal satisfaction from the work.
How much money do you need to reach CCM?

The answer will depend on a number of factors. Some of those factors are:

- Are you married (and, if so, does your spouse work)?
- Have you been through a divorce or do you plan on going through one in the future (‘trading up’ which we do not recommend)?
- Do you have children?
- Do you have grandchildren?
- Do you or will you live a lavish lifestyle (an expensive lifestyle)?
- Do you want to pass wealth to your children or grandchildren when you die?
- Do you want to give to charity?

Every client will be different based on certain goals of passing wealth to heirs or charity and based on how lavish a client wants to live in retirement. Our place is not to judge the client on the how they want to live but simply to show them how to reach CCM in the shortest time frames while doing so in a manner that has as little investment risk as possible.

Again, depending on when a client wants to have the opportunity to retire, the amount of money needed will vary. The younger you want to retire, the more money you need to accumulate.

How can you reach CCM?

In our opinion, there are only two ways to reach CCM. Those ways are through:

1) Good Luck, or
2) Good Planning

We believe you can break down Categories 1 and 2 into sub-categories of trying to reach CCM in a:

A) Non-Tax Favorable Manner; or
B) Tax Favorable Manner

How do most clients try to reach CCM?

The short answer is through 1A above. See if our characterization of a typical 40-year-old client sounds familiar (and we are working under the very big assumption that Dr. Smith in our example is not an old school spender and is truly interested in trying to reach CCM).
Dr. Smith, who makes $400,000 a year, has a stockbroker at Merrill Lynch whom he tries to give $30,000 a year to in an effort to build a large stock portfolio for retirement. Dr. Smith also has an online trading account where he day trades stocks (usually tech stocks or pharmaceutical stocks off of tips from the local drug reps) in an effort to beat the market and get rich quick. Dr. Smith has no other investments except his brokerage account, his online account, and his new five-bedroom, 5,000-square foot house.

Dr. Smith in the above summary is the classic physician investor. It would be typical if the stock broker never beat the indexes like the S&P 500. Even though the broker does a marginal job for Dr. Smith, he/she manages to make a nice living when buying all the new “hot” stocks and selling the out-of-favor stocks (churning the client). All along the way, Dr. Smith paid capital gains taxes and dividend taxes on the money invested with his broker, thereby, cutting down his effective rate of return each year.

Dr. Smith, when day trading technology stocks, always seems to do well in an up market but can never seem to “take profits” and, therefore, in the long run usually does much worse than the stock market indexes. Again, Dr. Smith, when day trading, incurs a significant amount of short-term capital gains, thereby, reducing his effective annual rate of return on his investments.

**Investing**

Most clients think the only way to create a sizable nest egg for retirement is to max out their 401(k)/profit sharing plans and take the rest of their money home after tax and invest it. While there is not necessarily anything wrong with that type of thinking, the client would have several advantages if he/she could figure out a way to get more money invested in a tax-favorable manner.

Let’s look at an example of post-tax investing vs. pre-tax investing. Assume our Dr. Smith, who is age 45, invested $60,000 in a brokerage account post-tax or invested $100,000 pre-tax and let the money grow until age 61 before Dr. Smith accesses the money for retirement purposes.

Which way would Dr. Smith be better off? Obviously, the answer is by investing $100,000 pre-tax (even if we assume Dr. Smith was still in the 40% tax bracket when he retired). Here are the numbers assuming an 8% pre-tax rate of return on the $100,000 investment and the typical blended capital gains and dividend tax rate on Dr. Smith’s post-tax investment account ($60,000) earning 8% gross each year.
Amount invested | Account value at age 61
--- | ---
$100,000 (8% in tax favorable environment) | $370,000
$60,000 (growth taxed with blended tax rate) | $151,000

Remember, the $370,000 has not been taxed yet; and so IF Dr. Smith took money out of a tax-favorable account and paid a lump sum tax, he would have $222,000 left (which is $71,000 more than the post-tax brokerage account or an improvement of 47%).

The above example is not a real-world example because there is no way to put $100,000 away tax deferred without “other costs”—other costs typically being contributions to a “qualified” plan for employees.

You will read about “income tax reduction” plans in this book that will allow you to defer $100,000 with only a 5% fee as well as plans that are more tax favorable than the $100,000 example outlined above. This portion of the book is simply meant to get you in the right frame of mind and, most importantly, to have you thinking of how you will get to CCM with the tools discussed in this book.

**Principal protection**

Getting to CCM is much easier if clients with their pre- or post-tax investing never have to worry about the down years of the stock market. How many clients who did not protect their investments lost millions of dollars when the stock market tanked between 2000-2002? If those clients would have protected their investments, they would be much closer to CCM than those who did not.

Many of the topics in this book revolve around implementing investment strategies (pre- or post-tax) that protect investments from downside growth but still allow an investor to partake in the upward movements of the market. Whenever an investor hedges the downside of the market, there is a cost (which varies depending on the product).

Because many of the topics in this book show clients how to put money aside in a tax-favorable manner, there is no need to “roll the dice” in an effort to get higher returns. Because more money is invested, receiving returns of 5-8% works very well when building a conservative model in an effort to help a client reach CCM.

**Asset protection**

A higher income/higher net worth client cannot reach CCM unless he/she is completely asset protected. Can you imagine how depressing it would be if a client with wealth (who was not asset protected) had saved for 10-20 years to reach CCM suddenly got hit with a $5,000,000 lawsuit that ended up wiping out several million dollars of the client’s personal wealth?
We spend nearly 75 pages of this book explaining to the readers how to asset protect themselves. While saving money on income taxes and reaching CCM might seem like the most important goals to set after reading this book, we submit to you that reaching CCM without being asset protected only gets you half way towards reaching CCM. Without a proper asset protection plan, the chances of you reaching CCM are reduced significantly.

**Tools used to reach CCM**

There are many tools that you can use to reach CCM. Some of the tools at the top of our list are the 1% CFA mortgage and equity harvesting (see page 255), ABC Plan (see page 187), a 401(k)/Profit Sharing Plan (see page 176), a 412(i) Defined Benefit Plan (see page 193), Section 79 Plan (see page 208), Leveraged Bonus Plan (see page 185) a Freeze Partnerships (see page 160), the Maximizer (see 248), and post-tax investment accounts (see page 259).

We suggest as you read through this book that you mentally think about how to reach CCM and what tools, as you read about them, make the most sense in your particular situation.

**Flexibility in planning**

Of the tools listed in the previous paragraph, some are flexible and some are not. Our opinion as CWPPs™ is that, the more flexible the plan, the better. The best wealth-building plan would be one that is tax favorable and one that can be varied at the end of each corporate year.

When implementing a plan, it would be ideal for a client to be able to identify “surplus” money that is not needed for the client and his family to live on. Figuring out how much surplus you have at the end of each year can be accomplished by using a simple flow chart (See page 345).

The following chart is for Dr. Smith, age 40, who makes $325,000 gross as his income from the medical practice. Dr. Smith has a spouse and two children.

The following are “personal” business expenses that Dr. Smith subtracts from his earnings which leave him with his “gross” income of $325,000 at the end of the year.
Critical Capital Mass

<table>
<thead>
<tr>
<th>Expense</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto lease</td>
<td>$7,000</td>
</tr>
<tr>
<td>Health insurance</td>
<td>$8,500</td>
</tr>
<tr>
<td>Other expenses (food, cell phone, misc.)</td>
<td>$6,000</td>
</tr>
<tr>
<td>Continuing Education (including travel expenses)</td>
<td>$3,500</td>
</tr>
<tr>
<td>401(k)/profit sharing</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

**Total Costs:** $65,000

The following are Dr. Smith’s after-tax (except the mortgage expense) expenses from his household.

<table>
<thead>
<tr>
<th>Expenses</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home mortgage (including property taxes and insurance)</td>
<td>$25,000</td>
</tr>
<tr>
<td>College savings plan for children</td>
<td>$5,000</td>
</tr>
<tr>
<td>Automobile payment</td>
<td>$6,000</td>
</tr>
<tr>
<td>Trips/Vacations (entertainment)</td>
<td>$5,000</td>
</tr>
<tr>
<td>Household spending (food, clothing, cable, etc…)</td>
<td>$25,000</td>
</tr>
<tr>
<td>Student loans (for the younger physicians)</td>
<td>$0</td>
</tr>
<tr>
<td>Utilities</td>
<td>$3,500</td>
</tr>
<tr>
<td>Charitable gifts</td>
<td>$5,000</td>
</tr>
<tr>
<td>Other investing (brokerage account)</td>
<td>$50,000</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

**Total Costs:** $129,500

Dr. Smith’s take-home pay ($325,000 x .6) if he was in the 40% tax bracket: $195,000

If Dr. Smith takes $195,000 and subtracts $129,500, he has $65,500 left (which is Dr. Smith’s post-tax “surplus”). Because the $65,500 is an after-tax number, we need to calculate how much pre-tax “surplus” Dr. Smith could use to obtain his goal of CCM. $65,500/.6 = $109,166.

**Total pre-tax “surplus” for Dr. Smith is:** $109,166

If you are making $325,000 as a gross income with a wife and two children and you are looking at the above chart and saying to yourself that you do not have $65,500 left at the end of the year, that’s because you spend more than the Dr. Smith example above. Dr. Smith is a fairly standard physician making and spending what most physicians would in his position. Dr. Smith wants to reach CCM by the time he reaches 55 years old and, therefore, he is not spending lavishly like many physicians. On the
other hand, Dr. Smith right now is not really trying to cut back his expenses so he can reach CCM quicker than he would otherwise.

You can create your own “surplus” calculation; and if you would like a blank chart to use, please e-mail one of the authors who will forward one to you.

If you look at the chart closely, you will notice that Dr. Smith only put $50,000 a year into a brokerage account. Many clients who are 40 years old have a $750,000 house, and much of the “surplus” is used to pay down the debt on the house. While this is not a bad thing, the better alternative would be to use the surplus in a tax-favorable manner and instead pay down the mortgage (your only major tax deduction on your personal tax return) over a 30-40-year period.

What could Dr. Smith do with his “surplus?” Dr. Smith has many options. Which option(s) will work best for him will depend on the size of his practice, when he wants to reach CCM, and how “locked” in he wants to be when funding a tax-favorable funding vehicle. Some of the best income tax reduction/wealth building solutions are not the most flexible. All the pre-tax tax reduction plans are covered in Section 3 of the book (starting on page 176).

What happens when you reach CCM?

That is a good question to ask and a good problem to have. The simple answer is that once you reach CCM you can do whatever you want (within reason) with your finances and not have to worry about running out of money in retirement. If you want to retire immediately, you can. If you want to continue to work for 1-2-5-10 more years, you can. If you want to work 1-3 days a week (which many clients will opt for), you can.

Once you reach CCM, it is very important that you have the proper investment mix so you do not end up being forced back to work in the event of a stock market crash (talk to your older friends who did not do this prior to 2000).

Typically what happens when you reach CCM is that you shift modes to seriously look at your estate plan (if you haven’t already) so as to minimize estate taxes and maximize wealth transfer (if that is one of your goals).

Charitable giving

Some clients are charitably inclined; and so a few years before retiring, they should start seriously looking at how they want to set up a charitable giving program. More clients would be charitably inclined if they knew of the concept of Simplified Planned Giving (SPG). SPG is client focused not charity focused and can be very beneficial to clients by creating tax deductions now and a guaranteed stream of income in the future (retirement).
Clients who give to charity typically want their children and, potentially grandchildren, involved (in an effort to make sure their heirs have a sense of giving themselves). We discuss very specifically a unique way to use charitable giving in a manner to maximize the tax savings (both income and estate taxes) while setting up a scenario where a client’s heirs can help direct how the gifted money is used. (You can read about charitable giving on page 202)

**Again, how do you reach Critical Capital Mass?**

The first step to CCM is to understand the tools available to get there, and you have already taken the first step by purchasing this book.

And so without further ado, enjoy the book; and when you are done reading it, you will be ready to sit down with a qualified advisor (hopefully a CWPP™) to map out your road to **Critical Capital Mass**.
Chapter One
Asset Protection

Introduction

The number one concern facing clients with wealth these days is what to do about runaway out of control personal injury attorneys who seem to be suing anyone and everyone they can. While personal injury lawsuits are a problem for anyone with wealth, they are especially a problem for “professionals.” A professional as used in this book is limited to physicians, attorneys, CPAs/accountants, insurance agents, financial planners, stockbrokers, mortgage brokers, architects and engineers.

Professionals have unique asset protection problems due to the fact that they cannot hide behind a “corporation” to limit their personal liability for work done for clients or on patients. Therefore, even if a professional is working on behalf of a corporation, the professional can be sued personally, thereby, setting up a scenario where all of a professional’s personal assets are subject to the plaintiff/creditor. This concept is explained in more detail on pages 59 where we discuss the difference between an “inside” creditor and an “outside” creditor.

Physicians by far have things the toughest due to the high chance (nearly 100% for a surgeon) that a physician will be sued personally sometime during their career. In fact, in many states, medical malpractice insurance is becoming so expensive that physicians are being forced to lower their coverages from $1,000,000 down to as little as $100,000 (and in some states physicians are going without any malpractice coverage). Alternatively, many insurance companies are dropping physicians from their policies due to poor claims’ experience; and those physicians sometimes are forced to go bare (without insurance) because they cannot find any insurance company (even in the secondary market) to insure them.

The asset protection part of this book will give you a practical guide as to why you (if you have any amount of wealth) need asset protection, what are the best (and most economical ways) to become asset protected, and what your future risks from lawsuits are after you become asset protected.

It is important to note that co-author Roccy DeFrancesco, JD, CWPP™ practiced law and for a period of time specialized in suing physicians for medical malpractice. His background on the “other side of the fence” is very helpful when giving advice to clients who are trying to protect themselves from their local personal injury attorney.
Section 1
Why Should “Professionals” Protect Their Assets?

When we lecture around the country on the issue of asset protection and when the PowerPoint slide comes on the screen that asks professionals (specifically physicians) why they need asset protection, we typically receive several good chuckles or laughs from the audience. We suppose the reason is that asking certain professionals (physicians) why they need asset protection seems like a silly question. If the question is, “Should a physician get asset protected?” most physicians see the question as more of a rhetorical question than a normal question looking for a response. While many other professionals do not see the question as a rhetorical one, they should since a lawsuit against any professional will put their personal and business assets at risk.

Since it would be awkward to continue to list all the professionals in the following material, it has been written to discuss the liability of physicians. As stated earlier, any professional has “personal” liability; and since physicians are sued the most, it makes sense to use a physician as the example for all professionals.

If you are not a “professional” (physician, attorney, CPA/accountant, architect, insurance agent, stockbroker, mortgage broker, or financial planner), you can skip to page 25 of the book where we discuss the liability issues for non-professionals.

The odds are against physicians

Depending on what publication you read, you will hear statistics like one out of every four physicians will be sued this year or six out of ten physicians have been sued at least once during their careers. Statistics can be misleading; but in layman’s terms, what all the statistics show is that physicians get sued a lot.

We like to break things down to what is realistic for physicians to worry about. If you are a surgeon of any kind, anesthesiologist or radiologist, the likelihood of you being sued sometime in your career is almost 100%. Why do we say that? Because with surgery, there is rarely a perfect outcome, thereby always leaving the door open to a potential lawsuit (even if it is frivolous from a technical standpoint). With a surgeon doing hundreds of surgeries a year and having a career that lasts several decades, the law of averages is going to catch up with him/her; and a lawsuit will ultimately happen.

Frivolous lawsuits

Larry Smarr of the Physician Insurers Association of America testified in Congress at hearings on medical malpractice caps (in January of 2003) and had the following to say:
Over 70% of all claims made against physicians are without merit. When the doctor goes to trial, the doctor wins 80% of the time; but our studies show that 50% of all the money available to pay claims goes to fund the attorneys’ lottery system.

Attorneys, co-author excluded, of course, know how to use the legal system to their benefit and that of their clients. Most personal injury attorneys know that, if a case can get past summary disposition (where it is determined by the court if there is a material issue of fact that needs to be decided by a court or jury and, therefore, a case has merit and needs to go to trial), there is a good chance the insurance company representing the physician will settle the case at some point. The settlement might not be for a huge amount, but the fact that a settlement is available in many cases that are not dismissed gives attorneys incentive to seek out and file medical malpractice cases against physicians.

Non-specialized attorneys

For the most part, the general public does not think too highly of attorneys. Our saying is that no one likes an attorney until you need one (and then you still wish you could avoid calling the attorney). While most people do not like attorneys, most do believe attorneys, in general, are smart people due to the three extra years of schooling and having to take a two-day bar exam to practice law.

The fact of the matter is that there are attorneys who are very smart, and there are attorneys who are not only less than smart but would be considered terrible attorneys by their peers. The vast majority of medical malpractice lawsuits filed that are what a physician would consider a “frivolous” claim are filed by an attorney who has no business taking a medical malpractice lawsuit in the first place.

Good personal injury attorneys who specialize in medical malpractice cases are interested in taking cases where the physician screwed up and where there are significant damages. If those qualified attorneys were the only attorneys taking cases, the number of filed medical malpractice cases would decrease by a significant amount.

How can an attorney file a medical malpractice case which is on a subject they know nothing about?

It is simple—if you have a client and a law license, you can file a lawsuit. The following is a simple example of a typical medical malpractice case that should not have been filed.

Client walks into the office of an attorney after seeing an ad in the yellow pages stating that the attorney does wills, trusts, real estate transactions, and personal injury claims. The client tells the attorney that he went to the doctor to get a knee looked at and, to make a long story short, the doctor
did surgery, screwed up the knee, and knew the client could not walk right for the rest of his life.

The attorney sees a several-hundred-thousand-dollar settlement after listening to the 20-minute story of the client and then has the client sign a contingent fee contract stating that, in the event of a recovery, the attorney gets to keep 33% of the recovery. (By the way, attorneys in general might not be that bright but they can all divide by 3).

The attorney does minimal due diligence on the case and finds a professional physician to say that the treating physician breached the standard of care and then files a lawsuit suing the physician, his office, and the hospital or surgery center where the surgery was performed.

As it turns out, the physician did nothing wrong; and after the insurance company spent $35,000 defending the claim, the case settled out of court with NO payment to the patient and was dismissed with prejudice.

How could the above scenario happen in any society that has some legal sanity?

Like it or not, the American system of law allows just about anyone to file a lawsuit against anyone else with only minimal good faith needed that a plaintiff had been harmed or wronged by a defendant. This is different than the British legal system that makes the loser of lawsuits pay the costs of the prevailing party. The theory behind the difference in the American justice system and the British is fairly simple—in America, we did not want to create a barrier to filing suit by the indigent. If the losers of all lawsuits had to pay the costs of the prevailing party, poor people who had meritorious claims would rarely file suit for fear that a loss of the lawsuit would push them into the poor house or into bankruptcy.

Again, how could the prior scenario happen even under the American legal system?

We call it the lottery syndrome. The local, unseasoned attorney (as far as medical malpractice claims are concerned) who usually sticks with real estate and divorce matters sees that medical malpractice client as his/her way to Easy Street. That non-personal injury attorney believes that, once in their legal career, a “home run” medical malpractice case is going to walk in their door; and when that day happens, the case is going to allow them to retire ten years earlier than normal.

The problem is that most of the medical malpractice cases filed by an attorney not used to doing medical malpractice cases should never have been filed in the first place. That is little consolation to a physician who has five frivolous claims and is now being dropped by his/her medical malpractice insurance carrier, not for high payouts, but for high volume of claims.
The big screw up

While in prior pages we illustrated why claims are filed, most of the time medical malpractice cases settle or come back with a jury verdict where nothing is paid to a patient/plaintiff. If that were the case, then why would a good physician need asset protection?—to avoid having personal assets taken by the patient who was injured because of a mistake when treating or operating on the patient.

According to a survey by Jury Verdict Research in 1994, the median award for compensatory damages in medical malpractice lawsuits was $362,500. By the year 2000, it was $1 million (and that number is only going up).

As we all know, if you screw up in a malpractice case, usually you screw up big and, therefore, that once-in-a-lifetime screw up could be a $5,000,000 verdict. That means a good portion of the verdicts were in excess of $1,000,000.

(As a side note, a malpractice screw up that causes patients to be crippled for life is usually much worse than actually killing a patient. The jury verdict for a patient who was turned into a quadriplegic is going to be many times larger than the jury verdict for a screw up that caused the death of a patient).

If a physician gets the $5,000,000 verdict against him/her and only has $1,000,000 worth of coverage, that is when there is a great need for asset protection.

Deep pockets

Physicians are good targets in general to sue because they are perceived to have “deep pockets” (lots of money). Personal injury attorneys almost always sue everyone they can get their hands on in a lawsuit and, most certainly, the defendant with the deepest pockets (even if liability might not flow to the deep pocket).

You have probably heard of cases where the physician who everyone thought committed malpractice did not have insurance and the hospital which no one really thought did anything wrong ended up getting sued and paying the malpractice claims of the patient. Why is that? Deep pockets and sympathetic judges and juries. Understand that local judges are elected officials who have it in their best interest to keep their constituents happy. Letting a patient who has a terrible injury go uncompensated because a physician did not have insurance does not sit well with the public; and because a hospital might be 1% liable, that hospital, because it had money and insurance, ended up getting stuck with the several-hundred-thousand-dollar verdict.
Why Any Client With Wealth Needs to be Asset Protected

Other claims besides medical malpractice

As stated earlier, all “professionals” have personal liability and, therefore, can be sued individually for acting in their course of employment (which puts all of a professional’s personal assets at risk).

What if you are not a “professional” with personal liability? Should you be worried about being sued by your local personal injury attorney? The answer is absolutely yes, and the following several pages will discuss just a few of the traditional negligence lawsuits that anyone with wealth (professionals and non-professionals) needs to worry about.

Homeowner Liability

Most people with wealth who have asset protection worries own their own home. Homes cause unique liability problems that many clients are not aware of; and if they were, those clients would implement an asset protection plan.

Example:

1) As a homeowner, you typically will throw a few parties each year for your friends. If you serve alcohol at those parties and one of your guests leaves the party after drinking too much and gets into a car accident and kills the three passengers (or worse turns them into quadriplegics), guess who is going to get sued for negligence? The homeowner. Most people think that an umbrella liability policy of 1 million dollars will protect them; but, if you can be linked to a death or serious injury via negligence, your 1-million-dollar umbrella is not going to go very far. After your insurance pays 1 million of the 3–million-dollar verdict, the attorney for the plaintiff is going to go after all your personal assets.

2) While most homeowners think their property is in good repair, many times it is not. How many homeowners have repairs that have been put off for years? Many. If you have guests over to your home, you have a “duty” to keep the premises in “good repair.” This duty is heightened if you run a business out of your home. If you have a faulty handrail or other defects that could cause harm to a visitor, you have personal liability that is real and could put all of your assets at risk from a negligence suit.
The following is a classic example that we tell when doing asset protection seminars. The example always brings a smile to the audience because they can all relate, but the liability is real and one that needs to be protected against.

**Example:**

If you have teenage children, chances are at some point you will go out of town and your children who you left home (the 15-17 year olds) will have a party or have friends over. Imagine telling your teenage child on Friday morning that you are going out Friday evening to go see an out-of-town football game or play and that you won’t be back until sometime after midnight.

What happens Friday afternoon at school? Your child passes around a note to all his friends (which gets passed around to many non-friends) that the party this Friday is at your house because you are going to be out of town. The note also says that the party is not “BYOB” because you have plenty of alcohol in the house for the teenagers to drink.

Friday comes and at 5:00 pm you leave. Who is walking in the back door? 50 teenagers looking to drink your alcohol and have a good time. What happens when midnight rolls around and everyone is told that the parents will be home shortly? The now severely drunk teenagers pile into their cars to drive home.

What happens next? The four teenagers get into a car and then drive down the road and hit a tree. What kind of injuries do they sustain? The typical response is that they die. That’s not what happens. Assume they all become quadriplegics.

Let’s change the story. Assume the same fact pattern but now assume that the drunk driving teenager with three passengers did not hit a tree but instead hit the local cardiologist who was driving home from a late dinner. Assume the cardiologist makes $1,000,000 a year and now cannot practice medicine for the next 30 years due to his/her injuries.

The first question you need to ask yourself is who is liable? The teenage driver? Sure. But that driver and his parents are poor and have no auto insurance. What about the homeowner where the party was held and who’s alcohol was consumed? Absolutely. The homeowner is going to be sued, and the personal injury attorney is going to go after everything the homeowners own including their personal residence.

If you think you did good asset protection by purchasing a $1,000,000 umbrella liability policy on your home, how helpful do you think that will be when you are sued for $10,000,000 plus in the above examples?
Boats, Automobiles, Snowmobiles, Planes (other toys)

If you own a boat (or waverunner), an automobile, snowmobile, plane, or other toy (fourrunner) then you have the normal liability problems that go along with negligent driving of each.

Examples:

1) Drunk Driving

While we all know it is not right to drink and drive, many people do it. This should ring true for many people with wealth who like to go to dinner and have a bottle of wine. With blood alcohol requirements going down each year, it does not take much be seen in the eyes of the law as legally drunk.

Clients with wealth need to not stick their heads in the sand and have the “it won’t happen to me” syndrome when thinking about all these examples. If you drink and drive and have an accident, you will more than likely be sued personally and your assets will all be at risk.

If you simply drive negligently and cause harm to another, you will more than likely be sued and your assets will be at risk. This is not an issue for someone who lives in a $75,000 home or rents and has a net worth of $0-$50,000. Negligent actions are a problem for clients with wealth; and if you have purchased this book, we as authors assume you have some amount of wealth you would like to protect.

2) Teenage Driver

If a family member dependent is driving in a negligent manner and causes harm to another person, the owner and driver of the boat, automobile, waverunner, snowmobile, etc., is more than likely going to get sued with the same damage potential and shortfall of insurance problems illustrated in the previous examples.

Co-author Roccy DeFrancesco, JD, CWPP™ had a very wealthy family friend who had a teenage child, a snowmobile, vacant property, and a big problem. The problem came from the fact that the child took a friend out for a ride on the snowmobile, hit a tree, and killed the friend. The parent had the typical $1,000,000 commercial liability coverage, but the lawsuit was for multi-millions. The parent ultimately had to dip into his own pocket and pay an additional $2,000,000 to settle the lawsuit and keep it from going to trial (where a jury verdict could have been much higher).
Vacation Rentals

It seems to be in vogue today to diversify one’s portfolio into real estate. When the stock market goes flat, investors look to real estate (many times rental property) as a way to spread out their investments.

Vacation rentals are nice to have, but they create a significant liability problem for the owners. As indicated above, when property is commercial in nature (running a business out a building or owning a rental property), there is an increased duty of the property owner to keep the property in good repair.

Depending on which part of the country you live in, you will have different problems. If you live in the northern part of the country, you may have the duty to make sure the property is in good repair when it comes to snow or ice removal (which creates the typical slip-and-fall personal injury case). If you live in California and your rental has gone through an earthquake, the stability of the home might be an issue which could cause several defective conditions that could cause renters injury.

Most clients own their rentals in their own name; and if there is an injury to a tenant or someone visiting a tenant, the lawsuit will be against the client personally which will put all of the client’s personal assets at risk.

Summary of Examples

The above examples should put all readers on notice that the treatment of a lawsuit is very real in this increasingly litigious society. You can take the attitude that it won’t happen to you (stick you head in the sand), or you can choose to implement the asset protection strategies discussed in the upcoming material.

Why isn’t normal negligence a problem for everyone and not just “professionals”?

It is, except most of the “normal” public does not have the wealth necessary to satisfy a million-dollar jury verdict. Many indigent people who can barely afford to buy an automobile will not be able to afford insurance. They are not worried about the million-dollar verdict because they have nothing to lose. Many professionals on the other hand, sometimes have millions of dollars in assets to protect.

Anyone can be sued for negligence, but only those clients with assets have to worry about asset protection.

A quick note on why insurance to cover negligence is not always adequate.

Underinsured – As discussed above, you could get a jury verdict for negligence that is above your insurance coverage (typically the $1,000,000 umbrella).
**Asset Protection**

**Exclusions** – You could be sued for something that is not covered by your insurance policy. A good example is intentional torts where you were found to do something intentional, and many insurance carriers will not cover you for intentional torts. The other example is a criminal act. Most insurance carriers will not cover you for acts that are deemed to be criminal in nature.

**Insurance company goes bankrupt** – As medical malpractice insurance companies struggle to stay profitable, you could be one of the unfortunate few who gets insured with a company that goes out of business. If you are a physicians you are probably aware of PIC out of Ohio which went bankrupt and more recently with PHICO. What happens if you are with an insurance company that goes out of business? The company usually pays out its money pro-rata to settle all claims, and any shortfall is left to the client and possibly state insurance pools that are there to protect clients for just such an occasion.

**Divorce Protection**

Besides protecting your assets from typical creditors, you might want to protect them in the event of a divorce as well. We will discuss this topic in the estate planning section of the book on page 146.

**Long Term Care Insurance**

Besides death, the one thing clients need to protect themselves against most is the need for long term care expenses. This is a huge topic right now as more and more people are going into assisted living centers, and yet it is the one topic that most clients just refuse to pay for and plan for. You can read much more about long term care insurance on page 150 in the estate planning section of this book.

**Estate Taxes**

You might not normally think of avoiding estate taxes as asset protection; but when saving your heirs sometimes millions of dollars in estate taxes, you are asset protecting your wealth from the government. You can read about Family Limited Partnerships (or Family Limited Liability Companies (FLLCs)) on page 154 in the estate planning section of the book to learn about one tool that will help you lower your taxable estate.

**What Assets Should You Protect?**

Most of the time, when a client puts down ALL of their assets on a piece of paper, they are surprised at how much needs to be protected. If you own any of the following, you are a good candidate for asset protection:
Family Home or Condominium
Rental Property
Non-Rental Property
IRA
Stocks or Mutual Funds
Life Insurance
Bank Account or CD’s
Planes, Boats, Automobiles, Waverunners or Motorcycles
Other business entity (especially S or C-Corp stock)
Any other collectible items that have value

*Accounts Receivables (at the medical, law, or accounting practice)*

Future Inheritance for Family

*Most medical, law, or accounting practices are worth very little to a personal injury attorney trying to satisfy a judgment for malpractice. Most of the value in a practice is in the good will, which comes from the professionals who work there. Typically, the ONLY major asset of a professional practice that is not protected that has any worth at all is the office’s accounts receivables (A/R).*

For a medical, law, or accounting practice to be completely asset protected, the A/R in the practice should be protected. For a discussion about how to protect an office’s A/R, please turn to page 92 of this book where you can read about A/R leveraging.

**Conclusion of Introduction to Asset Protection**

For many professionals, there are very few things in life that are more important than protecting assets. Most professionals work hard and long hours to accumulate wealth; and with one malpractice claim or general negligence claim, the majority of a professional’s wealth can be taken from him/her by a creditor.

While most non-professionals do not typically think asset protection is a major problem, it is for anyone with wealth (as was illustrated by the earlier examples). Hopefully, this book will be an eye opener for those non-professional readers with wealth and will motivate them to be proactive when thinking about protecting their wealth.

A good asset protection plan can be implemented for between $2,500-$10,000 and to do so would be some of the best-spent money a client can spend. Asset protection protects the client’s family wealth and can give the client peace of mind when living what is an otherwise stressful and hectic life.

We suggest that, if you take nothing else from this book, you seriously consider whether you are currently asset protected; and if you are not, we hope you take action to become asset protected as soon as possible.
Section 2
Asset Protection Planning

Introduction

Asset protection, in general, is about putting up barriers in front of creditors to make it difficult or impossible for them to get your personal and business assets. Asset protection is NOT about hiding or concealing assets or about committing fraud to conceal assets from creditors. Good asset protection discourages lawsuits to the point where a client can bluntly state to a personal injury attorney that he/she has millions of dollars in legally “protected” assets; and, if sued, the attorney will not be able to reach any of those assets.

Several clients when we start talking about asset protection expect that we are going to tell them how to move their assets offshore so no one knows about those assets (including the U.S. government). Concealing assets is fraud and illegal, and attorneys who advocate plans where you hide assets are not helping their clients and instead are subjecting them to further litigation in a fraudulent concealment proceeding.

Good Asset Protection Can Help Prevent Lawsuits

The more personal assets of a client that are not asset protected, the more likely a personal injury attorney can satisfy a judgment; and, therefore, the personal injury attorney is more willing to go after a client who is not asset protected than one who is.

Imagine the following two scenarios:

1) A cardiologist screws up in the operating room, thereby causing a substantial injury to a patient. The cardiologist’s bedside manner is not very good; and when the patient runs into a personal injury attorney, the attorney talks the patient into signing up with him/her to look into a potential medical malpractice claim.

   The attorney files the needed paperwork to start the discovery process and finds after minimal discovery that the cardiologist has $1,000,000/$3,000,000 in malpractice coverage and several million dollars in personal assets, which include a brokerage account of $1,000,000 and real estate personally owned worth $2,000,000.

   After some time, the patient, due to the negligence of the cardiologist, has several more surgeries to correct the problem; and now the patient is totally disabled for life and has $1,000,000 worth of medical bills.
After discovery revealed the assets of the physician, the personal injury attorney files suit and asks for $5,000,000.

2) Same scenario with the damages of scenario number one except this time, when the personal injury attorney does his discovery, he/she finds out that, while the physician has $3,000,000 of personal assets, those assets are fully asset protected and are not going to be assets available in a malpractice suit.

Because the medical bills are $1,000,000 and the malpractice coverage limits for the cardiologist are $1,000,000 per claim, the personal injury attorney decided not to spend the $85,000 + in expenses it would take to get the case to trial and tells the patient/client that, while it is clear malpractice took place, the case is not financially viable; and, therefore, the attorney could not take the case.

The only difference in the two scenarios above is that the physician’s $3,000,000 personal assets were totally asset protected from lawsuits.

Asset Protection Cannot Guarantee You Will Be Lawsuit Free

While the previous scenarios seem to indicate that good asset protection will prevent lawsuits; that is not the case. Good asset protection will discourage lawsuits, but any attorney (or any client acting without an attorney) can sue whether you are technically asset protected or not.

The goal with asset protection is to protect your assets before a lawsuit and keep the assets after the lawsuit is over. In the coming pages, you will learn the tools for how to asset protect yourself so, after a lawsuit is over and the collection process is through, the assets you started with on a personal level are still owned by you.

Legal Asset Protection

Correctly set up, asset protection plans are ones that use existing laws and are 100% legal in the eyes of the U.S. government (and foreign governments if offshore planning is needed). It might sound obvious to the reader that an asset protection plan needs to be legal; but as you will find if you search the country for information on asset protection planning, some of the solutions are what we would call a bit edgy or based not in law but in the absence of law.

Unlike a lot of issues dealt with in estate planning, investment planning, and income tax reduction planning, proper asset protection is a fairly black and white legal issue. There are certain ways to put an asset protection plan together; and when an
advisor is recommending something you cannot look up (or your local attorney cannot look up), chances are there is something not on the up and up with the recommended plan.

Reasonable minds might differ when it comes to determining what the best asset protection plan is; but reasonable minds of asset protection attorneys should not differ when it comes to determining if the asset protection plan options are, in fact, legal.

Keys to Asset Protection Planning

Do not wait

- Clients are famous for putting important issues off until another day. Due to the busy professional and personal lives of most clients, it is not easy to find several hours to sit down with a qualified attorney to put together an asset protection plan. If, after reading this section of the book, you believe you need help with an asset protection plan, have your assistant, secretary, or nurse chalk off an hour on your calendar at work so you can focus call one of the authors to help with your asset protection plan and get the ball rolling.

Do not go cheap on your attorney

- We have already said that no one likes an attorney (until you need one), and it will be impossible for you to set up an asset protection plan without a qualified expert. It is okay to go cheap on a lot of “experts” you will use in your life, but going cheap on an asset protection attorney will get you nothing but grief. Chances are good that, if you live in a decent-size city (200,000 or more people), you will be able to find an attorney who specializes in asset protection. If you cannot find one, please contact one of the co-authors of this book; and we will forward you the name of a competent local asset protection attorney.

- While it does not have to be expensive to implement an asset protection plan, going to the attorney who did your last divorce or the attorney who helped you set up your medical practice is probably not going to get you the technically correct asset protection plan you are looking for. Do your due diligence on the attorney you choose; and, if you cannot find one you feel comfortable with, again, contact one of the co-authors and we will find one for you.

Keep an open mind

- The best asset protection plan for any client completely removes all the assets from the name of the client. The worst asset protection plan has all assets held individually by the client. A good asset protection plan is somewhere in
between, and you need to work with your asset protection attorney to find a happy medium between the two.

**Support of the family**

- Most of the clients over the age of 35 are married and have children. It is important to involve those in your family who will integrate into the asset protection plan. Many times the spouse and the children, through limited liability companies or family limited partnerships, will be part of the asset protection plans; and so it is important to get their support from the outset.

**Do not wait**

- We started this list with “do not wait” and we’ll end it with “do not wait.” If, when reading this book, you know you need help, don’t wait. Implementing a plan after you know of a potential lawsuit will do you little good to protect against that impending claim. Hindsight is 20-20; and you do not want to look in the mirror after procrastinating for months only to say to yourself, “I told you so.” There is little consolation for knowing that you should have done something, and that, because you did not, it put millions of your family assets at risk.

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**Section 3**

**Fraudulent Transfers**

Fraudulent transfer laws have been around almost as long as there have been people trying to perpetrate frauds on other people. Unlike a lot of laws that have taken years and sometimes centuries to implement, fraud laws were implemented very early in the creation of the legal system and the reason is fairly simple—fraud, once discovered, is an obvious crime (or tort) that can cause significant harm.

**What is a Fraudulent Transfer?**

The Asset Protection news in 1995 gave the following definition of fraudulent transfer: In lay terms, a fraudulent transfer is a transfer of an asset (or incurring an obligation) with the *actual intent* to hinder, delay, or defeat a creditor’s claim (*actual fraud*), and, regardless of intent (*constructive fraud*), making a transfer while insolvent or which renders the transferor insolvent.
Actual fraud

Actual intent is proven in two ways: By the transferor's own statements, such as: "I knew Mr. X was going to sue me, so I gave the brokerage account to my wife," or, more commonly, by a review of the other factors surrounding the transfer. Over the last several hundred years, the court cases have identified a list of factors, sometimes referred to as "badges of fraud," which may be taken into consideration in determining a transferor's intent.

These factors include, among others: being sued or threatened with suit before the transfer, removing and concealing assets, concealing the transfer, transferring substantially all of the debtor's assets, and whether the transferor was insolvent at the time of the transfer or became insolvent shortly after the transfer was made. How does this translate into real life? You have been called by a person who says that he has a claim against you for one reason or another (no suit has been filed). You remember the person; and even though you think he has no basis to make a claim against you, you decide to play it safe and make "gifts" of your assets to your spouse and children. If the claimant is successful and obtains a judgment against you which he cannot collect, the transfers will likely be held to be a fraudulent transfer by the court unless significant non-asset protection motives can be proven for the transfer (remember – it is a question of intent).

Classic example:

Dr. Smith goes into the operating room where he is supposed to amputate a diabetic patient's right leg. Dr. Smith did not notice that the surgery techs prepped the wrong leg; and, in fact, Dr. Smith amputated the wrong leg. Dr. Smith figures this out in post op.; and instead of sticking around to console the patient and his/her family, Dr. Smith digs out his Doctor's Wealth Preservation Guide© to review and then calls his local attorney to immediately start drafting an asset protection plan.

Dr. Smith and his attorney immediately transfer Dr. Smith’s brokerage account and vacation home (value $2,000,000 collectively) to separate limited liability companies in hopes that this move will protect Dr. Smith from the lawsuit he is sure will arise from his amputating the wrong leg of his patient.

Sure enough, Dr. Smith is sued six months later by the patient for $10,000,000 (which seemed to be a just price to the personal injury attorney now that the client has NO legs after the second amputation). Dr. Smith has a 1-million/3-million-dollar medical malpractice insurance policy.
During the deposition of Dr. Smith, he testifies truthfully that he transferred all his major assets to limited liability companies one week after the surgery but before the lawsuit for malpractice was filed. The attorney for the patient asks for and receives a temporary restraining order to freeze the assets in Dr. Smith’s limited liability companies until a resolution of the case is complete.

The case goes to trial and the jury comes back with a $7,000,000 verdict in favor of the patient/plaintiff.

What is the outcome of Dr. Smith’s asset protection plan? Dr. Smith has violated the fraudulent transfer rules, and the court reverses Dr. Smith’s transfers and directs him to liquidate his brokerage account and sell his vacation property and hand over every penny to the patient (who is not a creditor or the physician).

The rule that comes out of this story is that a client should not wait to create an asset protection plan and should not make fraudulent transfers. If Dr. Smith would have had his vacation rental and brokerage accounts asset protected prior to amputating the wrong leg, those assets would have been protected and the court would not have been able to tell Dr. Smith to liquidate the assets and give the money to the patient.

**Constructive fraud**

Fraud generally is difficult to prove. It is not often that you will find the classic example as just outlined. It is more likely that a fraud will be more subtle such as selling an asset 1) for less than its fair market value, 2) when a claim for damages against the seller is known, or 3) makes the seller insolvent.

1) **Fair Market Value**

Selling an asset for less than fair market value (FMV) is just what you are probably thinking. You have an asset in the normal marketplace that is worth $100,000. If you had a fire sale because you needed money, you might sell it for 30-40% less than what it is worth; but no one in their right mind would sell it for more than a 50% discount (The exact discount that would be deemed below FMV for constructive fraud will vary depending on the individual circumstances and state law).

The typical scenario for a physician would revolve around the fact that a physician knows he screwed up on a case and knows he/she is going to lose his unprotected assets in a lawsuit and would rather sell assets at a discount to someone they know so the asset can be enjoyed by a friend (or maybe sold back to the physician at a later time at that same discounted price).
2) When a claim for damages against the seller is known

Again, it is not likely that a defendant who intentionally is trying to defraud a claimant is going to admit under oath that the transfer was made with the intent to defraud the claimant. In a situation where the defendant will not admit to the fraudulent transfer, the claimant will assert constructive fraud based on the circumstances which include the fact that the defendant just happened to make the transfer of property with knowledge that a claim against him for damages is known.

3) Insolvency

Insolvency is not something that most readers of this book will be able to accomplish in a reasonable manner in order to avoid paying negligence claims; therefore, we will not spend much time on constructive fraud. If you are transferring assets to become totally insolvent before a claimant can sue you, then you have real problems. Just know that, if you intentionally become insolvent when a potential claim against you known, the transfers can be reversed.

In general, the law states that a person should not be able to make gifts when insolvent or to make gifts that would, in turn, make a person insolvent (if there is pending litigation that can give rise to money damages). Creditors have rights that need to be protected, and not allowing an insolvent person (with a pending claim) to gift assets away (which would harm a creditor) is a public policy decision by the states that have enacted such laws.

This scenario is most likely when a client with children is divorced, and the client would rather sell or transfer property to the now not related ex-spouse in an effort to sort of keep the assets in the family (for the children) rather than have a claimant get the assets.

Defenses to fraudulent transfers

-Legitimate business purpose

If the transferor of property (in what looks like a fraudulent transfer) can prove that the transfer was made for a legitimate business purpose; that is generally the most viable form of defense to combat a fraudulent transfer claim.

Transferring assets to family members often can have a legitimate business purpose (with estate planning it is done all the time). The problem with family transfers of property in a fraud situation is that transfers to family members are looked at much more closely so it creates an interesting paradox for the court to deal with.
-Transfer before liability incurred (which is the main way to avoid the problems involved with fraudulent transfers)

If you can prove to the court that the transfer was made before the liability occurred, that will be a very strong defense against a fraudulent transfer. The only problem with this defense is if the plaintiff/creditor can prove that the defendant intended to go out and create claims (by harming people) and, in anticipation of causing harm, the defendant wanted to divest him/herself of all assets.

Conclusion

Fraudulent transfer laws will prevent you from removing assets from your estate after you know of potential claims against you for damages for malpractice or normal negligence (or contract actions which we did not discuss).

The only surefire way to prevent transfers of assets from being overturned by a court is to make the transfers before any liability occurs.

Even if a creditor cannot prove actual fraud, you still need to worry about constructive fraud when making transfers of assets after a claim for damages has occurred.

Bottom line—get asset protected now by using experts in the field who will help you shield all your major assets from lawsuits whenever they arise.

Section 4
Existing Laws Help Protect Your Assets

Introduction

In a later section of the asset protection part of this book, we will discuss the various techniques that are used to protect your assets. Those techniques are used and created under existing laws but are really thought of as “new” techniques. What this section of the book will discuss is the use of “normal” asset protection techniques.

Homestead Exemption

They say a man’s home is his castle, but is that really true? Most states provide some sort of creditor exemption for a personal residence. Each state has different rules and limits for what that exemption is, and you should check with your local advisors (or give one of the co-authors a call) to determine just how much the homestead exemption is in your state.
The homestead exemption came from public policy concerns to protect the family. The theory is fairly simple—the legislatures wanted to protect some portion (in some states it is unlimited) of the family residence so families (even those riddled with debt and hounded by creditors) have some safe haven.

**-Interest protected**

The homestead exemption is a statutory right to protect “homestead property.” This is typically the real estate owned by a person as his/her personal residence. Again, the states vary on their definition; so be sure to check with your local advisors to make sure the piece of property you are concerned about is covered.

Interestingly, 21 states now specifically include mobile/manufactured homes. Also of interest is that some states do not require that a client occupy the home or even have the intent to occupy the home to claim homestead.

**-Homestead exemption value**

The amount of homestead exemption in each state varies widely. States such as Rhode Island, Delaware, New Jersey, Pennsylvania, and the District of Columbia have no homestead exemptions. States such as Texas, Florida, and a few others have unlimited homestead exemptions (with some limits under new bankruptcy laws).

Some states have a different amount for married couples, some vary the amount by the number of dependent children an individual or couple has, some states raise the exemption if someone incurs significant hospital or medical debts, and some states increase the exemption in the case of bankruptcy.

We would say a general number for states that do not have an unlimited exemption and those that have no exemption is between $5,000 and $50,000 (depending on if you are married or single).

**-Debt exclusions**

Certain debts in all states are excluded from being covered by the homestead exemption. Almost all states exempt out consensual liens, mechanics liens, and property taxes from being covered by the homestead exemption. Many states now are adding to the list of exemptions debts for child support or spousal support. The IRS is also a creditor that does not fall under the homestead exemption. So, if you owe a significant amount of taxes you cannot pay to the IRS, they can take your home notwithstanding the state allotted homestead exemption.
-Procedural issues

It does little good for someone to have a homestead exemption if the property can be sold before an exemption is asserted. In many states (18), the homestead exemption is automatic.

Some states allow for a waiver of the homestead exemption (which almost universally requires the spouse’s consent if you are married). The homestead exemption, if limited, will not always prevent the sale of your homestead property. The rules for how homestead property is sold, even when the homestead exemption is applied, vary dramatically. Sometimes a house can literally be sold for any price above the homestead exemption, which could create a scenario where the homestead is sold for thousands less than its fair market value. The amount of the exemption will still be reserved for the homeowner, but the rest of the profit from the sale of the home can go to pay creditors.

-Practical example of how the homestead exemption would work if sued

Assume a patient sues Dr. Smith, and a jury verdict comes back for $1,000,000 over the malpractice limits he has with his medical malpractice carrier. Further, assume that Dr. Smith is single and has a home worth $1,000,000 with $500,000 in equity.

If Dr. Smith lived in a state with an unlimited homestead exemption, the patient through the collection process could not force a sale of the $1,000,000 home to satisfy the judgment.

If Dr. Smith lived in a state with NO homestead exemption, the patient through the collection process could potentially force a sale of the $1,000,000 home to satisfy the judgment.

If Dr. Smith lived in a state with a $50,000 homestead exemption, the patient through the collection process could potentially force a sale of the $1,000,000 home to satisfy the judgment. In this last example, the patient/creditor could receive all the proceeds from the sale of the house above $50,000. That first $50,000 is the exempted amount and stays with Dr. Smith.

Conclusion on Homestead Exemption

Having a homestead exemption in most states (the states without an unlimited exemption) does a high-end client with the potential for million-dollar creditors (your patients) very little good.
If you would like to know what the laws are with your state’s homestead exemption, please see a local attorney or feel free to give one of the authors a call. We would be happy to give you the specifics of your state.

### Life Insurance and Annuities

All assets are not created equal. This is proved by the fact that life insurance and annuities in many states (by state law) are specifically protected from creditors.

Like many laws, the laws protecting life insurance and annuities are rooted in public policy. The legislatures in some states believe a life insurance and/or annuity benefit is essential for citizens and/or their families to maintain at least a minimum level of financial well-being and, most importantly, from becoming wards of the state.

The state’s interest to avoid paying for the indigent is tempered by a creditor’s right to collect a legal debt; but as you can understand from the government’s point of view, it is always better for someone to support themselves than for the government to dig deep into their pockets to support even more needy citizens.

### Life insurance

Due to the public policy arguments surrounding life insurance contracts, the bankruptcy laws have specifically addressed giving protection to life policies even if individual states have not. We are not going to get into all the protections afforded to life insurance by the bankruptcy laws, but we would like to point out that the federal government has specifically addressed the issue.

- **State laws**

  Like the homestead exemption, state laws vary widely when it comes to protecting life insurance. Some states give an unlimited exemption to life insurance policies (Florida and Texas) that have cash value in them, and some states give none.

  South Carolina, for example, provides a limited protection for cash value in the amount of $4,000. (The death benefit in almost all jurisdictions is exempt from creditors who would be left to sue the estate of the deceased debtor).

  Hawaii specifically exempts the death benefit and the cash surrender value of policies provided that the policy is payable to a spouse of the insured, or to a child, parent, or other dependents of the insured.
- **Estate taxes**

In this section of the book, we are discussing asset protection as it usually pertains to protecting assets from creditors like a patient who sues for malpractice.

Besides a potential creditor who would come from a negligence suit; the biggest way to lose a significant portion of your life insurance proceeds is to pay the government 50% of the death benefit for estate taxes.

While you have an unlimited ability to have death benefits paid to your spouse, any other death benefits paid to other people (children) have a significant chance of being taxed at the 50% bracket to pay for estate taxes. We discuss this topic in more detail and how to avoid having your life insurance proceeds taken by the government for estate taxes on page 127 of this book in the estate planning section.

**Conclusion on Life Insurance**

Know whether or not your state exempts some, all, or none of the cash surrender value in your life policy and if the state exempts the death benefit.

Be aware that many “asset protection experts” in the marketplace are really life insurance agents looking to sell a massive amount of life insurance as protected investments for clients who are funded on a post-tax basis. The authors have nothing against the concept of purchasing life insurance to protect one’s assets; however, there are a number of ways to do so in a tax favorable manner instead of pumping thousands of dollars into a life policy on a post-tax basis.

For information on how to purchase life insurance in a tax favorable manner, please turn to pages 166, 193, 229, and 254 where in each section we discuss in detail various ways accomplish this goal.

**Annuities**

Annuities are treated similarly to life insurance when it comes to being treated as a protected asset by the states. The main difference is that annuities are designed to pay out a stream of income at some point whereas a lump sum death benefit is paid with a life insurance policy.

Some states will exempt all the cash built up in an annuity and the annuity stream, and some states will not protect either. Then there are the hybrid states which protect all of one and not the other or some of each.

Florida, not surprisingly, exempts the cash in an annuity and the stream of income from any annuity. Pennsylvania generally permits the exemption of only $100 per month of the proceeds from an annuity, and North Carolina does not exempt any proceeds that
come from an annuity. Some states allow as an exemption from an annuity what is reasonably needed to live on.

Be careful

The state and federal exemption laws as they pertain to annuities follow the same public policy reasoning to provide for families in the long term similar to ERISA plans (401(k) type plans). Variable annuities have become much more in vogue, not so much to provide for families later but simply as a way to have money grow tax deferred. If the client were truly worried about the money being there in retirement, the client would purchase a conservative fixed annuity. This is discussed in more detail in Chapter 4, Section 3 under annuities (see page 236).

Arguments are being made now by creditors asking for courts to differentiate between fixed and variable annuities and are asking the courts to hold that variable annuities are not protected the same as fixed annuities.

Section 5
Retirement Plans

The biggest single asset of many clients over the age of 50 is the money in their retirement plan or IRA. That money also happens to be the most liquid money in their entire portfolio; and, therefore, if not protected from creditors, that “qualified” money would be the first asset a creditor would go after to satisfy a judgment.

In 1990, the United States Supreme Court made clear that a creditor (outside of bankruptcy) could not reach “ERISA qualified” plan assets. In 1992, the issue of whether an ERISA qualified plan was subject to bankruptcy was raised; and the answer from the Supreme Court was “no.”

What is an ERISA qualified plan?

Unfortunately, there is no definition of an ERISA qualified plan in the IRS code or under the Employment Retirement Income Security Act (ERISA). The Supreme Court did fashion its own definition and the factors to be considered are:

1) The plan must be subject to ERISA;

2) The plan must be qualified under Section 401 of the Internal Revenue Code;

3) The plan must contain the anti-alienation provisions which are required under both the IRC and ERISA.
Instead of explaining in detail what the above requirements mean, I instead will list the plans you will know that are ERISA qualified. In general, however, the plan must cover employees and cannot discriminate in favor of highly compensated employees.

1) 401(k) Plan  
2) Profit Sharing Plan  
3) Money Purchase Plan  
4) New Comparability Plans  
5) Defined Benefit Plan  
6) 412(i) Defined Benefit Plan

Be sure to check with your pension plan provider (any listed above) to make sure that your plan is in compliance with ERISA laws. If your plan happens to fall out of compliance for whatever reason (and there are many plans that are not in technical compliance), then it will be left up to the courts and possibly the IRS to determine if your plan qualifies for exemption from creditors.

Non-ERISA Plans and IRAs

Simplified Employee Pension plans (SEPs) and Keogh plans are not specifically protected by federal law. The determination of whether SEP and Keogh plans are protected will be left up to the states to determine. If you have a SEP or Keogh plan that includes multiple employees and is funded in a non-discriminatory manner similar to ERISA governed plans, you will have a good argument for why those plans should be protected (especially in states like Florida and Texas, which have already exempted life insurance and annuities from creditors).

An IRA is not considered an ERISA qualified plan; and, therefore, the assets in an IRA have no federal protection from creditors.

Individual states, however, can and have protected IRAs in full (26 states) or in part. In states where IRAs are not specifically protected, it is up to the state courts to determine if, in a particular case, the IRA asset (in full or in part) is protected.

Recent Supreme Court Case

There has been a recent Supreme Court case addressing the issue of asset protection of IRAs in a “bankruptcy” case. The case changed the existing laws so that all IRAs are asset protected in a “bankruptcy” case. That sounds great, except 95% of the people who buy this book will not be in a position to file bankruptcy due to their amount of wealth. Therefore, it is the authors’ opinion that the recent Supreme Courts case is of little good to those clients who live in states where the IRA is not fully protected by state law.
What to do if Your IRA is not Protected?

**Asset Protect Your IRA by Using the MAXI-IRA**

There are tens of thousands of clients in this country who have estates in excess of $3,000,000 and $750,000 or more in an IRA (and there are more people every day who have this problem as the baby boomers get closer to retirement). Unless those clients live in states that have specifically asset protected IRA assets, the IRA is not asset protected from creditors (unless in a bankruptcy case).

In many states, IRAs are not asset protected. Many clients are unaware of this fact and simply lump in IRA asset protection with federally protected ERISA governed retirement plans like Profit Sharing or Defined Benefit Plans.

If you would like to know if IRAs are asset protected in your state, please call or e-mail one of the authors.

Many clients (especially physicians) are concerned about asset protection. For clients who live in the above-mentioned states, using the MAXI-IRA is a good form of asset protecting the money in an IRA.

How does the MAXI-IRA work? It is very simple. Inside the MAXI-IRA, the client simply directs the custodian of the IRA to purchase limited liability company (LLC) units with the money in the IRA. Once the money is in an LLC, any potential creditor who would attack the IRA asset would have his/her remedy limited to a “charging order” (CO). (See page 64 for an expanded explanation of charging orders).

For example, if a client had $1,000,000 in an IRA and lived in a state where IRAs are not asset protected, the client would want to use the MAXI-IRA to asset protect the money in the IRA. Very simply, the client would find an IRA custodian familiar with the MAXI-IRA and would direct him/her to use the money in the IRA to purchase FLP units.

![Diagram of MAXI-IRA process](image)

$1,000,000 “self directed” IRA is invested by IRA custodian

New LLC Capitalized with IRA Money

The money in the LLC can still be invested in whatever stocks, bonds, or real estate as it could if the LLC were not involved; however, now the IRA assets have the element of asset protection which is afforded to LLCs.
If a creditor is able to obtain a CO against the LLC, what happens? With a CO, the creditor cannot force liquidation of the FLP or force a distribution. A creditor cannot obtain an interest in the LLC. A creditor cannot direct how the money in the LLC will be used. In short, the creditor can simply sit around and wait for a distribution to be made from the LLC. If a distribution is never made, then the creditor will receive nothing*.

The * follows the word nothing in the above sentence because the creditor might get something from the LLC, and that something could be a K-1 for phantom income. The IRS came out with Rev. Ruling 77-137 which states that, if a creditor has a CO against an FLP or LLC and if the FLP or LLC creates but does not distribute income, the creditor will, in fact, receive a K-1 for that income (income which the creditor never received).

Therefore, when the IRA money that was used to capitalize the LLC creates investment income, the creditor will receive the K-1 for that income that stays in the LLC. We would submit to readers of this material that no creditor in their right mind is going to get a CO against an LLC that generates income.

**Offshore asset protection**

For clients who are paranoid about asset protection and do not want to leave it up to U.S. judges to give out a charging order as the sole remedy against the domestic LLC interest, the LLC could instead be an offshore LLC. If an offshore LLC is used, the remedy will still be a CO for the creditor; except when the LLC is offshore, the creditor must file suit offshore to obtain the charging order (which is very expensive). The creditor must go offshore due to the fact that a U.S. court has no jurisdiction when dealing with an offshore LLC.

- **Currently employed**

If you are currently employed and live in a state where IRAs are not asset protected, you can simply roll your IRA into your current employer’s ERISA qualified plan (401(k)/profit sharing).

- **Retired with an IRA**

If you are retired with an IRA and also happen to have an LLC or FLP that you use for estate planning purposes (and manage as the managing member), you can create a new profit sharing plan inside the FLP or LLC and roll your IRA assets into the newly created profit sharing plan. Since profit sharing plans are federally asset protected, the money inside would be completely asset protected. The MAXI-IRA would be a less expensive solution to asset protect the money in an IRA, but creating and having money in a profit sharing plan is the most secure way to protect “qualified” plan money.
Section 6
Typical Asset Protection Solutions (that do not always work)

Co-ownership comes in many forms, and most clients and some attorneys and CPAs believe that through co-ownership a client can adequately protect his/her assets.

Technically speaking, co-ownership can protect your assets. There are a number of problems associated with co-ownership that make its use not viable for many clients. There are many pros and cons with co-ownership that we will be addressing in the following pages.

Types of Co-ownership

There are three main types of co-ownership: Tenants in Common, Joint Tenants, and Tenants by the Entirety.

1) Joint Tenancy

Definition of Joint Tenancy:

“A single estate in property, real or personal, owned by two or more persons, under one instrument or act of the parties, with an equal right in all to share in the enjoyment during their lives. On the death of a joint tenant, the property descends to the survivor or survivors and at length to the last survivor.” Barron's Dictionary of Legal Terms.

From a legal perspective, the rights of all the owners of a piece of property owned as joint tenants are all the same. Those rights are as follows:

1) The right to use the whole property (with land, the right to occupy the entire property, with stocks or bank account money, the right to spend the whole amount).

2) The right to transfer the interest in the property without asking permission of the other co-owners. Each co-owner’s interest is owned individually and, therefore, can be sold, gifted, or transferred without permission. When a joint tenancy interest is transferred, the new owner also has access to use the whole asset (which is why joint tenancy is so unique).
3) A survival right—when a joint tenant dies, the share of the deceased tenant automatically becomes that of the other co-owners. In other words, a joint tenant cannot transfer his/her interest at death.

Why is Joint Tenancy used?

Unfortunately, joint tenancy is the most common form of co-ownership for many types of assets (such as bank accounts, brokerage accounts, and real estate). The reason is fairly simple—when one joint owner dies, the entire asset becomes that of the other joint tenant. What does this accomplish? The asset that passes to the other joint tenant does not pass through the estate of the deceased tenant, thereby avoiding probate fees and estate taxes.

Example:

Dr. Smith owns, through a joint tenancy with his two children, his vacation home in Florida. Each owns a 1/3 interest in the property. When Dr. Smith dies, the vacation home passes to the children who now each have a ½ interest in the property. The million-dollar vacation home did not pass through the estate and, therefore, saved the estate 4-6% of the total asset in probate fees and $500,000 in estate taxes.

That sounds wonderful. So why don’t we like joint tenancy?

1) Joint tenancy can be severed. If one of the joint tenants sells or transfers his/her interest in the property, the joint tenancy becomes a tenancy in common (discussed in the next section). Since there are no restrictions to prevent this, one joint owner can transfer his/her interest without the other owners knowing; and doing so in many cases will defeat the original purpose of the joint tenancy.

2) The joint tenancy is an asset of each co-owner and is subject to his/her creditors. So, if one joint owner was sued for negligence and lost, the creditor could end up with that joint owner’s interest in the property (which would also partially destroy the joint tenancy, or, potentially, the entire property could be sold to satisfy the debt of one of the co-owners).

Example:

Dr. Smith owns property worth 1 million dollars as joint tenants with his sister. Dr. Smith is sued for malpractice and has a judgment against him for $3,000,000 (and he only has $1,000,000 worth of coverage). The creditor/patient can ask the court to sell Dr. Smith’s property that is owned by joint tenancy with his sister, or the creditor could ask the court to have Dr. Smith transfer his interest in the property directly to the creditor. Each transaction has its own consequences, but
the bottom line is that the asset as owned by a joint tenancy IS subject to the creditors of each co-owner.

3) Gambling on life. Joint tenancy (unless severed) is a roll of the dice for the owners. He/she who lives the longest gets the asset. Most of the time, that is not the intent of the co-ownership arrangement, and many times, the people in a joint tenancy situation do not even realize the potential problems. This arises most often when a parent is trying to avoid probate and estate taxes on a piece of property and is trying to give an equal share in the property to the children.

Example:

Consider this horror story. Dr. Smith gets remarried and has three children from a previous marriage. Dr. Smith has $4,000,000 worth of assets of which he would like $2,000,000 to pass to his children at death. Dr. Smith, right after re-marrying, puts all his assets into a joint tenancy with his new wife. Dr. Smith’s will and trust direct $2,000,000 of his estate to go to his children.

When Dr. Smith dies, all this property owned as a joint tenant with the spouse is immediately out of his estate and is now owned 100% by his new spouse. There is nothing left to go through the will or trust, and Dr. Smith’s children get NOTHING.

Summary on Joint Tenancy:

Make sure that you have a valid reason for using a joint tenancy. Ninety-nine percent of the time a joint tenancy will not fulfill all your needs of asset protection and estate planning. The assets owned as a joint owner are not asset protected; and unless death occurs just as you planned, chances are significant that the joint asset will not pass to your heirs as planned.

2) Tenants in Common

Definition of Tenants in Common:

“An interest held by two or more persons, each having a possessory right, usually deriving from a title in the same piece of land. Tenancy in common also applies to personalty (personal property). Though co-tenants may have unequal shares in the property, they are each entitled to equal use and possession. Thus, each is said to have an undivided interest in the property. An estate held as tenancy in common can be partitioned, sold, or encumbered.” Barron’s Dictionary of Legal Terms.
Rights of an owner in property held as tenants in common:

1) Each owner of property held as tenants in common owns an undivided interest in the property. For example, three people (all with separate families) own a vacation home as 1/3 owner.

2) The ownership interest of a tenant in common is transferable. Unlike a joint tenancy, if a tenant in common died, his/her interest in the property would pass to his/her heirs like all his/her other assets.

Pros and cons of property owned as tenants in common as illustrated by an example:

Dr. Smith owns a vacation home with his brother, Dr. Phil, as tenants in common where each owns a ½ interest of a $200,000 home. Dr. Phil has been through three divorces and has five children and has very little disposable income. Dr. Phil decides he needs cash to take his new girlfriend to Europe for a month and takes out a mortgage on his half of the vacation home for $100,000.

Dr. Smith is a terrible surgeon with no malpractice insurance and just got hit with a $1,000,000 jury verdict for malpractice. The patient/creditor puts a lien on the vacation home to help satisfy part of the judgment.

Dr. Phil spends his $100,000 in Europe and enjoyed himself so much he decided to stay in Europe permanently, and he has decided not to pay back the loan.

Dr. Smith dies in a car crash and leaves his ½ interest to his wife.

What happens and how did property as tenants in common help or hurt?

1) The bank, because of Dr. Phil’s default on the loan, files to foreclose the loan and has the entire property sold (that is not a relief the judge has to grant, but is a relief a judge can grant).

2) Dr. Smith’s patient also files a petition with the court to have the house sold in order to help satisfy the $1,000,000 judgment. The fact that there is a lien on the property prior to Dr. Smith’s death keeps the claim against the property alive even though Dr. Smith left the house to his wife through the will. (And because the lawsuit against Dr. Smith would then become a lawsuit against his estate (because he died), property passing through his estate would not pass until all creditors of the estate have been satisfied).
The only pro of having the vacation home owned as tenants in common was that Dr. Phil was able to leverage his ½ interest to extract $100,000 from the home. From Dr. Smith’s point of view, allowing Dr. Phil to leverage the property was not a pro but a con.

The cons are obvious. Because the property was owned individually, Dr. Smith’s creditors were able to make a claim for the value of the property to satisfy a judgment against him. For Dr. Smith, as stated above, he again would have had issues with foreclosure due to the defaulted loan of his brother. Typically, a judge would make Dr. Smith buy out Dr. Phil for $100,000 to cover the defaulted debt or the judge would order the property sold (forced liquidation); and if there were any proceeds left over after the sale, Dr. Smith (and now his creditors) would take the remainder.

**Summary of tenants in common:**

The list of potential cons associated with property owned as tenants in common is much longer than listed in this book, but the bottom line is that property owned as tenants in common does nothing to protect your assets from creditors and can cause you more grief than you ever expected.

3) **Tenants by the Entireties**

*Definition of tenants by the entireties:*

“Ownership of property, real or personal, tangible or intangible, by a husband and wife together. Neither husband nor wife is allowed to alienate any part of the property to be held without (the) consent of the other. The survivor of the marriage is entitled to the whole property. A divorce severs the tenancies by the entirety and usually creates a tenancy in common.” *Barron's Dictionary of Legal Terms.*

*Characteristics of tenants by the entireties:*

1) Applies to married couples only.

2) Property right is not divisible or alienable. The property is owned as a couple not as two individuals with divisible interests that can be transferred or encumbered. (Neither spouse can sell the property without the other’s approval. Neither spouse can mortgage the property without the other’s approval. Neither spouse can sell his/her undivided ½ interest in the property without the other’s approval.)

3) Provides additional protection over joint tenancy and tenants in common if only one of the spouses incurs a liability.

4) Property is subject to joint creditors like the IRS.
5) Automatic rights of survivorship. (The property is automatically transferred to the spouse at the death of the other spouse).

**Side note (Community Property (CP) States):**

Nine states treat the property of married couples differently from the other states. These states are called "Community Property" states. The community property states are:

- Arizona  - California  - Idaho  - Louisiana  - Nebraska
- New Mexico  - Texas  - Washington  - Wisconsin

If you are married and live in a community property state, these property ownership rules apply:

- **Each spouse's interest in the community property is subject to the claims of the other spouse's creditors (meaning all CP assets are at risk).**

- If you acquired property before you were married, this property belongs to you alone even after you are married.

- Any property you accumulate during your marriage is considered to be community property. You and your spouse own an equal, one-half interest in this property.

- If you receive personal gifts or inheritance after you are married, that property continues to be owned separately by you.

- Remember: Beneficiaries are the persons or organizations you mention in your will. Heirs are the people the law says will get your estate.

We do not go into any major details about the differences between community property states and non-community property states. If you live in a community property state, please be sure to contact an attorney that knows the laws governing your state before implementing an asset protection or estate plan.

**Pros of tenants by the entirety:**

**Asset protection** – If one spouse is sued (say a physician for malpractice), property (usually only the marital home) is not subject to creditors. (This is the main reason that the homestead exemption limitation is not that big of a deal. Also check with an attorney if you live in a community property state.)

**Estate planning** – The assets owned as tenants by the entirety pass to the surviving spouse and do not go through the probate process.
Cons of tenants by the entirety:

Asset protection – Tenants by the entirety does not protect property from joint creditors of the spouses (such as the IRS or state government or a personal injury suit for negligence against the parents of a teenager still living in the home who got drunk from the parents’ liquor and killed someone in a drunk driving car crash).

Divorce Protection – Assuming your state allowed more than just the marital home or real estate to be owned as tenants by the entirety, in a divorce or at death, you have almost guaranteed that the spouse will get 50% of that asset. It would not matter that the asset was given to one spouse by his/her parents as an inheritance or if some portion of the asset was supposed to pass to the children at one spouse’s death. If the property is titled as tenants by the entireties, the surviving spouse will get the entire asset at the first spouse’s death. (Check with your state to determine if the community property rules apply).

Summary of tenants by the entirety:

There are many positives of owning the family home as tenants by the entirety, and that is the main reason when implementing an asset protection plan we typically do not recommend putting the marital home in a limited liability company. (The other main reason we do not recommend putting the marital residence in a limited liability company is due to the loss of the $500,000 capital gains tax exemption on the sale of a personal residence). A better way to protect the marital home could be through the use of a debt shield (which is discussed in detail on page 88).

Co-Ownership Conclusion

Never ever own property just in your name. We did not even really address this issue in any major way in the preceding pages. The worst of all worlds for a client is to own property just in your name. If you get sued, the property is absolutely at risk.

When you can avoid it, do not own property as joint tenants (with rights of survivorship). The entire property is subject to your creditors and that of the other joint owners.

When you can avoid it, do not use tenants in common. The share of property in your name is subject to your creditors, and the court could impose a forced liquidation of the entire property to satisfy the debts of one of the other co-owners.

Using tenants by the entireties is not a bad idea with the marital home. In doing so, you protect the marital home from each individual spouse’s creditors (although not joint creditors). Since the general public gets divorced at about a 50% clip and many “professionals” have an above-normal divorce rate, we do not suggest titling too many other personal assets as tenants by the entirety.
If we do not recommend joint tenancy, tenants in common, and restrict the use of tenants by the entirety, how do we suggest that property and other assets be held? The answer is through some sort of corporate structure or limited liability company or family limited partnership, which you can read about in the next two sections of the book.

**Section 7**

**Corporate Entities**

Most clients think that great asset protection comes through the use of “corporations.” What most clients do not realize is that there are different types of corporations and limited liability companies; and depending on which entity you chose, your asset protection and tax consequences could be different.

To read in more detail about the tax consequences of corporations and limited liability companies, please turn to page 287 in the business management section of this book.

**Sole Proprietorships and Partnerships**

While sole proprietorships and partnerships are not corporations, we did want to cover each in cursory detail when leading up to the pros and cons of corporations and limited liability companies.

**Sole Proprietorships**

Sole proprietorships are the second worst way to own or run a business behind a partnership.

Basically, a sole proprietorship exists when an individual operates a business without filing to have that business recognized as a legal corporate entity (like an S- or C-Corp or a limited liability company or professional company).

With a sole proprietorship, there are no barriers between the business done and the individual running/owning the business. Why is this bad? If a sole proprietor acting on behalf of his business commits negligence in his duties for the business that causes injury to a third person, the sole proprietor is **personally liable** for any and all injuries to that third person.

If the business puts out a product and the product malfunctions, thereby causing injury to some third party, the sole proprietor is **personally liable** for that injury.

If an employee of the business harms a third person when acting within the scope of his/her employment, the sole proprietor is **personally liable** for the injury.
If someone is harmed on the business premises (say for a slip and fall injury), the sole proprietor is **personally liable** for the injury.

When a sole proprietor is personally liable for any of the above examples, all of the sole proprietor’s personal and business assets are subject to claims by the creditors (the people who sued the sole proprietor’s business).

**Example:**

Dr. Smith’s medical practice is not incorporated and is treated as a sole proprietorship. Dr. Smith lives in Michigan; and after a winter storm, Dr. Smith forgot to have someone shovel his sidewalk at the medical practice. Dr. Smith is an orthopedic surgeon who has many people show up at his office using crutches and wheelchairs.

Mrs. Lucky came to Dr. Smith’s office after the snowstorm on crutches (she just had her ACL repaired); and when she was entering the building, she slipped and fell, thereby cracking her head open on the ice. Mrs. Lucky had permanent brain damage; and after she sued Dr. Smith, the jury returned a verdict for $3,000,000.

**Outcome of the Example?**

Even though Dr. Smith had a $1,000,000 commercial liability umbrella policy to protect his sole proprietorship, because the medical practice was not a corporate entity of some kind, Dr. Smith was personally liable for the entire judgment. Therefore, Dr. Smith was on the hook to pay $2,000,000 of the verdict (which was the amount of the award the commercial liability policy did not cover). Dr. Smith decided to file for bankruptcy due to the fact that he did not have the funds to pay Mrs. Lucky out of his personal assets. In bankruptcy, everything but Dr. Smith’s house was liquidated to pay the debt to Mrs. Lucky.

**Conclusion**

We’ll make this short—don’t ever be a sole proprietorship.

**Partnership**

A partnership is the absolute worst entity you could possibly be involved with from an asset protection standpoint. With a partnership, you get all the headaches and personal liability of a sole proprietorship with the additional twist of having a partner who can cause you even more liability.
Definition:

A partnership exists when two or more people run a business together that is not a “corporation” (like S- or C-Corp or LLC or P.C.).

Consequences of being a Partnership

Every partner is liable for all the actions and debts of the other partners (as it relates to the business).

A few examples are the best way to illustrate the problem.

1) If one partner signs for a loan on behalf of the business and takes the money and blows it on a trip or drugs or whatever, the debt becomes the debt of the partnership (and, therefore, ALL the partners are personally liable for the debt).

2) If one partner sexually harasses an employee and the business gets sued for sexual harassment, the suit is against the partnership in which both partners have personal liability.

Conclusion

Never be a partnership.

Corporations (not Limited Liability Companies or Professional Companies)

General information about formation and structure

- Corporations are a legal entity formed under state laws.

- Corporations are owned by shareholders.

- Shareholders elect a board of directors, which is responsible for overall management and hires corporate officers to run daily operations of the corporation. (A corporation can have as little as one shareholder who can elect himself to the board and to run the daily operations of the corporation).

- A corporation can be either an S- or C-Corp.

For a more detailed analysis of whether your company should be an S- or C-Corp or an LLC or P.C., please see page 287 of this book under the practice management section. In that section, we also discuss the tax ramifications of different corporate entities.
Limited liability

1) The main reason businesses are corporations (not partnerships or sole proprietorships) is to avoid personal liability for negligent actions of the corporations. This includes limited liability of the corporate shareholders as well as individual liability of the employees of the company (acting within the scope of employment).

Example:

Using the slip and fall example from a few pages earlier, assume that Dr. Smith’s patient (with the ACL tear and walking on crutches), as she walks into the medical office, slips and falls on the ice and after a trial for negligence wins a $3,000,000 jury verdict (remember that the patient had permanent brain damage from the fall).

What is the liability of the shareholders, officers, and employees of the company in the above example?

- **Shareholders** (which would be all the physician owners)
  The shareholders have NO personal liability (unlike with a sole proprietorship or partnership).

- **Officers** (which again would be at least one–four of the physician shareholders).
  The officers have NO personal liability (unlike with a sole proprietorship or partnership).

- **Employees** (which in this example might be a nurse who was supposed to shovel and throw ice on the sidewalk).
  The employee has NO personal liability (in a sole proprietorship or partnership, the employee would also have no personal liability absent an intentionally negligent act which we do not have with this example).

Exceptions to the example:

a) The main exception to the limited liability that goes along with corporations is in the area of personal (“professional”) services. Those personal service liabilities include work done for or on behalf of clients by:

- Physicians
- Attorneys
- CPAs/Accountants
- Insurance Agents
- Stockbrokers
- Financial Planners
- Mortgage Brokers
- Architects
- Engineers
For example, if a physician treats or operates on a patient, he/she cannot hide behind the corporate veil that normally provides limited liability for owners and employees working in the normal course of business. If a patient sues for malpractice, the physician is named individually (because of the personal liability which cannot be removed by incorporating).

A “professional” does have limited liability from negligent acts of his/her employees but not for individual advice given to client from the professional him/herself.

There is no distinction in how liability is treated in an S- or C-Corp or LLC or P.C. All provide limited liability to owners and shareholders.

b) Piercing the corporate veil

Piercing the corporate veil is the horror story that every corporation owner fears.

A court may ignore the corporate structure for asset protection purposes (pierce the corporate veil) if:

i) A party is tricked or misled into dealing with the corporation rather than the individual.

ii) The corporation is set up never to make a profit or always to be insolvent, or it is too thinly capitalized.

iii) Statutory corporate formalities are not followed.

iv) Personal and corporate interests are commingled to the extent that the corporation has no separate identity.

Piercing the corporate veil is not that big of a deal in professional companies due to the fact that most lawsuits will come out of personal liability for professional services where a professional cannot hide behind the corporate defense shield anyway.

2) The other main reason businesses are a corporation (not partnerships or sole proprietorships) is to avoid personal liability for debts of the corporations.

Who can incur debts on behalf of the corporation?

- Officers
- Managers (with authority)
- Employees (with authority)

If your corporation incurs significant debt (assuming no personal guarantees) where the corporation is forced out of business, those remaining debts DO NOT become personal debts of the officers, shareholders, or employees.
Keep the corporate entity valid and viable

Just because you filed for your business to be a corporation does not mean that your business automatically gets the protections that go along with being a valid corporation.

There is a laundry list of things a corporation needs to do each year in order to remain valid in the eyes of the state and/or courts. Some of the things you should do to be treated as corporations are:

- **Pay your annual corporation dues.** You would be amazed at the stories you hear about corporations not paying their annual or bi-annual $50-$300 state corporation dues and then finding out after a lawsuit is filed, that the corporate entity is no longer valid in the state’s eyes; and, therefore, there is no limited liability to owners of the corporation.

- **Keep good corporate records.** Issue stock when the corporation is formed, create an operating agreement, elect officers, and have a board meeting at least once a year (and record it in writing).

- **Identify the corporation.** You must have Inc. or Incorporated on your corporation’s bank account name and checks. It is also a good idea to have Inc. on all advertisements and letterhead.

- **Sign corporate documents with a title.** When you sign on behalf of the company as an officer, make sure you write the title after your name (such as President, Secretary, or whatever).

There are other things you can do to make your corporation look like a real live entity, but the above stated are the major ones that you should make sure you always do.

**Types of Creditors**

You have two main types of creditors: “Inside” and “Outside.”

**Inside creditor**

This is a creditor who has its exclusive remedy as one against the assets of the corporation.
Example:

Using our slip and fall example, the patient who slips and falls on property owned by a corporation has, as his/her exclusive remedy, assets and income of the corporation. (This assumes no intentional bad act on behalf of an owner who caused the injury).

Most creditors with lawsuits involving negligence of a corporation are inside creditors.

Outside creditor

This is a creditor who not only can go after a corporation’s assets, but your individual personal assets as well.

Example:

A patient sues a physician for a medical screw-up because of bad advice or a bad surgery. The patient sues the physician individually (and probably corporately although the corporation does not typically do anything wrong in a medical malpractice case).

Because a physician (or anyone providing “professional services”) works in a corporation means absolutely nothing when it comes to asset protection of his personal assets.

The corporate assets are at risk to the extent the corporation did anything wrong to cause injury to the patient AND to the extent the claimant can get at assets of the corporation that are owned individually by the professional providing services.

Another outside creditor would be a guest visiting your home. Assume you had a Christmas party at your house and you gave one of your friends too much to drink. If the friend drove home and got in a car accident causing injuries to the friend, he/she would be considered an outside creditor and would sue you for all of your assets.

Accounts Receivable (A/R) at risk. Sometimes a personal injury attorney will go after the defendant’s interest in the company. This usually comes up with physicians whose main interest is made up of the A/R; and sometimes the attorney will, while the litigation is in process, ask the court to freeze the A/R of a medical practice pending the outcome of the litigation. For a more detailed review of how to protect your business’s A/R from lawsuits, please turn to page 92 of the book.
Rule of thumb

Inside creditors can get whatever a corporation owns, and outside creditors can get at a client’s personal assets, which include ownership interests in corporations.

Director and Officer Liability

Depending on what type of corporation in which you are an officer or director will depend on your degree of liability. As is the case with many professionals, more and more suits are being filed against directors and officers of corporations. Most of those revolve around publicly traded companies where suits are being brought either by shareholders or by the federal government (Enron and WorldCom).

Professional offices by their nature are privately owned by the professionals providing services (95% of the time), and any lawsuit against a director or officer would come from one of the co-owner professionals (who did not happen to be an officer or director).

Since that type of lawsuit is tough to file (due to the daily interaction of the owners), we are not going to spend time on it in this book. Just be aware that, if you are an officer or director in a non-profit or other company, you do have real live liability that you want to make sure is a liability worth taking.

Trustee/Fiduciary Duties

The biggest and most overlooked liability an owner in a medium-to-small business is that of the 401(k)/pension plan (qualified plans). Most businesses with qualified plans have the owners as the trustees. As trustees, owners have an impossible duty imposed upon them by the Federal Government (through the Department of Labor (DOL)).

The DOL Requires Pension Plan Sponsors to:

“…Prudently select & monitor plan investment options…”
[DOL 2550.404c - 1 (f)(8)]

The above duty is for pension plans that allow for self-directed investments by the employees (self-directed meaning your plan has multiple investment options like mutual funds, and the employees pick their own funds).

DOL duty is impossible to comply with

In our opinion, it is impossible for an owner/trustee to comply with the DOL’s requirement to prudently select and monitor the investment options given to the
employees in the plan. In order to technically comply, every trustee would basically be required to become stockbrokers who watch the market all day so they can say in good faith that they did monitor and select prudent investments.

**Non-delegable**

The duty by the DOL described above is also non-delegable. That means you cannot pay someone a fee to take the liability for you. Many pension providers say they relieve this burden, but that is not technically accurate. Pension providers might help give you investment information so you can review it to comply with your duty, but the duty itself cannot be outsourced or delegated.

**Pooled account**

If your company has a pooled account (where all the money of the owners and the employees is all in one account that is managed by someone), the duty is a bit different. The duty for a pooled account is to make sure the money in the plan is invested in a prudent manner. Again, if you are not a stockbroker and you rely on others to invest the company’s pension money, your duty to prudently monitor the investments is impossible to technically comply with.

**The First Union case**

The First Union case comes to us from a bank in Florida. The employees of the bank sued the bank (and the individual trustees) for violating their fiduciary duties as they pertained to the bank’s pension plan. To make a long story short, the investments did not do nearly as well as the averages over a period of time; and the suit settled out of court for $26,000,000, of which the attorneys received $8,000,000.

**Do Not Become the Next First Union Case**

Now that we have told you with any pension plan there is no way to comply with your duties as a trustee, what do you do?

First things first—unless you have disgruntled employees and you have done a terrible job with the company’s pension plan, the likelihood of your company getting sued and you getting sued INDIVIDUALLY as the trustee is extremely remote. The smaller your company, the less the likelihood that you will get sued (mainly because most cases will be too small for attorneys to look at as a viable case for their law practice).

If you want to avoid becoming the next First Union case, please turn to page 312 of this book in the business management section where we will explain how to have the most technically sound pension plan which should basically (although not technically) insulate the trustees from liability.
Conclusion on Trustee Liability

Just be aware that you have corporate and personal liability when it comes to your business’s qualified pension plan. If you are a trustee, that liability is personal and cannot be delegated. If you are worried about this type of liability, we would suggest that you seriously look to make sure your pension plan is set up as technically sound as possible from an investment standpoint.

Limited Liability Companies (LLCs), Family Limited Liability Companies (FLLCs) and Family Limited Partnerships (FLPs)

LLCs, FLLCs and FLPs are “the” tools to use when it comes to asset protection. The following material will give you the reasons from A-Z as to why an LLC, FLLC, or FLP is used by most of the asset protection gurus around the country when advising clients.

For future use in this section of the book, we will use LLC interchangeably as a term that stands for all three entities (LLC, FLLC, and FLP). For asset protection purposes, each entity works the same. If you would like to read how to use each entity for estate planning purposes, please turn to the estate planning section of the book starting on page 154.

We will not be covering in any detail how to technically set up an LLC. Setting up an LLC is very simple and can be done by getting on the Internet and finding the appropriate form on your state government’s web site. Each LLC should have an operating agreement and should be funded (which will not be covered in this book), and so it is still wise to have an attorney help set up your LLC.

What is an LLC and How Does it Function?

LLCs were first introduced in 1976 and have increased steadily with their popularity each year since their introduction. FLPs had been around for years prior to the LLC and were the traditional workhorse of asset protection and estate planning experts (but the FLP had limited applicability to a traditional business which most of the time did not involve family members or friends and left the general partner of the FLP liable for all debts and liabilities of the partnership).

LLCs were designed to bring together a single business organization with the best features of the pass through income tax treatment of a partnership and the limited liability of owners in a corporation.
From a corporate operations standpoint, an LLC functions similarly to an S- or C-Corp in many ways.

**Differences between LLCs and S- or C- Corporations**

1) Unlike an S- or C-Corp, instead of issuing “stock” (and stock certificates) to the owners, each owner simply owns a percent (%) interest in the LLC.

2) For tax purposes, an LLC can be treated like a sole proprietorship, partnership, S-, or C-Corp. The creator(s) of an LLC make an election of how they would like the LLC treated from a tax standpoint. If an election is not made, a default tax status will be taken by the state (which differs depending on your state). For a more detailed discussion on which type of entity your company should be to minimize income taxes, please see page 287 in the business management section of this book.

3) Non-uniform income distributions. In an LLC, the members can vote to divide up the income differently than by member interest. In an S- or C-Corp, the income “distributed” (which is different than W-2 income of the employees) must be distributed in a pro-rata manner by the amount of stock everyone owns. So, if you owned 25% of the stock in an S- or C-Corp, you must get 25% of any distributions. In an LLC, the parties can vote to divide up the distributions any way they see fit.

There is minimal applicability to many companies when talking about different distributions. However, in a consulting company where one member’s worth to the LLC is significantly higher than the others, the members can vote to distribute to that key member more in the way of distributions than his/her member interest would call for on a percentage basis.

**Similarities between LLCs and S- or C-Corporations**

LLCs are treated the same from a corporate liability standpoint as S- or C-Corps in that professionals providing professional services still have personal liability when giving advice. LLCs also provide the standard corporate protection to shareholders and directors for negligence actions against the LLC itself.

**Major Difference between an LLC and an S- or C-Corporation - The Charging Order**

**What is a Charging Order?**

A charging order is the ONLY* remedy a court of law can give a creditor who is trying to obtain the assets of a debtor when the assets are in an LLC (or limited partnership). A charging order **DOES NOT** allow creditors to sell assets of the LLC or to force distributions of income. The best way to illustrate what a charging order does is
to use an example. (Always check your state statute to make sure there have been no changes in the law since the publishing of this book).

**Example:**

Patient Lucky sues and obtains a judgment against Dr. Smith for $3,000,000. Dr. Smith has $1,000,000 worth of medical malpractice coverage and has all the rest of his major personal assets owned by an LLC of which he owns 100%.

Lucky asks the court for satisfaction and asks the court to have Dr. Smith turn over the assets in his LLC to him. The court tells Lucky that the only remedy the court can give to him is a “charging order.”

What does the charging order get Lucky in the above example? Only the right to pay the taxes on income generated in the LLC. (Explained below)

*The asterisk above on the word ONLY is a reminder that only a handful of states have solid charging order statutes. When using an LLC as an asset protection tool, it is vital to set one up in a state where a charging order is deemed the “sole” remedy of a creditor.

**What a creditor cannot get with a charging order**

1) A charging order does not transfer the interest in the LLC to the creditor or force the debtor to sell his/her interest and turn over the sale proceeds to the creditor.

2) A creditor cannot force the LLC to sell assets.

3) A creditor cannot force an LLC to distribute income

**What does a creditor get with a charging order?**

The right to pay income taxes on income generated in the LLC but NOT distributed.

There was a revenue ruling issued in 1977 (77-173) which states that a creditor who obtains a charging order can be treated as a partner for federal income tax purposes.

Why does 77-173 matter?
An example is the best way to illustrate the power of 77-173:

Using the example with Lucky who has a $3,000,000 judgment against Dr. Smith (who only had $1,000,000 worth of medical malpractice coverage), assume that Lucky obtained a charging order against Dr. Smith’s LLC, which owns Dr. Smith’s $1,000,000 brokerage account and $1,000,000 vacation home in Florida.

Further assume that Dr. Smith earns dividend income of $25,000 a year from the brokerage account and rental income of $20,000 a year. Normally, Dr. Smith takes the combined $45,000 home as income from the LLC and spends it as he sees fit.

When Lucky obtains his charging order, Dr. Smith as the managing member of the LLC decides not to take any of the $45,000 out as income and instead leaves the income in the LLC.

Normally, when a corporation does not distribute all the income out of the corporation, there will be corporate taxes levied on that income. If the LLC is treated as an S-Corp or partnership (which is the case 95% of the time), the income is passed through to the shareholder (or member) and taxed at his/her individual tax bracket (as if he/she took the money out of the LLC).

Now that Lucky has a charging order against Dr. Smith’s LLC, Lucky, not Dr. Smith, will receive the income from the LLC. However, in our example, Dr. Smith as the managing member did not distribute the income from the LLC.

What happens?

Lucky gets a K-1 for the taxes on what would have been distributed from the LLC to Dr. Smith. If Dr. Smith were a 100% owner of the LLC interest, Lucky would get a K-1 for all $45,000 that he NEVER received. We call this phantom income (which is income you do not receive but have to pay taxes on anyway).

Summary

The power of an LLC is derived from the fact that a creditor can only obtain a charging order against the LLC (vs. forced distribution of assets or income or, in the alternative, the sale of a debtor’s interest in the LLC) where, if the LLC creates income and does not distribute it, the creditor will get a K-1 for income they never did and never will receive.

The following is a little schematic that might help you visualize what happens (or does not) with a charging order.
What A “Charging Order” Means

Creditor:
Does not become partner (ULPA sec 27)
Cannot touch assets
Gets no LLC voting rights
Cannot force LLC distributions

Creditor gets the K-1 (Rev. Ruling 77-137) on phantom income
(IRS no longer actively pursuing charging orders)

More Differences between an LLC and S- or C-Corporations?

If your assets are held in an S- or C-Corp, the judge has a few different viable remedies upon request of a creditor to implement. Those are:

1) The court can order a debtor’s interest in an S- or C-Corp sold to satisfy the judgment. (A client/defendant becomes a debtor after a judgment is entered against him/her and in favor of a plaintiff (who then becomes a creditor)).

This means, if you are a 100% owner of an S- or C-Corp that owns a $1,000,000 brokerage account and $1,000,000 vacation home, a judge can make you sell your stock which should be worth in the open market $2,000,000. (If you own less than 100% of the stock, a court can make you sell whatever interest you have)

2) The court can order that the ownership interest of a debtor in an S- or C-Corp be transferred to the creditor.

Once the stock ownership in an S- or C-Corp is transferred to a creditor, that creditor can:
1) Vote as a stockholder and act as a stockholder of the company. If you had majority interest in an S- or C-Corp and your children had a minority interest, the creditor would then be the majority owner in that corporation with your children. The same goes if you have friends as partners.

As the majority owner, the creditor would have the right and power to vote to sell corporate assets and make distributions of income.

2) Sell the stock to any third party allowed by the corporation’s operating agreement.

In either scenario, the owner of the S or C stock would lose that stock.

---

**Potential Problems with an LLC**

Not all 50 states yet allow for single member LLCs. (Although all 50 states now recognize LLCs as a legal business entity). As the years pass, eventually all 50 states will have single member LLCs. **Lastly, although single member LLCs have been used for some time now, it is usually wise to have another person as at least a 5% owner of an LLC. This will prevent a creditor from arguing that an LLC without more than one owner should not be able to hide behind a Charging Order as the sole remedy.** If this issue is a concern in your state, we would recommend using an FLP (which has the same protection as described above for the LLC with less concern of a judge giving a creditor other relief besides the Charging Order).

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**What types of assets should be held in LLCs?**

1) **Real Estate (mainly rental or vacation properties)**

Some advisors recommend putting family residences in an LLC. That is fine if you are single where the asset is totally at risk if it is titled solely in your name, but one issue to watch out for is losing the capital gains tax exemption of $250,000 per spouse (which can be used every two years on the gains from the sale of a personal residence). One other issue to watch out for is the fact that the client will lose the ability to take the home mortgage deduction once the home is transferred to the LLC.

In most states, owning property as tenants by the entireties is better than nothing although such a tenancy will not protect the home against joint creditors. If you live in Texas or Florida, the marital home if fully asset protected by state statute.
2) **Brokerage Accounts**

If you have any sizable brokerage accounts, you should have them owned by an LLC. If set up correctly, you will have full authority to buy and sell stocks or mutual funds or whatever inside the LLC. It is just that the assets in the account will be protected.

3) **Planes, Boats, Waverunners, Snowmobiles**

Many clients have either a plane or boat or both. It is important to protect the asset value itself from creditors; but it is also important to protect the rest of your estate from the liability of the airplane, boat, waverunner, or snowmobile.

You have all heard the horror story about a physician going down in the V-Tail Bonanza plane (nicknamed the Doctor Killer) because of pilot error or the boating accident that happened when the owner/driver of the boat had too much to drink.

The above listed assets have unique liability, and you want to protect the rest of your estate from that liability. Therefore, we would strongly recommend that the fun assets listed in 3) be placed in their own separate LLC.

4) **Any other personal asset of value**

**Real World Example**

If the previous material confused you a bit, we want to give you a real world example of how to protect your assets.

Example:

Assume Dr. Smith is 45 years old, married with two children, lives in Michigan, and has the following assets:

<table>
<thead>
<tr>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal residence</td>
</tr>
<tr>
<td>Vacation Home</td>
</tr>
<tr>
<td>Brokerage Account</td>
</tr>
<tr>
<td>401(k)/Profit Sharing</td>
</tr>
<tr>
<td>Airplane</td>
</tr>
</tbody>
</table>

The following is the recommended asset protection plan using LLCs.
Title

Personal residence Tenants by the Entireties

(Not typically in an LLC due to the fact that the client will eventually sell the house and will want to take advantage of the $500,000 joint capital gains tax credit.) Dr. Smith might also use a debt shield to protect the personal residence (see page 88 for more information on debt shields).

Vacation Home LLC #1

If the clients choose to rent the vacation home, we would suggest transferring the vacation home to its own individual LLC to protect it from a suit by a tenant for negligence.

Brokerage Account LLC #1

Again, if the vacation home were ever rented, the brokerage account would get its own LLC.

401(k)/Profit Sharing Qualified retirement money is federally protected

Airplane LLC #2

Because the airplane itself is a source of liability, we would suggest that it be owned in its own LLC so, if there is a crash (and it is always pilot error), the passenger who sues the client’s estate will have to settle instead for whatever is in the LLC (nothing after the crash) and the insurance payments from the company insuring the plane.

Where to Incorporate

Most of the time you are going to file your LLC in your home state or the state in which the asset is held (or where the corporation will conduct business) unless there is a tax reason to incorporate in another state or if your state has a “weak” charging order statute.

Ninety percent of the time a client who creates LLCs for asset protection will have no need to use a DE, AZ, NM, MO, AK or NV LLC for the advantages listed below. If, however, you form a company that creates significant directors’, officers’, and shareholders’ liability or a company that will generate significant corporate income, using a Nevada or Delaware corporation might make sense.

If you use a “foreign” state to incorporate in (a state where the company does not operate its business), you will still have to file a declaration of foreign corporation with your home state, which most of the time will subject your corporation to the state tax laws of your home state.
One popular state to incorporate is **Nevada**.

Why Nevada? From the state’s web site, we found the following:

No Corporate Income Tax, No Taxes on Corporate Shares, No Franchise Tax, No Personal Income Tax, No I.R.S. Information Sharing Agreement, Nominal Annual Fees, Minimal Reporting and Disclosure Requirements, and Stockholders are not Public Record

Additionally: stockholders, directors, and officers need not live or hold meetings in Nevada or even be a U.S. Citizen. Directors need not be stockholders, officers, and directors of a Nevada corporation and can be protected from personal liability for lawful acts of the corporation. Nevada corporations may purchase, hold, sell, or transfer shares of its own stock. Nevada corporations may issue stock for capital, services, personal property, or real estate, including leases and options; and the directors may determine the value of any of these transactions, and their decision is final.

Finally, Nevada has a very strong charging order statute (which is vitally important).

**Conclusion**

Unless you have a specific reason to incorporate in another state besides your home state or the state where the asset is located, don’t. Doing so will simply add to the costs of your asset protection plan.

**Section 8**

**Trusts as Asset Protection Tools**

The general rule of thumb is:

Unless a domestic trust is irrevocable, it provides no asset protection.

**Types of Trusts**

**Revocable**

A revocable trust is just that—a trust that is set up where typically the client is the grantor (person setting up and usually funding the trust with assets) and is revocable at **ANY** time.
Irrevocable

A grantor sets up an irrevocable trust like a revocable trust except the grantor can NEVER get the assets back that were used to fund the trust. There are ways to draft irrevocable trusts so family members have control of the assets; but technically speaking, the grantor is not supposed to have any control over who gets the assets from the trust.

Intervivos

An intervivos trust is simply one that is set up and used during a grantor’s lifetime.

Testamentary

A testamentary trust is one that is set up at the death of a client or is created by will and takes effect upon the death of a client.

What Asset Protection?

Revocable trusts provide NO asset protection. While revocable trusts are used sometimes for estate planning purposes, they provide a client with no current asset protection. Because a grantor client has the power to take assets out of the trust, a court of law can demand just that at the insistence of a creditor.

Irrevocable trusts provide total asset protection when done correctly. Because the grantor client irrevocably funded (gave) assets to an irrevocable trust (and can never get them back), those assets are no longer owned by the grantor and can never revert back to the grantor; thus, there is nothing a court of law can do to make the grantor take back those assets to satisfy a judgment.

Most wealthy clients who are aware of their risks have at the top of their list asset protection, but giving assets away where the client has no rights to use or enjoy those assets is not something most of them have in mind. As stated early in this section of the book, good asset protection is about maintaining control of assets and making it difficult for creditors to get those assets, not about giving assets away.

Irrevocable trusts do have a place in an asset protection/estate plan of high-end clients (usually through an irrevocable life insurance trust (ILIT) (see page 127 of this book for the proper use of an ILIT) or through normal gifting to children at $12,000 per spouse per child as of 2006); but when it comes to asset protection, irrevocable trusts are not terribly helpful due to the fact that the client literally has to give up control of assets to protect them.

Finally, there are several provisions that should be in every irrevocable trust that are outside the scope of this book. Just be sure that the attorney you use with all of your
asset protection and estate planning needs is an expert in his/her field. If not, your attorney could seem to set up a properly drafted irrevocable trust when, in fact, the trust is missing several key elements (that could cause the trust to be defective and deemed a revocable trust).

Section 9
Offshore Asset Protection Strategies

We would like to preface this section of the book by stating that this is not intended to make you an expert in offshore planning. We will be giving you the basics of offshore and enough information for you to determine if offshore planning is something you need to look at further.

Why Offshore?

We think the question of why not to go offshore is a better one to start with. You should not be thinking of offshore because you heard from a friend or read somewhere that offshore asset protection is the only way to go to truly protect your assets.

Further, you should definitely not go offshore if you think you will save on U.S. federal income tax. Any advisor who tells you that you can move assets offshore and AVOID taxes is an advisor you want to stay away from. While there are ways to have assets in certain investments that are tax favorable offshore (private placement life and captive insurance companies), simply moving your $1,000,000 brokerage account to an offshore asset protection trust is not going to save you annual income taxes on dividends earned from your brokerage account.

The fact of the matter is that 50% of the people who need asset protection can accomplish their goals domestically through the use of LLCs. Offshore is always more expensive with more complexity. While at the end of the day you might get more asset protected with offshore planning, the real question you need to ask yourself is—Does offshore planning make sense in your particular situation?

Most of the people who really gravitate to offshore planning are the ones who already know they have a potential lawsuit in the works. By transferring your assets offshore and giving notice to creditors, sometimes offshore is the only way to attempt to protect your assets in the face of what is certain litigation (as long as you are not in violation of the fraudulent transfer rules).

Lastly, offshore planning will not work with real estate in the U.S.
Pitfalls of Offshore Planning

While many of the properly used foreign jurisdictions for asset protection do not recognize U.S. court orders, a question to ponder before implementing an asset protection plan is:

Whether a U.S. court having jurisdiction over the debtor (because he or she is domiciled in the state) will nullify the transfer of assets to an offshore trust under state law principles or otherwise rule that the transfer of assets to the foreign trust was invalid or illegal in the first place.

If there is a flaw with offshore planning, it is that the person trying to protect his/her assets by moving them offshore still lives in the U.S. and is subject to the court’s jurisdiction and court orders including a contempt order.

Generally speaking, offshore planning done right will not run into conflict with U.S. courts; but if there is any indication that a transfer to an offshore entity was done with fraudulent intent, there is precedent that would cause a U.S. citizen to worry.

The Anderson Case

The Anderson case was a 1999 case where the defendants (the Andersons) defrauded investors of millions in a Ponzi scheme (you can read about what a Ponzi scheme is on page 281 of this book in the personal finance section).

When the Andersons knew troubles were brewing with the clients they bilked out of millions, they transferred to a Cook Island Trust (Foreign Asset Protection Trust (FAPT)) several million dollars. The Andersons were co-trustees of the trust along with a local trust company. When the lawsuit was filed, by the rules of the trust, the Andersons were dropped as co-trustees and the remaining foreign trustee was the only person/entity that could authorize the disbursement of money from the foreign trust.

To make a long story short, the court in Anderson threw the clients in jail for contempt of court when they refused the court’s demand that the Anderson as co-trustees bring the money from the Cook Islands back to the states where it could be divided out by the court at the conclusion of the case against the Andersons.

The Andersons argued that, when the suit was filed and a demand was made on the trust to bring the money back to the U.S., they were automatically terminated as trustees and did not have the authority under the foreign jurisdiction to take money out of the trust and bring it back to the U.S. This argument normally would have worked except that the Andersons set up the foreign trust with knowledge that a lawsuit was imminent.
Could a court hold you in contempt of court and throw you in jail if you did not bring money back to the states after you deposited it into an offshore trust? (Which is different than offshore LLCs discussed in the upcoming pages)

It is very unlikely that a U.S. court would hold someone in contempt of court if the money transferred to a properly set-up offshore trust was done for a legitimate business purpose and done before there was an awareness of future litigation. The Anderson case is a classic example that bad facts make bad law, and so most of the asset protection gurus do not believe the Anderson case is applicable to clients except if they are making transfers to an offshore trust with the knowledge of potential litigation.

**Expense**

Offshore planning is a bit on the pricey side. While you might be able to implement an entire asset protection plan domestically for $2,500-$10,000, a similar offshore asset protection plan could cost in excess of $25,000. Expense should not be an impediment for a high net worth client to protect his/her assets; but unless the client has $500,000 or more in liquid assets he/she is trying to protect, we typically do not even bring up the topic of offshore protection (because it is difficult to justify the costs).

**So again, why offshore?**

The simple answer is that offshore planning will be the best way to asset protect your assets. Why, because good offshore planning takes the asset out of your control, puts your money in a place the U.S. government has no jurisdiction; and, therefore, an order from a U.S. court is not binding. As a general statement, the U.S. only has jurisdiction over people or property located within the U.S. borders. When you move your assets to an entity that is offshore (with offshore investments), you remove your property from U.S. control.

The other reason offshore planning is so powerful is that, for a creditor to attempt to get those assets, the creditor has to bring a separate lawsuit in the jurisdiction where the assets are located. To bring such a civil lawsuit after getting a judgment from a long U.S. civil lawsuit is not an enviable position and one that will cause a creditor much grief and much expense.

Lastly, with many offshore trusts, there is language that requires the trustee of the trust to immediately move the assets from one foreign jurisdiction to another when litigation is filed in the original jurisdiction. So you can imagine the pain a creditor would have after spending $25,000 to get a judgment in a foreign jurisdiction only to find out that the money was transferred to another jurisdiction (in compliance with the first foreign jurisdiction’s laws) where the creditor has to spend another $25,000 to re-litigate the case in hopes that the money might be there when and if the suit is completed successfully.
What are the main offshore tools?

1) Offshore Limited Liability Companies (LLCs)

2) Offshore Trusts

3) Closely Held Insurance Companies (CIC or Captive)

1) Offshore Limited Liability Companies (LLCs)

Several offshore jurisdictions implemented LLC legislation similar to that of existing LLC legislation in the U.S. Jurisdictions such as Nevis (everyone’s current favorite), the Cayman Islands (limited duration companies), Turks and Caicos (limited life companies), Anguilla (LLCs), the Bahamas (limited duration companies), and the Isle of Man (limited duration companies) all have existing LLC legislation.

While we will not be going into the specifics of each country’s laws, know that the Nevis LLC laws seem to be most applicable when implementing asset protection plans due to the fact that they are similar to (but better than) the LLC laws in the U.S.

Basically, with a Nevis LLC, a client is getting the best of all worlds—asset protection similar to U.S. LLCs where the only remedy a court can give a creditor is a charging order, but yet the LLC is in a foreign jurisdiction where, in order for a creditor to obtain a charging order, the creditor has to file suit in Nevis. Asset protection plus litigation deterrence make the use of an offshore LLC the simplest and one of the best offshore planning tools.

Because we have not dedicated pages of material to offshore LLCs, do not take that as a sign we do not prefer the option for asset protection. Our preference for offshore asset protection many times is through the use of an LLC. However, because offshore LLCs function similarly to domestic LLCs (with the additional litigation deterrence of a creditor having to file suit offshore), we are not going to regurgitate the information explained in an earlier section of the book as to why LLCs are good asset protection tools.

2) Offshore Trusts

Offshore trusts (which go by different names: Foreign Asset Protection Trusts (FAPT), offshore trusts, or asset protection trusts) are similar in some respects to traditional trusts in the U.S. Offshore trusts have all the same flexibility of design as domestic trusts when it comes to adding provisions to the trust such as discretionary provision where the trust is not required to make distributions.
Protect your assets

Offshore trusts are supposed to protect your assets because:

U.S. Courts have no jurisdiction in a foreign country and, therefore, have no control over the assets in a foreign offshore trust.

U.S. Courts typically do not use Contempt of Court (where the court would send you to jail until you brought back your assets from the offshore trust) when assets are properly transferred to offshore trusts. We say typically because there have been cases where clients have gone to jail for long periods of time for contempt because they refused to bring back assets from an offshore trust to satisfy a judgment.

Offshore asset protection havens are your friends. Most of the offshore asset protection havens have drafted their local laws to be as friendly as possible to U.S. citizens looking to shield assets from lawsuits. The laws make it extremely difficult (or impossible) for a creditor to gain access to the money in an offshore trust.

Typical Offshore Trust Setup

Similar to domestic trusts, offshore trusts have a:

**Grantor** (sometimes called a settlor) - The person who sets up and funds the trust.

**Beneficiary** - The person who will eventually benefit from the money in the offshore trust. It is not a good idea to have the grantor as the sole beneficiary (or a beneficiary at all depending on your risk tolerance). Typically, you would name a spouse or child as the beneficiaries (which cause other long-term planning problems and instability).

The more it looks to the court like a client/grantor has power over the trust or will benefit (especially exclusively) from the trust, the more likely the client will run into the bad fact scenario in the Anderson case where the U.S. judge saw through the sham of the offshore asset protection plan and held the debtor client in contempt of court and threw the Andersons in jail.

**Trustee** - The trustee is really where an offshore trust differs from a domestic trust (besides the fact that it is offshore and subject to the favorable laws of an offshore asset protection haven).

With an offshore trust, there are usually at least two trustees—the grantor and a foreign trust company (with no ties to the U.S.). There is an extensive trust agreement.
that spells out the trustee’s duties and how the money is to be distributed to the beneficiaries.

**Potential Problems with a Foreign Trustee:**

One of the potential problems with offshore trusts is finding a foreign trustee who can be trusted and will remain solvent. What typically happens if there is a lawsuit where a creditor tries to get at assets in the offshore trust is that the client who is a co-trustee loses his/her powers and the foreign trustee (who is not subject to the jurisdiction of U.S. Courts) takes over total control of the assets in the trust.

When the foreign trust takes over the exclusive control of the assets in a trust that was funded by a client, there tends to be some worries about whether or not the foreign trustee is going to “do the right thing”—the right thing being to protect the assets in the trust, not embezzle the money, and eventually distribute the money as the U.S. co-trustee would have distributed it (to the client and/or his family). In other words, a client would be worried the foreign trustee would take the money and run, and the client would never see that money again.

Because of this issue, it is vitally important that you work with advisors who know that they are doing, have a track record you can check on, and work with reputable offshore trustees. If you use large institutional trustees and protectors, using an OAPT is the best way to protect liquid wealth from creditors.

**Protector**

The protector is a person/entity that should be considered when creating any offshore trust. A protector does just what the name implies, which is to protect the assets in the trust from being distributed contrary to the trust document or embezzled by the trustees.

Typical powers of the protector include: (1) the ability to remove and appoint trustees; (2) to veto a trustee’s distributions (made at the discretion of the trustee) from the trust; (3) to add or change beneficiaries; (4) to consent to the exercise of the “flight” clause (causing the trust to change its location to a different country); and (5) the right to protect against mismanagement of the funds in the trust.

While it is important to have a protector, it is also important to have the trust document written in such a manner so as to be able to remove the protector, change the protector’s authority, limit who may act as the protector, or deal with replacing the protector in the event they resign.

We would suggest that the protector not be a U.S citizen so as to avoid a U.S. court from directing the protector to bring your assets in the foreign trust back into the states to satisfy a judgment.
Contempt of Court

If you do any serious reading about offshore trusts, you will find two main schools of thought: 1) offshore trusts are the best way to asset protect your assets and 2) offshore trusts are dead due to the contempt of court ruling recently handed down where clients have been sent to jail for not returning assets from their offshore trust to the U.S. to satisfy a judgment.

Our opinion is that offshore trusts are still viable if set up correctly and in a timely fashion. Too often people using offshore trusts are doing so because they know of an impending problem. If that is the case, we believe contempt of court is a real live consequence a client needs to worry about. Additionally, if an offshore trust is set up to give the client too much control (like the power to bring assets back to the U.S.), then again we think contempt of court is a real live consequence the client needs to worry about.

What is Contempt of Court?

Contempt of Court is defined as: Any willful disobedience to, or disregard of, a court order or any misconduct in the presence of a court; action that interferes with a judge's ability to administer justice or that insults the dignity of the court; punishable by fine or imprisonment or both.

Everyone by now has seen a TV court drama where someone (either attorney, client, or witness) does something to upset the court, and the judge yells out for the person to stop or they will be found in Contempt of Court.

In the offshore area, contempt revolves around a judge telling a debtor (after a money judgment is rendered for the plaintiff (now creditor)) to bring back money from a foreign asset protection trust set up by the debtor and the debtor refusing or claiming a defense to being able to perform the act the judge has requested.

What defenses are available for contempt?

Impossibility of performance (which is a complete defense)

In the offshore scenario, the debtor would tell the court that he/she has no legal authority to order the money in the offshore trust back to the U.S.

With a properly setup offshore trust, the client, even if he/she was a co-trustee by the language of the trust, as soon as a creditor tried to get at the assets in the offshore trust, would be removed as a co-trustee and, therefore, would lack the legal authority to transfer anything out of the trust. It is impossible for the client to comply with the U.S. Court’s order to bring back the money from the offshore trust; and, therefore, the client
has a good argument for why he/she should not be held in contempt for not abiding by the court’s order to bring back the money to the U.S.

There are problems with impossibility of performance defense. By setting up the trust for the specific purpose of avoiding the long arm of the U.S. court system, the court can determine that the trust was set up in bad faith (to avoid legally being able to bring back money from an offshore trust to the U.S), that you intentionally created the **impossibility of performance defense** and strike that as a viable defense. Then you have facts that are similar to the Anderson case (discussed previously) where the court did send the Andersons to jail even though technically the Andersons did not have the legal authority to bring back assets from the offshore trust they set up.

When a court determines if a debtor self-created the impossibility defense, the court looks to see 1) if the debtor acted in good faith; 2) whether the party cooperated with the court by complying to the extent possible; 3) whether the debtor created the impossibility scenario at the time the debtor anticipated the issuance of an order by the court; and 4) how much time had elapsed from the creation of the offshore trust (and trust document) and the time of the contempt proceedings.

It should be noted, at the time this book is being published, even though a few cases have held clients in contempt and thrown them in jail, no cases that these authors are aware of has actually “broken” the offshore trust and taken the money out to give to a creditor. Clients like the Andersons may have had to stay in jail for six months, but so far the money in their offshore trust is still intact.

### Conclusion on Offshore Trusts

Offshore trusts under today’s laws are a viable option for asset protection. Some commentators say offshore trusts are the best way to asset protect your personal assets and some say the concept is dead because of the potential for a court to order a contempt citation, thereby sending a client to jail if they do not bring money back from the offshore trust.

It is our belief that, if an offshore trust is set up in a timely manner (well in advance of litigation where creditors will be after your assets) and if you do not retain too much control over the assets in the trust, offshore trusts will work very nicely to not only protect your assets but deter any litigation attempts to even go after your offshore assets. It is also very expensive and a pain in the neck for a creditor, with no guarantee that the creditor will have success, to go after assets that are in offshore trusts; and if they do have success, the money in the offshore trust will most likely be moved to another haven where the creditor will have to start the process all over again).

Even if your offshore trust is not set up correctly, the deterrent factor of a creditor having to go offshore to try to collect should be enough to fend off most attempts to get at your offshore assets.
Lastly, do not try to avoid taxes with an offshore trust. That is fraud; and if you are caught, the consequence from the U.S government will be significant.

### 3) Closely Held Insurance Companies (CICs)

CICs are a nice way to implement an offshore asset protection plan that is different from the traditional offshore LLC or offshore trust.

CICs are used by small-to-medium business owners more for income tax reduction and estate planning; but because the CIC is set up offshore, it turns into a terrific asset protection tool as well.

**What is a CIC?**

A CIC is just what it sounds like; it literally is your own insurance company that can sell insurance to a number of different people or entities (although most of the time your CIC will sell insurance to your own small business). Due to the lack of space in this book, CIC’s and how they function as income tax reduction and estate planning tools are not covered. If you would like more information on CICs, please contact one of the authors for a 25-page summary.

**How Does a CIC Work as an Asset Protection Tool?**

CICs are typically created offshore due to the lower initial capitalization requirements. Because CICs can be created offshore, they provide asset protection like any offshore company.

**Example:**

Mr. Smith has a manufacturing company which he owns 100% of the stock. Mr. Smith generated $2,000,000 of take-home income after expenses from his company, and he does not need the money to live on. Mr. Smith is 58 years old with 3 children, a spouse, and a net worth including the value of his company of $15,000,000.

Mr. Smith could set up a CIC that could be owned entirely by his children. Mr. Smith’s company would then purchase $1,000,000 worth of insurance from the CIC for various types of insurance coverage.

Mr. Smith’s company would pay this premium each year, and several good things are accomplished with this scenario:
1) Mr. Smith transferred $1,000,000 into an offshore CIC which is owned by his children. This transfer was done without gift taxes (and with a good claims’ history, the children will be able to keep that money).

2) Mr. Smith did not have to take the money home and pay income taxes on it.

3) Mr. Smith did not have to figure out how to asset protect the $600,000 he would have taken home after tax (in the 40% tax bracket) since the money has not only been transferred to the children’s CIC but is in an offshore CIC.

The money in the CIC is there in the event there are any insurance claims, but realistically that money will be used by the children as part of their inheritance.

CICs are not for everyone, but they are something that should be explored by anyone looking to implement an offshore asset protection plan. The CIC also must have as its primary business purpose the sale of insurance. Make sure when looking into the topic you have an advisor who can counsel you on the proper way to set up a CIC so it can be set up in compliance with all the applicable laws.

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**Conclusion on Offshore Planning**

Offshore planning for asset protection is the best way a high net worth client can protect their assets from creditors.

The question you have to ask yourself from a practical standpoint is:

“Is offshore planning and its expense (and sometimes risk of loss of control of your assets with offshore trusts) worth it?”

For most clients (50%+ for the wealthy), there is no need to go offshore when domestic LLCs will do the job just fine.

For those clients with sizable liquid assets ($500,000 or more), the expense of offshore can be justified.

For those clients who have a real worry (although not a confirmed worry) about an impending lawsuit, offshore is definitely the way to go (although you need to avoid a fraudulent transfer). The deterrent factor of going offshore most of the time will be enough (when the lawsuit involves less than $5,000,000) for a creditor to not want to go through the expense and headache of litigating a lawsuit offshore with no idea if the money will still be in the offshore trust account or LLC when it is time to satisfy a judgment.
Section 10
Protecting the Marital Home/Personal Residence

Unfortunately, there is no great answer for how to protect a client’s personal residence; and below we will discuss the problem in more detail. Because a client’s personal residence for many years is the greatest asset in terms of dollars, it is one of the most important assets to protect from creditors.

Homestead Exemption

As discussed in more detail on page 38, the homestead exemption is very limited in most states ($5,000-$10,000). In states like Texas and Florida, there is an unlimited homestead exemption which protects the entire value of the house (whatever that may be).

Since most of the country does not live in Florida or Texas, the homestead exemption is of little help to those that have more than $5,000-$10,000 of equity in their homes.

Tenants by the Entireties (TE)

As discussed on page 51, states like Michigan allow married couples to own property titled as “tenants by the entireties” (TE). Owning property as TE means that each spouse has an undivided interest in the “whole” property. Even though each spouse owns 50% of the marital residence, they each have an undividable right to use the whole property.

A creditor cannot force the sale of either spouse’s interest because to do so would affect the other spouse’s enjoyment of the “whole” property. Therefore, if you live in a state where married couples can own property as TE, then by good fortune, your marital residence is protected.

Problems with TE

1) Besides the fact that few states allow property to be held as TE, TE does not protect the marital home from joint creditors of both spouses. Let’s look at an example of how this problem might come into play.
Example:

Dr. and Mrs. Smith are having a Christmas party where they have invited over all the staff from Dr. Smith’s medical practice. Everyone has a nice meal; and then from 7 pm-midnight, several of the staff members proceed to drink multiple gin and tonic drinks that Dr. Smith was only too happy to provide.

After Dr. Smith’s personal nurse has seven (7) gin and tonic drinks, she looks at Dr. Smith and says she is going home. Dr. Smith can see that his nurse is obviously drunk and lets her drive home anyway due to the fact that she only lives a few miles away.

The nurse pours herself into a car and then drives home. On the way home, she crosses the center line and then hits an oncoming car causing a crash that kills all four passengers.

The four passengers happened to be four cardiologists coming home from their Christmas party, and each one of them had an annual income of $750,000 a year.

Who is going to get sued in the above example?

Oh, by the way, the nurse died as well.

The nurse is going to get sued; and her auto insurance company is going to simply hand over the $1,000,000 coverage to be divided up among the families of the four cardiologists.

Dr. Smith AND his wife are going to get sued by both the doctors and by the nurse’s heirs. Why? Because they gave alcoholic drinks to a guest and let her drive home when she was obviously drunk. You may have heard of lawsuits against bars and taverns called “dram shop” cases? A dram shop case is when a bar serves too much alcohol to a patron and then lets an obviously drunk patron drive home drunk. The bar is liable.

In our above example, Dr. and Mrs. Smith are sued in a similar negligence case as a bar would be sued when letting an obviously drunk person drive home.

But the house is owned as tenants by the entireties. Doesn’t that protect Dr. and Mrs. Smith? Unfortunately, the answer is no. Why? Because the both Dr. and Mrs. Smith own the house where the party and negligence took place; and they will both be sued, thereby, putting all their assets, which are owned jointly, at risk. A house owned as TE is owned jointly and is at risk.
2) What if a client is not married? Tenants by the entireties is not available to a client who is not married. When is this a problem? It potentially could be a problem for a younger client who has not yet been married and has significant equity in his/her residence. (However, younger clients typically have significant debt on their houses which makes the house an asset a creditor will not want).

What about divorce?

When a client ages 55-65 gets divorced, the minute the divorce is final whichever spouse ended up with the house no longer owns the house titled as tenants by the entireties. Therefore, when a client gets divorced and if the house is owned personally by the client after the divorce, the house is absolutely at risk to creditors.

Other Solutions

Qualified Personal Residence Trust (QPRT)

The first tip off that someone is not an asset protection planner is the suggestion that the best way to asset protect a residence is through a QPRT. We are not personally fans of a QPRT for most clients; and as it is discussed below, you will see why. Having said that, a QPRT is one of only a few ways a client who does not have an unlimited homestead exemption or lives in a TE state can protect his/her personal residence.

A QPRT is our least favorite kind of trust; i.e., it is an irrevocable trust.

A QPRT is a trust set up where the personal residence is gifted to the children in an irrevocable manner. Those who like the QPRT tout the fact that the personal residence can be transferred to the heirs via a trust at a low gift tax value and with NO estate tax consequence. The person gifting the house to a QPRT gets to live in the house rent free to a specified period of years. If the person gifting the house survives to the end of the term, the residence will pass estate tax free to the heirs.

During the trust term, the owner/spouse in the residence is responsible for maintaining the property and paying taxes and expenses connected with the occupancy. This means that the term holder is treated just like an ordinary owner in a residence. If there is a mortgage on the property, the term holder should continue to make the payments; but a portion of each principal payment may be considered to be an additional gift to the remainder beneficiaries. That would add to the complexity of the calculations for the trust.

Let’s look at an example of how to set up and use a QPRT.

Dr. Smith is age 65, and his spouse is also 65 years old. He does not live in Florida or Texas; and, therefore, the homestead exemption is of little help when it comes to asset protection. Also, assume he does not live in a TE state.
Dr. Smith is an OBGYN and is fearful of losing his house to a patient creditor in a medical malpractice suit. The house is worth $400,000 with no debt on it so he decides to gift it to a QPRT. If we assume the term of occupancy for Dr. Smith in the house is four (4) years, the current value of the gift to the QPRT would be approximately $210,000. Dr. Smith could use some of his estate tax credit to pass the house to the QPRT gift tax free.

The taxable gift upon transfer of an asset to a QPRT is determined by subtracting the value of the client’s right to remain in the home (valued as an income interest) and the value of the possible reversion to the grantor's estate. No gift tax will ever be paid on any future appreciation on the home.

After the fixed term ends, Dr. Smith can continue to use the residence in one of two ways. First, the residence can be retained in trust for his spouse's lifetime, thus assuring that the entire residence is available to her before it will be distributed to the children upon the spouse's death. Second, he can enter into a lease with his children which will allow him to live in the residence for as long as he wishes. If Dr. Smith does so, however, he must pay fair market value rent to his children after the fixed term ends in order to keep the residence from being subject to estate tax on his death.

If Dr. Smith survives the fixed term of the QPRT, the value of the residence will not be included in his estate for estate tax purposes. Even if he does not survive the fixed term, the estate tax consequences will be no worse than they would have been if he had not created the QPRT in the first place. In other words, from an estate tax point of view, there's no potential downside to a QPRT. A QPRT is not a bad way to remove a residence's value from one's estate at a greatly reduced gift tax cost.

**Downside to a QPRT**

1) If the client dies prior to the end of the term, the asset will be includible in the client’s estate (and this will act for the most part like the QPRT was never put in place). The deceased client’s estate will be given credit for any gift tax previously paid, and the estate tax calculation will take into consideration the entire lifetime exemption.

2) If the client outlives the term of years, typically he/she will lose control of the property and could be thrown out of the house if there was a falling out of with the beneficiaries of the QPRT.

3) If the client has a provision in the trust to live in it past the term of years, the client will end up paying rent to the beneficiaries of the trust at the fair market rate. This rent is not deductible to the renter and will be income to the beneficiaries.
Conclusion on the QPRT

The QPRT can work as an asset protection tool, but younger clients will be hesitant to use this concept due to the difficulty in picking a term of years on a property that will most likely be sold prior to an ultimate transfer to the heirs. If the client lives through the term of years of the QPRT, he/she runs the risk of being thrown out of their own residence by the beneficiaries or paying non-deductible rent payments which will be taxable to the beneficiaries.

As an asset protection tool, the QPRT has marginal value; however, the QPRT is not a bad estate planning tool for clients over the age of 60 to gift away a large asset at a significant discount where if the client (grantor) lives through the term of years of the QPRT, the asset will pass income and estate tax free to the beneficiaries (even if the asset significantly appreciates in value).

LLCs and FLPs

It is absolutely amazing how many attorneys and CPAs/accountants recommend that their clients transfer their personal residence to an LLC or FLP for asset protection purposes.

Why use an LLC or FLP? Many advisors these days have at least read about why people use LLCs or FLPs for asset protection, i.e., the charging order protection. While it is true if a client has a properly set up LLC or FLP in the a state with a good statute that the “sole” remedy a judge can give to a creditor is a charging order; does that automatically mean that using an LLC or FLP is a good idea for the personal residence?

The simple answer is no. Why?

There are three potentially significant downsides to putting a personal residence in an LLC or FLP depending on which state you live in.

1) The client can lose the capital gains tax exemption upon the sale of the residence. Each spouse has a $250,000 capital gains tax exemption on the sale of the personal residence (which renews itself every two years). In order to take advantage of this exemption, the spouse(s) must live in the house and own it personally for two years out of five.

Therefore, if a client transfers the personal residence to an LLC or FLP and then suddenly wants to sell it, the client would lose the capital gains tax exemptions if he/she had not lived in it for the last two years out of five. In the event the client did not want to lose this exemption, he/she could transfer the house back to him/herself personally and live in it for two years and then sell the house.
2) The client will lose the home mortgage deduction if it is owned by an LLC or FLP. This is huge for most clients who have a mortgage. One of the biggest itemized deductions for clients is the home mortgage deduction, and most clients will not want to forego that deduction to asset protect the personal residence.

To the extent the client had no home mortgage, this would not be an issue.

3) In some states (like Michigan), if the marital residence is not owned individually, the client would lose the ability to claim it as their “homestead.” The consequences in Michigan for not being able to claim a home as the homestead is an increase in property taxes that is over 50%.

For example, if a client had a $500,000 house and claimed it as his/her homestead, the property taxes would be $5,000. If the client’s personal residence was owned by an LLC, thereby not giving the client the ability to claim it as his/her homestead, the taxes would be $13,000.

Again, most clients will not want to pay extra for their property taxes just so they can protect the value of their personal residence. Like with any asset protection strategy, the decision for a client to implement comes down to the fear of losing the asset and the cost and headache of asset protecting it.

The homestead exemption varies per state, and you should check with one of the authors before making any decisions.

**Conclusion on LLCs and FLPs**

Unless a client has no home mortgage and no problems with having to live in the residence two years out of five before selling the residence, we do not recommend LLCs or FLPs as good asset protection tools for the personal residence.

**Debt Shields (Equity Harvesting)**

Debt shields have been around for some time but have not really come into their own as a sales tool for insurance salespeople until some of the new life insurance policies have come onto the market in the last few years.

While debt shields and equity harvesting sound fancy or exotic, the terms simply stand for taking out a large amount of debt on an important asset that otherwise does not have debt (or much debt).

The theory behind debt shields is simple; if an asset is riddled with debt, a creditor will not want it. If a creditor does want it, he/she will have to stand behind the first creditor holding the loan against the valuable asset.
How does Equity Harvesting work?

Prior to recent internal revenue code changes, clients could simply borrow as much money as a lender would give them via a re-finance of their home and write off the entire interest payment as an itemized deduction on a personal tax return. Then the client could take that borrowed money and invest it in certain places to create supplemental retirement savings.

Because so many clients were taking the equity from their homes and investing it for retirement savings (due to the tax favorable nature of the investment) the IRS came out with rules to limit refinance debt increases to $100,000.

Therefore, if a client has a $500,000 home with no debt, the maximum financed debt allowed on the property (to qualify for the interest deduction) is $100,000.

We find the IRS’s limit on the interest deduction very telling. Basically the IRS is telling the American public that there is too much of an economic windfall to clients who take the equity out of their houses, write off the interest, and invest it for retirement savings.

There is a way around the above stated $100,000 limit on debt. The way a client can get around the limit is to buy a new home. For example, if a client has a $500,000 home with no debt and is concerned about asset protection (or simply wants to take advantage of the ability to borrow money, invest it and write off the interest), the client can sell the home and buy a new $500,000 with a $500,000 debt and the entire interest payment on that debt would be deductible. Then the client can take the proceeds from the sale of the previous house and invest it for retirement savings.

Where is the borrowed money invested?

There are NSDA rules regarding where borrowed money can be invested; and as a general statement, that money cannot go into individual stocks or mutual funds.

With the equity harvesting program, the money from the loan is typically invested into a cash-building life insurance policy where the death benefit is at the minimum rate allowed so the client can take “tax free” loans from the life policy in retirement (tax free loans from a life policy are discussed in greater detail in the life insurance section of this book on page 235).

The home loan is typically set up as interest only and tied to the lowest interest rate possible (Libor for example). The reason the loan is interest only is due to the fact that the whole point of the loan is to keep it on a valuable asset so the asset is not attractive to a creditor (and even if a creditor makes a claim against the asset, the creditor is second in line behind the lender).
Is Equity Harvesting financially viable?

As stated above, the IRS thought it was so financially viable, it acted to limit the interest deduction on home equity loans and re-financing of homes. As a general statement, if life insurance policies perform as they have for the last 20+ years and if interest rates remain anywhere near what they have for the last 20 years, then the answer is that equity harvesting will work well for a client financially.

As you will read below and in much more detail in the A/R Leveraging part of this book, borrowing money and pouring it into a life insurance policy as an investment can work out well for a client even if the client does not write off the interest. With equity harvesting, the interest on the loan is deductible (when done right) thereby increasing the financial viability of the program.

Let’s look at an example as it pertains to the personal residence.

Dr. Smith, orthopedic surgeon, age 42. Dr. Smith lives in a state where the homestead exemption is $5,000 and where tenants by the entireties is not available as a way to own property.

Dr. Smith has been working hard for over ten years as a surgeon, and he recently paid off the debt on his house which is worth $600,000. Dr. Smith’s partner was just sued and lost a jury verdict for a malpractice suit where the verdict was $2,500,000. All the physicians in the practice have $1,000,000 worth of malpractice coverage; and, therefore, Dr. Smith’s partner’s personal assets are all at risk from the patient with the $2,500,000 verdict.

Dr. Smith looks in the mirror and asks himself what he can do to protect his newly paid-off $600,000 house. His local attorney suggested an LLC and his CPA suggested a QPRT. After talking with a CWPP™, Dr. Smith decided that neither the LLC nor a QPRT would be the best way to go to protect the residence.

Dr. Smith’s CWPP™ advisor suggested that Dr. Smith look at putting a “debt shield” on the house, and Dr. Smith asked the advisor to run the numbers. Due to the fact that Dr. Smith has no debt on his house, he is limited to a $100,000 home equity loan if he wants to write off the interest. As a good coincidence, Dr. Smith’s wife is ready to move into a new house, and so they chose to sell the house and purchase a new $600,000 with a new $600,000 mortgage (where all the interest is deductible).

The advisor shows Dr. Smith taking the equity from the sale of the house ($600,000) and investing into a cash building life insurance policy over a five year period (which is done to minimize the expenses in the life policy).
Dr. Smith has a Libor + 1% loan at 5% with a rate lock for five years. The interest on the loan every year is $30,000 which costs Dr. Smith $18,000 out of pocket due to the fact that he gets to deduct the interest from his taxes (assuming the 40% tax bracket).

Dr. Smith pays $18,000 a year (after tax) each year for as long as he would like to asset protect his $600,000 home (which is also appreciating).

If Dr. Smith purchased a life policy specifically for equity harvesting, he would have $600,000 in cash surrender value in the policy at the end of the fifth year (which would mean if he decided he did not want to have the loan any longer he would have the cash to pay it off). Dr. Smith would also start out with a $2.1 million dollar death benefit with the life policy.

If Dr. Smith waited until age 63 to pay back the loan using our reasonable assumptions, he would be able to pay back the loan and then take out of his life policy of $191,000 via income tax free loans each year for 20 years. To compare this to post-tax investing, Dr. Smith would have had to earn 11.55% pre-tax in the stock market on the amount paid in interest every year ($18,000) to equal the same return as the life policy. The investment growth used while building cash in the life insurance policy is 7.9% (less than the long term average of the S&P 500).

Added benefit

Also, do not forget that, if a client chooses to use equity harvesting as a way to asset protect the marital home, he/she will most likely be able to get rid of any other life insurance policy he/she is paying for. Why? Because with the equity harvesting concept, the client is buying a life policy with a sizable death benefit; and, therefore, many times there will be no use for any other life insurance policies for that client. So, when calculating the economics of equity harvesting, make sure you take into consideration the reduced post-tax cost of paying for a traditional estate planning life insurance policy.

1% Cash Flow Option Arm Mortgage

The debt shield/equity harvesting concept and financial calculations can be dramatically improved by using the 1% option arm home mortgage. This is discussed in more detail on page 254 in the financial planning part of this book under equity harvesting.

Conclusion on Debt Shields

There is no prefect way to asset protect the personal residence. By using equity harvesting, the client is creating a situation where no creditor would want to make a claim against the house and a situation where it is highly likely that the concept will work out as a very nice investment for the client (assuming the advisor uses the correct type of life policy that is specifically designed for equity harvesting).
Section 11
Asset Protecting Your Accounts Receivables

Accounts Receivable Leveraging

Leverage Your Business’s Accounts Receivables (A/R) for Asset Protection, Estate Planning, and Potentially to Create Retirement Savings

Introduction

The topic of protecting an A/R is WHITE HOT right now in this era of litigation and abnormally high verdicts being handed down by out-of-control juries. This is especially the case with physicians.

There are various ways to protect a company’s A/R, and this section of the book will discuss in great detail the number one option (and what to avoid when being pitched the plan by advisors). It will try to convey to readers the real-world truth and the actual financial benefit of the A/R leveraging plan to a client in retirement.

The ability to turn a company’s A/R (what is basically a large non-income producing asset) into a retirement benefit has been around for some time and is making a comeback in the marketplace as topics like 419 plans and others are no longer viable options for wealth building.

Overview of A/R Leveraging Plan

The A/R Leveraging Plan involves using a company’s A/R balance as the primary collateral for a bank loan. Depending on the lender used, the loan will be equal to the entire amount of revolving A/R balance generally ranging anywhere from 30 to 120 days. Since the bank will have a primary lien against the receivables’ balance, this “asset protects” the balance from the claims of other creditors.

Once the bank loan is made, the loan proceeds can be invested for the purpose of providing the client with death benefit protection and, potentially, a source of supplemental retirement income.

Cash value life insurance can be ideal for this purpose for a couple of reasons. First of all, since creditor protection may be a major concern, individually owned life insurance may be advantageous due to the fact that it may enjoy significant protection under state creditor protection statutes. In states where life insurance cash value is not
protected, the client would instead use an LLC structure to asset protect the cash value of the life insurance (a discussion for how to use an LLC structure to asset protect life insurance is outside the scope of this book).

Secondly, an individually owned life insurance policy may provide the client with income tax advantages. One advantage is that any growth of the policy cash value will be income tax deferred and, potentially, income tax free depending on how the client chooses to take money out of the life insurance policy in retirement.

The bank making the loan will very likely require the life insurance policy be assigned as secondary collateral to the bank. Although, in most cases, the bank will look primarily to the accounts receivable balance in the event of default, the life insurance policy cash value provides a liquid source of collateral in the event the accounts receivable balance is insufficient to pay back the loan.

The loan will typically be outstanding as long as the client (typically the owner of a company or medical practice) is still working (i.e., until retirement). However, the loan will need to be extended from time to time; and the bank will likely do so, assuming the client continues to be a good credit risk. Once the client retires, the loan agreement will generally provide that the loan must be repaid within a specified period of time. Oftentimes, the loan agreement may give up to 180 days in order to provide sufficient time for the outstanding accounts receivables to be collected.

Keep in mind that the receivables, once collected, will be income taxable. Therefore, it may only be the “net” after-tax amount of the receivables that is available to repay the bank loan. To the extent there is a deficit, the life insurance policy values can be used.

Once the loan has been repaid, the bank’s secondary collateral interest in the life insurance policy is released; and the client now owns the policy unencumbered. At this point, the client is free to begin taking potentially income tax free distributions from the policy cash value for purposes of supplementing his or her retirement income.

If the above summary is a little confusing, below you will be able to see a few simple flow charts and examples that will help you understand the A/R Leveraging Plan.

A/R Leveraging – Asset Protection Nirvana?

Is the A/R Leveraging Plan an Asset Protection Nirvana? The honest answer is no with a caveat. The caveat being that the A/R Leveraging Plan can work great or it can work poorly depending on the following factors:

1) Interest Rates – The A/R Leveraging Plan is one that requires a loan for upwards of 20 years. The lower the interest rates and the longer the loan rate is fixed, the better the plan will work.
2) **Investment Returns** – If the investment where the borrowed money is placed does not perform well (7% or better), the likelihood of the A/R Leveraging Plan working better than post-tax investing is reduced (unless interest rates on the loan stay abnormally low).

If interest rates are moderate throughout the life of the Plan and if the return in the investment is similar to what the S&P 500 has done over the last 30 years, then the A/R Leveraging Plan when done right can be a nice and economically effective way to asset protect a company’s A/R.

The problem in the past and still in the marketplace with the A/R Leveraging Plan is that it is not done right a majority of the time and is not sold with full disclosure.

**A/R Leveraging done wrong**

Before talking about the ways to implement a properly setup A/R Leveraging Plan, we think it is important to understand what is currently being pitched in the marketplace and what, in our opinion, is the “wrong” way to implement an A/R Leveraging Plan. The following example is for a medical practice (the prime candidate for this concept).
How does the above plan work?

This method involves 1) making a bank loan to the business which 2) then distributes the loan proceeds to the participating physician(s) pursuant to the terms of a “deferred compensation” agreement. The distribution is treated as a property transfer under I.R.C. Section 83. 3) The physician then funds a life insurance policy with the distributed money and 4) the life insurance policy is collaterally assigned to the bank as secondary collateral for the bank loan.

It is contended that the assignment of the life insurance policy constitutes a “substantial risk of forfeiture” by the physician pursuant to Section 83; and, therefore, transfer of money to the physician is not taxable until some later time.

The client is told the following when being sold the Section 83 Plan:

1) The medical practice can write off the interest on the loan.

This is a much debated point, but we come down on the more conservative side and believe the interest on the loan to the medical practice is not deductible. For specific reasons, please feel free to e-mail us or give a call to one of the authors.

2) The borrowed money that is poured into the life policy will grow with no tax consequences and can be borrowed from the life policy income tax free in retirement.

What the promoters of the plan do not tell the client is when the cash in the life policy gets above the amount of premium poured into the policy, they will have to recapture as income each year the investment gains in the life policy. We call this phantom income because the client ends up paying tax on money not in their hands.

When you run the numbers of the A/R Leveraging Plan where the client has to recapture as income the growth in the policy above its “basis” (what was originally paid in premium), the plan is an absolute 100% guaranteed loser from an economic standpoint. If clients actually understood this, they would never use a Section 83 A/R Leveraging Plan.

3) There is no immediate income recognition of the borrowed money.

If you don’t think it sounds strange that the medical practice can borrow $200,000 in the example above, give that money to Dr. Smith, and not have him recognize income on that money, you should. The promoters of the plan say, because there is a “risk of forfeiture” of the life insurance policy back to the bank (because of the collateral assignment), the physician does not have to recognize income on the borrowed money. Without getting too technical with the reasons for why we do not believe that is true, we’ll simply state that it is our position that Dr. Smith in the above example should recognize as income in the first year of the plan the $200,000 that was borrowed and poured into the life insurance policy.
When you run the financial numbers for the A/R Leveraging plan with a client who has to recapture the borrowed money as income in the first year, the plan CANNOT work in a positive financial manner for the client.

4) There will be enough A/R left in the medical practice to pay back the loan used to protect the A/R. This part of the sales pitch is very deceptive. If a medical practice had $200,000 of A/R on the books and, therefore, took out a $200,000 loan on the A/R to asset protect it, eventually the $200,000 has to be paid back. Loans for the Plan are interest-only loans to be paid back in full when the plan is terminated.

So what’s the problem, and why won’t the $200,000 of A/R on the books at termination pay back the $200,000 loan? Because the client will have to pay income tax on the A/R prior to paying off the loan. Therefore, if the client was in the 40% tax bracket, he/she would only have $120,000 left after tax on that $200,000 and then would have to find an additional $80,000 in post-tax money to pay back the loan at termination of the A/R Leveraging Plan.

Section 83 A/R Leveraging Summary

We would not recommend that anyone use a Section 83 plan because we: 1) do not believe the interest is deductible; 2) believe the client should recapture as income all the money borrowed in year one; and 3) believe the client would have to recapture as phantom income all the growth in the life policy above its basis each year.

A/R Leveraging Done Right

A/R Leveraging can be done “correctly” so as to asset protect a medical office’s A/R. While reading over the following pages, keep in the back of your mind the most important question, i.e., while the A/R Leveraging Plan can be done correctly, is it a plan worth implementing given your particular circumstances and fears about the loss of your A/R in a lawsuit.
The Steps for A/R Leveraging Done Right:

1) Bank loans money directly to the physician. The loaned money is equal to the amount of current “real” A/R on the books of the medical practice.

2) Physician purchases a single premium immediate annuity (SPIA) with the borrowed money.

3) The SPIA pays income for 3-5 years, and that money is used to fund a life insurance policy that is supposed to act as a long-term investment for the physician.

4) The SIPA and life insurance policy are pledged as secondary collateral on the loan.

5) The medical practice’s A/R is pledged as the primary collateral for the loan.

That is as complicated as it gets when doing A/R leveraging the correct way. Because the A/R is pledged as the primary collateral for the loan, it is asset protected as long as the loan stays in place.
The Finances of the A/R Leveraging Plan

If you’ve taken anything from the previous information on the A/R Leveraging Plan, you probably know a medical practice borrows money to asset protect the A/R and the borrowed money is invested in a life policy. The A/R is protected, but how does that help or hurt you where it counts the most, i.e., your pocket book.

The A/R Leveraging Plan in the past was sold more as a supplemental retirement plan than an asset protection plan. This was in the old days when advisors really did not understand all the negative tax ramifications of the Section 83 version of the Plan.

Now that some sanity has set in with how to properly account for the A/R Leveraging Plan, clients should be told the Plan can work great or poorly depending on how the life insurance policy works as an investment and how low interest rates stay during the life of the Plan.

Instead of trying to explain in paragraph form how well or poorly the A/R Leveraging Plan works from a financial standpoint, we instead will use three illustrations outlined below.

The following are the important variables that remain constant with all three examples.

1) The client is a 45 year old male in good health (Dr. Smith).

2) The client is looking to asset protect $200,000 of A/R and, therefore, the loan taken out in the example is that same $200,000.

3) The lending interest rate stays the same in the examples (you’ll notice we use as a base interest rate 6% and then we bump up the interest every five years. Interest rates at the time of the publishing of this book are at record lows, and we wanted to use more real world interest rates in our example).

The following are the important variables that change in the three examples.

1) The age when the client borrows money out of the life policy that was funded with the borrowed money to create “supplemental retirement income”. In the first example, we use ages 71-85; in the second and third examples, we use ages 65-80. The longer you wait to borrow money income tax free from a life policy the better the illustration will work.

2) The investment rate of return in the policy. We assumed 7.9% annual return in the life policy in the first two examples and a 6% rate of return in the third example.
3) The investment rate of return on the money Dr. Smith could have invested in the stock market if he did not implement the A/R Leveraging Plan. In other words, if Dr. Smith did not implement the A/R Leveraging Plan, he would have extra income to invest because he is not paying non-deductible interest payments on the $200,000 loan.

We assumed the same investment rates of return with the post-tax brokerage account as we used in the life insurance policy (which is 7.9% in the first two examples and 6% in the third example).

Is A/R Leveraging a Good Deal Financially?

Assumptions/Constants in the below examples

- Medical Practice has $200,000 of “real” A/R on the books;
- $200,000 of Loan Proceeds (used to encumber and asset protect the A/R)

Loan Interest: 6% yrs 1-5; 7% yrs 6-10; 8% yrs 11-15; 9% yrs 16-20.

- 45 yr old Male Physician—Non-Tobacco Preferred (Dr. Smith)
- Pre- AND Post-Retirement Tax Bracket – 40%

**Example 1**

Assuming a 7.9% rate of return in the life policy and in the brokerage account.

**Financial Outcome**

Dr. Smith would have an extra $27,590 a year in post-tax retirement benefits from ages 71-85.

This is **44% better** than taking the interest payment home and investing it post tax in the stock market.
Example 2

Assuming a 7.9% rate of return in the life policy and in the brokerage account. Borrowing from the life policy from ages 65-79.

**Option One** (invest interest payment)
- Loan interest invested @ 5.3% Net ROR would grow to $516,317 in 20 years
- If Dr. Smith drew down the brokerage account, he could take out $48,200 after tax a year from ages 65-79 (which should be in an FLP for asset protection)
- A/R taxable when Dr. Smith retires
- A/R vulnerable

**Option Two** (implement A/R Leveraging Plan)
- 20th Year Life Insurance Cash Value - $637,000
- Initial Death Benefit - $758,000
- Pledge of A/R to bank will take priority over other creditors and lawsuits to the extent of the loan balance and PA/PC guaranty
- A/R taxable when Dr. Smith retires

**Financial Outcome**

Dr. Smith would have an extra $1,800 a year in post-tax retirement benefits from ages 65-79.

This is 3.7% better than post-tax investing.

Example 3

Assuming a 6% rate of return in the life policy and in the brokerage account. Borrowing from the life policy from ages 65-79.

**Option One** (invest interest payment)
- Loan interest invested @ 4.2% Net ROR would grow to $459,109 in 20 years
- If Dr. Smith drew down the brokerage account, he could take out $40,185 after tax a year from ages 65-79 (which should be in an FLP for asset protection)
- A/R taxable when Dr. Smith retires
- A/R vulnerable

**Option Two** (implement A/R Leveraging Plan)
- 20th Year Life Insurance Cash Value - $442,000
- Initial Death Benefit - $758,000
- Pledge of A/R to bank will take priority over other creditors and lawsuits to the extent of the loan balance and PA/PC guaranty
- A/R taxable when Dr. Smith retires

**Financial Outcome**

Client would have $10,000 a year LESS in post-tax retirement benefits from ages 65-79.

This is 25% worse than post-tax investing.

What seems interesting about the above three examples and what can we learn from them?
What should quickly jump out at you is that, for the two illustrations which both worked better than post-tax investing, Dr. Smith had to wait at least until age 65 (and 71 worked much better) before accessing income tax free loans from his life policy.

You can look at this fact two ways: first, it is great that a client can asset protect his/her A/R and at some point down the road have the plan work as a nice supplemental retirement plan (or at least a break-even plan), or second, that you really don’t want to get into a plan where you have to wait until age 65 to access money tax favorably from a life policy.

What should also seem interesting is, even if the Dr. Smith waited until age 65 in Example 3, he would have lost money with the plan. Because the internal rate of return of the policy was not high enough to counteract the rising interest payments, Dr. Smith would have been better off financially to invest the interest payments instead of implementing the A/R Leveraging Plan.

Is the A/R Leveraging Plan right for you?

If you are looking at the A/R Leveraging Plan as a “supplemental retirement plan,” we’d submit to you that you are looking at the wrong topic. You would be better off using equity harvesting with the marital home (due to the interest deduction) or using the ABC Plan, Defined Benefit plan, or 412(i) plan.

If you are worried about losing your A/R in a lawsuit to creditors, then the A/R Leveraging Plan is a nice option to consider as long as you understand how it works. In the long run, you might be better off financially because of a life insurance policy that has a lot of cash or you might not have been better off financially by implementing the plan because interest rates rose too high or because of low internal returns in your life policy.

The use of the A/R Leveraging Plan should be looked at simply as an asset protection plan that should work out neutral or positively from a financial point of view of the client. It is our opinion that, unless interest rates go through the roof (10%+), the A/R Leveraging Plan should work well for a client as an asset protection tool and at least neutral with the likelihood of positive financial returns for the client in retirement.

Bottom line — if asset protecting your A/R will help you sleep at night and will make your life less stressful, we recommend you implement the A/R leveraging plan.

*Asset Protection — if the state you live in does not specifically asset protect life insurance or annuities, you would need to use a different structure than outlined above to make sure the life insurance or annuity investment is asset protected. This can be done through a simple LLC structure. In order to keep this section of the book compact, we chose not to discuss the LLC structure. If you would like help with this topic, please feel free to give us a call or send an e-mail to one of the authors.
Conclusion/Summary on Asset Protection

We will make this short and to the point—every "professional" or high net worth non-professional client should have an asset protection plan.

In the U.S. today, lawsuits run wild; and “professionals” specifically have the added burden of working in an industry where they can be sued individually.

If you have a:

- Personal residence
- Vacation home/condo
- Brokerage account/CDs/cash/bank account over $75,000
- Vacant investment property
- Rental property
- Plane/boat/waverunner/snowmobile
- IRA
- Significant accounts receivables (A/R)

Then you need asset protection.

Most of the time you can use domestic LLCs to own all of the above-stated assets except the IRA (which should be rolled into a Profit Sharing Plan).

Example:

Assuming a client had all the assets above, what could an asset protection plan look like?

**Personal residence** – The client should consider a debt shield to protect the home and to build wealth in a tax-favorable manner (using a 1% option arm mortgage would also be an option).

**Vacation home/condo** (not rented) – would be in domestic LLC #1.

**Brokerage account/CDs/cash/bank account** over $75,000 – LLC #2.

**Vacant investment property** – LLC #3 due to the extra liability with vacant rental property.

**Rental property** – LLC #4 due to the fact that it is rented. This property would not go into LLC #2 because then, if a liability arose from the vacant property, the creditor could go after any assets in the LLC, which would include the rental property.
Plane/boat/waverunner/snowmobile – LLC #5 due to the fact the individual liability with each is significant, and you do not want to subject any other asset to that liability by sticking it into the same LLC.

IRA – should be rolled into a Profit Sharing Plan at work or into a newly created Profit Sharing Plan in one of the four new LLCs.

Significant accounts receivables at your business—consider factoring or leveraging to remove them as an asset that a creditor could go after in a medical malpractice lawsuit.

**Cost of the above plan?**

Each domestic LLC should cost $2,500-$3,500 for the first one and then $1,500 or subsequent LLCs. It costs nothing to roll the IRA into a business’s current Profit Sharing Plan and very little to set up a new Profit Sharing Plan in one of the newly created LLCs.

Total costs should be less than $9,000.

Lastly, in the above example, it is likely that the client would want to use an FLLC for estate planning purposes to discount the value of the client’s overall estate and to start a gifting program to the children. An FLP will work just the same as an LLC for asset protection purposes.

**Help from the Authors**

We have given you in the preceding pages a fairly detailed summary of asset protection. While you can purchase a book just on asset protection, the topics discussed in this book will be sufficient to help most of the clients formulate a complete asset protection plan.

If you write down on paper what you believe to be a good asset protection plan after reading this book, you will be amazed if you go to a local attorney to have him/her implement it for you. The local attorney should tell you your design is correct and that he/she wished he/she had suggested it in the first place.

Implementation is a key component of putting together an asset protection plan, and so it is important to work with an advisor who will understand the topics discussed in this chapter and have what it takes to follow through until implementation is complete.

Unfortunately for the vast majority of clients around the country, it will be nearly impossible to find an advisor who knows asset protection as discussed in this book (as well as the other topics discussed in later chapters).
The authors of this book are unique in many ways when it comes to being able to provide advice on “advanced” planning topics for high income and/or net worth clients. Each one of the co-authors are Certified Wealth Preservation Planners (CWPP™). One of the Co-Authors is the founder of the Wealth Preservation Institute and the creator of the CWPP™ certification course.

In short, while is it possible to get help from a local advisor on some of the issues in this book, in order to have a complete plan put in place to help readers become completely asset protected and help them reach Critical Capital Mass, it is always best to work with a pre-certified advisor who you know can get the job done right.

In order to contact the co-author of this book who is in your local area, please turn to page ix for contact information. That author will be able to determine in short order whether you are properly protected and, if not, what needs to be done to ensure that your assets are protected, your estate plan is in order and that your overall plan is done in as tax favorable a manner as possible.
Chapter Two
Estate Planning

Introduction

When we give seminars for clients, they are advertised as asset protection and an income and estate tax reduction seminars. In the normal seminar, we also cover several estate planning mistakes we see over and over with many clients.

The ironic thing is that most clients think their estate plans are set up correctly. Everyone is confident that their estate planning attorney and CPA know what they are doing. While it is true that most CPAs and attorneys know how to put together a complete estate plan, rarely does it ever happen.

We will list some statistics from our seminars that should hold true to the readers of this book.

Out of ten seminar attendees:

- 1-2 will NOT have a simple will. (Usually those are the younger client. Without a will, you will be allowing the state you live in to dictate who gets your assets at death).

- 9-10 will NOT have Durable Powers. (Durable Powers deal with what to do with a client in the event they get incapacitated or, should the situation arise, where a decision needs to be made about discontinuing a feeding tube to sustain life).

- 5-6 will NOT have marital trusts (A&B, marital, or living trusts are used to maximize estate tax exemptions which can save the heirs of an estate $500,000 in estate taxes. Trusts also avoid the probate process, which costs between 4-10% of the entire estate).

- 9-10 will NOT have a Family Limited Liability Company or Family Limited Partnership. (FLLCs are used to discount the value of an estate).

- 7-8 will NOT have an Irrevocable Life Insurance Trust (ILIT). (An ILIT will pass a death benefit from a life policy income and estate tax free to the heirs/beneficiary).

The above-mentioned tools (explained below) are just the basic tools that are needed in almost every estate plan of a client with any amount of wealth.
Without the previously listed tools, you could be costing your heirs millions of dollars that will go to the government via taxes or to the probate system via fees. While you will be dead and will not have to worry about it, your children (or any heirs) will curse the fact that you did not find time (or were too cheap) to set up a proper estate plan.

We are going to explain how the topics listed above work and why you would want each one in your estate plan. You may have a will or A&B trusts; but if you are like many of the attendees at our seminars, you may have trusts but have no idea why. Our point being that, even if you have some of the tools outlined above, reading the following material can still be beneficial to increase your knowledge base on estate planning (something that needs constant updating as your life and that of your family changes).

Additionally, at the end of this chapter, you will be able to read about a handful of “advanced” estate planning topics that can be very beneficial to clients with significant wealth.

Section 1
Wills

A will is the most basic part of a client’s estate plan. An attorney starts with a will and then adds different estate planning document as the client gets married, has children, and increases the value of his/her estate. There is nothing terribly exciting or unique we can tell you about a will; so we will not spend much time on it, but there are a few items you need to keep in mind.

If you do not have a will when you die, you will be seen as someone who died intestate. That simply means that the property in your estate will be divided up per your state’s statute on intestacy. In every state, there is literally a list of who gets what and in what percentages when you die. If you have a spouse, some states pour the entire estate to the spouse; however, that is not always the case. We would suggest that you check your state statute if you do not have a will, but a better idea is to go out and get one.

How much should a will cost?

Not much. You should be able to get a will for you and your spouse for between $150-$250. Attorneys do not do much when creating a will; however, the professional liability with the document created lasts for the life of the client, thereby justifying the fee.

How often should you update a will?

You should update your will any time you get married, have children, get divorced, increase the value of your estate, if a child happens to predecease you, or if the
tax laws change. You should also update your will if you do not have A&B marital living trusts and want to change who gets what when you die.

**Why don’t I just handwrite a will instead of paying for one?**

A handwritten will is called a holographic will, and many states do not recognize holographic wills as a legal document. We do not have any problem not hiring an attorney to draft a will, but make sure your state allows for holographic wills and if you do one, make sure you follow the rules. We do not suggest a holographic will because we believe every estate plan should have A&B trusts, which must be drafted by an attorney.

**Can I leave my spouse out of my will?**

Believe it or not, high income or net worth clients have a high divorce rate. Many times a second spouse is taken later on in life (the crude term is “traded up” when a man marries a much younger female, which we frown upon if for no other reason than it is just too darn expensive).

Most states do not allow you to cut your spouse (typically the second spouse) out of your will, and so just make sure you check your state laws before doing anything drastic with your will. Also, when you get divorced, you should immediately change your will so your ex-spouse does not have a claim to some of your estate.

In some cases, a divorce, which is high profile and has substantial asset or income issues, will continue for a year or more. In such cases, if you continue to have the old will in place and you happen to die, there is a strong argument to be made that, although you were estranged from your soon-to-be ex-spouse, he/she still gets to take from the will as if he/she were still married to you (which is true at your death since the divorce was not final). If that happens, the soon-to-be ex-spouse typically will receive the majority or all of your estate instead of the state mandated minimums for widows/widowers (widow’s election).

If you want to turn over in your grave, die during a divorce and look down from above and watch as your soon-to-be ex-spouse spends all your money.

In some cases, those who have such complicated divorce cases should consider consulting with both their divorce attorneys and their estate planners to consider **changing the will during the divorce process** while the spouse is estranged. After the divorce is completed, another final will should be completed to deal with the post-divorce situation.
Conclusion

Everyone should have a will if for no other reason than to prevent the state from dictating who gets your belongings when you die. Wills are inexpensive and not time consuming to put in place, and so we do advocate that everyone obtain a will as soon as practical in life.

Section 2
Durable Powers of Attorney

What is a Durable Power of Attorney (DPA)?

It is expected that during the course of our lives we may become incapacitated and unable to act either because of a physical infirmity or mental incapacity. When that happens, it is important to have a Durable Power of Attorney (DPA) in place to deal with the day-to-day issues of our lives when incapacitated.

A DPA is a document that allows a person or entity, referred to as the attorney in fact, to act on behalf of the person giving the Power.

A Durable Power of Attorney is needed to allow the designated agent to handle financial transactions, such as writing checks, voting stock rights, and, generally, to act in all matters of a financial and/or legal nature for the principal who generally is not in a position to act for themselves.

When most people hear the words “Power of Attorney” they are on guard that they might be giving away some power that will become abused and cause the person authorizing the Power harm. In reality, a **DURABLE POWER OF ATTORNEY** is actually something that could save you or your estate money and time.

**Why would such a document save you time and money?**

Let’s take an example where we assume you are in good health and still gainfully employed and then suffer an accident resulting in a total mental or physical incapacity. If you do not have a Durable Power naming your spouse (a trusted relative) to act in business matters for such things as paying bills, operating his or her checkbook, paying taxes, and signing business papers from bills of sale to contracts for services or products, then your family will have to generally go to court and ask the court to determine that you are incapable of acting on your own and that someone else should act for you and be given these powers that could have otherwise been included in the Durable Power document. The court will typically require notice to others, and a hearing and testimony, including possibly some independent expert testimony concerning the extent of the disability to allow the spouse (or other elected person) to act for the incapacitated person.
The hearing procedure generally referred to in most states as a conservatorship or guardianship is time consuming and expensive and, generally, will require the services of one or more attorneys.

Had you simply implemented a Durable Power of Attorney signed in advance of the hardship or incapacity, you would be able to use that document in lieu of the court hearing and the court orders that would otherwise be necessary to act upon the assets and/or businesses held in the name of the incapacitated person.

**What kind of Durable Powers are there and what should you inquire about when you have to have one drafted?**

In the above example, if you had a retirement account, pension accounts, Profit Sharing, stock bonus plan, and Keogh or other retirement plans, a Durable Power can have language which will allow the appointed person to act for you in connection with those accounts. This is an important issue for a client’s spouse when the couple is retired and is primarily living off the income from the client’s IRA. Depending on the circumstances, without a DPA, the spouse might not be able to access the money from the IRA without going to court to have someone appointed to act on behalf of the incapacitated spouse.

Some DPAs have “springing powers” which are only effective upon disability and will, generally, terminate upon the disabled client becoming capable or no longer disabled. Usually these springing Powers of Attorney are activated by one or two physicians stating the nature and extent of the disability to verify that the DPA should be used; and when the period of disability ends, the physicians will determine that such incapacity ended and the need for the use of the Durable Power ends, thus putting the client back in charge of his/her affairs.

Other powers are effective forthwith upon signing and allow the designated attorney in fact to act for the incapacitated person immediately. One should always check their resident state laws to determine what flexibility is allowed under that state in developing a Durable Power of Attorney.

Powers of Attorney can even provide for the delegation of an agent’s power to deal with a Section 529 college education savings plan account(s). All Durable Powers of Attorney or springing Durable Powers should include specific language that allows the attorney in fact to create, open, or invest the owner’s assets in a Section 529 account, to maintain that account, and make decisions with regard to handling account disbursements and the change of designated beneficiary of a Section 529 account.

Durable Powers can provide for another person to make gifts for the principal, appoint a separate agent to vote the stock, make business decisions, and the like.
Delegating medical treatment options and/or directives

In some states, like Michigan, a Durable Power of Attorney can also appoint an individual called a Patient Advocate (PA) to make medical treatment decisions if the individual is at least 18 years of age and of sound mind when the power was signed. Usually this kind of patient advocate form would include language typical of the “living will” in which the quality of life and opinion of the grantor is stated. In most cases, the Durable Power might now include the patient advocacy matter and a separate document called a “Patient Advocate” form would be used to cover the issue of the treatment, or lack thereof, of a person desiring to appoint another to determine the future of the incapacitated person’s medical treatment.

The Living Will used in some states would be similar to the Patient Advocate form, which attempts to accomplish the same objective of appointing someone close to the nominee to make decisions concerning medical treatment or the lack thereof.

Why is a Patient Advocate Designation or Living Will important and why you should have one?

Many Americans die in a hospital or other care facilities. Physicians and healthcare workers who work in these facilities are generally charged with preserving a patient's life. You may or may not want a physician or hospital making decisions about your care when incapacitated. Health Care Directives give you the opportunity to write out your wishes in advance and ensure some legal respect for them if you are ever unable to speak for yourself.

What is a Living Will?

A Living Will, known in some states as a Health Care Directive, sets out a person's wishes about what medical treatment should be withheld or provided if a person becomes unable to communicate those wishes. The directive creates a contract with the attending physician. Once the physician receives a properly signed and witnessed directive, he or she is under a duty either to honor its instructions or to make sure the patient is transferred to the care of another physician who will honor them.

Health Care Directives are not used just to instruct physicians to withhold life-prolonging treatments. Some people want to reinforce that they would like to receive all medical treatment that is available, and the Patient Advocate Form or Health Care Directive is the proper place to specify that.

In most states, you must be 18 years old to sign a directive of this nature; and every state law requires that the person making a Health Care Directive must be able to understand what the document means, what it contains, and how it works.
If you are physically disabled, you may make a valid health care document by simply directing another person to sign the document for you if you are unable to sign it yourself.

If you do not have a Medical Directive, a Living Will, Patient Advocate Form or Durable Power with medical directives signed, then the physicians who attend you will use their own discretion in deciding what kind of medical care you will receive.

Problems also can develop when your family members are not in agreement as to what type and extent of medical treatment you and/or your spouse should receive or not receive. In worse cases, the court will decide these cases even though the judge has little medical knowledge and no familiarity with you. These legal court wars are usually expensive and begin to use up the financial resources of the person incapacitated who would have otherwise, given the choice, not wanted the heirs battling over the extent of medical treatment and expensive legal fees and costs.

The execution of a Living Will, Patient Advocate Form, Medical Directive, and/or other appropriate Durable Power would save time and the expense of a court trial.

Your Health Care Directive can take effect when you are diagnosed to be close to death from a terminal condition or to be permanently comatose, and you are unable to communicate your own wishes for your medical care. Under these circumstances, your Medical Directive can be given to the medical personnel taking care of you; and that Medical Directive with specific instructions should then be followed.

The directive should be a part of your medical record when you are admitted to a hospital or other care facility. If your need for care arises unexpectedly or while you are out of your home state or country, it is best to give copies of your completed documents to your family and your personal physician.

Conclusion

Durable Powers and Patient Advocate Forms should be incorporated into every estate plan so as to avoid delay in medical treatment or the payment of household bills. Because of the litigation that can be required in order to have a court determine who will have the authority to pay bills and make determinations about your medical care (life and death decisions), we can state with confidence that not having Durable Powers and Patient Advocate forms in your estate plan would be a tremendous mistake.
Section 3
A&B, Marital, or Living Trusts

Besides a will, A&B/marital/living trusts (hereinafter A&B trusts) are the most commonly used estate planning tool and one we recommend in nearly every estate plan. This assumes that you are married. If you are not married, you would simply have one living trust which would have the same advantages in Number 1) directly below. If you are not married, you cannot take advantage of Number 2) directly below, which discusses maximizing estate tax exemptions among spouses.

What are the benefits of A&B trusts?

1) The first benefit of having A&B trusts is that your estate will not be probated through the court system. Your will does end up being probated, but the assets of the estate pour through your will to the A&B trusts. When that happens, your estate will typically be probated in an “unsupervised” manner where the court does not have to probate everything in your estate; and when this happens, you save (depending on the state) between 1-8% (4-6% is average) of the entire value of your estate in probate fees.

2) A&B trusts maximize your estate tax exemptions. In 2007, there is a $2,000,000 estate tax exemption per spouse. That exemption increases until 2010 when there is no estate tax; and then in 2011, the estate tax is right back at the $1,000,000 (unless Congress re-passes the estate tax repeal).

If one spouse dies without the A trust in place, the entire estate will then become the property of the surviving spouse. What happens when the first spouse dies? The $2,000,000 estate tax exemption died with that spouse, and the remaining spouse now only has $2,000,000 total in exemptions to use.

Let’s look at an example –

Clients Dr. Smith and spouse are 50 years old. Total estate worth equals $4,000,000. $1,000,000 of the estate is the value of the marital home. Assume that the clients have a will but no A&B trusts.

If Dr. Smith dies tomorrow, what happens? The entire $4,000,000 estate per Dr. Smith’s will go to the surviving spouse.

What estate taxes are due? None, because there is an unlimited estate tax exemption when passing wealth to a spouse.
Then shortly after Dr. Smith dies, the spouse dies. What happens? The $4,000,000 will pass through the will (and will go through probate) to the heirs. Forgetting the probate fee of up to 5%, because they did not have A&B trusts, what are the estate taxes due? $2,000,000 or 50% of the entire estate, which is $4,000,000 at the second spouse’s death.

What would have been the estate taxes due if the couple had A&B trusts?

When Dr. Smith died in 2007, the $2,000,000 worth of assets (including the $1,000,000 home) would become the property of the A trust and not the spouse. Per the language of the A trust, the living spouse gets to stay in the house until death, at which time the house will pass to the heirs. When the $2,000,000 was poured into the A trust, the language in the trust designated that the $1,000,000 house and $1,000,000 in other assets were transferred by using the deceased spouse’s $2,000,000 estate tax exemption.

Now assume the second spouse dies the next day.

What happens and what estate taxes are due?

The remaining assets will be poured into the B trust (to avoid probate) and $2,000,000 worth of those assets will be given to the heirs through the use of the second spouse’s $2,000,000 estate tax exemption. That leaves a total taxable estate of $0; and, therefore, the heirs will not have to pay estate taxes.

What was the benefit of the A&B trusts?

We saved the heirs in the prior example $1,000,000 in estate taxes and $200,000 in probate fees. Not bad.

Now we hope that Dr. Smith and the spouse had life insurance in an ILIT to pay for the estate taxes; and in the next section of the book, we will explain how that works.

The following is a schematic of what happens with Dr. Smith and his spouse when they died a few days apart assuming they died in 2007.
What if Dr. Smith and his spouse died in 2009 with no A&B trusts?

While most of our clients intend on living for at least 20 years (beyond their present age), that is not always the case. In 2009 (four years before the estate tax exemption will default back to $1,000,000), the estate tax exemption is $3,500,000. When the first spouse dies, the entire $4,000,000 estate will transfer to the surviving spouse estate tax free. When the second spouse dies a day later without a trust, the estate will have to pay estate taxes of $250,000.

What if the couple had A&B trusts when the first spouse died?

$3,500,000 dollars would have poured into the A trust (for the benefit of the surviving spouse until death), and $500,000 would have gone to the surviving spouse without estate taxes. Then, if the second spouse died the next day, the remaining $500,000 would pour through the B trust to avoid probate; and $500,000 of the remaining $3.5 million exemption would be used. The estate taxes due at the 2nd spouse’s death would be zero, but be careful with this fact pattern. You might not want $3.5 million going to the A trust. Instead, the surviving spouse might rather have more of that money in her control where she does not have to ask a trustee for the money.
What are the estate tax exemptions through 2011 (unless congress acts to change them)?

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<tr>
<th>Year</th>
<th>Estate Tax Exemption</th>
<th>Highest Rate</th>
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<tbody>
<tr>
<td>2005</td>
<td>$1.5 million</td>
<td>47%</td>
</tr>
<tr>
<td>2006</td>
<td>$2 million</td>
<td>46%</td>
</tr>
<tr>
<td>2007</td>
<td>$2 million</td>
<td>45%</td>
</tr>
<tr>
<td>2008</td>
<td>$2 million</td>
<td>45%</td>
</tr>
<tr>
<td>2009</td>
<td>$3.5 million</td>
<td>45%</td>
</tr>
<tr>
<td>2010</td>
<td>N/A (taxes eliminated)</td>
<td>0%</td>
</tr>
<tr>
<td>2011</td>
<td>$1 million</td>
<td>55%</td>
</tr>
</tbody>
</table>

What should A&B trusts cost?

<table>
<thead>
<tr>
<th>Size of the estate</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 3 million</td>
<td>$2,500</td>
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<tr>
<td>3 to 5 million</td>
<td>$3,500</td>
</tr>
<tr>
<td>5 to 10 million</td>
<td>$5,000</td>
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<tr>
<td>10 to 25 million</td>
<td>$7,500</td>
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<tr>
<td>over 25 million</td>
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</tbody>
</table>

We get upset when we hear that clients have paid $25,000-$50,000 or more for estate plans. Unless your estate is over $15 million dollars, you should be able to get an entire estate plan for less than $15,000. If your estate is less than $5,000,000, you should be able to get an entire estate plan done for around $5,000. (That does not include a lot of specific asset protection planning or advanced planning with FLPs).

Attorneys very rarely will reinvent the wheel when it comes to estate planning. If you read this book carefully, you will know as much about the basics of estate planning as your attorney does; and we can state with confidence that you will know as much or more about advanced tax planning than most of the local attorneys and CPAs in your city.

If you are wondering why estate plans can get costly when the same shell documents are used over and over, it is because of the lingering liability with the estate plan. The malpractice liability for estate planning attorneys does not go away until you die, which could be 50+ years for some clients.

Revocable

A&B trusts are revocable trusts. It is very common for an attorney to set up A&B trusts and not put anything in the trusts. We would say that 90% of the A&B trusts out there are not funded correctly. We suggest funding them with something when you
implement them. It is very typical to transfer the family residence into the trusts. If, for whatever reason, clients want to take assets out of their trusts it is not a problem since the trusts are revocable (we will discuss irrevocable trusts in an upcoming section).

Conclusion

We know it is a strong statement, but EVERYONE with any amount of assets should have A&B marital/living/revocable trusts (or just a single trust if you are not married) to avoid probate and maximize the estate tax exemptions. It is just that simple. If you do not have A&B trusts, you are doing your heirs a tremendous disservice and eventually will make the federal and possibly state government very happy at your death.

Section 4
Life Insurance

Does anyone like life insurance? Typically, the answer is no. We do, however, use life insurance for a variety of different purposes (income and estate tax reduction being the primary); and when using life insurance in a tax favorable manner, it can make a lot of sense.

We believe that more people would warm up to life insurance if they just understood how it works and why one policy over another can be beneficial. In the following sections of the material, we are going to explain the three main types of life insurance and why we prefer to use one type of life insurance to another.

Term Life Insurance

Most people are aware of term life, and most of the breadwinners in a family household will have had term life insurance at one point or another in their lives.

Term life is the least expensive type of life insurance policy you can purchase. Unlike the other life insurance policies we will discuss, term life has no cash value; and if you do not die, you (and your beneficiaries) do not get a benefit. For a 33-year old to get $1,000,000 worth of term coverage, it might cost as little as $250 a year with non-guaranteed rates.
Types of term life

Non-Premium Guaranteed Term

Non-guaranteed term simply means, as you get older, the company will charge you more every year for the insurance. The pros of non-premium guaranteed term is simply that every year you will get the lowest possible term cost, but you have no guarantee what that will be in any given year.

Level Term

Level term is the most common. You can purchase 5-, 10-, 15-, 20- and 30-year term policies from almost any company. Level term means that the premium will be level for a particular death benefit. After the term is up, typically you still have the contractual right to purchase insurance from the company; but there is no guarantee what the rates will be. You typically do not have to go back into underwriting at the end of the term, which is nice for those who happen to get sick (cancer) before the end of the term.

Convertible Term

Most companies will allow you to convert your term policy to a whole, universal, or variable policy without going through the underwriting process. There are a number of reasons to purchase convertible term, the main one being that, as you get older, you will typically want a guaranteed and possibly a paid-up life policy. Term insurance is far too expensive after the age of 70, and most people for estate planning purposes will switch their term policies around the age of 50 to a cash building guaranteed policy. With convertible term, you do not have to go back into underwriting in order to switch insurance policies. Again, this is important to people who have a family history of cancer or diabetes who might not be able to purchase a new guaranteed policy when they get older.

Return of Premium Term Life

Purchase “Free” Term Life Insurance with a Return of Premium Rider

The vast majority of clients under the age of 60 have purchased term life insurance at one time or another. Usually, clients purchase 10-30 year level term insurance (where the premium is constant for up to 30 years) because it is the most inexpensive way to fund a death benefit without increasing costs for a specific period of time.

While most clients purchase level term life insurance, they also despise the concept of term life because they believe death will not occur during the term of
coverage. Therefore, the premium at the end of the period was a total waste (although the policy holder did have peace of mind while insured).

Insurance companies love to sell term life. Depending on the statistics, as a ballpark number, 93% of all clients who buy term insurance do not die during the coverage period. That means, if you purchased term life insurance, you have a 93% chance that the premiums will be a waste of your money (and you are hoping for that because the alternative is that you are dead).

A few select companies have come out with Return of Premium Term Life Insurance (ROPT). ROPT is very simple to understand. You pay a premium that is marginally higher than the normal level term life costs and if you do not die, you get the premium returned to you in full.

The rub is that you do not get investment growth on the difference in premium paid. However, you do get returned to you the term premium you would have paid and never seen again in the event you did not die.

Let’s look at an example:

Assume Dr. John Smith is age 38, has two children, and a wife. Dr. Smith’s total assets are less than $1,000,000; and he wants to make sure that, if he were to die in the next 20-30 years, his spouse and children would be taken care of. By “taken care of” we mean that the house payment and bills would be paid, the children would be able to go to college, have nice clothes, drive nice cars, and the spouse would not have to go to work in order to provide for the children and herself. Dr. Smith would normally buy 20-30 year level term to take care of those needs until he found out about the ROPT.

<table>
<thead>
<tr>
<th></th>
<th>Term Life Cost</th>
<th>Return of Premium Term Life Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 Year Level Term Life</td>
<td>$2,400 (per year)</td>
<td>$3,940 (per year)</td>
</tr>
<tr>
<td>Total cost for 30 years</td>
<td>$72,000</td>
<td>$118,200</td>
</tr>
<tr>
<td>Premium Difference</td>
<td>($46,200) over 30 years</td>
<td>($1,540) per year</td>
</tr>
</tbody>
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Interpreting the numbers:

The amount of premium paid per year was $1,540 more with the ROPT. Automatically, most clients will resort to their default position when it comes to spending money—that position being, always opt for the less expensive product when it comes to insurance and invest the difference in the stock market.
If Dr. Smith invested the difference in premium, $1,540 per year, in the stock market each year for the 30-year period, Dr. Smith would have in a brokerage account approximately $88,255 after tax (capital gains and dividend taxes) assuming a 6% annual investment return.

Dr. Smith via his ROPT will receive a guaranteed return of premium of $118,200 income tax free.

The difference between the amount in Dr. Smith’s brokerage account ($88,255) and ROPT ($118,200) = $29,945.

(Remember that while Dr. Smith is investing the difference in premium ($1,540) each year, he still had to pay his traditional level term life premiums of $2,400 each year for 30 years. When you add the $2,400 traditional level term costs with the amount invested in the above example ($1,540) you get the annual ROPT premium of $3,940).

Final numbers: Dr. Smith would have to earn in excess of 6% pre-tax in the stock market with the difference in premium ($1,540) in order to have more money than he would receive with his ROPT. And Dr. Smith has NO guarantee that his money in the stock market will not earn less than 6% or even negative returns (as we have seen in 2000-2003).

**Conclusion on ROPT**

If you despise paying your term life insurance premiums due to the fact that there is a 93% chance you will not die and therefore the premium was a waste of money, then you should consider ROPT. With ROPT, you are getting **free death benefit** coverage due to the fact that you will receive every dollar paid in premium back via the Return of Premium Rider. This will allow you to avoid the feeling we all get when we cut a check for term life insurance. That feeling being that we could make better use of the money by making a bond fire with it and roasting marshmallows (assuming we ended up being in the 93% category of people who did not die during the term period).

If you would like help determining if using a ROPT policy can save you money over your current term life policy, please feel free to contact one of the authors.

**Miscellaneous comments on term life**

You can purchase all sorts of different term riders like increasing and decreasing term. You would buy increasing term because you think that, as you get older, your estate will grow; and you want a policy you know will increase its death benefit. Others like decreasing term because they believe, as their estate grows, their need for insurance decreases due to the fact that, if they die, their heirs have ample assets in the estate to live a comfortable life. Finally, there are those that would rather buy ROPT due to the fact
that every dollar they pay in premium will come back to them via the Return of Premium Rider.

**Our recommendations**

We recommend 10-30 year level term for those clients who need life insurance to take care of a family in a manner they have become accustomed to when the breadwinner is still working and less than 50-60 years old. We suggest term insurance of 2 million dollars (or more) so that, if a younger client dies, the spouse does not have to go back to work in order to support him/herself and so there is enough money to send the children to college. Term is good for younger clients because it is inexpensive.

If you are going to be paying term life premiums for 10-30 years we strongly recommend you consider purchasing ROPT if the numbers make sense. With ROPT you can receive free term life insurance in the event you do not die and, therefore, it will not seem nearly as painful to you when paying your term life premiums.

**Whole Life Insurance Policies**

Whole life provides a death benefit and an accumulating cash value. By definition, it has a **fixed premium** and a **level death benefit** to age 100. The **premiums do not increase** with age, which averages the client’s cost of the policy over the life of the policy (although there is a high internal upfront load with whole life). The cash value increases with time until it equals the death benefit at age 100.

Most clients when they look at a whole life illustration wonder why there is very little cash surrender value the first several years of the policy. The main reason is that, as compared to the other types of cash building policies, the costs for the first few years in a whole life policy are astronomically high. The premium costs for the client are the same over the life of the policy, but the internal costs decrease as compared to universal life and variable life which have high internal expense in the later years of the life policy (especially after age 70).

**Where do whole life premiums go?**

The insurance company essentially makes all of the decisions regarding how and where money in a whole life policy is invested. Regular premiums both pay insurance costs and cause equity to accrue in a savings account. That cash value is invested in fairly conservative investments (depending on the company) and usually is heavily invested in the bond market. The cash surrender value is an amount of money that you are guaranteed to receive in the event of policy cancellation. You also have the right to borrow against the cash value on a loan basis (tax free income).

Also, be aware that premiums are due in your whole life policy every single year. If you cannot come up with the premium one year or several, the policy will pay the
Estate Planning

insurance expenses internally from built up cash value (if any). However, eventually the
policy will surrender itself if you do not request a lowering of the death benefit (which
not every company is willing to do) or if the policy runs out of cash to pay premiums
internally.

If you think you will need flexibility in your life policy both with premium and
death benefit, a whole life policy is not for you.

Why would you want to use whole life?

Whole life (otherwise known as permanent life insurance) works well for estate
planning purposes. As soon as you purchase the policy, you know what your premiums
are going to be for life; and unless the company goes bankrupt, as long as you pay your
premiums, you will have that death benefit no matter what happens in the equity markets.

If you are not looking for a long-term estate planning life insurance policy, then
we do not typically suggest using a whole life policy mainly because the investment
returns on the cash in whole life policies are typically low in comparison to the stock
market averages over a period of time. Our point being that, if you ever got to a point
where you were strapped for cash because of the early expenses in the policy and the low
investment returns, your whole life policy is not much of a resource to use if you get in a
financial pinch. You will have a guaranteed death benefit as long as you pay the
premium, but do not look to the policy as a major liquid asset of your estate unless you
are pumping in significant premiums (well above what is required) for a number of years.

Miscellaneous

As with term policies, there are a number of variations with a whole life policy. For those who cannot afford a normal whole life today but think they will have the
money later, they can purchase a policy that starts with lower premiums that go up
dramatically (supposedly when you have more money) after the third-fifth year.

Limited pay policies (guaranteed life) are a nice option to use in an estate plan for
someone who does not want to pay premiums until death. The life insurance company
figures a one or multiple pay policy (typically 1-10 pay) where the client will pay the
calculated premium and then will never have to pay another premium to guarantee the
death benefit in the policy. This is the type of policy we typically recommend for high-
end clients who have a need for a guaranteed death benefit (usually for estate taxes and to
pass wealth to the heirs) but do not want to pay premiums for more than five years.

We almost always recommend guaranteed policies (although the advice is not
always taken) for clients 50-60 and older looking to use life insurance for an estate plan.
Variable Life Insurance

Higher income clients are typically aware of variable life because it has been pitched to nearly every high income client in the country by salesperson trying to talk a client into purchasing the policy as a post-tax investment. While investing in a life policy can make sense as a post-tax investment (if the policy has good and steady long-term returns), we would prefer clients to fund a life insurance policy as an investment when doing so in a tax favorable manner.

Where does your premium go?

Variable life is simple to understand. When you pay your premium, X amount of the money goes to pay term insurance for someone your age; and the rest of the money goes into the stock market via mutual funds. Many clients seem to love this policy because they seem to like the fact that they are buying life insurance but their money is really going into the stock market.

If you had a variable policy from 1999-2002, then you know why we do not like variable. Most people do not seem to grasp (and the agents do not bring to light) the fact that, when you get over 70 years old, the costs of insurance in a variable policy are tremendously high. Further, the illustration given to the client only assumes a level rate of return (usually 10-12%) every year of the policy. That is not realistic; and if you throw in negative returns early on in the policy (or if the average return in the policy is a more reasonable 6-8% return), the entire illustration that you received when you were sold the policy is not worth the paper it is written on.

No Guarantees

There are no guarantees on investment returns in the majority of variable policies. That means that, if you have a negative year (or several like 1999-2002), the cash value in your policy (the money invested in mutual funds) takes a nosedive with the stock market. You might think that is not a big deal due to the fact that over the long haul the policy will still average your assumed rate of return of 10-12%. What you have not probably thought of is that the expenses in your policy increase every year, and the insurance company does not care if you do not have cash in your policy to pay premiums because the market is in a funk. The insurance company on schedule still takes out its chunk of your money for life insurance premiums. We call that a double whammy, to use a not so sophisticated term, to describe premiums coming out and cash value decreasing.

Big problem

Many clients were sold variable policies with 12% illustrations where they were told that they would only have to pay premiums for 10 or so years. Many of those clients were told that the cash build up would be tremendous and that not only would the client
not have to pay premiums but they would also be able to take tremendous income tax free
loans from their life policies when in retirement.

You know what those agents are telling their clients after three terrible years in
the stock market? They are telling their clients that they will have to pay premiums for
an additional five years or more and that their life company will not even let them run life
insurance illustrations that exceed 10%. Strange how the worm has turned.

We always thought 12% illustrations were a bit rosy, and now the insurance
companies are starting to agree with that assertion.

**Our recommendation**

With the new universal life and indexed universal life policy (see below), we see
no need for anyone to go out and purchase a new variable policy.

What if you currently have a variable policy? What can you do and what should
you do?

One suggestion is simple. Unless you have massive surrender charges (a penalty
for canceling your policy and moving the cash value to another company), we suggest
**1035 exchanging your variable policy** for an indexed universal life or traditional
universal life policy. With the new non-variable policies, you can give yourself
minimum guarantees on investment returns, have lower long-term costs and, if the market
does well, you will be able to get the investment return up to 11-15% annually.

**Universal Life Insurance**

Universal Life (UL) is sort of a hybrid between whole life insurance and variable
life. UL is the most flexible type of life insurance because of the fact it does not
technically require that a premium be paid into the policy every year (out of your pocket)
and because the investment returns are much more stable than a variable policy.
Premiums can be paid in a lump sum, annually, or anywhere in between.

Interest on the cash value is usually guaranteed but will vary according to the
investment performance. Each month deductions are made from the cash value in the
policy to pay for the costs of the insurance protection. As long as the cash value is
substantial enough to maintain the monthly costs, the policy will remain in force. The key
to any form of Universal Life is that it is interest sensitive and allows for an adjustable
death benefit.

**Why do we like Universal Life (UL) best of all?**

In two words: flexibility and guarantees. We like to build in options for clients
that are based on a stable footing. With a UL policy, the cash in your policy usually has
some minimum guaranteed rate of return (2-4% typically). Because of the flexible way you can pay your premiums and the fact that it is easy to lower the death benefit if necessary, a UL policy very simply provides a client with the most options (which helps protect a client from market swings and poor earning years).

Finally, with the new UL policies, companies are offering a **guaranteed death benefit**, which previously could only be purchased with a more expensive whole life policy.

**Our recommendation**

Unless you just have to have the action of the cash in your life policy in the stock market (with no guarantee), we recommend a UL policy for your life insurance. The long-term costs are less than a variable, and you insulate yourself from down markets.

If you need permanent life insurance, a UL with a guaranteed death benefit will usually be significantly less expensive than the traditional whole life policies everyone is used to purchasing.

We would like to leave you with the following thought on UL policies— they are not all created equal. You can go to ten different companies and get ten different kinds of UL policies with different costs, different guaranteed returns, and different upper-end crediting amounts on your cash value.

**Shop your insurance**

When all else fails, work with an agent who is able to work with many different life insurance companies so you will get access to several different policies in an effort to choose the best one. Many agents are only able to work with one insurance company because of an exclusive contract. These agents are what we call captive agents. Most agents that are not captive agents can sell with more than one company but typically place their business with one company anyway because the more business they place with that one company the better their commission overrides are and, therefore, the more money they make.

As much as we would like to think insurance agents are doing what is in our best interest, we would say the vast majority of the time they are doing what is in their best interest.

In our opinion and after reviewing many in-force life insurance policies, we can confidently say that a significant portion of the life insurance in force out there has been incorrectly placed. By that, we mean the client was sold the wrong type of policy, too much or too little death benefit, and, worst of all, a majority of the time, we have been able to show a client why the policy they currently have is just far more expensive than it needs to be. This may sound strange, but life insurance is about the only industry we can
think of that has had its costs lowered over the years. People are living longer and, taking into account inflation, insurance costs are less today than they have ever been.

So if you have not had your life insurance policy re-examined, you should do so with an insurance agent you trust. And, lastly, if you have a policy from a company that traditionally sells auto insurance or homeowners’ insurance, the chances are significantly higher that the premiums you are being charged by that company are not competitive with life only companies.

If you would like a free analysis of your life insurance policy to determine if you have the right type of policy at the lowest possible rate, please feel free to contact one of the authors who would be happy to give you an opinion.

The “New” Equity Indexed Life Insurance Policy (EILIP)

We have yet to meet a high income or high net worth who does not have some form of life insurance. Years ago, clients purchased traditional whole life policies that were very secure but had very poor returns. More recently, clients have become enamored with variable life insurance because the policies buy term insurance (which is inexpensive at a younger age) and invest the balance of the premium payment in the stock market via mutual funds. Clients seem to like the action in the market whenever they can get it and, therefore, having a life insurance policy that can roll with the market is very appealing.

As many of the readers with variable life policies have found out, cash values in a variable policy not only go up with the market but they fall (very hard the last two years) with the market as well. This section of the material was created to inform clients of a “new” EILIP in the marketplace that has an annual minimum return guarantee every year but still allows the cash value in the policy to grow at a between 12-17% rate every year if the stock market performs well. (High-end cap rates vary with different companies).

An example is the best way to illustrate how switching to the “new” EILIP can save you significant money.

Doctor Smith in January of 1999 had a variable life insurance policy with a $2,000,000 death benefit and a cash value of $250,000. Because Dr. Smith had his cash value invested in an XYZ aggressive growth fund (which we will assume averaged negative eighteen percent (–18%) over the last two years), today Dr. Smith’s cash value in his variable life policy is $168,100. Needless to say, Dr. Smith is not happy.

If Dr. Smith had the “new” EILIP, he today would have had plus 2% credited towards growth in his policy; and, therefore, his cash value would be approximately $260,100.
For those clients using a traditional whole life policy, an example works as well to illustrate how much money could be lost by not using the “new” indexed life insurance policy.

If Dr. Smith bought a whole life policy today, typically the investment return inside the whole life policy will be less than 5% a year. If Dr. Smith has $250,000 in cash value inside a whole life policy today making 5% in growth every year, Dr. Smith will have $319,070 in five years. If Dr. Smith used the “new” indexed life insurance policy and the S&P 500 Index had returns of 8%, Dr. Smith would have $367,332 or about $48,262 more in cash value just over that five-year period by using the “new” EILIP.

Pros and Cons of the “new” EILIP:

**Cons** – 1) If the market averages over 17% for the time you have your life insurance policy, you would be better off in a variable policy (not very likely).

2) If the market averages less than 5% over the time you have your life insurance policy, you would be better off in a conservative whole life policy (not very likely)

**Pros** – 3) There is a minimum guaranteed return every year (1-3% for the Universal Life Policy)

4) The policy does let the owner partake in the upswings in the market up to 17%.

5) Mortality costs (costs of insurance) are much lower in the later years than a variable life insurance policy.

6) Flexibility, unlike typical whole life policies, the “new” EILIP is very flexible with its premium so the owner can choose when and how much premium is to be paid each year.

**Newest Product on the market**

Just prior to the printing of this book, a new EIUL policy has come on the market which is “revolutionary.” The product has a crediting method where the insurance company will credit 140% of what the S&P 500 returns on an annual basis. For example, if the S&P 500 returns 5%, the policy will credit its growth at 7%. If you look into buying an EIUL policy, we strongly recommend you look at this product.

**Conclusion**

If you would like the possibility of getting upwards of 12-17% return on the cash value in your life insurance policy every year and would like to avoid the stock market’s negative years with a 1-3% minimum guarantee, then you should look into the “new” EILIP. Also, if you are nearing the age of 50 and have a variable life insurance policy,
you should seriously consider changing to the “new” indexed life insurance product to protect the principal cash value in your policy and to lower the costs of insurance inside the product.

**Side note: Tax Deductible Life Insurance:**

It is rare that we recommend that a client who owns a business purchase life insurance on a post-tax basis. There are several ways to pay for life insurance in a tax deductible manner, and we would suggest that all readers explore those tax deductible options before shelling out any significant money for life insurance on a post-tax basis.

If you read several of the sections of the income tax reduction part to this book, you will read about a few ways to purchase life insurance in a tax favorable manner.

**Section 5**

**Irrevocable Life Insurance Trusts (ILIT)**

ILITs are a much-underutilized tool in the estate planning arena. Only about two clients out of ten will have an ILIT, which means a good portion of the other eight will mostly be underinsured due to the fact that 50% of the life insurance proceeds will go to the government via estate taxes at death.

**Life Insurance**

Do you have enough? For the younger clients, overall we would say that the majority have too little life insurance in their estate plans. There is the need for life insurance when you are young to protect the family in case of an early death of the breadwinner. Many younger clients we get calls from have between $500,000-$1,000,000 in term life insurance. (We typically advise against whole, universal, and, most certainly, variable life for younger clients).

The question we pose to each younger client is: Do you have enough life insurance so that, if you die in the near future, your spouse does not have to go back to work (if the spouse is a homemaker) and will your children (if any) have enough money to pay for their living and educational expenses until they get through college? The answer 90% of the time is that the client does not have enough life insurance to pay for that noble goal.

While the clients will be dead and will not have to worry about what is left behind, most clients intend to take care of their families as if the clients had not died. That is usually not possible with $500,000-$1,000,000 worth of insurance.

How much is right for you? Without talking with you, we have no idea; but any decent insurance agent (one whom you can trust) should be able to tell you how much
insurance you need taking into account all the debts of the family and the needs ongoing after a premature death of the breadwinner. At a minimum, most younger clients will need at least 2 million dollars of life insurance.

For those older clients, they too are usually underinsured due to the fact that almost all high net worth clients over the age of 50 have estate tax problems. You can either 1) gift assets away; 2) have your heirs pay 50% estate taxes on the assets above $2,000,000 in your estate (assuming you were married and properly used your A&B marital trusts to minimize estate taxes), or 3) you can purchase life insurance to pay for those estate taxes. For clients with estates over $5,000,000, it is easy to justify the purchase of 2-3 million dollars of death benefit for estate planning.

**Income tax free death benefit**

As you are probably aware, life insurance death benefits pass to beneficiaries Income Tax Free. That is one of the wonderful things about life insurance. (Let’s also not forget that any death benefit can pass to your spouse income and estate tax free). Unfortunately, unless you are giving the entire death benefit to your spouse, there will be estate taxes due on your life insurance death benefits unless the life insurance policy is owned by an irrevocable life insurance trust (ILIT).

**Estate tax free death benefit**

As we indicated above, death benefits will pass to your spouse income and estate tax free. That is why many people think that there is little need for an ILIT. However, ask yourself what happens if your spouse, who lived on after your death, happened to die the next day, or the next year, or within five years. That is where good planning really pays off.

We spell out for clients the problem of passing the entire death benefit to the living spouse and, typically, they agree that they are, in fact, underinsured. That living spouse many times will not be able to spend down the estate before he/she dies, and the life insurance benefit that passed to the living spouse will get zapped with estate taxes anyway. Careful budgeting is needed to determine how much, if any, of the death benefit should be given to the surviving spouse.

Many times the surviving spouse will only need a fraction of the death benefit because the rest of the estate is already several million dollars, of which hundreds of thousands are liquid IRA/401(k) money or stocks, which the spouse can live on until death.

We would prefer to set up an ILIT and have the death benefit poured into the ILIT at the death of the breadwinning client. The ILIT will, typically, have the children as the beneficiaries and have special language in it not to give the children the money until the second spouse dies (where the death benefit can be used to pay estate taxes, if needed). The special language of the trust will allow the trustee to provide for the well being of the
surviving spouse, if needed, so that, even though the ultimate beneficiary may be the children, if the spouse needs money to keep up her lifestyle, the trustee can take money out of the ILIT to fund such needs.

With the special language, you have accomplished all your goals of having the entire death benefit of your life policy pass to your children or a living benefit to your spouse while living.

**ILIT has to own the policy**

In order for the death benefit to pass income and estate tax free, the ILIT needs to be the owner of the policy and should also pay the premiums for the policy. Many times we will see that an ILIT is set up and is either not the owner of a policy or not paying the premiums of the policy.

The proper way to fund a policy in an ILIT is as follows:

1) Set up the ILIT;
2) Gift money to the ILIT for the first year’s premium (and every year thereafter);
3) Send crummy powers to the heirs to complete the gift to the ILIT.
4) Have the ILIT set up a bank account;
5) Have the ILIT pay the premium on the policy it owns from the ILIT’s own bank account. Funding a policy in an ILIT any other way is simply wrong.

**Conclusion**

ILITs are not necessarily needed for the younger client with a small estate (although keep in mind that, if you have a 2-million-dollar life policy and if you have any other assets, your estate is already over the cap where estate taxes will come into play).

If you have an estate of more then $2,000,000 (usually closer to $3,000,000 and up (which includes any life insurance)), then you should consider having an ILIT.

If you are 45 years and older with a large estate and you think you have enough life insurance, make sure you get your calculator out and see if you really have 50% too little life insurance due to the fact that 50% of the life insurance could go to the government via estate taxes.

No one likes insurance, but it is vitally important to your heirs that you have not only the right amount of life insurance but have the insurance owned by the right entity (which for many clients is an ILIT).
Section 6
Leveraged Life

Leveraged life is very in vogue right now and being pushed by many financial planners. Leveraged life (so they say) is a way to get a “free” death benefit for your heirs. Basically, what you are doing is going out and borrowing money to pay for life insurance premiums. The hope is that there will be enough cash in the policy throughout its life to pay for the interest internally in the life policy until the client dies (so you do not have to dip into your personal assets to pay for interest).

An example is the best way to describe the concept.

Dr. Smith, age 70 and single, has a $10-million-dollar estate made up of $9 million of real estate and $1 million in stocks. Dr. Smith knows he has a huge estate tax problem; but since Dr. Smith retired last year, he has only an income of $300,000 a year pre-tax, which comes from real estate rentals and dividend income on the stock. The estate taxes, with Dr. Smith’s current planning are 50% on $9 million or $4.5 million.

Dr. Smith would like to pass all his properties to his children; but in order to do that, he needs to buy $4.5 million in life insurance and put that into an irrevocable life insurance trust (ILIT). The premium on $4.5 million for a 70-year old is in excess of $350,000 a year pre-tax, which comes from real estate rentals and dividend income on the stock. The estate taxes, with Dr. Smith’s current planning are 50% on $9 million or $4.5 million.

The Solution

Since Dr. Smith does not have the liquid cash to pay for the $4.5 million death benefit, he can purchase “Leveraged Life,” which on paper will cost Dr. Smith NOTHING. The marketers of leveraged life sell it as follows:

Insurance company XZY will loan Dr. Smith money for the life insurance premium at $500,000 a year for ten years for a $9.5 million death benefit policy. Interest on the loan will be very low (lower than you can get from a traditional bank) and let’s assume a rate of 5%. The interest on the loan the first year is $25,000, and it escalates every year until the 10th year where it levels off. Interest is actually paid on the loan, but it is paid internally in the life policy from the cash value. Then, eventually the client dies. The death benefit goes to the heirs, and the loan inside the policy is paid back. What a wonderful thing—the client was able to
purchase $4.5 million (the remaining death benefit after the loan is paid back inside the policy) in insurance, and it cost him nothing.

How can Leveraged Life Work?

Leveraged life works great if the life insurance policy has a better internal investment rate of return on the cash in the policy than the loan rate on money borrowed in the insurance policy. If that is the case, then the client and his/her heirs win. If the rate of return in the policy is lower than the interest charged eventually, the policy will implode; and the client will have to pay the interest out of pocket or a “call” will be made selling assets of the client to satisfy the loan.

Collateral

What assets will be sold? It depends on the company. Insurance companies selling leveraged life all have different lending scenarios; but there is one constant—the need for collateral.

One company requires that clients be 90% liquid (stocks, bonds, CDs) with the makeup of their estate, AND the insurance company requires that the clients allow the lending institution to manage all of those liquid assets while the leveraged life plan is in place. Also, by contract, if the policy is doing poorly and a “call” is made for money from the clients to pay premiums or interest, the client’s new money manager (the lending institution on the new leveraged life policy) has the authority to sell the client’s stocks without notice to pay premium payments or interest on the loan. That is not an aspect of the plan we like.

Obviously, the financing arrangement in the previous paragraph will not work for someone without a liquid estate. There are other companies out there that will loan you money for the leveraged life concept and take a secured interest in your real estate.

What are you collateralizing?

Watch out for how much you actually have to collateralize on the loan. Some companies make you put up enough collateral to cover the difference in the cash surrender value (CSV) in the life policy and the loaned amount (which could be millions over the first seven years of the contract). Some companies, however, will only make you collateralize the difference in the cash account value (CAV) and the loaned amount. The difference in the two methods is usually upwards of 80% the first few years of the contract due to the fact that there is little cash surrender value in the policy in the early years.
Interest rate sensitive

The biggest risk with the leveraged life solution is that we have no idea what interest rates will do in the upcoming years. Some of the lending provisions with leveraged life will lock the interest rate on the loan for ten years, some for five, and some with one-year variable rates. If rates go up dramatically after your fixed term and the investment returns in the policy do not go up accordingly, the likelihood of your policy surrendering itself (losing all of its cash value) is significant. If the policy implodes, you will lose all of your collateralized assets.

Who is a Candidate for Leveraged Life?

A client with a large estate planning problem who is either too cheap to purchase life insurance to cover the estate taxes or is not liquid enough to pay premiums is a candidate. A potential client really needs to die within 20 years of setting up the plan (although 10-15 would be better). The longer the client lives, the more interest that accumulates (since you never pay it back out of pocket), the more likely the investment returns are not going to be significant enough to pay for the interest internally in the policy.

Charities

Many advisors are going around the country trying to sell this concept to charities or universities looking for donations. The theory is that a wealthy person or alumni would like to make a sizable donation but just cannot pull the trigger to give out of their own pocket. If a wealthy client does not mind collateralizing the loan with the leverage life concept, then the pitch is that the client should do just that—pay NOTHING out of pocket and then give via a large death benefit a donation to the charity. Sounds great, doesn’t it?

Conclusion

Leveraged life can work fine if the client uses the right company and understands that, at some point down the road, there might be a “call” to have the client pay interest or premiums in the policy because the cash value did not grow sufficiently to pay the interest internally. If a client over 65 with a large estate wants to look at this topic as an estate planning tool, we are fine with it as long as the client is willing to take the risks associated with the financing. It really can be a free death benefit to the children or charity if done right and the client dies within a reasonable time frame.
Section 7
Life Settlements

Why You Should Consider Selling Your Life Insurance Policy

The concept behind Life Settlements (hereinafter LS) is fairly simple. LSs are for someone who purchased a life insurance policy, no longer needs that particular policy (for a variety of reasons discussed below), and would like to sell the policy today for cash and use the proceeds for any number of different purposes.

The concept of buying or selling a life insurance policy has been around for some time mainly in the form of a “viatical settlement.” A viatical settlement is the purchase of a life insurance policy of a terminally ill person who is going to die within two years. The buyer buys the policy at a discount (less than what the death benefit is), and the person selling the policy gets cash now to improve their life before passing away. To many clients a viatical settlement might be an interesting investment option; but the concept as a seller will not be applicable unless the client is terminally ill.

An LS, as the name infers, is the sale of an existing life insurance policy of a client who is intending on living but has no current use for the particular life insurance policy he/she is thinking of selling.

Why sell a life insurance policy?

We think a better question is why keep a life insurance policy you have no need for. That question brings us to the age old question of why and when should someone buy a life insurance policy. We discuss at length starting on page 116 why someone would purchase a life insurance policy and, specifically, which type of policy to purchase. There are two main reasons people buy life insurance:

1) To protect the family in case the “breadwinner” (parent who makes the most money) dies. This protection covers the non-working (or working at a lower income level) spouse who will want to have his/her debts paid off and money to live on. There is typically a need to protect the children so the living parent can buy food, clothing, and put the children through college.

2) To pay for estate taxes so wealth can be passed to the heirs at the second spouse’s death. Most clients will not implement proper estate planning; and, therefore, the cure-all is to purchase life insurance to pay for estate taxes (assuming the clients and spouse do not both die in 2010 when there is no estate tax).
Let’s look at a real world example and see if it makes sense for Dr. Smith to consider selling his life insurance policy.

**Facts:** Dr. Smith is a 65-year-old retired orthopedic surgeon who is married to a 65-year-old retired nurse. Dr. and Mrs. Smith have three children and six grandchildren. Their assets consist of a home worth $1,000,000 that is paid off, a $2,000,000 brokerage account, a $1,500,000 IRA, a vacation condo in Naples worth $350,000, and a universal life insurance (UL) policy on Dr. Smith with a $2,000,000 death benefit and a cash surrender value of $75,000. Dr. Smith’s total taxable estate for estate tax purposes is: **$6.85 million dollars.**

Assume that the life insurance policy is **not** in an irrevocable life insurance trust (ILIT, which you can read about on page 127); and, therefore, if Dr. and Mrs. Smith died in a car crash tomorrow, their heirs would be left with approximately $4,375,000 of that $6.85 million dollars **after** income and estate taxes. This assumes Dr. and Mrs. Smith had, as a minimum, A&B living revocable trusts to maximize their estate tax exemptions. If the Smiths did not use their estate tax exemptions properly at death, they would pass to their heirs after all taxes, $3,625,000.

**Facts about Dr. Smith’s current UL policy:**

Dr. Smith purchased the UL policy at age 55 for estate planning/investment purposes where the annual premium was and still is $20,000 a year. The UL policy has $75,000 in cash surrender value and a $2,000,000 death benefit.

If the Smiths could rewind the clock prior to their death (we are assuming they died together in a car crash), they would have certainly figured out a way to get that $2,000,000 death benefit policy into an ILIT so the entire death benefit could pass income and estate tax free to the heirs. This blunder in their estate plan cost their heirs $1,000,000 (half of the death benefit at the 55% estate tax rate in 2011 and beyond).

Again, why would someone sell their life insurance policy for cash?

In our example, what would the Smiths be able to sell their $2,000,000 policy for? An educated guess based on the current life settlement market would be $345,000.

**Side Note:** Tax consequences of selling a life policy.

The amount of premiums paid into the policy is its “basis,” and no tax is due on that value. The cash surrender value in the policy is taxable as ordinary income, and the life settlement payment which accounts for the remainder of the sale price (if any) receives capital gains tax treatment.
In our example, Dr. Smith paid $20,000 a year for 10 years, which would give him a basis of $200,000. The cash surrender value is $75,000. If you add the two, you get $275,000; and the remaining $70,000 would be taxed at the capital gains rate.

Outcome:

No tax on the $200,000 basis.

$75,000 taxed at 40% (worst case scenario) leaves $45,000 after tax.

$70,000 taxed at 20% capital gains leaves $56,000.

Total in pocket for the Smiths after tax = $301,000.

Getting back to the example—if Dr. Smith and his wife were healthy, Dr. Smith could sell his UL policy and have in pocket $301,000 (net). The Smiths could then purchase a $2,000,000 second-to-die life insurance policy owned by an ILIT where the death benefit will pass income and estate tax free to their heirs.

The premium for the Smiths’ new second-to-die $2,000,000 policy would be $25,000 a year until death. Remember that Dr. Smith is currently paying $20,000 a year for his current UL policy; and, therefore, he would only have to pay an additional $5,000 a year to purchase the second-to-die policy that would be owned by the ILIT.

Let’s finally assume that Dr. Smith and Mrs. Smith die together in a car crash in Naples, Florida, where they were retired at their ages of 85. How did the Smith family heirs benefit from the above example?

1) The $2,000,000 second-to-die life policy would pass to the heirs income and estate tax free therefore saving the heirs $500,000 in estate taxes.

2) The additional cost of the life insurance policy per year was $5,000 and that was paid for 20 years until the Smiths’ turn age 85. If we subtract that $100,000 extra premium from the $301,000 net payment from the life settlement, the heirs received an additional $201,000 (assuming no growth on that money for 20 years).

Total additional money for the heirs = $701,000.

Again, why should a client consider selling his/her current in-force life insurance policy? Because in some circumstances that sale will have a significant positive financial impact on the insured and his/her heirs.
Another example for the benefits of a Life Settlement

What if a life insurance policy is purchased and the reason the life insurance policy was purchased no longer exists. When might this situation arise?

1) If Dr. Smith bought a life policy to take care of his spouse should Dr. Smith die first, but instead of Dr. Smith dying first, Mrs. Smith died first. Since the policy was for the benefit of Mrs. Smith, there might no longer be a need for the policy. The same would be true if the life policy was purchased for Mrs. Smith and, instead of dying, she divorced Dr. Smith.

2) If Dr. and Mrs. Smith wanted to pass wealth to their heirs (children) and then the children turn out to be heroin addicts or otherwise become estranged from the family. In this situation, the Smiths might decide to cut the children out of the will altogether or, at the very least, simply do not want a large death benefit to pass to the undeserving children.

In situation one above, there is NO reason for Dr. Smith to continue to pay on a universal, variable, or whole life insurance policy. Mrs. Smith is dead or divorced (the first situation is sad, and the second is expensive), but the bottom line is the need for the death benefit is gone. Therefore, a Life Settlement for Dr. Smith would make a lot of sense so he could stop paying premiums and get in his pocket cash to do with what he wanted. We suggest in the divorce situation that Dr. Smith wait until the divorce is finalized before cashing in the policy.

In situation two above, while the children are not dead, they are not deserving of the death benefit; and, again, there is no incentive to continue to pay the premiums. Therefore, finding a situation where the Smiths can stop paying premiums and recoup all of their premiums and more is an attractive option.

Summary of Life Settlements

While the topic of Life Settlements is not in the main stream, it is becoming much more common. We not only wanted to make sure readers knew the concept exists, but we wanted to give quite a bit of detail. We explain this topic in greater detail on page 271 of this book. While the topic might not be too useful for a younger reader, it might apply to a younger reader’s parents or older friends.

We know that many clients have had changes in their lives that could give rise to a situation where a Life Settlement would make sense. Now that you know what they are and how they work, hopefully, if you ever have a need to look at the Life Settlement concept, you’ll remember reading about it in this book.
Section 8
Reverse Mortgages

A reverse mortgage (RM) is a topic that is becoming much more popular as our society ages. Many advisors have heard of a RM, but few truly understand how they work and the pros and cons for the client.

What is a RM?

A RM is a special kind of loan that is easy to obtain if you are at least 62 years of age (if married, the youngest must be at least 62) and own your own home, condo (planned unit development) or co-op (mainly in New York). A RM converts a portion of the value (equity) of a home into instant cash. The pool of money that is created by a RM can be received by a senior homeowner(s) in a variety of ways.

One other key feature to a RM is that there are no income, asset, or credit requirements to obtain the loan. That means you could have a client who has poor credit, no income, and no other assets besides a home with equity and the client could obtain a RM to raise money for a variety of needs.

The amount of money that can be created from a RM is dependent upon the program used. Generally speaking, it can be said that three things will determine how much a client can receive from a RM:

1. The age of the youngest borrower.
2. The value of the home (up to a certain limit for some programs).
3. The interest rate (for some programs).

The pool of money that is created from a RM can be received in lump sum, partial lump sum, monthly payment, line of credit, or any combination.

One of the key things that sets a RM apart from any other kind of loan is that it is a non-recourse loan. There is no personal liability to the borrower, their estate, or to their heirs (the house is the only collateral).

Another key thing that makes a RM loan special and different is that monthly mortgage payments are not required. Interest and servicing fees accrue over time. This means as with any negative amortization loan the amount that becomes due will be always increasing because mortgage payments are not required.
Why do clients gravitate to RMAs?

For many, a RM is nothing short of a life changing event. Many of our clients never expected to live as long as they have. Many of our seniors did not plan for retirement, and the expenses today are sometimes overwhelming. Therefore, many clients have a need for immediate cash to pay for a variety of expenses (drug and health care costs being the most common). Seniors could sell their homes and raise cash to pay for expenses, but many clients have lived in their homes for over 30 years (which is why there is no or little debt). Their need for immediate money can be satisfied with a RM and they can still stay in their home. For many, this is a huge burden off of their shoulders; and, therefore, a RM is seen as a significant stress reliever for the elderly.

Why a RM works

It works because we are dealing with an asset (the home) that has carried the load of appreciating over the years. Now, after growing in value, the home is going to return its love to the owner. Part of the value of the home is paying most of the closing costs of a RM. If the client chooses, the only out-of-pocket expense is $450-$600 (depending upon the program). In return, a pool of money is thus created. It is the home that ultimately becomes responsible for paying the loan back. Remember, it is a non-recourse loan (with an interest rate that is NOT fixed).

Risk reversal

A RM is 100 percent risk free. First, no document requires that a borrower continue the process if they subsequently have a change of mind. Second, every RM has a counseling component to it. The purpose of the independent counseling is to insure that every senior understands the concept and is not coerced into action. Third, federal law provides that, even after signing the closing documents, every senior has three days to reconsider. If at that time they change their minds, then any funds that they paid out must be returned. This is a 100% risk free loan.

Things you might be told that are not true

RUMOR: You will be told that they have to make monthly mortgage payments.

TRUTH: You will never, ever make monthly mortgage payments.

RUMOR: You will be told that the bank will own the house.

TRUTH: You will continue to own the house. The bank will never own the home while the client is living.

RUMOR: You will be told that their heirs could become responsible for paying this loan back.
TRUTH: It is a non-recourse loan. There is no personal responsibility for the borrower, their estate, or their heirs.

RUMOR: The loan is due and payable when the first borrower dies.

TRUTH: The loan is not due and payable until the last surviving borrower dies, sells the home, or is not using the residence for 365 consecutive days. The loan must be paid in full when the youngest borrower reaches their 150th birthday.

RUMOR: Closing costs are way too expensive.

TRUTH: The numbers do not tell the whole story. Not all RM programs have closing costs.

Case Study

Assume you have a parent age 74 with a spouse age 74 and a house with an estimated value of $400,000. The parent’s initial interest rate on the loan would be 4.39%, and that interest would accrue during the life of the loan. The parents could receive $108,000 from a HUD loan.

What does this mean to the parent? They could receive $108,000 up front or over time to spend as they see fit.

What do the numbers look like?

At the parent’s age 85, there would be $180,855 owed on the loan.
At the parent’s age 90, there would be $224,000 owed on the loan.

If the parents died at age 85, the home would be sold, the lender would be paid back $180,000, and the remaining equity would pass to the heirs. The debt becomes a debt of the estate, but the only recourse the lender has is against the home itself not the other assets of the estate.

Many advisors and clients will look at the numbers from a RM and will come to the conclusion that the loan is just too expensive. The question is who is it expense for? Not for the parents who received the money because they’ll ultimately be dead. It could be very pricey for the heirs; but the question is, if a RM is not used, how are the parents going to pay to keep their quality of life high and still be able to stay in the home.

RMs are not for every older client who needs instant cash flow. However, RMs will be a good fit for some; and even if a RM is not a good fit for you or your parents or older friend, it is important to learn the topic so you can advise them.

For a longer 23-page summary of this topic, please feel free to e-mail one of the authors.
Section 9
Disability Insurance (DI)

What You Need To Know Before You Buy

Overview

You have probably heard that the disability insurance (hereinafter “DI”) policies available today are drastically different from those available a few years ago. Although this is true, you can still find quality disability coverage if you know what to look for and understand how individual disability income insurance policies are offered.

How policies are offered

DI can be purchased on an individual or group basis. Group insurance is usually provided by an employer or purchased individually from a sponsoring professional association. Although initially low in cost, group policies have several limitations. They can be cancelled (by the association or insurance company), rates increase as you get older, and premiums are subject to adjustments based on the claims’ experience of the group. In addition, group and association contracts often contain restrictive definitions of disability as well as less generous contract provisions.

As a general statement, group policies many times are not worth the premiums paid. Most of the clients using group policies are those who cannot purchase affordable individual policies. Therefore, the premiums, with the limiting language of the contract, are typically not worth paying.

Most insurance companies used to issue DI coverage equal to approximately 60% of earned income. Unfortunately, due to adverse claims’ experience, insurance companies have decreased the amount of individual coverage available to insureds regardless of their earnings. The most common maximum monthly benefit is now $10,000 (although many specialties can purchase $15,000 if they can financially qualify). Some companies might allow you to purchase up to a total of $15,000 combined with group disability coverage you already own.

The cost of Disability Insurance

The premium rates are based on several factors including age, sex, monthly benefit, riders added to the policy, and the occupational classification the insurance company assigns to your medical specialty.
The younger you are when the purchase is made the lower the cost of the insurance. Therefore, you should purchase a policy as early in your career as possible to lock in lower premium rates.

The occupational classification assigned to you if you are a professional by the insurance company will have a significant impact on your premium rates as well as the policy provisions made available to you. For example, if you are a physician and perform invasive procedures, you will be placed in the “surgical” category; and the definition of disability made available will not only be more restrictive, the premiums charged will be higher as compared to a non-invasive, non-surgical physician.

**What to look for in a Disability Policy**

**Renewability provision**

The renewability provision is one of the key features of an individual disability income insurance policy. This provision defines your rights when it comes to keeping your disability policy in force. In general, a disability policy can be Guaranteed Renewable only or both Non-Cancelable and Guaranteed Renewable.

**Guaranteed Renewable**

If a policy is Guaranteed Renewable only, the insurance company cannot cancel or change any provisions of the policy as long as you continue to pay your premiums (up to age 65). However, the insurance company does reserve the right to increase premiums with state approval for an entire class of policies in the event of poor claims’ experience.

**Non-Cancelable and Guaranteed Renewable**

If a policy is both Non-Cancelable and Guaranteed Renewable, the insurance company cannot cancel, change any provisions, or increase the premiums for the life of the policy (up to age 65); therefore, a policy that is both Non-Cancelable and Guaranteed Renewable is preferable as it provides you with an added level of security.

**Definition of Total Disability**

Arguably, the definition of disability is the most important aspect of a disability policy. This is especially true for highly skilled professionals who must pay careful attention to the definition of disability found in their policies as it will ultimately determine how any claim they make for benefits will be judged. There are three definitions of “disability” commonly found in the insurance industry with significant differences between them.
“Own Occupation”

“Own Occupation” (also known as “true” or “pure” Own Occupation) is clearly the definition of choice for most professionals as it is the most liberal definition of total disability available. This type of disability policy pays benefits if you “are not able to perform the material and substantial duties of your occupation.” Therefore, if you were a physician you would collect full disability benefits if you could no longer perform surgery, even if you decided to work in another occupation or medical specialty earning the same or more income than you did as a surgeon. Ideally, you want to purchase a policy with the longest “Own Occupation” period available.

As a side note, Own Occupation policies refer to an occupation at the time of disability NOT at the time of purchase.

Modified “Own Occupation”

This type of disability policy has become the most prevalent in the industry today and, typically, pays benefits if you are “unable to perform the substantial and material duties of your occupation and you are not working.” Although benefits are still contingent upon your ability to perform your normal job (as an example, surgery for many physicians), this definition will not allow you to continue receiving full disability benefits if you are working in another occupation (or medical specialty for a physician).

“Any Occupation”

This definition is the most restrictive of the three described and is commonly found in group or association policies. Under this definition, you are eligible to receive benefits only if you are found to be “unable to work in any occupation which you are reasonably suited to by your education, training, or experience.” Unfortunately, it is the insurance company that makes this determination and many clients (surgeons being the best example) are well educated and trained and will find it extremely difficult to collect benefits from this type of policy.

Hybrid definitions

Many policies offered to clients today might incorporate an “Own Occupation” with a Modified “Own Occupation” definition. Here, the policy would contain a true “Own Occupation” definition for a limited time period (typically one, two, or five years) and then convert to the more restrictive Modified “Own Occupation” definition described above.

Although the hybrid definition is not as liberal as a policy with a true “Own Occupation” definition for the entire benefit period, after five years of receiving benefits (in the same claim), it is the insured’s decision to continue collecting disability benefits or to return to work in another occupation or specialty.
Merely being able to work in another occupation or specialty would not affect your disability benefits. You would actually have to engage in another occupation to have your benefits reduced or eliminated.

**Optional Riders**

**Residual Disability Rider**

Unless your policy contains a Residual Disability Rider, you may have to be totally disabled to collect any benefits.

There are many disabilities that might allow you to continue working in your occupation on a limited basis while suffering a loss of income. Adding a Residual Disability Rider to your policy would allow you to continue receiving benefits proportionate to your loss of income if you returned to your occupation on a part-time basis.

Furthermore, with policies such as Modified “Own Occupation” or “Any Occupation,” this Rider might allow you to continue receiving benefits if you decided to work in another occupation or if the insurance company determined that you could work in another “reasonable” occupation with reduced earnings.

Generally, to qualify for Residual Disability benefits, you must experience an income loss of 20% or more compared to your pre-disability earnings. Additionally, if your loss of earnings were equal to or greater than 75% or 80%, depending upon rider provisions, then 100% of your monthly disability benefit would be paid.

**Cost Of Living Adjustment (COLA) Rider**

A COLA Rider is designed to help your benefits keep pace with inflation after your disability has lasted for 12 months. This adjustment can be a flat percentage or tied to the Consumer Price Index. Ideally, you want a COLA that is adjusted annually on a compound interest basis with no “cap” on the monthly benefit. Although important, if cutting the cost of coverage is an issue, this might be the first optional rider to consider excluding from your policy.

**Future Increase Option Rider**

This rider is a must for young clients. It offers the ability to increase your disability coverage, regardless of your future health, as your income rises. It is important to know when you can increase your coverage as well as by what increments on any given option date.

If you are in the later years of your career, you need to make sure you are not paying for this rider after the maximum age. The insurance companies offer this rider but
then have an age where it is no longer available (but the companies still let you pay for the premium rider which is a complete waste of money).

**Tax deductible**

Personal DI benefits are generally received on an income tax free basis. However, if you take a **tax deduction** for the premiums paid, the benefits are **taxable when received**. This means you could lose as much as 50% of your benefits at the time you need them most. Therefore, we do not recommend that you write off your traditional disability premiums.

We have talked with many clients over the last several years who have been told by their disability agents to write off the premiums until you run into a potential situation where you will get disabled and then pay your next premium post-tax. The theory being that your last premium was not deducted; therefore, the benefit will be tax free. Do not believe it, and do not take that advice.

**Sidestep the $10,000 (or even $15,000) Maximum Monthly Benefit Level**

The most common way to increase your benefit is through a Future Increase Option Rider. The only problem with this option is that you might be subject to the rules that applied at the time you bought the policy. Another possibility might be to supplement your existing individual policy with a group disability policy.

**Disability Insurance Protection for Retirement Plan Contributions**

If we gave a seminar on DI and said with a straight face we knew an insurance company that sells to clients an additional $40,000 a year over and above any other DI a client owns, would that interest you? It should. How can this be true when every client (especially highly skilled professionals) complains because they have been told for years they cannot buy any more DI?

The answer is very simple; DI carriers will sell to clients protection against the cost of funding their retirement plans (401(k), Profit Sharing, Keogh, SEP, 403(b), and even some non-qualified deferred compensation plans). Therefore, if a client normally pays $42,000 a year to fund their retirement plan, the disability carrier will pick up that cost with retirement plan DI.

The most effective approach uses an individual DI policy that pays benefits into a trust set up specifically for the benefit of the insured client. If a disability occurs, monthly benefits from the policy are paid directly into the trust. The trustee, with input from the disabled client, then invests the monies received into mutual funds, annuities, or
individual securities until the insured (the trust beneficiary) reaches age 65. At that point, the trust’s assets are distributed to the individual to provide supplemental income for retirement.

Policy benefits and trust earnings are subject to the normal rules that govern the taxation of trusts and individual disability income insurance. Trust earnings are generally taxable to the insured as the beneficiary of the trust. As mentioned previously, DI policy benefits are either taxable or tax free depending on who paid the premiums and if they were deducted.

Example:

Dr. Smith, age 40, with an annual income of $250,000 a year. Assume Dr. Smith traditionally funds his 401(k)/Profit Sharing Plan in the amount of $40,000 a year. Now assume that Dr. Smith purchased retirement plan protection insurance with the maximum benefit of $40,000 a year.

If Dr. Smith became totally disabled at age 40, the insurance company would fund approximately $40,000 a year into a trust account where the money would grow and could be used in retirement. If Dr. Smith stayed disabled, his total cumulative benefit at age 65 would be $993,720.

If Dr. Smith purchased a cost of living adjustment (COLA) with a 6% inflation rider, his total cumulative benefit at age 65 would be $2,205,396.

What did the insurance cost to have the coverage and benefits outlined above? With the COLA rider, the premium each year for Dr. Smith would be $2,385; and without the COLA rider, the premium would be $1,883. This premium can be deducted from the practice (although the benefits like other retirement benefits would be taxable when received).

Our personal opinion is that clients looking for more benefits should strongly consider purchasing retirement plan protection DI. While we typically do not recommend writing off a traditional individual DI policy, we would recommend the client write off this type of insurance due to the fact that, if he/she has a long stretch of permanent disability, the likelihood the client will be in a very low tax bracket in retirement is great (and, therefore, the benefit while taxable will not be too taxable due to the low tax bracket).
Business Overhead Expense Disability Insurance

Protecting Your Business As Well As Yourself

Most clients do not carry Business Overhead Expense insurance (BOE). The main reason is that clients cannot see the value and are too frugal to buy a product they do not understand and do not think they will need in the future.

For example, if you are a business owner in a private business and are responsible for some or all of the monthly expenses to keep your business open, you should consider purchasing a BOE policy in addition to a personal disability policy. A BOE policy provides reimbursement for the expenses of operating your business if you or one of your partners are sick or hurt and cannot work. These expenses may include staff salaries, office rent or mortgage payments, utilities, malpractice insurance premiums, and other fixed costs normal to the operation of your business.

The benefit can be sizable and partners in companies should not expect their other partners to pick up their pro-rata share of expenses in the event of a disability. The disabled partner will have to dip into his/her own pocket to pay for these expenses until such time as they are no longer disabled or have their interest in the company purchased.

BOE insurance is fairly inexpensive and is a type of insurance that clients should write off (due to the fact that the benefit when received will be expensed out to pay for deductible office expenses). No complete asset protection plan can be complete unless a client has the proper amount and type of disability insurance.

Section 10

Divorce Protection

Have you ever had a friend or relative come into an inheritance and then hear the horror story about how that friend or relative lost half of it to an ex-spouse in a divorce? It happens more than you would think.

Imagine the scenario where you are married and your last living parent passes away leaving you with $2,000,000 (real estate and stocks). You put the money in your marital bank account or put the real estate in yours and your wife’s name and then go on with life as normal. Then one year later your spouse decides to divorce you. (A similar scenario can play out if you die in the middle of obtaining a divorce).

What is the departing spouse entitled to?

The answer is it depends on the state; but if you have been married for more than 10 years, the chances are significant that your spouse is going to get half of everything
you inherited from your last remaining parent. If that does not make you sick to your stomach, nothing will.

How do you Protect Inherited Assets in a Divorce?

Unfortunately, there is very little you can do. The planning needs to come from your parents. Usually, parents will leave a fairly liquid estate (usually in the form of a death benefit from a life policy). Real estate and personal belongings are also given, but many times the estate is made up of a nice size life insurance policy. Either way, the main way to protect yourself from losing inherited assets in a divorce is through the use of an irrevocable trust.

Your parents can set up an irrevocable trust so that, when they die, the assets are all poured into it. You may be the ultimate beneficiary of that trust; but during most of your life, the language of the trust will allow the trustee (usually a bank or trusted family advisor or friend) to dip into the irrevocable trust for many different purposes (almost for whatever they feel like as long as it is on your behalf).

The trust document could be written so that, if you ever get divorced, none of the assets of the trust will go to your ex-spouse in the divorce or after. Many times a portion of the assets will be given outright to you at a scheduled age no matter if you are divorced or not. For example, there might be language to give you 25% of the assets at age 60, then 65, then 70, and, finally, at 75. The thinking behind this is that, if you are still married at those ages, the chances of getting divorced (assuming you have been married for a while) are much less likely.

The trustee would still, typically, have the ability at early ages to dip into the trust for purchases of items or outright cash distributions; but those would be at the discretion of the trustee as per the language of the trust.

Prenuptial Agreement

Many clients with significant wealth will use a prenuptial agreement to dictate exactly what each spouse is entitled to in the event of a divorce. Most times a prenuptial agreement is used in second marriage situations where one of the spouses has already amassed a significant estate and where one spouse has almost no estate. The spouse with significant wealth going into the second marriage typically desires to preserve the majority of the estate for his/her children from a prior marriage, and a prenuptial agreement is a nice way to accomplish that goal.

Prenuptial agreements are not an easy topic to discuss with a potential spouse; and because of the touchy nature of the subject, many times wealthy clients who really should have prenuptials do not. Hindsight is always 20-20; and if you are concerned that a spouse will be awarded more than what you think is fair in a divorce matter, then you
should seriously think about a prenuptial agreement prior to marriage (especially in the case of a second marriage).

If you are currently married and wish you had a prenuptial agreement, you can see if your spouse will sign a postnuptial agreement, which will work the same as a prenuptial agreement.

If you plan on using this technique because you are worried about this issue, we do not suggest leaving this book lying around the house for everyone to read.

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**Section 11**

**Generation Skipping Tax**

The generation skipping tax (GST) is not a huge issue for most estate plans because most of the time the majority of the assets in an estate will pass not directly to the grandchildren but instead to the children who, in turn, down the road might pass wealth to the grandchildren. However, if your estate is large enough, using a generation skip to pass wealth could save your grandchildren millions of dollars in estate taxes.

The IRS wants assets to flow through as many estates as possible (to collect revenue in the form of estate taxes), and so the system is set up to have assets pass to children (where it will be estate taxed) and then to grandchildren where assets will again be estate taxed. If assets were allowed to go directly to the grandchildren, then a whole level of estate taxes would be skipped where the government could lose literally millions of dollars in estate tax just from one client’s estate.

If you tried to pass wealth directly to your grandchildren at death without the use of your GST exemption, the transfer would be double taxed both at the estate tax rate (50% in 2007 which is used when you pass wealth to your children) and then at the flat GST rate of (45%). If you take advantage of your GST exemption, you can give upwards of $2 million (per spouse in 2007) to your grandchildren at death and have that money pass without the GST.

**GST Exemptions**

The exemption rates for the GST are as follows:

In 2007 you have a $2 million exemption per spouse which will increase to $3.5 million in 2009. Then in 2010, the exemption will be unlimited for 12 months until 2011, when it falls back to only $1.1 million.

Your estate will still have to pay estate taxes on money given to the grandchildren (although, if you gift less than the amounts per spouse listed above, you will avoid the double tax hit on the GST).
Why use a Generation Skip?

The main time you would use a generation skip (and, therefore, the GST exemption) is when you know that, when your children die, they will have an estate tax problem. If that is the case, you will avoid having your wealth double estate taxed at your death and then again at your children’s death by using the GST exemption.

We will use one quick example where we will assume the client dies after 2011 (Most if not all of the readers of the material should die after 2011).

Dr. Smith has an $8-million-dollar estate, one child (who is also a physician), and three grandchildren. When Dr. Smith dies (assuming no living spouse), $8 million will pass to his child; and the estate taxes due are $3.5 million ($8 million minus $1 million that gets estate tax exempt) leaving the child with $4.5 million after estate taxes.

Dr. Smith’s child practices medicine for 30 years and invested the $4.5 million wisely (now $7 million) and also created his own $5-million estate. When Dr. Smith’s child dies, he now has a $12 million estate that will be taxed when giving it to his/her children. The $4.5 million (now $7 million) that was passed to Dr. Smith’s child (where estate taxes were paid once when Dr. Smith died) gets estate taxed again when Dr. Smith’s child passes that now $7 million to his children (Dr. Smith’s grandchildren).

If Dr. Smith had used the $1.1 million dollar GST exemption (in 2011), at least $1.1 million would have avoided being estate taxed again when Dr. Smith’s child eventually passed that $4.5 million (now $7 million) to Dr. Smith’s grandchildren. By using the GST exemption, Dr. Smith’s grandchildren saved $550,000 in estate taxes at the death of their parents.

We know this topic will only apply to a small percentage of the readers, but we did want to briefly cover the topic. If you wonder if using a GST exemption makes sense in your estate, please see your local attorney or CPA or give one of the authors a call.
Section 12
Charitable planning

While charitable planning is certainly an estate planning tool, for purposes of this book, the topic fits much better into Chapter Three on Income Tax Reduction. Most clients do not realize that charitable giving can be client focused instead of charity focused.

If we told you that we could show you a tax and estate plan with the following benefits, would you think we were talking about charitable planning? 99% of clients would say no.

**Benefits of charitable planning:**

1. Increase a client’s discretionary (“spendable”) income  
2. Reducing or eliminate a client’s income taxes, capital gains taxes, and estate taxes  
3. Securing a tax free inheritance for a client’s chosen heirs  
4. Allow a client to leave a lasting family and social legacy

If you turn to page 202, you will read about our favorite charitable plan that has all of the above benefits. Remember, charitable planning can be client focused not charity focused.

Section 13
Long Term Care Insurance

Why Most Clients Should Have It

Long term care insurance (LTCI) is the number one frustrating estate planning topic we deal with and lecture on to clients. In our opinion, LTCI is an absolute must in every estate plan for a client with an estate size of over $500,000; but yet few clients want to purchase it.

We are not going to lobby or lecture the reader in this section of the book. Instead, we are going to state matter of fact some statistics and our opinion and then move on to another estate planning topic.
Who is a Candidate for LTCI?

The United Seniors Health Cooperative says you should buy the insurance only if you meet these guidelines:

- You have more than $75,000 in assets per person in the household.
- Your annual income is $30,000 or more per person in the household.
- You can afford the premiums without making a lifestyle change.
- You could still afford the premiums even if they increase by 20% to 30% in the future.

We agree completely with the comments above.

Why do Those who are Candidates for LTCI Need It?

In one word—protection. We suggest that clients purchase LTCI to protect their wealth from the devastating and potentially long lasting costs of LTC. In some areas of the country, the cost of nursing home care, or quality around-the-clock, in-home care may be $250 per day ($91,250 per year). Additionally, the U.S. Health Care Administration reports that costs are increasing 5.8% per year and are expected to more than triple in the next 20 years.

Clients purchase LTCI to protect their wealth not only for their spouse but also for their children. If you do not care about protecting your wealth from devastating LTC costs, then you do not need LTCI. Additionally, many clients buy LTCI so they can insure they have “quality” care (instead of relying on care funded through Medicaid).

Will you need LTC?

While only a fraction of all long term care is provided in nursing homes, recent studies indicate that 40% of Americans over age 65 will need nursing home care at some point during their lives and 10% will stay in a nursing home for five years or more. Looking at it another way, about 54% of women and 30% of men will spend some time in a nursing home.

Since the majority of clients who call for asset protection or income tax reduction help are males, 50% of those who call and do not take our advice on the purchase of LTCI will actually need LTC sometime in their lifetimes.
Why don’t High Income/Net Worth Clients Purchase LTCI?

This may come as a shock to those reading the book; but, as a general rule, clients with money are a bit on the frugal side (Read the Millionaire Next Door). We will bet a good percentage of the clients purchasing this book had to pause before spending whatever they paid for it because they did not want to waste money on a book they were not sure would be beneficial.

We do not care how frugal or cheap a client is, with the ability to pay for your LTCI in a 100% tax-deductible manner through a company with the caveat that every dollar paid in premiums will go to the client’s heirs income tax free, every client who can afford it should purchase LTCI.

Conclusion

We recommend LTCI in every estate plan and so far have been ignored 100% of the time by clients who do not think they will ever need LTC and, therefore, do not want to allocate money to protect their estate from the costs of LTCI.

If you are interested in purchasing LTCI, we suggest turning to page 150 of this book where you can read in more detail how you can get FREE LTCI by writing it off through your company and attaching a return of premium option.

Section 14
IRA Protection
Controlling Your IRA from the Grave

Protect IRA assets from your children’s poor decisions

More and more wealth over the coming years will transfer between generations as our population ages. Those that know say there will be more wealth transferred from one generation to the next over the next 20 years than in anytime in our country’s history. Much of the assets transferred will be IRA money.

Many readers of this book will pass IRAs with balances of $100,000+ to their children. Many readers will have balances of $1,000,000+. So what’s the big deal?

You know your children better than we do, but what do you think your children will do with $100,000 - $1,000,000+ cash in an IRA after you are gone? We’re sure “your” children will continue to invest the money wisely and use it in their retirement?
What many of you should fear is the reality that your children will do things with that money that you would not approve of or would make you roll over in your grave. But don’t worry about it, just because it took you 30+ years to accumulate the money, shouldn’t your children have the right to burn through that money in a weekend in Vegas? If your children do not blow it all at once (and don’t forget there will be income taxes due on that money and potentially estate taxes), maybe they will slowly burn through it over a several year period by taking trips around the world, buying expensive cars, throwing lavish parties and otherwise living well above their normal standard of living. Heck, why would they want to use that money for the grandkid’s education when they can buy a new Hummer to drive around in and schedule a month long trip to Europe?

Question: if you had the ability to control your IRA assets from the grave would you?

Our guess is that well over 80% of those reading this will say yes.

How can you control IRA assets from the grave?

By using a simple LLC (Limited Liability Company).

While you may not be aware of this, an IRA can invest in all sorts of interesting asset including an interest in an LLC. You do need to know that there is a specific way an IRA needs to buy the LLC interest, but that is outside the scope of this material. We want you to simply assume it’s not difficult to accomplish.

Why have an IRA transfer all of it’s assets to an LLC? The reason is simple and powerful. Once the money is funded into the LLC, the manager of the LLC will control what happens to the LLC assets NOT the IRA owner. In fact, the IRA owner can not be the manager of the LLC.

Think about that for a second. It makes sense doesn’t it?

You may be saying to yourself, this does not prohibit your son or daughter in the above example from distributing the IRA and getting the money does it? It does. When the IRA distributes assets what is it distributing? It is distributing the LLC interest. An IRA distribution DOES NOT remove the money from the LLC.

So your son or daughter in the above example now has ownership of the LLC interest and the manager of the LLC still controls the money (including distributions to pay estate and income taxes). If the LLC manager has enough discretion in the LLC operating agreement, the manager does not have to take money out of the LLC for any reason he/she does not feel is appropriate.
What’s not appropriate? The list is long and would probably include a week long bender to Vegas, a Ferrari, a new 60 foot speed boat, diamonds for a part time girlfriend, etc.

Hopefully you are getting our drift. The LLC structure acts similar to an irrevocable trust (IT) after a client dies. You are probably familiar with how ITs are used to make sure children spend inherited money wisely (per the trust agreement and with the watchful/discretionary eye of a trusted trustee). The LLC structure with an IRA basically does the same thing. A client will setup this structure inside their IRA and have a trusted person or institution act as the managing member of the LLC. Direction will be given to the manager of the LLC through a well written operating agreement. The manager, not the child/heir, controls the money in the LLC.

So we’ll ask you again, would you like to control your IRA assets from the grave to make sure the money it took you 30+ years to build is spent wisely by you heirs? Our guess is your answer is yes.

Section 15
Family Limited Liability Companies (FLLCs); Family Limited Partnerships (FLPs) and Limited Liability Companies (LLCs)

Lower Estate Taxes by Using FLLCs, FLPs and LLCs

It is absolutely amazing how few clients who can benefit by FLPs, LLCs, and FLLCs actually have them. You can read starting on page 63 of this book why every client with wealth should have an LLC, FLP or FLLC for asset protection purposes and how these entities can provide substantial savings when it comes to estate taxes.

For purposes of this section of the material, we will use FLP (Family Limited Liability Partnership) as an interchangeable acronym for Family Limited Partnerships (FLP) and Limited Liability Companies (LLCs).

FLPs are not a primary estate planning tool (those are your wills and marital or A&B trusts), but FLPs can nicely supplement an estate plan and save your heirs sometimes millions of dollars in estate taxes if done correctly.

Lifetime Gifting

As you are probably aware, parents can gift to their children $12,000 per spouse per child each year (2006 and beyond) without incurring gift taxes (50% tax in 2006 for
gifts in excess of $12,000 per spouse per child). Many clients do not like the concept of gifting during their life to children because, once money or property is gifted, it is gone forever (even though the parent can dictate to some extent how the gift is used when gifted to an irrevocable trust).

Who is a candidate for gifting to reduce estate taxes? Any individual or couple with an estate over $2,000,000. That is about 80% of all clients with wealth over the age of 50. Why? Because in 2007, there is only $2,000,000 per spouse in estate tax exemptions available (if used correctly with marital trusts) and, therefore, every dollar in the estate not passed to the heirs via the estate tax exemption will get taxed at approximately 50%. Now you could die in 2010 and avoid all estate taxes, or a miracle could happen where the Congress prior to 2010 re-enacts the estate tax repeal; but putting those two issues aside, the estate tax exemption will remain at $1,000,000 per spouse from 2011 and beyond.

The FLP allows for accelerated gifting through the use of substantial discounts on assets in the FLP.

**How Does an FLP Work?**

An FLP is simply a limited partnership made up of family members. An FLP is really not too much different than the corporation except the FLP usually owns family assets like a house or vacation home or even a brokerage account.

A client with assets and an estate tax problem would set up an FLP and then capitalize the FLP with an asset or multiple assets. Again, usually we are talking about a piece of property (although a brokerage account can get discounts up to 20% of their value). Then, through gifting of the interest in the FLP and through discounting of the stock, discussed next, the children, eventually, end up owning the majority (upwards of 99%) of an asset they would receive anyway when the parent(s) die. The value of the asset for gift tax purposes and estate tax purposes is less than market value, thereby making the entire transaction worthwhile.

**General vs. Limited Partner Interest**

Typically, the FLP is formed by the older generation family members (i.e., the parents) who contribute assets to the FLP in return for general partnership units and limited partnership units. Normally, the general partners have a 1% interest in the FLP (commonly held by a C-Corp to avoid personal liability) and limited partners have a 99% interest. The parents can then embark on a plan of giving limited partnership units to their children and grandchildren, while retaining the general partnership units that control the FLP.

General partners **retain control** over the assets in the FLP, whereas limited partners are granted very limited rights. Limited partners also have restrictions on their ability to transfer their partnership units to others so that the general partners can prevent the units from being transferred outside of the family.
Discounting of the Assets in an FLP

The entire concept of using an FLP for estate planning revolves around discounting of the FLP interest. Depending on the law firm, CPA firm, and valuation firm involved, assets can be discounted upwards up to 40% of their normal market value. (Except when using a “freeze” partnership which can obtain upwards of a 90% discounts. See page 160 for an explanation of a freeze partnership).

There are two basic discounts available to FLPs. The first discount comes from the fact that the interest in the partnership is no longer marketable in the open market due to the fact that the children’s interest in the partnership has restrictions on to whom the interest in the partnership can be sold, (i.e., the interest in the partnership can only be sold to another family member). The second discount comes from the fact that the interest held by the children is considered a “minority interest” in that the children have no voting rights (a non-controlling interest). Taking the two discounted issues into account, a total discounted value is given to the interest in the partnership.

Practical Example –

Assume Mom and Dad have 2 children over 18 years old.

<table>
<thead>
<tr>
<th>FLP owners</th>
<th>Percentage Owner</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mom and Dad (general partner)</td>
<td>1% each</td>
</tr>
<tr>
<td>Mom and Dad (limited partner)</td>
<td>98%</td>
</tr>
</tbody>
</table>

Mom and Dad capitalized (transferred into) the FLP their vacation condo in Naples, Florida (value $500,000) and their cottage on Traverse Bay in Michigan (value $500,000). Assume for purposes of this example that the couple has a $1,000,000 personal residence, $2,000,000 in stocks, and $1,500,000 in an IRA for a total estate worth of $5.5 million.

The couple has just enough life insurance to cover the estate taxes on the rest of their estate which, after using their marital deductions, is $3.5 million.

Now assume that the interest in the new FLP gets a 40% discount on its value.

Here is the math when looking at the value of the asset per its interest in the FLP

<table>
<thead>
<tr>
<th>Original Value</th>
<th>Value after all Discounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Naples Condo</td>
<td>$500,000</td>
</tr>
<tr>
<td>Traverse City Cottage</td>
<td>$500,000</td>
</tr>
<tr>
<td>Total Value</td>
<td>$1,000,000</td>
</tr>
<tr>
<td></td>
<td>$600,000</td>
</tr>
</tbody>
</table>
If Mom and Dad died before the gifting was complete, the value for estate tax calculations still creates a savings of 40% of whatever interest of the FLP that is still in the parents’ names. If Mom and Dad are able to gift out 98% of the interest in the FLP before they die, then only $12,000 or 2% of the value of the discounted asset will pass through the parent’s estate. (Assuming the value of the 2% general partnership interest at the parents’ death is $12,000).

If Mom and Dad gift $44,000 worth of their interest in the FLP each year ($22,000 per child in limited partnership interest) then, after 13.5 years, 98% of the FLP will be completely out of the parent’s estate and not subject to estate taxes. Mom and Dad have retained the rights to do what they want with the assets in the FLP (i.e., they can live in the house or cottage until death) because they are still the controlling general partners with their 2% interest.

What was Accomplished with the FLP?

If you did not really follow everything in the preceding paragraphs, we will leave you with the following thoughts. If Mom and Dad in the above example did nothing and then both died in a car crash, the estate would have to find $500,000 to pay the estate taxes on the Naples condo and the Traverse City cottage. Most likely the children would sell one to pay for the estate taxes of the other and hope they had enough after capital gains taxes (if any) to accomplish that goal.

If Mom and Dad died the day after they funded and set up the FLP where they owned 2% as general partners and 98% as limited partners, they would have saved the estate approximately $200,000 in estate taxes (combined before putting the assets into the FLP, the properties were worth $1 million, and after the transfer, the interest in the FLP was worth approximately $600,000. The difference is $400,000, and the estate taxes on that $400,000 would be $200,000).

If Mom and Dad died 13.5 years after starting to gift their FLP interest, they would have saved their estate approximately $500,000 in estate taxes. Basically, the entire asset (the real estate) was gifted to the children; and since the two properties were worth $1,000,000, the estate would have had to pay $500,000 in estate taxes on the death of the parents.

FYI, if Mom and Dad simply tried to gift the property over a period of time to their children without using the FLP, it would have taken 22.7 years and the parents would have lost control of the asset.

Property that Appreciates

It makes much more sense to use an FLP with assets that will appreciate. In our Mom and Dad example, if Mom and Dad did not die for 30 years, the two vacation properties could be worth $1,000,000 or more each at the time of their deaths. If the
properties were not gifted via the FLP, the estate would have to come up with $1,000,000 in estate taxes upon death ($2,000,000 x 50%). Because of the FLP, Mom and Dad were able to retain control of the assets (live in them for life); and when they died, 98% of the FLP (and, in turn, the property) is already owned by the children; and, therefore, NO estate taxes are due on 98% of the value of the assets in the FLP. It’s a beautiful thing!

**Reduce Income Taxes with FLPs**

We will bet the following statement rings true for a good majority of clients reading this book:

> My son (18-30 years old) called the other day and said he was not doing too well with his new job and wondered if I could help out financially.

We cannot tell you how many times we have heard of clients giving massive amounts of money to children who are 18-30 (and sometimes older) to help with living expenses or to buy a car or to fix a car. Parents, in general, are giving people; and clients with sizable income take giving up a notch due to their income.

What is wrong with giving money to your children when they need help? Nothing, except that, for a client in the 38.6-48% income tax bracket (state and federal), to give a child $1,000, the client has to take home $1,628-$1,923 in taxable income to have that $1,000 left over to give to the children.

**A better way**

If you have any kind of asset that creates income, that asset can be transferred to an FLP where the children can have a minority non-voting interest in the FLP. When income is generated from the FLP, some of that income can go to the children where they can pay taxes on the money in their tax bracket. If the child has no real income, they will effectively pay no income tax on the distribution from the FLP.

**Example:**

Dr. Smith has three children, ages 14, 22, and 27. The 22-year old is in college, and the 27-year old graduated from college but is currently unemployed and not particularly motivated to make a good living.

Dr. Smith is paying for the 22-year old to go to college out of his income each year (since he did not pre-pay the college tuition or fund a 529 Plan), which is costing him a bundle since he has to pay tax on his income before paying the college tuition. Tuition, books, and room and board cost $30,000 a year.
Dr. Smith is also paying the rent and car payment for the 27-year old child until he “finds himself.” Total costs to keep the 27-year old in “chips” is $20,000 a year.

Total cost to keep the two older children going a year is $50,000; and so Dr. Smith needs to take home $81,433 in order to pay for those bills with post-tax money.

Through the use of an FLP, Dr. Smith can save $9,437 in federal taxes on the 27-year old and $13,553 on the 22-year old (each year). How? Look at the numbers:

<table>
<thead>
<tr>
<th>Income</th>
<th>Taxes (federal)</th>
<th>What is left</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Smith</td>
<td>$48,859</td>
<td>$18,859</td>
</tr>
<tr>
<td>22-year old child (from FLP)</td>
<td>$35,306</td>
<td>$5,306</td>
</tr>
<tr>
<td>Tax Savings</td>
<td></td>
<td>$13,553</td>
</tr>
<tr>
<td>Dr. Smith</td>
<td>$32,573</td>
<td>$12,573</td>
</tr>
<tr>
<td>27-year old child (from FLP)</td>
<td>$23,136</td>
<td>$3,136</td>
</tr>
<tr>
<td>Tax Savings</td>
<td></td>
<td>$9,437</td>
</tr>
</tbody>
</table>

In the above example, we used a graduated income tax scale for the unmarried children (which scales up from 10% to 27%); and for Dr. Smith, we used the 38.6% federal tax rate.

The FLP accomplished the unthinkable goal of saving Dr. Smith $22,990 in pre-tax income or $14,115 in take-home pay to give his children the same $30,000 and $20,000 respectively.

The above example is a bit over the top in that giving $50,000 a year to children post-tax is a lot of money. Further, not every FLP is going to be able to generate $68,000 in income to slide to the children each year. But one thing is clear—using an FLP to slide income to the children so they can pay tax on it in their tax bracket is a topic worth looking into.
Multiplying the Discounts
How to Receive a 90% Discount on an FLP

“Freeze Partnerships”
An Interesting Planning Opportunity

So where is the next generation of FLP planning headed? While not new, the concept of using a derivation of the traditional FLP appears to be making a comeback. The concept of a “freeze partnership” is again receiving attention as an alternative to the traditional FLP structure.

A “freeze partnership” is a partnership in which there are two classes of interests: a preferred interest and a common interest. The preferred interest is typically limited partnership interest but could be the general partnership interest (in very rare circumstances). The preferred interest is considered “preferred” because it is entitled to preferred dissolution rights. The preferred interest holder has a fixed dissolution value based on the value of the property initially contributed to the partnership. There are typically preferred income rights as well which means the preferred interest holder is entitled to receive preferred distributions of net cash flow from the partnership equal to a set percentage of the value of the dissolution value.

As a practical matter, preferred interests operate very similarly to preferred stock in a corporation. The “common” interests in the partnership are subordinate to the preferred interests with regard to dissolution and income rights, but the common interest holders tend to have voting and managerial control over the partnership. The common interest holders will share proportionately in the partnership’s income distributions but only to the extent that the preferred interest holders have received the preferred income or dissolution payments.

Example:

A preferred family limited partnership is formed in which $2,000,000 worth of assets are contributed to the partnership. In return for the contributions, parents retain a preferred interest equal to a $1,000,000 dissolution value and a 10% preferred income distribution and the balance of the interests are common interests and are either sold or gifted away by the parents to their children or trusts for the benefit of their children.

In this case, the preferred interest is entitled to the first $100,000 of distributable income (i.e., net cash flow). Once this $100,000 is distributed, the balance of the distributable income will be distributed to the common interest holders based on each partner’s pro rata ownership of the partnership. If upon the death of the preferred interest holder the partnership is liquidated, the preferred interest holder’s estate will include the full $1,000,000 liquidation value; but the balance of the assets and all the appreciation from the date of inception would be allocated and distributed to the common interest holders.
The planning implications of using preferred family limited partnerships are several:

First, because the liquidation values of the preferred interests are “frozen,” the common interests will receive all of the growth and appreciation of the assets held by the FLP. This can result in substantial amounts of wealth being shifted to the common interest holders.

Second, since the common interests are subordinate to the preferred interests in many respects, especially with regard to cash flow, it is possible that the common interests would be subject to valuation discounts for gift or sale purposes. Thus, depending on the types of assets which the FLP is intended to own, there are substantial planning opportunities to use the preferred and common interest structure to provide significant wealth transfer planning benefits.

For example, suppose the assets held by the FLP are capable of producing more than the $100,000 of income as set forth in the above example. For argument sake, suppose that the assets held by the FLP produce $150,000 worth of income, thus leaving $50,000 of income remaining after the preferred distribution has been made. Assuming that the FLP would make tax distributions to each of the common interest holders equal to the tax they owe on the $50,000 of income, the balance of the income not distributed could be used to purchase life insurance or other assets to increase the overall value of the FLP.

Thus, if a $1,000,000 life insurance policy could be purchased with the remaining cash in the FLP after the preferred and the tax distributions are made to the preferred and common interest holders, and the preferred interest holder died the next day, all of the assets in excess of the frozen $1,000,000 liquidation value (i.e., the balance of the $1,000,000 of assets and the $1,000,000 of death benefit proceeds) would be allocated to the common interests holders.

Oftentimes, a preferred limited partnership has multiple classes of interests (i.e., senior preferred, junior preferred, participating common, and non-participating common), so the planning can be very creative. The ability to use the preferred and common interest FLP in connection with a family’s overall wealth planning can present substantial planning opportunities.

In the following schematics, keep in mind the following assumptions: the mother capitalized the FLP with $2,000,000 and her son capitalized on the FLP with $20,000. The mother is issued a preferred interest representing 49.5% ownership and a non-preferred interest equaling the same 49.5% interest. The son has a 1% non-preferred interest but is the managing member of the FLP. Also assume that the FLP interests receive a 30% discount for the various restrictions put in place via the FLP documents.
In this example, the FLP generates $150,000 in income from investments—$100,000 goes to the mother via her preferred interest, $15,000 is distributed to the son to pay for the taxes on the remaining $50,000 income, and $35,000 stays in the FLP and is used to purchase a life insurance policy for $1,000,000 on the mother’s life.

Mother gifts $700,000 in non-preferred interest to son which because of the 30% discount equals her entire 49.5% non-preferred interest.

What happens after mother dies one (1) year later?

1) The FLP would be dissolved

2) The Mother’s estate would receive as a preferred investor in the LLC the remaining $1,000,000 preferred interest plus a 10% rate of return ($1,100,000)

3) The son receives via the dissolution his initial $20,000 investment, $1,000,000 in assets via the gifted non-preferred interest from the mother, and $900,000 of the death benefit which was paid income tax free to the FLP prior to dissolution. The son owes no estate taxes on these assets and no income taxes.
Multiplying the Discounts

The previous example is a great way to show a client how to freeze the value of a preferred interest in an FLP and how to use life insurance as a nice way to pass wealth income and estate tax free to the heirs without incurring gift or estate taxes.

The following is a much more interesting example that will illustrate how to use the same structure to dramatically increase the discounts available for estate tax purposes. We need to assume some additional facts.

1) Assume the client (mother) has no need for a future flow of income.

2) Assume the client has a 25 million dollar estate and has $10,000,000 in bank accounts, CDs, or securities. Further assume that much of the entire $25 million is includable in the client’s estate for estate tax purposes.

3) Assume the client is totally uninsurable and cannot purchase life insurance (which would be owned by an irrevocable life insurance trust) to pay for estate taxes.

4) Assume the son is 45 years old and in good health.

5) Finally, let’s assume an additional goal is to create a situation where the heirs could have access to cash (tax free) at some point in the future before the mother dies, rather than waiting.
Steps for the above schematic

1) Mother and Son both capitalize the FLP (no gift tax issues). Mother is the preferred non-managing member, and the son is the non-preferred managing member (who controls the investments of the FLP). Because this is a related party transaction, mother’s rate of return on her preferred interest can be limited to a reasonable rate of return (like the long term Applicable Federal Rate (AFR) based on simple vs. compound interest). Let’s assume the long term AFR is 5%.

2) The FLP invests in two separate life insurance policies using the son’s life. The “preferred” policy is strictly used to pay back mother her preferred investment plus a simple interest rate of return (therefore, the FLP will purchase an increasing death benefit policy).

With the remaining money, the FLP will purchase a “cash building” life insurance policy as an investment (in the example an indexed equity life policy is used). The premium is paid into the policy over a seven-year period so the policy does not become a modified endowment contract (which would prevent tax free loans from being taken from the policy).

3) When and if the son needs cash, he would have the FLP take a “policy loan” from the cash building policy. There is no income tax due when an owner of a life policy takes a loan (assuming the policy stays in force until death).
3a) The son then would take a “special allocation” from the FLP in an equal amount to the loan. The special allocation is an income tax free transaction due to the fact that the son will assume the debt of the FLP to the life insurance company.

A complete explanation of a special allocation and adjusting the member’s capital accounts is outside the scope of this material. For more information, please contact The Wealth Preservation Institute.

4) When the son dies, a death benefit will pay from the preferred policy to the mother, if still living and, if not, it will pass to the heirs.

Explaining the benefits of the previous transaction:

1) There are **no gift taxes with this transaction**. The mother was able to transfer $10,000,000 into an FLP and have $8,500,000 invested into a cash building life insurance policy where the son will have access to the cash through special allocations both gift and income tax free.

Multiplying the discounts

2) While living, the mother owns a very interesting asset from an estate tax point of view. The mother now owns FLP units that will not pay unless and until the son dies. The son is 45 when the preferred life policy is purchased, and his life expectancy is age 82. If the 70 year old mother dies next year or in five, ten, or twenty years, the question for evaluation purposes is **what is the current value of her interest in the FLP when she dies** (taking into consideration the son’s life expectancy is 82)?

The following chart will illustrate the power of this technique for estate tax planning by illustrating different discounting percentages.

Projected value of ownership interest in mother’s estate at the time of formation and purchase of the preferred life insurance policy:

<table>
<thead>
<tr>
<th>Discount</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>6%</td>
<td>$6,692,614</td>
</tr>
<tr>
<td>8%</td>
<td>$2,510,710</td>
</tr>
<tr>
<td>10%</td>
<td>$1,815,664</td>
</tr>
<tr>
<td>12%</td>
<td>$925,210</td>
</tr>
<tr>
<td>14%</td>
<td>$464,209</td>
</tr>
</tbody>
</table>

Most attorneys who understand this strategy are comfortable with at least a 10%-14% discount. Therefore, if mother died in year one, the value of the FLP interest in her estate would be $1,815,664 (using a 10% discount), NOT the $10,000,000 she capitalized the FLP with. Why? Because the FLP units are not liquid and will not pay off from the investment in the FLP until the son dies. The calculation is to find out the current value of a future interest and, when discounted, the number becomes very low.
The reason typical 20-40% FLP discounts are not used is due to the fact that the mother’s interest is “preferred” and, therefore, the value of her interest cannot be discounted to the same degree as FLP interests in a “traditional” FLP set up for estate planning purposes.

Even if mother dies in five, ten, or twenty years, there is always a sizable discount in the value of the FLP interest due to the fact that the interest is always going to be discounted based her son’s projected life expectancy.

Summary of the preferred non-manager/non-preferred manager LLC structure

This structure is one of the most powerful and little known estate planning techniques in the estate planning industry. It is very flexible, depending on the needs of the clients, and cannot only significantly reduce the size of a taxable estate (without gift taxes) but can also create a situation where a young heir can have access to income and gift tax free loans from a life insurance policy years before a parent passes away.

While at first glance, the schematic is not the simplest to grasp, after going through the material a few times, most advisors will be comfortable enough with the techniques to discuss them with clients and other advisors.

Conclusion on FLP Planning

Besides the fact that all of a client’s major assets should be in an LLC, FLP, or FLP for asset protection purposes (other than possibly the primary residence), if a client intends on passing wealth to his/her children upon death, the FLP is a terrific way to do so in a manner that can significantly lower the estate taxes the children will have to pay on the death of their parents.

If a client has significant wealth, ($5,000,000 or more) a Freeze partnership is a terrific way to transfer sizable assets out of the estate at up to a 90% discount.

Section 16
Other Estate Planning Tools

There are a number of other estate planning tools that we are not going to discuss in any major detail. We will list several other tools below with a cursory explanation of what they are just so you can know the topics exist and know the lingo when talking to your CPA or attorney.
Grantor Retained Annuity Trust (GRAT)

A GRAT is an irrevocable trust (you gift money to the GRAT) from which the grantor retains the right to receive an annuity payment for a specified period of time. The concept relies on discounts in the value of the asset in the GRAT and several other factors including when the client dies (which is not a factor in our control).

The GRAT concept is very complicated; and since the outcome is not certain due to variables outside of our control (death), it is not a topic we typically recommend for most clients.

Defective Grantor Trust (DGT)

DGT is again very complicated; but like the GRAT, a DGT is used to pass wealth to your heirs and avoid estate taxes. The DGT freezes the value of an appreciating asset for estate tax purposes, which can be important in a closely held business appreciating quickly. If you are trying to pass a business to your children, a DGT is a good topic. Otherwise, we deal with other topics to mitigate capital gains taxes and estate taxes on highly appreciating assets.

Qualified Personal Residence Trusts (QPRT)

A QPRT is another freeze technique to pass an appreciating asset to the children with a lower estate tax value at some time in the future. Typically, a parent transfers a personal residence (the home) into a QPRT for the benefit of the children (but retains the right to use the home for a specified term of years). For gift tax purposes, the value of the remainder interest of the children is determined after subtracting the value of the parents’ right to use the residence for the term of years.

This valuation procedure allows a parent to discount substantially the value of the gift made to the children and also removes from the parents’ estate all post-gift appreciation in the value of the residence.

Again, this tool is not one we use for clients due to other options available; but since it is a tool used by some estate planning attorneys, we did want to make you aware of its existence.
Section 17
Capital Gains Avoidance

For information on how to reduce or avoid capital gains, please see page 202 of this book where you can read about Charitable Gift Annuities.

Section 18
Mitigating the 70-80% Tax Trap

On page 45 of this book, we describe how to use the MAXI-IRA to asset protect money in an IRA when a client lives in a state where IRAs are not asset protected. A similar tool called the Qualified Pension Insurance Partnership is a tool that can be used to mitigate the 70-80% tax trap of money in qualified plan or IRA.

While all clients will not have an asset protection problem with their IRAs, all clients with wealth and “qualified” money have the 70-80% tax dilemma. This dilemma revolves around the topic of Income in Respect to Decedent (IRD). IRD includes any income an individual is entitled to but does not receive over his/her lifetime. This includes IRA and pension plan account balances. The theory behind IRD is simple—the government does not want qualified (deferred) money to pass to a client’s heirs without someone paying income tax on that money.

While most advisors create estate plans in order to avoid probate and large estate taxes, most forget to address the IRD problem. This material was created to give readers one very unique option for what to do with the money a wealthy client has in his/her pension plan or IRA so as to mitigate taxes.

Example of the 75% tax trap

Client: Dr. Smith, age 60, married, two children, five grandchildren. Dr. Smith has a $7,000,000 estate, of which $1,000,000 is in an IRA. What would happen with Dr. Smith’s IRA money if he died today? Nothing. Dr. Smith’s IRA would pass to his spouse without income or estate taxes.

Assuming Dr. Smith had a revocable living trust and assuming the estate tax exemption was $1,000,000, Mrs. Smith would be left with a $6,000,000 estate (because $1,000,000 would pass into Dr. Smith’s trust and be removed from Mrs. Smith’s estate). What would happen with the IRA if Mrs. Smith died in the next few years? Mrs. Smith would still have a $6,000,000 estate at death (which would include the $1,000,000 IRA)
and, therefore, the IRA is going to pass to her heirs at which time income and estate taxes are going to be levied against the IRA. Let’s look at the math.

<table>
<thead>
<tr>
<th>IRA</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estate Tax:</td>
<td>($500,000)</td>
</tr>
<tr>
<td>Assets after Estate Taxes:</td>
<td>$500,000</td>
</tr>
<tr>
<td>Income Taxes (State and Federal)*</td>
<td>$250,000</td>
</tr>
<tr>
<td>Total Taxes</td>
<td>($750,000)</td>
</tr>
<tr>
<td><strong>TOTAL IRA ASSET AFTER TAX</strong></td>
<td><strong>$250,000</strong></td>
</tr>
</tbody>
</table>

So the heirs of Dr. Smith received only $250,000 of the $1,000,000 IRA.

*The exact calculation of the income tax due in the above example is quite complicated and the $250,000 number used is an approximation. For the exact math, please contact one of the authors.

**Why clients create the 75% tax dilemma**

For years the American public has been told to defer money into retirement plans. With the very real scare that the Social Security system will bankrupt itself sometime in the next 15-20 years, Americans have taken it upon themselves to fund for their own retirement.

Almost every high income client we receive calls from is “maxing out” their qualified plans (401(k), profit sharing, and defined benefit or 412(i) plans). Maxing out is a good idea and creating funds for retirement is a good idea; however, what inevitably happens with poor estate planning is that the 75% tax trap is created.

**Solutions advisors offer to combat the 75% tax dilemma**

**No Advice**

Most often there is no advice given to the client except to spend down the money in the qualified plan or IRA so the money does not get double taxed when a client dies.

**The Legal Solution (Gifting IRA asset)**

The simplest way to avoid income and estate taxes on IRA assets at the client’s death is to gift the IRA upon death (a testamentary transfer). It is rare to have a client with money in an employer sponsored plan when the topic of gifting deferred qualified plan assets to charity is discussed. Typically, the client is retired and therefore has rolled
his/her money to an IRA. Once the money is in an IRA, then the advisor tells the client that they should consider gifting the IRA asset to a charity upon death.

Giving the IRA asset to a charity certainly will relieve the client of income and estate taxes; however, the client’s heirs received nothing from the IRA.

**The insurance solution**

Many advisors will suggest that a client start taking distributions from the IRA, pay tax on that distribution, and gift the amount remaining after tax to an irrevocable life insurance trust (ILIT). Then the ILIT would buy life insurance to pay for the estate and income taxes that will be due when the IRA is transferred to the heirs at the client’s death. This can work; but clients would rather find a situation to mitigate the taxes paid, not simply pay full taxes on distributions, and then use that money to pay for the remaining estate taxes.

Let’s look at an example of a client that has $1,000,000 in an IRA who also has a $5,000,000 estate besides the IRA. Assume the client is Dr. Smith who is 60 years old with a healthy spouse who is also 60 years old.

If the client does nothing the heirs (see the above example) will receive approximately $250,000 from the IRA after income and estate taxes are paid.

What would the heirs receive if Dr. Smith used the “insurance” solution? Let us assume the clients need $2,500,000 in life insurance for their estate plan.

The clients would set up an ILIT and somehow they would need to find $55,000 a year to gift money to the ILIT so the ILIT can buy a $2,500,000 second to die life insurance policy.

Because the client has no other liquid money and because the client is aware of the 75% tax trap of money in the IRA, the client simply takes a distribution of $91,666 from the IRA. When the client takes such a distribution, income taxes will be due. If Dr. Smith is in the 40% tax bracket, he will have $55,000 left after income taxes to gift to the ILIT.

The insurance solution is an OK solution and better than doing nothing, but the Qualified Pension Insurance Partnership (QPIP) as explained below can be better and much less painful for the client.

**The investment solution**

Recently, “stretch IRAs” have been discussed as a viable option. Stretch IRAs lengthen the time over which distributions must be taken from retirement plans or rollover IRAs. The common belief underlying this strategy is that “tax-deferred growth” is always a great idea. However, when you crunch the numbers, you will realize that the
Estate Planning

Stretch IRA is generally a bad idea for anyone who will have an estate tax liability (although a good idea for those who do not have estate tax problems).

The following is the sale’s pitch on the stretch IRA. Dr. Smith, how would you like to turn your $1,000,000 IRA into $44,000,000 for your child for his/her retirement when the child turns age 70? Putting aside the question as to whether any child should have $44,000,000 at any point in their life, Dr. Smith, if he is a normal person, would be intrigued with the idea.

Why doesn’t a stretch IRA work for someone with an estate tax problem? Simple, while a stretch IRA was created to stretch out the time when estate taxes are due; stretch IRAs do not avoid estate taxes at the death of the initial owner.

If a client passed a $1,000,000 stretch IRA to his/her heirs, there would be $500,000 in estate taxes due. Where are the children going to get $500,000 to pay the estate taxes? They will take money from the IRA. When the children take money from the IRA to pay the estate taxes, income taxes will be due on that money. This creates a vicious cycle and one that can be avoided with the strategy discussed below.

A better solution—use the QPIP to mitigate the problems

How does the QPIP work?

The QPIP (which is a fancy name for self-directed IRA) uses an LLC and an irrevocable life insurance trust (ILIT) to mitigate the 70-80% tax dilemma.

Very few consultants know that IRAs can purchase an interest in an LLC. There are a number of technical rules to follow that are outside the scope of this material; but based on Swanson vs. the Commissioner, February 14, 1996; FSA 2001-28011 and DOL 2000-10A, there is solid footing for what will be explained below.

Very simply, the QPIP, irrevocable trust (usually an ILIT), and the individual client form an FLP. See the following schematics.
The QPIP must own more than 50% of the partnership. The irrevocable trust is the general partner of the FLP. Each partner is required (like with any well set-up LLC) to make at least a nominal capitalization of the LLC in exchange for the interest in the LLC. The ILIT would have the SOLE authority to manage the partnership assets as the managing general partner.

What was accomplished with the above scenario? If the LLC is set up correctly with the correct restrictions, the LLC interests could be discounted up to 20%. Why is this important? Because now the value of the assets inside the QPIP just became deflated by 20%. Let’s look at the math.

Example:

$1,000,000  The New value of the IRA assets after a 20% discount is: **$800,000**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estate Tax:</td>
<td>($400,000)</td>
</tr>
<tr>
<td>Assets after Estate Taxes:</td>
<td>$400,000</td>
</tr>
<tr>
<td>Income Taxes (State and Federal)</td>
<td>($200,000)</td>
</tr>
<tr>
<td>Total Taxes</td>
<td>($600,000)</td>
</tr>
<tr>
<td>TOTAL ASSETS AFTER TAX</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

At first blush, the client still paid 75% in tax; and that is true. However, while the value for tax purposes of the LLC received a 20% discount, the real value to the owners of the LLC interest is still $1,000,000. Remember, the QPIP has stocks or mutual funds in it worth $1,000,000. The QPIP purchased an LLC interest that for valuation purposes received a 20% discount. When the client passes away, the discounted LLC interest transferred to the heirs; and because of the discount, the heirs paid **$600,000** in income and estate taxes instead of **$750,000** in income and estate taxes. The above scenario saved the client **$150,000 in overall taxes**.
What about life insurance?

Many clients with the 75% tax dilemma still need to or want to buy life insurance for use in their estate plans. The problem with any life insurance purchase is that the purchase is almost always done with post-tax money by gifting money to an ILIT. With the QPIP, a situation can be created where the life insurance purchased by and owned by an LLC could be done in a tax-favorable manner.

The following explains how insurance is purchased using the QPIP:

- The LLC (which is owned 98% by the IRA) purchases life insurance as an investment (using the client as the insured). The LLC will typically use the investment income from the initial contribution to purchase the insurance thereby not dipping into the principal amount contributed to the LLC.

- The ILIT would contribute each year to the LLC the “cost of insurance.” This cost of insurance is gifted to the ILIT by the client each year. See the following schematic.
What happens when the client dies?

1) The IRA will be paid back its initial investment ($1,000,000) plus an investment rate of return (usually the long term Applicable Federal Rate (AFR)) using simple interest (vs. compound interest). Therefore, the IRA will be paid back $1,000,000 plus a modest rate of return. If the LLC did not dip into principal to pay the insurance premiums, it would have $1,000,000 inside to pay back the IRA its investment and a small portion of the death benefit from the life policy purchased by the LLC will be used to pay the IRA its investment growth.

2) The owner of the 5% interest that the client purchased individually will be paid back its initial investment ($50,000) plus an investment return using simple interest and the long term AFR. Typically, this 5% interest will be gifted to the client’s children shortly after implementation of the QPIP.

3) The ILIT will receive the remainder of what is in the LLC. What will be remaining in the LLC for most clients will be the majority of the death benefit which will be paid to the LLC from the life insurance company. Because assets from an ILIT pass income and estate tax free to the beneficiaries, virtually the entire death benefit will pass income and estate tax free to the client’s heirs. See the following schematic.

![Diagram of QPIP at death of retirement account owner](image-url)
Summary and Conclusion about the QPIP

Many advisors are not aware of the double taxation dilemma or asset protection problems that confront clients that have estate tax problems and sizable balances in their IRAs. In the past, clients could take advantage of traditional “pension rescue” by rolling IRA money back into a profit sharing plan and buying a very specific type of low cash value life insurance policy. That solution is dead due to the recent proposed 412(i) regulations.

The QPIP solution is one that when reviewed in its basic form is not too complicated and one that can be very beneficial to a client and his/her heirs. With the QPIP clients are able to use what is effectively tax deferred money to purchase life insurance for estate planning purposes where the majority of the death benefit will pass to the heirs income and estate tax free.

Few advisors in the country are familiar with this concept; and if you would like more information for how to mitigate the 70-80% tax trap with money in a qualified plan or IRA, please feel free to contact one of the authors. The QPIP topics was created by Andrew Willms, JD, of Willms Anderson, P.C. (www.willmsanderson.com).
Chapter Three
Income Tax Reduction

Section 1
Introduction and Traditional Solutions

If the following comment from your CPA sounds familiar to you, then you are like most of the high-end clients in the world:

“Put money in your 401(k)/Profit Sharing Plan and pay taxes on the rest.  If you want to take home more money, you need to make more money.”

We have found that very few CPAs are proactive when it comes to saving their clients money on taxes. Most CPAs simply process tax returns and are so busy that they do not have time to meet with individual clients to work on a true income tax reduction plan.

The traditional income tax reduction solutions are simple, and you have heard of every one of them. They are as follows:

A **401(k) Plan** is a qualified retirement plan in which an employer permits an employee to defer receipt of part of his or her compensation by contributing that part to his or her account in the 401(k) Plan. This is a paycheck deduction for the employee and is completely voluntary. Typically, a company will have a match of some sort as a benefit to the employees. The match is typically 50 cents on the dollar up to 6% of pay, thereby capping any potential match at 3% of payroll. The maximum payroll deduction for 2006 is $15,000 with a $5,000 catch up provision for those ages 50+ and in 2007 the deferral limit goes up to $15,500 with the same catch up amount. The following is a table of 401(k) contribution limits:

<table>
<thead>
<tr>
<th>Employee Deferral Limit</th>
<th>Catch-up</th>
<th>Total Age 50+</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006 15,000</td>
<td>5,000</td>
<td>20,000</td>
</tr>
<tr>
<td>2007 15,500</td>
<td>5,000</td>
<td>20,500</td>
</tr>
</tbody>
</table>

For 2008 and later the above amounts will adjust for inflation in $500 increments.

A **Profit Sharing Plan** is a qualified retirement plan where the annual contribution limits are 25% of pay or $44,000 in 2006 and $45,000 in 2007. (See page 179 for more information on the “next level” profit sharing plans)
A combined 401(k)/Profit Sharing Plan allows an employee/owner to “max out” the pension plan contributions. (Although it is very painful to “max out” due to the amount of money required to be funded for the employees).

A **Money Purchase Plan** is a defined contribution plan. A Money Purchase Plan is one in which the employer is required to make an annual contribution to each employee's account regardless of how much money the company makes each year. Contributions are usually specified as a percentage of annual compensation and in 2006 were capped at the lesser of $44,000 or 25% of an individual's annual salary.

A **"New Comparability" Plan** came about with the final 401(a)4 regulations, allowing defined contribution plans to be tested for discrimination based on benefits, just like a defined benefit plan. An allocation formula can be utilized that creates separate allocation levels. This formula is allowed by permitting "averaging" of projected benefits, similar to the old comparability rules, in a plan providing for two levels of allocations, one for the staff and one for the principals. The basis of the testing is comparing what the contributions of the staff will grow to at retirement age, with what the contributions for the principals will grow to at retirement. The results are divided by the cost of an annuity and expressed as a benefit for testing purposes.

*This is an appropriate plan design in a situation where a small business wants to discriminate in favor of the highly paid participants.*

It is our opinion that, if you are looking for a 401(k)/Profit Sharing Plan that is the most discriminating (one where the owners of the company have to contribute the least amount of money for their employees), you need to implement a New Comparability Plan. (See page 179 for more information on the “next level” profit sharing plans)

A **Defined Benefit Plan** is the old school qualified retirement plan that funds for a retirement benefit in the future for its employees based typically on years of employment, wages, and/or age. Defined Benefit Plans are funded solely by the employer and were in vogue 20 plus years ago when the rules on funding benefit plans were not nearly as stringent as they are today. Due to a change in the law back in 2000, Defined Benefit Plans have become more in vogue.

Defined Benefit Plans calculate an amount owed at a future time, and the Department of Labor (the DOL governs qualified retirement plans) does not care if your company does not have the funds to pay the future benefit when the time comes. Legally, a company is obligated to pay the future benefit; and if the company does not have the money, it better go out and borrow the money to pay the benefit in order to stay out of trouble with the DOL. Because of this future funding requirement, Defined Benefit Plans are typically funded with guaranteed annuities. (For more on Defined Benefit Plans, see page 193 of this book).
IRAs (traditional) are not applicable for 99% of the high income clients who have some kind of qualified plan (401(k), Profit Sharing, Money Purchase, or Defined Benefit Plan). If you have no qualified plan at work, the following are the IRA contribution limits per spouse:

<table>
<thead>
<tr>
<th>Year</th>
<th>IRA contribution limit</th>
<th>Catch-up age 50+</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006-2007</td>
<td>$4,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>2008 and after</td>
<td>$5,000</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

A Simplified Employee Pension (SEP-IRA) is a traditional IRA set up by an employer for a firm's employees. An employer may contribute up to $44,000 (2006) or 25% of an employee's compensation annually to each employee's IRA. SEP plans are usually set up in smaller companies where the owner is looking to provide something for the employees at the lowest cost while still allowing the owner to contribute a decent amount of money. Remember that, if a client establishes a SEP-IRA, he/she must also include all eligible employees. Eligible employees include anyone who earns more than $500 and has had any service in three of the past five years. For example, if an employee/owner contributes 10% of his/her salary to a SEP, he/she must also contribute 10% of each eligible worker’s salary to their own IRA.

A Savings Incentive Match Plan for Employees IRA (SIMPLE IRA) is a “simplified” version of the famed 401(k) plan for employers with 100 or fewer employees. The major virtue of this plan is that nondiscrimination testing usually found with 401(k) plans is eliminated. A SIMPLE also has certain administrative aspects that has made it the plan of choice for many small employers. A SIMPLE plan allows employees to defer dollars from their own paycheck (up to a $10,000 limit for 2006 and 10,500 for 2007) and generally requires a dollar for dollar match up to 3% of pay or a 2% non-elective contribution from the employer.

The Solo 401(k)

Another plan that should be considered in lieu of a SIMPLE or SEP-IRA is what we call the Solo 401(k).

A Solo 401(k) allows a business owner with NO employees (except a spouse) to contribute to both a 401(k) and a profit sharing so the total contribution in 2006 could be $44,000 (plus catch up amounts for clients over the age of 50).
Unlike a SEP or SIMPLE, life insurance can be a permitted investment in the “Solo 401(k)” which is good for the client who can benefit from purchasing life insurance with tax deferred dollars (not typically a client with an estate tax problem).

A Solo 401(k) can also include a loan provision where the owner/employees may borrow up to ½ the account balance from the Plan up to $50,000. This added liquidity can be very important to a small business owner who has a bad year and needs cash. As the client essentially borrows money from the Solo 401(k), all the interest goes back into his account. By contrast, a SEP or SIMPLE-IRA cannot offer this important feature.

**Next Level Profit Sharing Plans**

A retirement plan cannot discriminate in favor of “highly compensated employees” in either contributions or benefits. This, however, does not mean that everybody has to receive the same contribution. Far from it. When designing a “Next Level” profit sharing plan, many pension plan providers offer three tools that can be used to craft the plan that best meets your client’s goals and budget.

These Include:

1. “Integration” with Social Security
2. Age-Weighting the Contribution
3. New Comparability Classification Plans

To best understand the impact of each of these tools, let’s consider the following example:

<table>
<thead>
<tr>
<th>Employee Name</th>
<th>Age</th>
<th>Current Salary</th>
<th>Traditional</th>
<th>Integrated</th>
<th>Age-Weighted</th>
<th>New-Comparability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner (key)</td>
<td>55</td>
<td>$225,000</td>
<td>$45,000</td>
<td>$45,000</td>
<td>$45,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>% of Pay</td>
<td></td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Key Employee</td>
<td>45</td>
<td>$100,000</td>
<td>$20,000</td>
<td>$16,912</td>
<td>$8,846</td>
<td>$10,000</td>
</tr>
<tr>
<td>% of Pay</td>
<td></td>
<td>20%</td>
<td>16.9%</td>
<td>8.8%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>Employee 1</td>
<td>30</td>
<td>$40,000</td>
<td>$8,000</td>
<td>$6,708</td>
<td>$1,200</td>
<td>$2,000</td>
</tr>
<tr>
<td>% of Pay</td>
<td></td>
<td>20%</td>
<td>16.80%</td>
<td>3.0%</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Employee 2</td>
<td>35</td>
<td>$35,000</td>
<td>$7,000</td>
<td>$5,870</td>
<td>$1,369</td>
<td>$1,750</td>
</tr>
<tr>
<td>% of Pay</td>
<td></td>
<td>20%</td>
<td>16.80%</td>
<td>3.9%</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Employee 3</td>
<td>30</td>
<td>$25,000</td>
<td>5000</td>
<td>$4,192</td>
<td>$750</td>
<td>$1,250</td>
</tr>
<tr>
<td>% of Pay</td>
<td></td>
<td>20%</td>
<td>16.80%</td>
<td>3.0%</td>
<td>5%</td>
<td>??</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$85,000</td>
<td>$78,682</td>
<td>$57,165</td>
<td>$60,000</td>
<td></td>
</tr>
<tr>
<td>% to Owner</td>
<td></td>
<td>53%</td>
<td>57%</td>
<td>79%</td>
<td>75%</td>
<td></td>
</tr>
</tbody>
</table>
Integrated Profit Sharing Plans

All employers already sponsor at least one retirement plan jointly funded by employers and employees. It’s called the Old Age & Survivor Benefit of Social Security. Government rules let you take this into account by allowing you to “integrate” your qualified retirement plan with your Social Security contributions. Although the rules are flexible and somewhat complex, this concept helps employers skew additional benefits to the highly compensated employees while lowering them somewhat for the lower-paid workers.

Under an Integrated Profit Sharing Plan, compensation is broken out into two parts—the amount above the integration level (excess compensation) and the amount below the integration level (base compensation). Usually the integration level is the Social Security Taxable Wage Base in effect for the applicable year. The employer is permitted to “offset” their contribution to Social Security by applying a lower contribution percentage to the base compensation (i.e., the base percentage) and a higher contribution percentage to the excess compensation (i.e., the excess percentage).

A Profit Sharing Plan Integrated with Social Security works best in situations when the company wants to make greater contributions to highly compensated employees who are the same age or younger than the other employees.

Age-Weighting

The final regulations governing nondiscrimination (found in IRC 401(a)(4)) introduced an old pension plan concept to profit sharing plans. Recall that the contribution cannot discriminate in either contributions or benefits. Therefore, giving everybody 20% of pay is clearly nondiscriminatory. However, giving each the same theoretical retirement benefit is also nondiscriminatory (as with a defined benefit plan).

Why is Age-Weighting a profit sharing plan helpful? The reasoning is simple: with fewer years until retirement, older participants require larger contributions than younger participants to get to the same benefit level.

A review of the design chart shows that this plan is perhaps the most favorable to the owner. However, in operation, it is a little cumbersome. Older employees get higher contributions, period. Employees in the same job, getting similar wages, will get very different contributions unless they share the same age. Because of these reasons, this plan is less popular than the next option.

New Comparability

Perhaps the most exciting development in pension plans, this “Next Level” design offers a method to allocate significantly greater contributions to specific classes of employees. It combines both the integration and age-weighted rules, but uses weighted averages to determine the contribution. This plan is ideal for principals who:
- Are older and **earn more than most of their employees**;

- Want the biggest possible share of the plan contribution allocated to their own accounts; and,

- Desire the contribution flexibility of a profit sharing plan.

This type of plan is known by many names: “super-integrated,” classification plan, group allocated plan, and, more commonly, “new comparability.” Because it was finalized in the Code in 1993, it is really no longer new; so we prefer to call it super-comparability since it is among the most flexible of plans and can target, with precision, extra benefits to select classes of employees.

New Comparability is highly customizable and can be matched to your client’s business quite easily. For example, groups can be created for different profit centers, subsidiaries, sister companies, or, most commonly, by job class—in short, any clearly identifiable group. Some common examples include:

1. Owners
2. Non-Owners
3. All Other Employees
4. Employees of Subsidiary A
5. Employees of Subsidiary B

Some sponsors get quite creative to create clearly identifiable classes that best match their business organization. Interestingly, creating different classes does not mean you have to give different contributions in any given year. In some years, you can give each class zero or perhaps 25% of pay to everyone. It’s your call, as long as the contribution satisfies testing each year.

The basic rule of thumb is that the contribution you give to the bottom group(s) will determine how much you can give to the others. If the preferred groups are, on average, older than the bottom groups, you should be able to leverage modest contributions to the rank and file employees into substantial contributions to the other groups.

**“DASH 401(k)”**

Perhaps the most exciting development in retirement plan design today is the “New Comparability” Profit Sharing Plan. This innovative method allows the sponsor to make substantial contributions to selected groups of employees while limiting the cost for other groups by using an “age-weighted” mechanism to satisfy nondiscrimination testing. Essentially, if the preferred employees are older than the average age of the non-preferred employees, this design can dramatically skew benefits to the older groups. A Double Advantage Safe Harbor (DASH) 401(k) plan combines a “safe harbor” 401(k) plan with a new comparability profit sharing feature. The results are often dramatic and compelling.
### Income Tax Reduction

<table>
<thead>
<tr>
<th>Employee Name</th>
<th>Age</th>
<th>Current Salary</th>
<th>Salary Deferral</th>
<th>3% Safe Harbor</th>
<th>New Comparability</th>
<th>Total Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner (key)</td>
<td>55</td>
<td>$225,000</td>
<td>$20,500</td>
<td>6,750</td>
<td>22,750</td>
<td>$50,000</td>
</tr>
<tr>
<td>% of Pay</td>
<td></td>
<td></td>
<td>9.1%</td>
<td>3.0%</td>
<td>10.11%</td>
<td>22.4%</td>
</tr>
<tr>
<td>Key Employee</td>
<td>45</td>
<td>$100,000</td>
<td>15,000</td>
<td>3,000</td>
<td>5,000</td>
<td>23,000</td>
</tr>
<tr>
<td>% of Pay</td>
<td></td>
<td></td>
<td>15%</td>
<td>3.0%</td>
<td>5.0%</td>
<td>23%</td>
</tr>
<tr>
<td>Employee 1</td>
<td>30</td>
<td>$40,000</td>
<td>?</td>
<td>1,200</td>
<td>560</td>
<td>1,760</td>
</tr>
<tr>
<td>% of Pay</td>
<td></td>
<td></td>
<td></td>
<td>3.0%</td>
<td>1.4%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Employee 2</td>
<td>35</td>
<td>$35,000</td>
<td>?</td>
<td>1,050</td>
<td>490</td>
<td>1,540</td>
</tr>
<tr>
<td>% of Pay</td>
<td></td>
<td></td>
<td></td>
<td>3.0%</td>
<td>1.4%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Employee 3</td>
<td>30</td>
<td>$25,000</td>
<td>?</td>
<td>750</td>
<td>350</td>
<td>1,100</td>
</tr>
<tr>
<td>% of Pay</td>
<td></td>
<td></td>
<td></td>
<td>3.0%</td>
<td>1.4%</td>
<td>4.5%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td>12,750</td>
<td>29,150</td>
<td>77,400</td>
</tr>
<tr>
<td>% to Key</td>
<td></td>
<td></td>
<td></td>
<td>76.5%</td>
<td>95.2%</td>
<td>94.3%</td>
</tr>
</tbody>
</table>

In the case above, you will note that there are two “key” employees—the owner and an officer of the company. The owner wants to favor himself first and the key employee second. Another goal is to keep the employee benefit cost reasonable or minimal, if possible.

A DASH 401(k) accomplishes these objectives by first awarding a flat 3% “safe harbor” to all eligible employees. This is the ONLY required employer contribution each year. By awarding this safe harbor, both the owner and the Key employee may defer the maximum with Average Deferral Percentage (ADP) testing. By including a new comparability profit sharing feature, the owner can dramatically skew added benefits to himself and his Key employee with discretion. Thus, the safe harbor and the new comparability provision combine to offer a Double Advantage.

**Other Solutions** Other solutions (boring deductions) really are not so much solutions but more line item deductions that CPAs often tell clients to take. Those include: automobile expenses, cell phones, health insurance, life insurance, and, typically, anything else that can legally be deducted through a corporation via a normal 162 business deduction.

If you are an owner in a professional practice that does not allow for the above-mentioned and self-titled boring deductions, then you should read about the Perfect Corporate Structure on page 287 to learn how you can set up your own P.C., P.A., or LLC and take whatever boring deduction you so choose.
While we do not blame the typical CPA for not being proactive, we do have issues with the fact that most CPAs do not spend a certain portion of their time during the year looking for advanced tax solutions (like the ones you will read about in this book). Time is a factor for every professional (physician, attorney, and CPA); but in order to fully service clients, advisors need to do more to educate themselves on the issues that are most important to our clients.

The number one issue for most high-income clients is that they would like to put more money somewhere through their corporations in a tax deductible manner and would like to do so, if at all possible, without having to put significant amounts of money away for the staff.

The rest of this section of the book deals with many income tax reduction solutions that most advisors (CPAs, attorneys, and financial planners) have never heard of and are not likely to hear of due to the fact that many of the topics are held close to the vest by the creators of the plans.

Section 2
Non-Qualified Deferred Compensation

Traditional Non-Qualified Deferred Compensation plans (NQDC) have been around for many years. Small business owners rarely run into the concept due to the fact that NQDC plans are not a good fit for owner/employees. While NQDC might not be prevalent in the small business and professional practice market, when starting to talk about income tax reduction (or deferral), NQDC is a nice place to start since the concept has been around for years and is the most conventional and traditional type of “deferred compensation” plan in the marketplace. It is also the least advantageous plan you can implement.

How does NQDC work?

Simply stated, a NQDC plan is an arrangement whereby compensation earned by an employee in one year is paid to him or her in a later year. The money that normally would have been paid as compensation to the employee is invested by the employer (and hopefully grows), and then sometime down the road (at retirement typically), the employee gets paid that deferred compensation plus the growth on the money while it was deferred. Usually deferred compensation plans pay the employee over a period of years rather than in one lump sum. Also, NQDC plans can be implemented in a discriminatory manner for key executives, which is why at first glance the topic might intrigue a small business owner.

In 2004, NQDC plans were turned on their heads by Congress with the passage of The American Jobs Creation Act of 2004. This law made “old school” NQDC a painful tool with the new restrictions and tax consequences of having an old school NQDC plan. Because old school NDQC plans are no longer viable, they will not be discussed in this
material. Readers who have old school NQDC plans should know that, if those plans are not (or were not depending on when you are reading this book) terminated or frozen prior to the end of 2006, the negative tax consequences to the employees with those plans will be dramatic.

**The 162 Bonus Plan**

The 162 Bonus Plan is a fancy term for a company simply giving a bonus to a key employee at the end of the year. These plans are deductible to the employer and can have contractual language that go along with them if the employee does not stay with the company for X amount of years, the employee must re-pay some or all of the bonus to the company.

The problem with the 162 Bonus Plan is that the employee (who is already in the top income tax bracket) has to pay tax on the bonus. So the employee doesn’t see a $100,000 year end bonus as a bonus; he/she sees it as a $60,000 bonus after paying $40,000 in income taxes.

**The 162 Double Bonus Plan**

The 162 Double Bonus Plan is a fancy term for giving an employee a bonus at the end of the year and then giving the employee another bonus to pay for the taxes on the first bonus.

See the following chart for the math on the double bonus plan.

<table>
<thead>
<tr>
<th>Plan Bonus</th>
<th>(100,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Deduction</td>
<td>40,000</td>
</tr>
<tr>
<td>Net Cost of Bonus</td>
<td>(60,000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Double Bonus</th>
<th>(66,667)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Deduction</td>
<td>26,667</td>
</tr>
<tr>
<td>Net Cost of Double Bonus</td>
<td>(40,000)</td>
</tr>
</tbody>
</table>

**Gross Cost:** (166,667)  
**After-Tax Cost:** (100,000)

You can tell from the above numbers that any employer will not like the double bonus plan because it is very expensive. Having said that, employers who will look to a NQDC plan will be forced to use either the bonus plan or the double bonus plan so as to avoid problems with the 2004 American Jobs Creation Act.
Who should use NQDC plans?

C-Corporations who are looking to retain key employees are the best candidates for NQDC plans.

Do NQDC plans work in small companies?

A small company where the key employees are also owners will traditionally not look to NQDC as a tool to build retirement savings. When you run the numbers, it makes little sense for an owner to implement a NQDC plan. The plan is nothing more than a non-deductible bonus plan.

162 Leveraged Bonus Plan

In response to the problems with old school NQDC plans and the expenses involved with the Double Bonus Plan, companies in the marketplace have produced a new alternative that is less costly and will not run afoul of the 2004 American Jobs Creation Act.

A 162 Leveraged Bonus Plan (“LBP”) works like a §162 Double Bonus Plan except that, with LBP, rather than the company making a “grossed up” second bonus to cover the entire cost of taxes lost on the first bonus, the company makes a much smaller second bonus to cover the interest cost of borrowing an amount that replaces the taxes lost on the first bonus. That is, the employee borrows an amount equal to the tax paid on the first bonus (the participant may borrow an amount equal to a multiple of the taxes paid in order to create greater leverage and better performance of the retirement arrangement).

<table>
<thead>
<tr>
<th></th>
<th>§162 Bonus</th>
<th>LBP</th>
<th>LBP Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plan Bonus</td>
<td>(100,000)</td>
<td>(100,000)</td>
<td>0</td>
</tr>
<tr>
<td>Tax Deduction</td>
<td>40,000</td>
<td>40,000</td>
<td>0</td>
</tr>
<tr>
<td>Net Cost of Bonus</td>
<td>(60,000)</td>
<td>(60,000)</td>
<td>0</td>
</tr>
<tr>
<td>Double Bonus</td>
<td>(66,667)</td>
<td>(4,000)</td>
<td>62,667</td>
</tr>
<tr>
<td>Tax Deduction</td>
<td>26,667</td>
<td>1,600</td>
<td>37,600</td>
</tr>
<tr>
<td>Net Cost of Double Bonus</td>
<td>(40,000)</td>
<td>(2,400)</td>
<td></td>
</tr>
<tr>
<td>Gross Cost:</td>
<td>($166,667)</td>
<td>($104,000)</td>
<td>$62,667</td>
</tr>
<tr>
<td>After-Tax Cost:</td>
<td>($100,000)</td>
<td>($62,400)</td>
<td>$37,600</td>
</tr>
</tbody>
</table>
LBP is essentially an individually owned executive benefit program that is funded with universal life insurance owned by the employee. A portion of the premium is funded through a loan made by a third party finance company. **Most importantly, LBP is deductible to companies currently while substantially reducing the overall cash flow cost to the company.**

Employees like LBP because they own the retirement plan outright and are no longer subject to the general credit risk of the company for their future retirement cash flow. Also, because LBP funds a universal life insurance policy, the employee can borrow cash from the policy retirement for a “tax free” retirement benefit.

LBP is unique in that a third-party loan is utilized to fund a portion of the premium due on the insurance policy. The loan should be non-recourse relying solely on the underlying insurance policy as collateral. Consequently, the executive participant should not provide a personal guarantee of any kind and should not pledge any other personal assets. Because there is no personal guarantee, the lender should not have a minimum net worth requirement and require no credit reporting or financial underwriting.

**Who should use LBP?**

Again, this topic is mainly for larger private C-Corporations who are looking to retain non-owner key employees or for public companies looking to do the same. If you think about it, the first “bonus” is not deductible and is really not a “deferred compensation” plan. The deferred compensation aspect to Bonus Plans comes in the form of funding a cash building life insurance policy where cash is able to grow tax free and taken out tax free via policy loans.

The bottom line with any Bonus Plan is that most small employers who are looking for a benefit plan for key employee/owners is that the plan will not be nearly as beneficial as the topics to follow.

**Conclusion**

If you are a key employee who is NOT an owner of the company and you would like to have a NQDC plan offered to you by your employer, we would recommend that the employer look into the LBP as a viable option. Otherwise, please see the topics below which are geared towards the small business owner.
Section 3
Accounts Receivable Business Continuation Plan:

The “ABC Plan”

Introduction

If you are a small business owner making significant taxable income, you are probably tired of hearing about all the too-good-to-be-true income tax reduction plans that never pan out after a thorough review of the plan is completed.

If you are ready for an “advanced” plan that is so simple you wonder why it has never been done before, then you are ready to review the ABC Plan. The ABC Plan is the simplest “advanced” plan in the marketplace that every CPA or attorney in the country will not only understand with relative ease but should also approve without having a salesperson give the hard sell.

The ABC Plan is a program created for small business owners who are interested in business continuation, income tax reduction, and asset protection.

With the ABC Plan, small business owners can make their A/R more difficult for creditors to collect, reduce the owner’s current take-home income, and assure that the business at a predetermined period of time in the future will have cash flow.

How?

Through an installment sale of the business’s accounts receivables (A/R).

How does the ABC Plan work?

1) A business sells a specific amount of A/R to a Factoring Company ($25,000-$100,000+).

2) The Factoring Company (hereinafter FC) takes a 5% factoring fee on the A/R factored and issues to the business an installment note for payment of the remaining 95%. This installment note has repayment terms as dictated by the business selling the A/R.

3) When the business collects the A/R that was sold, that money is transferred to the FC.
4) The FC invests the money it receives (minus the 5% factoring fee). Typically, the money is invested in indexed annuities that have minimum guarantees and growth pegged to the S&P 500 index.

5) When the installment note comes due to pay the business, the FC pays back to the business the initial amount factored (minus the original factoring fee) plus any growth on the money (as it was pegged to the S&P 500 index).

6) The business then can choose to use the money for any business purpose, including the option of paying it to the owners or employees as a bonus.

**Who can use the ABC Plan?**

Any cash accounting company or individual who has A/R. This would include:

- Medical Practices (the A/R from insurance companies)
- Law Practices (the A/R from clients)
- Accounting Practices (their A/R from clients)
- Financial Planners (their commission income)
- Insurance Advisors (their commission income)
- Any client who is owed money via contract which could include
  
  Professional Athletes (endorsement income)
  Entertainers (residuals from song rights or movie rights)

- Real Estate Developers (rental income is an A/R that can be factored)

**Example**

**Assumptions:** Assume the client, Dr. Smith, age 40, works for XYZ Orthopedic Clinic, P.C., makes $600,000 a year and has an extra $100,000 he does not need to take home as income this year. Further, assume the medical practice at any given time has $700,000 of real A/R on the books and Dr. Smith’s patients represent $200,000 of that A/R.

**Implementation:**

1) XYZ Orthopedic Clinic contracts with FC to sell $100,000 of A/R in exchange for an installment note that will be payable starting in 21 years and will pay in a lump sum when Dr. Smith is 60 years old.

2) The FC takes a 5% factoring fee and invests $95,000 (typically the money is invested in indexed annuities with a minimum guarantee and growth pegged to the S&P 500 index).
3) If that $95,000 grew at 7% for 21 years, there would be $310,835 at the end of the 21-year period. That $310,835 would come back to the medical practice via the installment note in lump sum at the end of the 21st year (when Dr. Smith is age 61).

4) The medical practice can use the money for any business purpose and can choose to disperse it out to Dr. Smith as income. If Dr. Smith received the $310,835 in a lump-sum bonus from the medical practice, he would have **$186,501** left after paying tax on the money in the 40% tax bracket.

5) In the above example, if Dr. Smith invested $60,000 post-tax in the stock market for the same 21-year period, he would have **$130,686** in a post-tax brokerage account. Therefore, the ABC Plan worked **45% better than post-tax investing**.

**Continuous contracting**

If the medical practice so desires, it can choose to sell a similar or different amount of A/R each year. Using the Dr. Smith example, XYZ Orthopedic could factor $100,000 a year for 10 years. If the money at the factoring company grew at 7%, there would be $2,481,844 that could be paid in a lump sum to the medical practice at the end of 21 years.

If the medical practice did not desire to have an installment note paid in a lump sum, it could direct via the installment note to have that money paid to the medical practice over any period of time up to 30 years.

**The ABC Plan vs. Post-Tax Investing**

In the 10-year continuous contracting example, Dr. Smith could take home $195,335 a year for 20 years as taxable income (leaving $117,201 a year after tax in the 40% bracket).

If Dr. Smith instead of implementing the ABC Plan took his $60,000 home after tax ($100,000 x 40% tax) and invested it in the market at 7% (where typical income and dividend taxes are levied every year), Dr. Smith could take out of his brokerage account $77,318 a year after tax for that same 20-year period. The ABC Plan returned to Dr. Smith **52% more income each year from ages 61-80**.

The ABC Plan is a terrific and simple income deferral/wealth building tool that will be a nice fit for many clients and is a topic advisors will not have to spend hours explaining to the client.
The following is a schematic illustrating the 10-year funding example.

Pros and cons of the ABC Plan

Pros –

A) Simplicity – The ABC Plan is about the simplest “advanced” plan in the marketplace. All a business has to do is identify A/R it would like to factor, sell the A/R via an installment note and, at a set time in the future, have the amount factored and the growth on that money returned to the business.

B) Principal Guarantee – The Factoring Company typically uses as its investment vehicle products that have guaranteed minimum rates of return to assure that the Factoring Company will always have the money needed to pay the installment that eventually becomes due.

C) Variability – Many of the asset protection/income tax reduction topics in the marketplace use life insurance as an investment (which is a good wealth accumulation tool when used tax favorably). The main problem with life insurance is that a client 1) needs to commit to a period of level funding and 2) cannot access the cash via policy loans until the surrender charges evaporate in the life policies (which typically takes 10-15 years).
With the ABC Plan, the business chooses to implement the plan annually for whatever amount it sees fit. One year the business could factor $100,000, and the next year it could factor $0 or $250,000. Because each year is a new installment note payable by its own terms, there is no requirement to fund every year.

D) Tax Simple – While most CPAs and attorneys are not used to reviewing the “creative” income tax reduction plans in the marketplace, all CPAs and attorneys are familiar with installment notes and factoring. The ABC Plan is one that should not be difficult for a client’s advisor to review and approve as a conservative asset protection/income tax reduction/business continuation plan.

Cons –

A) Lack of investment control – The factoring company has the ultimate authority to invest the money as it sees fit. The business selling the A/R cannot control the investment or direct where the money will be invested. The FC typically uses principal guaranteed products so the FC will have the money to pay back the installment note (and the FC typically uses indexed annuities pegged to the S&P 500 which should generate rates of return between 7-10% long term).

B) Lack of flexibility when repaying the installment note – Except for certain circumstances, the time table for repayment of the note will be set the day the installment note is issued. So, if the business selling their A/R accepts a note where payment will not happen for 15 years and the business needs money, it will not be able to go to the Factoring Company and demand early payment.

Early payment options

The following circumstances allow Seller to receive early payment on the note:

1) Death of an identified key executive.

2) At the discretion of Seller: anytime after the note has been in place for 12 months with 90 days written notice to the FC. With this option, the Seller is assessed a 6% penalty on the balance to be paid back to Seller.

Vitals about the plan

- The factoring company is a $100,000,000+ net worth company that guarantees repayment of the note.
- The Installment obligations are protected from creditors of the factoring company due to the fact that they are owned by Special Purpose Delaware Trusts.
- There has been more than $300,000,000 factored into the plan from 2002-2004.
- The plan has been approved for use by over 50 CPA/accounting firms.
Conclusion

If you are looking to reduce your income taxes, the ABC Plan is the simplest “advanced” income tax deferral plan/business continuation plan in the marketplace. The ABC Plan while creative is not going to raise the eyebrows of your local CPA and, most importantly, that of the IRS.

We strongly recommend the ABC Plan as a main instrument in your financial plan which should ultimately lead you to “Critical Capital Mass” and, in turn, a worry-free retirement.

If you would like more information on the ABC Plan, please feel free to contact one of the authors.

Section 4
Accounts Receivable Leveraging

On page 92 of this book we cover in great detail how an A/R Leveraging Plan can work to asset protect a company’s A/R. The reason we covered the A/R Leveraging Plan in the asset protection part of this book is due to the fact that we do not think the plan should be sold as an “income tax reduction plan” or “supplemental retirement plan.”

Why? Because the Plan is not structured with enough safeguards to guarantee that the Plan will do better than post-tax investing for a client.

Can the A/R Leveraging Plan work out and create a nice supplemental retirement benefit for a client? Absolutely. Can the Plan also not work out so well from a financial standpoint? Absolutely.

We will not insert into this section of the book all the information that is already covered on pages 92-101, but we did want clients to know that, if they have been sold an A/R Leveraging Plan or are considering using one for “supplemental retirement benefits,” the chances are significant that the salesperson selling you the plan is not doing so with full disclosure.

To learn how the A/R Leveraging Plan works, we suggest turning to the asset protection part of the book to read the pros and cons of the Plan.
**Section 5**  
**Defined Benefit Plans and 412(i) Defined Benefit Plans**

**The Perfect Retirement Plan for Business Owners Over 50**  
**Who Have Little or No Money in a Qualified Plan or IRA or are Looking for “Guaranteed” Investment Returns**

Of course you do not like paying income taxes. However, navigating your way through ERISA, Department of Labor, and Internal Revenue Service rules and regulations for retirement plans can be tedious, if not dangerous. The key for all clients is finding the plan that provides the maximum deductions with the minimum contributions for the employees.

A basic 401(k) offers very little in the way of annual deductions. Profit Sharing Plans can get you up to $44,000 (in 2006); but, generally speaking, you have to put in a significant amount of money for the staff in order to get up to $44,000. A Money Purchase Plan may offer you deductions of $44,000 as long as you contribute the same percentage of each employee’s compensation to his/her account; and unlike most Profit Sharing Plans, the Money Purchase Plan is mandatory.

Generally, a Defined Benefit Plan allows for much bigger deductions for employees who are getting a late start on their retirement planning (or who have lost their plan assets in a divorce or other lawsuit). For example, a 50-year-old client who makes over $170,000 per year and is just starting to make contributions to a newly formed Defined Benefit Plan may make up to $69,000 of tax deductible contributions per year. How is this possible?

**The basics of Defined Benefit Plans**

Defined Contribution Plans, like 401(k)s and Profit Sharing Plans, restrict your contributions but do not put a cap on the potential growth of the plan assets. Of course, every client will have a different amount available in his/her plan at retirement, which depends on the investment results. Further, there is no guarantee on how much will be available for retirement unless the investments inside the plan are all guaranteed with fixed investments.

In a Defined Benefit Plan, the amount you will retire with (at a predetermined age) is set based on your salary and year of retirement. Then, under IRS approved and actuarially reviewed assumptions, you are allowed to put money away on a tax deductible basis to achieve that goal. Of course, if the plan accounts for 8% growth in your investments and you get 6%, there will be much less available in retirement. To make up
for this risk, the government allows you to alter the amount each year based on the returns on the investments in the previous year. There is also a possibility your investments may exceed the assumed rate of return. If that happens, you will not be allowed to deduct as much in annual contributions in future years.

Because of the annual costs of the actuarial review, Defined Benefit Plans are more costly than the Defined Contribution Plan alternatives. However, if you are over the age of 50 and do not have much in the way of retirement plan savings, the tax deductions will more than offset the additional $500-$1,500 cost per year in administration costs—not to mention you will be able to save more for your retirement.

**A variation on the theme—how to deduct over $100,000 per year; 412(i) Defined Benefit Plans**

A 412(i) Plan is a special type of Defined Benefit Plan. This plan works almost exactly the same way as the typical Defined Benefit Plan. However, there is one major twist—the benefit in retirement is Guaranteed! That is right. If you construct a 412(i) Plan to give you a monthly benefit of $10,000 per month in retirement, it is guaranteed to be at least that high. How is this done?

The 412(i) Plan purchases annuities from insurance companies that offer guarantees of 2%, 3%, 4%+ a year. With a 2% or 3% return guaranteed, the IRS allows you to use the 2% or 3% return in your calculation of future value of the plan. Because the regular Defined Benefit Plans assume a non-guaranteed return of 6%-8% when determining the amount of tax deductible contributions the owner can make and the 412(i) Plans use a much lower 2%-3% return, the 412(i) Plans allow for significantly more in tax deductible contributions annually. For example, it is possible for the same 50-year-old client mentioned before to make substantial tax deductible contributions ($100,000 a year or more) into a 412(i) Plan annually.

**Why would you want lower returns?**

You are not getting lower returns. You are just guaranteed a lower return—with the upside potential of greater returns. The annuities in the 412(i) Plan may still give you 6%-8% or more per year. In fact, the 412(i) Plan’s investments will likely give you more than the 2%-3%. However, we only have to use the guaranteed amount in our actuarial calculation. This is what allows some 60-65-year-old clients to make $300,000+ in tax deductible contributions per year into a 412(i) Plan. (Again, if in the early years of the plan the returns are greater than the 2%-3% assumed rates, future funding will have to be reduced).

You are saving significant income taxes in your prime earning years, you are getting a guaranteed return on your investment, you have the upside of the market, and you do NOT have to have any employees to start a 412(i) Plan. We find that many clients either work for themselves or are employees in larger companies. In the latter
case, we generally do not recommend 412(i) Plans or traditional Defined Benefit Plans and instead counsel clients to look at an ABC Plan. To fund a 412(i) plan for an owner/employee when there is a sizable amount of staff will be price prohibitive.

**Life Insurance vs. Annuities**

Because 412(i) Plans need guaranteed return investment vehicles, the only two allowable options are annuities and life insurance. A 412(i) Plan can use a combination of life insurance and annuities as long as the amount of life insurance used does not exceed 49% of the planned contribution amounts.

**Pros and Cons of using life insurance in a 412(i) DB Plan**

In order to “max out” a 412(i) Plan, the client would need to purchase the maximum amount of life insurance in the Plan. On the flip side, if you were allowed to fund the same amount of money into an annuity, you would have significantly more money to use in retirement. Let’s look at an example for Dr. Smith who is age 55, makes $400,000 a year, and has three employees in his practice, ages 25, 30, and 34.

Dr. Smith could contribute in a tax deductible manner **$206,000** to a 412(i) DB Plan each year for seven years IF he uses annuities only.

Dr. Smith could contribute in a tax deductible manner **$245,000** a year into a 412(i) DB Plan each year for seven years. Of the $245,000, $142,000 would go into an annuity product and $103,000 would go into a life insurance policy.

The simple question seems to be: Why wouldn’t Dr. Smith opt for a 412(i) Plan that uses life insurance if he can put more money away? Because the returns inside the life policy will be less than the returns of the annuity. Why? Because with annuities there are no life insurance costs.

So the questions becomes: Is there a point where the deduction just for the sake of a deduction doesn’t make sense? As a general statement, if you do not need additional life insurance for estate planning, you should not be using life insurance in a 412(i) DB Plan. There are more complex strategies which would require the use of life insurance to reach a maximum deduction, but they are outside the scope of this material. If you want to put additional tax deferred monies away, you can use the ABC Plan or you could simply take the money home and invest it in the stock market where the returns post-tax will most likely be better than the investment return of a life policy owned inside a DB Plan.
Discrimination

Every employer/owner wants to discriminate when implementing a qualified plan so the costs for the employees are kept to a minimum. Many clients and amazingly many advisors get the bright idea that a good way to solve this problem is to create a separate company for the owners to receive their income and implement a qualified plan only in the new company which has no rank and file employees. Creating this corporate structure to skew qualified plan contributions is not legal, and the following explains the rule that need to be followed in order to avoid problems with the Department of Labor.

Related Employers

Perhaps the largest issue in making sure that a qualified plan satisfies nondiscrimination testing and remains compliant is the inclusion of all “related employers” as joint sponsors of the plan. That’s because many small business owners may indeed own or control more than one enterprise. It is tempting to adopt a 412(i) plan to benefit one group of employees, and not cover all the related employees, but this may not be possible under current pension law as a plan must meet specific coverage and participation rules. [IRC §410(b) and §401(a)(26)]

Generally, all the employees of businesses under common control are aggregated for nondiscrimination testing vesting and top-heavy rules. Also, the 415(a) contribution and 415(b) benefit limits will aggregate as if all the employees worked in one single employer. [IRC §414(b)]

Presented here are definitions of the “controlled” and “affiliated” service groups that the professional advisor must consider before recommending adoption of any qualified retirement plan.

Parent-Subsidiary Controlled Group

1. One business must own at least 80 percent of another business.

2. If the businesses in item 1 together own 80 percent of a third business, the third business is also a member of a parent-subsidiary group.

Brother-Sister Controlled Group

1. Five or fewer persons own in combination at least 80 percent of the stock of each business, AND

2. The same persons own more than 50 percent of each business counting only identical ownership in each business.
3. A person’s stock ownership is not taken into consideration for the 80 percent test in item 1 above unless the person owns some stock in each business. [IRC §1563(a)]

4. Attribution rules for stock ownership of spouses and certain family members may apply. [IRC §1563(d)]

**Example:**

<table>
<thead>
<tr>
<th>Owner</th>
<th>Business 1</th>
<th>Business 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>50%</td>
<td>40%</td>
</tr>
<tr>
<td>B</td>
<td>30%</td>
<td>60%</td>
</tr>
<tr>
<td>C</td>
<td>20%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Result: Businesses 1 and 2 are members of a Brother-Sister Controlled Group because A and B own at least 80 percent of both businesses and more than 50 percent of both, counting only up to 40 percent ownership for A and 30 percent ownership for B. Because C owns no stock in Business 2, C is disregarded for the 80 percent ownership test.

**Combined Group**

1. Consists of three or more businesses, each of which is a member of a parent-subsidiary or a brother-sister group; and

2. One company is both a parent of a parent-subsidiary group and a member of a brother-sister group.

**Affiliated Service Group**

1. Consists of a service organization (e.g., medical practice, law firm, or other service business) and an affiliated organization (e.g., employs nurses or paralegals) which is at least 10 percent owned by highly compensated employees of the organization, AND

2. The affiliated organization performs services for the service organization, which account for at least 5 percent of the gross receipts of the affiliated organization. [IRC §414(m)]

*Example:* Dr. Smith owns 100 percent of Medical Practice. She also owns 20 percent of Nurses, Inc., a firm whose employees provide nursing services to Medical Practice. Fifty percent of Nurses, Inc.’s gross receipts are on account of services provided to Medical Practice.

Result: Medical Practice and Nurses, Inc. are members of an Affiliated Service Group.
Legally Discriminate with “Carve Out” Planning

As stated repeatedly in this book, the goal of most business owners is to set up retirement plans that benefit the owners at the lowest possible cost to the employer for the employees. While the previous material is helpful to allow business owners to create large deduction to fund their retirement plans, defined benefit and 412(i) defined benefit plans are still an expensive proposition if there are any amount of rank and file employees.

Most clients and their advisors are not familiar with carve out planning. It is really the new wave of legal discrimination when using qualified plans. If you are thinking of implementing a defined benefit plan or 412(i) defined benefit plan or if you already have one, you should strongly consider a carve out plan as a way to save the business money on its contributions to the plan for the employees.

Explaining the technical details behind why Carve-Outs work is outside the scope of this material, but the following example for a hypothetical Dr. McIntire will illustrate to the readers how powerful Carve-Out planning can be. This book is all about giving readers more knowledge than others and knowledge that will benefit readers significantly from a financial point of view.

A “Next Level” Retirement Plan for David C. McIntire, DMD

Step 1: Determine Your Goals and Budget

Meet David McIntire, a successful dental surgeon with a small but thriving practice. He had been using a SEP-IRA plan to meet his retirement needs because he was told it was the cheapest and best option. As many “baby boomers” nearing retirement are now learning, a SEP-IRA may fall far short of actual retirement income needs. Dr. McIntire’s goals are to receive the maximum retirement benefit allowed by law and to retire by age 62. However, he wants to make sure his employee benefit costs do not get out of control. He can commit up to $200,000 a year to his tax-deductible plan and is pleased to know that assets within his retirement plan are protected from the claims of creditors and potential litigants.

Step 2: Analyze Potential “Safe Harbor” Solutions

An initial study reveals that Dr. McIntire may certainly improve his retirement security by turning to a defined benefit plan. That’s because the tax-deductible contributions are not limited to $42,000 as with his current SEP-IRA. Interestingly, the cost of Dr. McIntire’s traditional defined benefit plan is more than triple his SEP-IRA contribution, while the attributable cost for his Generation X employees is actually lower. Although he and his wife, Rita, receive the majority of the benefits, he is troubled by the benefit cost attributed to his baby boomer employee: Linda Booker.
“Carve-Out” Planning

Although employees who do not have one year of service or who are younger than age 21 can be excluded, all other eligible employees need to be considered for non-discrimination testing. There are two tests that must be satisfied annually. The first is fairly simple: at least 40 percent of the otherwise eligible employees need to be covered in the defined benefit plan.

The second rule is more complex: the ratio of rank-and-file employees benefiting in each plan must be at least 70 percent of the ratio of the owners, their family members, and other high-income employees. Note that we now included Nurse Nancy, his part-time surgical assistant, to satisfy this test in the profit-sharing plan. Thus, when there is more than one owner or family member in the business, a plan sponsor may choose to create non-discriminatory classes of employees to include or “carve-out” of the defined benefit plan.

What about the excluded employees? Because the “carve-out” group will often contain family members and other highly paid employees who are important to the business, it is recommended that they be included in a separate plan. It is important to make sure that absolutely no employee participates in both plans, since this may cause some employer contributions to be non-deductible.
Step 3: Consider Advanced Design Services as Necessary

Dr. McIntire likes the defined benefit plan idea but is concerned with the added expense and potential confusion of operating two plans for two different groups of employees. He would like to pursue a “Next Level” alternative that can accomplish a similar objective using one plan, if possible.

After consulting with a CWPP™, who is supported by a quality pension plan administrator to see if he is a good candidate, Dr. McIntire retains the plan administrator to prepare a “Next Level” defined benefit plan alternative. By using a “New Comparability” approach that places the employees and spouse in one class and the doctor in another, he can tailor the plan to meet his objectives. Like the “Carve-Out” plan option, this design works best when there are other family members or highly compensated employees who can be included in the more modest benefit group.

A “New Comparability Plan” allows clients to craft a plan specifically to meet their retirement goals and business needs. By creating non-discriminatory classes of employees and placing them in various groups, clients can accomplish their objectives,
while still providing meaningful benefits to everyone eligible. Dr. McIntire’s plan formula could look like this:

1. **Dentists Who are Owners**: 6.71 percent of final average salary times years of future service (maximum 24).

2. **All Other Employees**: 2.00 percent of final average salary times years of future service (maximum 24). The minimum monthly accrued benefit for any employee earning less than $37,500 in a year will be $111.00 for that year.

Complex testing must be made each year to ensure that your plan is nondiscriminatory. For this reason, the client must supply employee census and other plan data to the actuarial firm immediately after the end of each plan year. This will allow more time to calculate and discuss alternatives if your plan does not pass testing due to a change in employee census. The added administrative time and expense of this oversight and testing should be outweighed by the reduced employee benefit cost if this “Next Level” option is appropriate for you.

**Conclusion**

Defined Benefit Plans and 412(i) Plans are nice options for the right client in the right corporate setting with the right financial makeup to income tax defer significant amounts of money into a qualified retirement plan. The right corporate setting is that of a small employer with as few employees and owners as possible (less than ten employees or less than three-four employees per owner). The right financial makeup would be a client who does not have a sizable IRA or traditional pension plan balance.

If you are over the age of 50 and would like to fund significant dollars into a “guaranteed” retirement plan, then you should strongly consider using a 412(i) DB Plan. If you would like to see an illustration for how a 412(i) plan would work in your company, please feel free to give one of the authors a call, (an illustration can usually be created within 48 hours). With the ability to create a “carve out” plan, this topic now can be used by more employers than ever.
Section 6
Charitable Planning

High income and high net worth clients by nature seem to be more giving people than the general public (mainly because they have the extra money to give).

At the back of this book, you will find a client questionnaire you can fill out and fax to one of the authors to receive a review of your asset protection, income tax reduction, and estate plans. On the very last page of the questionnaire, we ask the clients how they would like their estates divided up when they pass away. Most of clients allocate 80-90% of the money to their family and 10-20% to charity. There are even some who amazingly state that they would like to leave 10% to the IRS. (We are assuming this happens because of the mentality that we have to leave something to the IRS at death and that 10% is much better than 50%).

There are many different ways for a client to gift money to charity, i.e., Charitable Remainder Trust (CRT), Charitable Remainder Annuity Trust (CRAT) Charitable Remainder Unitrusts (CRUT), Charitable Lead Trust (CLT), Family Foundations, Charitable Gift Annuities and the list goes on and on.

Since this book is not a client’s guide to charities, we decided to discuss the solution we believe is hands down the simplest, least expensive, and most beneficial way to fund a client’s charitable goals, i.e., the Charitable Gift Annuity (CGA).

Charitable Gift Annuity (CGA)

CGA Quick Facts (A client is the donor)

-A charitable gift annuity is a contract between a donor and a qualified 501(c)(3) public charity.

-The donor makes an irrevocable gift to the charity in exchange for a promise of lifetime income.

-Typically, the lifetime income is paid to the donor or to donor and spouse (joint and survivor).

-The charity pays the donor(s) for life (monthly, quarterly, or annually) at an agreed upon rate.

-Once reserve or reinsurance requirements to make donor payments have been satisfied, the charity uses whatever remains from the original gift for its charitable purposes.

-Some charities allow a portion of this “charitable remainder” from the CGA to pass into a client/donor’s Donor Advised Fund (DAF).
**Income Tax Reduction**

-A CGA can provide **lifetime income** at a high rate that is guaranteed by the charity and an **immediate tax deduction** for the donor.

The following is a schematic for how the CGA works.

**CGA Program Overview**

1. Client transfers an asset (typically a highly appreciated asset) to the Charity and receives an immediate income tax deduction.
2. Charity uses a portion of the funds to purchase a commercial annuity and (assuming insurability) a life insurance policy on the donor.
3. Commercial annuity pays Charity.
4. Charity pays income to Donor(s)
5. Donor gifts a portion of the income to an ILIT which purchases life insurance to replace value of the gifted asset.
6. At death of donor, insurance policy will distribute funds to client’s DAF at Charity.

**Guaranteed Benefit Income Protection**

When entering into a CGA contract, most donors want to make sure the charity has a safe method of protecting funds that will be used to make their lifetime income payments to the donor. Charities are required to maintain certain reserve requirements and may also be mandated to invest funds according to strict parameters depending on state requirements.
Just because there are reserve requirements, it is still vitally important to work with a reputable charity that knows how to implement a CGA—one that can be trusted not to mismanage the money that is partially to be used to pay a “guaranteed income” to the donor or his/her heirs. Most of the time, a charity will use a single premium immediate annuity (SPIA) for the life of the donor(s) from a highly-rated commercial insurance carrier. In essence, this allows the charity to pass interest rate, investment, and mortality risks to an insurance company.

**Charitable Benefit**

Once a charity has met its payment obligation to a donor, it can use the remainder of the gift from the donor for its charitable purposes. Some charities allow all or a portion of this remainder to be designated for a Donor Advised Fund (DAF) which is typically funded at the death of the donor(s). This permits the donor (or the heirs if funded at the death of the donor) to have some say in an advisory capacity as to how the charitable funds are used and provides an excellent method of establishing a legacy.

In other words, the charity will purchase a life insurance policy on the donor (sometimes second–to-die policy for a greater death benefit) with the remaining funds that are ultimately supposed to stay with the charity. Life insurance is used so a large guaranteed death benefit will ultimately pass to the charity.

Many clients want their children and grandchildren to learn what charitable giving is all about. A good way to do that is through a CGA where the charity will allow a portion of the death benefits from a life policy purchased with the proceeds from the gift to the charity to be used in a DAF. The DAF is one the client (donor) sets up in advance of death where the client’s heirs would help direct how the death benefits will be used (in a charitable manner).

By using a DAF, the children and grandchildren do not receive the money but instead are there to see the money used to help those in need. The theory is that such a charitable setup is good to help build the moral foundation of the children and grandchildren by getting them involved in the DAF at the charity.

**Substantial Tax Benefits**

There are three primary ways in which a CGA can assist in tax management. First, when transitioning the ownership of a highly appreciated capital asset (marketable securities, real estate, business interests, etc.) to a charity in exchange for a CGA, the donor does not realize a lump sum capital gain. The capital gain is reduced significantly and then amortized over the donor’s life expectancy. This means that a portion of the donor’s CGA income will be taxed at the lower capital gains rate.

Second, a substantial immediate income tax deduction is given, which can be used to offset current income taxes up to a certain amount based on adjusted gross


income. Any surplus deduction can be carried over up to five additional years. The amount of the tax deduction is based upon the projected value of the ultimate gift to charity.

Third, transitioning an asset to a CGA **removes the asset from the donor’s taxable estate**, which can greatly reduce potential estate taxes. In some cases, depending on the type of asset, transitioning an asset can also avoid income with respect to a decedent (IRD) taxation at estate settlement.

**Wealth Replacement**

Many clients who do not have a charitable intent will not look at the CGA. However, for those who are on the fence, one way to rationalize using a CGA is to implement a “wealth replacement” strategy.

Wealth replacement is a fancy term for buying life insurance with some or all of the income stream that flows to the donor client from the CGA. The theory is that a client can give away a $500,000+ asset to a charity, get a current income tax deduction, and use the stream of income from the Charity to purchase a $500,000+ life insurance policy inside an irrevocable life insurance trust (ILIT). This policy would typically be purchased inside an ILIT so the death benefit will pass income and estate tax free to the heirs.

**Example:**

Assume that Dr. Smith has an estate of $5 million at the age of 60. The $5 million estate is made up of a home worth $1 million, a brokerage account worth $1.65 million, an IRA of $1.5 million, a vacation condo worth $350,000, and a rental property worth $500,000. The rental property has a basis of $100,000. Assume Dr. Smith still works as a surgeon where he makes $400,000 a year.

Dr. Smith has three children and five grandchildren, and he and his wife would like to leave something to charity so they can teach their children about those who are less fortunate by having them involved in charitable giving through the DAF.

Dr. Smith decides to implement a CGA, and it would work as follows:

1) Dr. Smith gifts the $500,000 rental property to a charity which sells the property for $500,000 (and the charity pays no capital gains).

2) Dr. Smith receives an income tax deduction for his tax return of $60,925 (saving Dr. Smith $24,370 in income taxes on his current year’s tax return). This deduction could be increased substantially if Dr. Smith waited to receive income payments from the CGA. Also, if Dr. Smith was older when making the gift, the income tax deduction would be larger (in our example the deduction if Dr. Smith was age 65 would be $89,890).
3) The charity buys a single premium lifetime annuity on Dr. Smith and starts paying Dr. Smith $28,000 in income each year until his death. The first year, $14,515 of the payment is taxable to Dr. Smith at the long term capital gains rate, $13,216 is treated as ordinary income, and $269 is tax free. The taxable consequences of CGA payments to Dr. Smith change during his lifetime and are not discussed for the sake of brevity. The tax consequences to each client will vary widely; and if you are a candidate for a CGA to fund your charitable goals, please feel free to give any one of the authors a call to create a specific example for your individual situation.

3a) The charity also buys a $500,000 second-to-die life insurance policy on Dr. Smith and his wife that will fund the DAF at the last spouse’s death.

4) Dr. Smith takes $4,500 from the income he receives from the CGA each year and gifts that to an ILIT where a $500,000 second-to-die life insurance policy is purchased and where the death benefit will pass to the heirs income and estate tax free.

5) When Dr. Smith and his spouse die, $500,000 will pass to their heirs income and estate tax free (thereby replacing the $500,000 piece of real estate that would have passed to the heirs if it were not for the gift).

5a) The DAF is funded at the second spouse’s death and that money will then be used in the DAF for charitable purposes with the help and direction of Dr. Smith’s heirs.

Benefits of the above example:

Dr. Smith helped a charity by gifting it a $500,000 asset; Dr. Smith received an immediate deduction for his current income taxes; Dr. Smith’s heirs did not lose the asset due to the fact that a $500,000 life insurance policy in an ILIT was purchased with the income from the CGA; Dr. Smith removed a $500,000 asset from his estate for estate tax purposes; and at Dr. and Mrs. Smith’s death, the heirs became involved in the DAF that was funded with a life insurance policy that was purchased and owned by the charity.

Distinguishing CGAs from the Most Commonly Recommended Charitable Solution (the Family Foundation)

Family Foundations (herein after FF) for many “charitable experts” is the tool of choice for their high income/high net worth clients when it comes to charitable planning.

Why? The more you read this book the more you will be able to answer the questions we ask in the book. The reason is simple—the attorney setting up a family foundation will typically charge $10,000-$15,000. In contrast, a client would not have to even hire an independent attorney to use a CGA.

Why do clients like family foundations?
1) Control of the money gifted to the charity. While a client’s heirs can have significant input on how in a CGA is distributed (which is done through a DAF), a FF gives the family total (the ultimate) control over assets in the FF.

2) Ego. FFs seem to appeal to people who want their name on “foundations” to create not necessarily a charitable legacy but a family name legacy. Ninety-five percent of the clients looking for charitable planning can accomplish their charitable goals with a CGA and can do so in a more tax favorable manner (but then their family legacy would not live on in name).

3) Passing wealth to the children. Charities are not supposed to be set up to benefit the children financially, but instead they are supposed to be set up to benefit charities and people in need. One main sales pitch to clients when selling a FF is to tell the client that they can set up a FF, have the client’s children run the FF, and draw a nice salary. Also, and somewhat comical, is the sale’s point of having the FF board meeting (which is fully paid for by the FF) every year in a nice vacation spot like Hawaii.

We believe benefit 3) above is an abuse of FFs and the tax laws that make FFs.

The real difference between FF and a CGA?

The main difference in our minds between a FF and a CGA is cost. The setup costs of a CGA are ZERO and the setup costs of a FF are between $10,000-$15,000. More importantly, when a client contributes to a FF, there are additional limits on the deductions a client can take against his/her personal income. The limit differences on the income tax deduction a client can take between FF and a CGA are as follows:

<table>
<thead>
<tr>
<th>Income Tax Deduction for Donor</th>
<th>CGA</th>
<th>Family Foundation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Gift</td>
<td>50% of Adjusted Gross Income</td>
<td>30% of adjusted gross income</td>
</tr>
<tr>
<td>Property/Securities</td>
<td>30% of Adjusted Gross Income</td>
<td>20% of adjusted gross income</td>
</tr>
</tbody>
</table>

Conclusion

Charitable giving sounds simple—just give your property or money away, receive a deduction, and provide wealth replacement for the heirs via a death benefit and everyone is happy. The reality is that setting up a charitable giving program is similar to buying life insurance. If you use the wrong advisor, the chances are significant you will be setting up a plan that is in your advisor’s best interest instead doing what is best for you and the charity your are trying to benefit.

It is our opinion that, if you are looking for a simple way to fund your desire for charitable giving, you should consider a CGA. You can remove a low basis asset from your estate and pass an equal amount of wealth to your heirs, while at the same time...
funding a charity your heirs will be able to work with to help others who are less fortunate.

Section 7
Section 79 Plans

A Simple Plan to Take a Sizable Deduction for an Individually Owned Life Insurance Policy.

Section 79 Plans have been around for some time and are making a comeback as topics like 419 Plans have lost favor in the “deferred compensation” market. The plan as devised before the recent proposed 412(i) regulations was more tax favorable, but even now in its current form the plan has applicability for certain clients.

In the tax code

If you look in the tax code under Section 79, you will find the basic outline for Section 79 Plan benefits. The title of the section is Group Term Life Insurance. Traditional Section 79 Plans are sold often to companies as a way to provide additional employee benefits (in the form of fairly inexpensive group term life insurance benefits).

Over the years, like with many topics, promoters have figured out how to use the tax code to make it more beneficial than what it appears to be to the average person. That is really what has happened to the Section 79 Plan.

What are the benefits of a Section 79 Plan?

- Allows for a current tax deduction on contribution to the plan.
- Allows for tax deferred growth.
- It provides for a flexible, unlimited-funding window for key participants.
- Employee participation requires a minimal funding outlay.
- There are no minimum age requirements to withdraw income (no early withdrawal penalties).
- The plan provides a non-taxable, on-demand income stream.
- Transfer of assets at the participant’s death is income tax free to heirs.

How does it work?

Basically, a Section 79 Plan allows an employer to purchase life insurance on the employees (which include owners of the business) in a tax deductible manner. What typically ends up happening is that the employees will opt for $50,000 in term life insurance and the key employee(s) (the owners) will opt for a Universal Life Insurance Policy (UL). Life insurance premiums are paid as a corporate deduction; and if the life
policy is a universal life policy (UL), the employee with that type of policy will have to recapture as income some portion of the deductible premium made by the employer. The $50,000 term costs for the employees should range from $75 to $500 a year per employee, which is deductible to the corporation.

One main sales pitch of the Section 79 plan is that the UL policies purchased have cash value in them so that at the end of the day the key employee(s) will be able to take income tax free loans from their life policy as supplemental retirement income (or the policies can simply be used for estate planning purposes).

**Tax consequences**

The promoters of the Section 79 Plan used to state that the cash building UL policy purchased for the business owner was approximately 70% deductible over the five-year funding window. Now after the 412(i) regulations and passage of regulations on the proper way to value the fair market value of a life insurance policy, the premiums are typically 35-40% deductible (on life policies that have cash in them).

Again, the theory behind the plan is simple—buy inexpensive term insurance on the employee (which is deductible) and a cash-building policy for the key employee(s) or owner(s) which can be used for supplemental retirement income.

**Example**

Let’s use our typical Dr. Smith who in this example has four employees who must be covered under the Section 79 Plan. As stated above, the medical practice will purchase $50,000 of term life insurance on the employees. Dr. Smith is looking to create a supplemental retirement benefit using the plan, and so let’s budget $100,000 payment towards the plan every year for five years.

**Employee costs (annually for five years):**

<table>
<thead>
<tr>
<th>Employee</th>
<th>Death Benefit</th>
<th>Corp Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>EE#1</td>
<td>50,000</td>
<td>$81</td>
</tr>
<tr>
<td>EE#2</td>
<td>50,000</td>
<td>$102</td>
</tr>
<tr>
<td>EE#3</td>
<td>50,000</td>
<td>$115</td>
</tr>
<tr>
<td>EE#4</td>
<td>50,000</td>
<td>$177</td>
</tr>
</tbody>
</table>

Total per year: $475 (pre-tax or $285 per year after tax to Dr. Smith if he is in the 40% tax bracket)
Sample Contributions and Tax Free Distributions for Dr. Smith
Assuming 5 year Corporate Contribution of $100,000/year

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual Funding by Corporation</th>
<th>Additional W2 to Dr. Green 40% Bracket</th>
<th>Net Cost in 40% Bracket</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$100,000</td>
<td>$66,804</td>
<td>$26,722</td>
</tr>
<tr>
<td>2</td>
<td>100,000</td>
<td>67,124</td>
<td>26,850</td>
</tr>
<tr>
<td>3</td>
<td>100,000</td>
<td>67,544</td>
<td>27,018</td>
</tr>
<tr>
<td>4</td>
<td>100,000</td>
<td>68,074</td>
<td>27,230</td>
</tr>
<tr>
<td>5</td>
<td>100,000</td>
<td>68,694</td>
<td>27,478</td>
</tr>
</tbody>
</table>

Total Tax Paid by Dr. Smith $135,296

Income Tax-Free Retirement Distribution (Age 65-84)* $91,354

Total 20 Year Tax-Free Retirement Distributions $1,827,000

*Assumes crediting rate of 4.05% (from age 45 to age 51) 9% thereafter

In our Dr. Smith example above, Dr. Smith over a five-year period paid through the medical practice $250,000 in premiums into his UL policy. The cost of the policy each year was slightly under 35% deductible. Over the five-year period, the plan cost Dr. Smith $135,296 out of pocket for taxes paid on premiums that went into the life policy.

Then when Dr. Smith hits retirement age, he is able to borrow out of his life insurance policy $91,354 income tax free each year for 20 years.

**Who is a candidate for a Section 79 Plan?**

- A company with fewer than five owners and 40 employees. (If you have more than 40 employees (unless every owner wants to take part in the plan), the term costs of insurance for the staff make the concept much less viable).

- A client looking for a way to purchase life insurance in a partially deductible manner for an estate plan.

- A client looking for a plan that does not have upper-end funding limits. There is no maximum amount of money the key employee/owner can deduct from the company for the purchase of life insurance.
Caution

There are several Section 79 Plans in the marketplace that are much more tax favorable than the one described in this book. The authors have reviewed those plans and find them too aggressive from a tax standpoint and are not plans we can recommend.

If you are being pitched a Section 79 Plan, make sure you contact a competent attorney, CPA, or CWPP™ advisor who can competently review the plan and make sure it is in compliance with all applicable laws.

Conclusion about Section 79 Plans post-412(i) proposed regulations

While the proposed 412(i) regulations have reduced the financial viability of Section 79 Plans, we believe the plan is still a viable option for the right client to fund in a tax favorable manner a cash building UL policy which can be used for supplemental retirement benefits or for a client looking to tax deduct life insurance for estate planning purposes.

Section 8
Employee Stock Ownership Plans (ESOPs)

Introduction

Some small-to-medium size business owners have heard the term ESOP. Many clients think the term ESOP stands for Employee Stock Option Plan when the O in ESOP is really the term Ownership. An ESOP is a “qualified” benefit plan that is designed to transfer ownership in a company to the employees.

Few businesses that could take advantage of ESOPs know much about them; and even worse, most advisors (attorneys, accountants/CPAs, financial planners) know very little about the plan.

What is an ESOP?

An ESOP is a special kind of employee benefit plan (which is governed by ERISA) that enables employees to acquire beneficial ownership in their company (own stock) without having to invest their own money.

Several features make ESOPs unique as compared to other employee benefit plans.
First, only an ESOP is required by law to invest primarily in the securities (stock) of the sponsoring employer. This helps ensure that employees will have a significant ownership stake in the company where they work.

Second, ESOPs are unique among “qualified” employee benefit plans in their ability to borrow money. As a result, “leveraged ESOPs” can be used as a technique of corporate finance.

The most common application for an ESOP is to buy the shares of a departing owner of a closely held company. Therefore, even though an ESOP is an employee benefit plan, they are rarely implemented unless the main beneficiary is the key owner(s). Owners can defer tax on the gain they have made from the sale to an ESOP if the ESOP holds 30% or more of the company’s stock (and certain other requirements are met). Moreover, the purchase can be made in pretax corporate dollars.

**How do ESOPs Work?**

A company which wants to set up an ESOP creates a “trust” to which it makes annual contributions. These contributions are allocated to individual employee accounts within the trust. A number of different formulas may be used for allocation.

**Vesting**

The shares of company stock and other plan assets allocated to employees’ accounts must vest before employees are entitled to receive them. Vesting is a process whereby employees become entitled to an increasing percentage of their accounts over time. The least liberal vesting schedule allowed by law is 20% after three years, increasing by 20% per year until the employees are fully vested after seven years of service.

**Uses of ESOPs**

The two most common uses of ESOPs are to buy the stock of a retiring owner in a closely held company and as an extra employee benefit or incentive plan. These two uses probably account for over two-thirds of all the ESOPs now in existence. Since readers of this book are mainly interested in benefiting themselves, we will focus on the benefits to the owner, not the employees.

**Buying the Stock of a Retiring Owner**

Many closely held companies have no plans, or incomplete plans, for business continuity after the departure or retirement of the founder or major shareholder. If the company repurchases a retiring or departing owner’s shares, the proceeds will be taxed as capital gains. A sale to another company will also be taxed as capital gains, and finding a buyer is not always easy even for a profitable closely held company.
An ESOP can provide a ready made market for the equity of a retiring owner, or any interested major shareholder, of a closely held company, and provide a benefit and job security for employees in the process. Retiring owners of closely held companies that are C corporations incur no taxable gain on a sale of stock to an ESOP, provided that the plan owns at least 30% of the company immediately after the sale and that the sale’s proceeds are reinvested in “qualified” securities within a 15 month period beginning 3 months before the date of the sale. This tax-free rollover is the most tax favored way for an owner of a closely held company to sell his or her stock and, thus, encourages the owners of closely held companies to help create new owners through ESOPs.

Types of ESOPs (Leveraged and Non-Leveraged)

Non-Leveraged ESOPs

This first type of ESOP is one which does not involve borrowing any funds to acquire stock of the sponsoring employer. It is funded by contributions of cash or stock directly from the employer sponsor. Shares of stock contributed by the corporation are “newly issued shares.” New shares are issued to the ESOP and a deduction is taken by the corporation for their appraised fair market value as of the date of contribution. Alternatively, cash can be contributed to the plan in annual discretionary amounts as cash flow permits, to purchase shares at a later date, or simultaneously, from either the corporation or from another shareholder.

Generally, a non-leveraged ESOP is established to promote growth of the sponsoring company by creating tax deductions from the newly issued shares, thus improving cash flow and reducing taxes. The purpose of the ESOP can be to purchase shares from a shareholder on a cash flow basis where the tax incentives attributable to leveraged ESOPs are either not important, or do not require borrowing funds. Using a non-leveraged ESOP will avoid the impact of debt on the corporation’s value and balance sheet.
Steps:

1) Company makes a tax deductible contribution of cash or stock to the ESOP.

2) ESOP purchases stock from company or shareholders.

3) Company increases its cash flow and net worth or shareholder receives liquidity for company stock.

Example: If the company contributed new shares of stock to the ESOP to fund the ESOP, the company receives a “deduction” for the fair market value of the stock (which in a cash flow analysis did not cost the company anything to issue and contribute).

If we assume the stock in a typical contribution was valued at $50,000, the company would receive a deduction for the contribution of stock to the ESOP. The deduction will allow the company to pass through more money to the shareholders in the year of the contribution. Remember, the company’s cash flow was not lessened by the contribution of newly issued stock.

**Leveraged ESOPs**

In a leveraged ESOP, the ESOP or its corporate sponsor borrows money from a bank or other qualified lender. If the leveraging is being used to buy out the stock of a retiring owner, the ESOP will acquire those existing shares.

Two tax incentives make borrowing through an ESOP extremely attractive to companies that might otherwise never consider financing their employees’ acquisition of stock. **Since ESOP contributions are tax deductible, a corporation which repays an ESOP loan, in effect, gets to deduct principal as well as interest from taxes.** This can cut the cost of financing to the company significantly, by reducing the number of pre-tax dollars needed to repay the principal by as much as 34%, depending on the company’s tax bracket.
Example outlined above: The client is an owner of a closely held business with an interest (stock) in the company worth $10,000,000. The client has no ready market for the sale of his company, and he would also like to sell the stock with no current income tax or capital gains taxes. The best way to help this client is with the creation of an ESOP which will purchase the owner’s stock for a “fair market value.”

<table>
<thead>
<tr>
<th>Scenario A</th>
<th>Scenario B</th>
</tr>
</thead>
<tbody>
<tr>
<td>“On The Street”</td>
<td>ESOP Sale</td>
</tr>
<tr>
<td>Discounted Sale</td>
<td>Premium Sale</td>
</tr>
<tr>
<td>A. Selling Price</td>
<td>$8,000,000</td>
</tr>
<tr>
<td>Cost Basis</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>B. Capital Gain Tax</td>
<td>$1,859,200</td>
</tr>
<tr>
<td>C. Net Proceeds from Sale</td>
<td>$6,140,800</td>
</tr>
<tr>
<td>D. Company Loan Repayment Deductions</td>
<td>$0</td>
</tr>
</tbody>
</table>

Source: UBS Paine Webber, ESOP Transactions Report, Issue I, 4/16/01.
The above example illustrates how a company can have a fair market value of $10,000,000, but no viable buyer at hand. If a seller does not want to wait for a buyer or simply wants to transfer ownership in the company to the employees, he/she could choose to implement a leveraged ESOP (assuming the company meets the criteria to obtain the needed loan).

If the FMV is $10,000,000 and the seller would have to discount the sale price to $8,000,000 in order to sell quickly, the seller got an extra $2,000,000. In addition and, as with any ESOP transaction, the seller is able to use a Section 1042 rollover to defer the capital gains with the sale of the stock.

As you can see from the numbers above, a leveraged ESOP can be a very powerful tool to help clients sell their business and fund their retirement in a tax favored manner.

Leveraged ESOPs will not work for companies that cannot qualify for an ESOP loan due to lack of assets to pledge as collateral and/or a lack of cash flow to service the debt on the loan.

**Seller Financed ESOPs** (the most common ESOP for medium-to-small businesses)

If the corporation does not have the cash flow to fund the ESOP which, in turn, would buy the selling shareholder’s stock, where does the money come from? As you will read, the ESOP could borrow the money which would create a “leveraged” ESOP. Many small companies will not qualify for such a loan and those that can, may not want to for the typical reasons companies do not want to have sizable loans on the books.

A way for a company to create a non-leveraged ESOP without a loan from a traditional lending source is to have a seller financed ESOP. The seller of stock is typically the owner of the company. Instead of being paid with borrowed money (see leveraged ESOPs), the owner will take a note payable from the ESOP as payment for the purchased stock. See the following schematic.
Steps:

1) A Shareholder sells his/her stock to the ESOP in exchange for a note payable from the ESOP. The note has repayment terms as negotiated and will pay interest and principal to the Shareholder over a specified period of time.

2) The company makes tax-deductible contributions to the ESOP for up to 25% of the annual payroll.

3) Shareholder receives principal and interest payments from the ESOP tax-free.

4) Shareholder defers the tax due on the sale of stock by rolling the money into QRP (Qualified Replacement Property).

A seller-financed ESOP allows the company owner to collect the interest on a note payable from the ESOP and allows **much more flexibility should the company have problems funding the principal and interest payment** on the note to the ESOP every year.

**Tax Deferral Dilemma**

One problem that arises with a seller-financed ESOP is that the seller MUST invest the sale proceeds from the stock in qualified replacement property (QRP) within 12 months of the sale. If the installment note payable to the seller from the ESOP is due to pay over a several year period, the seller still must fund the QRP within 12 months for the entire proceeds of the sale. Few sellers have the liquidity to fund the QRP without actually receiving the funds from the sale of the stock; and so many times a seller-financed ESOP will still involve a loan from an outside lender and the use of “Floating Rate Notes” (FRNs).

Using FRNs in conjunction with QRP is discussed in an upcoming section specifically dealing with FRNs as an investment tool.

What is important to understand with a seller financed ESOP is that the structure is very user friendly for the company (because of a friendly lender) and that the client will be earning the interest on the loan (instead of a bank). Most importantly, if the client desires to roll the sale proceeds from the sale of stock into QRP, the client must use an outside lender (which usually involves the use of FRNs) and fund the QRP within 12 months of the sale of stock.

**Tax Advantages for Business Planning**

**ESOP “Section 1042” Rollover**

ESOPs allow a major shareholder of a closely held company to sell his stock in the company to the firm’s ESOP and **defer federal taxes on the gain** from the sale.
The ESOP rollover provides a substantial tax advantage that might otherwise be unavailable to a retiring owner. Normally, his options would be to sell his shares back to the company, if such a transaction is feasible, or to sell out to another company, either for cash or for a block of shares in the other company. Selling to an ESOP, on the other hand, allows a retiring shareholder to exchange his interest in the company for a safely diversified portfolio of securities—or the stock of a single new company—without paying any taxes on the transaction.

The seller’s tax basis in the employer stock which he sells will be carried over to the replacement property in which he invests the proceeds. If the replacement property is held until death, however, a stepped-up basis for those securities is provided.

To qualify for rollover treatment, the stock sold to the ESOP must be common or convertible preferred stock of a closely held domestic corporation and must have been owned by the seller for at least three years. Additionally, at this time, Section 1042 tax deferral is only available to selling owners in a C-Corporation, not an S-Corporation.

**Practical Planning: The Use of Floating Rate Notes (FRNs)**

We know the topic of ESOPs is not an easy one to learn. We believe this material does a good job of explaining the basics of real world ESOP planning in English so readers can determine if the concept makes sense to look at further.

The following material for how to use FRNs is really why many small business owners use ESOPs when selling their low basis interest in the company.

In the Leveraged ESOP example, the majority owner of the company sold $10,000,000 worth of his stock to the ESOP and rolled the entire $10,000,000 into “qualified replacement property” (QRP). By rolling the money into QRP, the seller had to pay NO capital gains on the proceeds from the sale; and the money is allowed to grow tax deferred for use at a future time.

The example is something that could happen in real life, but most clients who sell $10,000,000 in stock will want to use some of that money for multiple purposes. Without other planning, in order for a client to have access to the money, at the very least, the client will have to pay capital gains tax when accessing the money.

As stated earlier, the rollover money can be re-invested in U.S. securities; but most of the clients will not want to have limits on how they can re-invest the money and many will want to re-invest in something with principal protection (like an equity indexed annuity). “Floating Rate Notes” (FRNs) qualify QRP. What is a FRN? It is a bank or lender “note” similar to a home or business loan. The client through a QRP trust would invest in these FRNs, purchased in the open market as an investment.
FRNs can be used to balance risks incurred through other interest rate instruments in an investment portfolio.

**Creating a “margin” account**

Before continuing, a discussion/explanation of how clients use FRNs in conjunction with rollover money from an ESOP, it is important to understand what a **“margin” account** is and how it works. A margin account is typically created when a client has a stock portfolio and pledges that portfolio as collateral on a loan. The client receives cash from a lender, and the stock account is considered “margined” as collateral.

Margin loans can be called by the lender (a call is a demand for immediate payment of the note); so when using a margin loan in conjunction with an ESOP and QRP, it is important to find a margin loan with a long callable period, meaning the lender cannot call the loan for many years (sometimes up to 30 years).

With a typical ESOP transaction, the client will find a lender (which could be the same brokerage house that helped the client purchase the FRNs) who will lend directly sizable amounts of money to the client, and will create a “margin” account using the FRNs as collateral.

The main reason clients have the QRP trust purchase FRNs is to create a stable investment that will track interest rates charged on “margin” loans. The client is trying to create a situation where the return on the FRNs is greater than the interest charged on the margin loan. There are no taxes due inside the QRP trust, and the returns from the FRNs will be used to pay the interest on the margin account. See the following schematic for an illustration for how to incorporate FRNs and margins account money to benefit the client.

In the following schematic, assume **the client has already received $10,000,000 from the ESOP** for the sale of his company stock.
What was accomplished with this strategy?

- The client paid **NO capital gains** when he received $10,000,000 from the ESOP (due to the fact that the money was rolled into the QRP trust).

- Since the QRP trust margined the FRNs, the client received **$9,000,000 income and estate tax free to invest** or spend as the client sees fit.

- The $9,000,000 FRN investment creates an investment return that will move up and down with interest rates charged on the margin account. In doing so, the QRP should not be in a situation of dipping into principal to pay interest on the margin account.

**Example with numbers**

Suppose the owner of a company sells 30% of his ownership to an ESOP for $10 million. This transaction is tax-free because he invests the $10 million in a FRN, which bears interest at 7% per annum. The owner decides he needs money to invest short term, so he borrows $9 million against the security of the FRN. The loan can bear (for this example) a floating interest rate as high as 7.8%, and the owner will still have enough income on the FRN to cover the interest obligation. Since both the FRN and the loan are pegged to the same market index, the owner will always have enough income on the FRNs to cover the interest cost of the loan, whether market interest rates rise or fall. He or she is then free to spend or invest the $9 million in any way.

When the loan comes due, the owner can sell the FRN at face value and pay off the loan. The owner is subject to taxation only on the interest earned and can deduct from the taxable amount all the interest paid on the $9 million loan. Taxes must also be paid on any gains realized from the $9 million of short-term investments.

**Results**

The result of the rollover is that the seller can become completely liquid on the portion of the proceeds from the sale to an ESOP represented by the amount borrowed against the FRNs. Let's assume the advance rate is 90%. The balance, 10%, remains as a high-quality asset owned by the seller.

**Older Clients**

Because most ESOPs benefit older owners looking to sell their companies, the example above can be tweaked so that the “call” on the margin account will happen after the client dies. If the client dies prior to having a call on the margin account, the margin account would be paid off and the remaining assets in the QRP would pass to the heirs with a “stepped-up basis.” This creates a very beneficial situation for both the client and the heirs.
If the client uses some of the money from the margin loan to purchase life insurance in an irrevocable life insurance trust, the client can assure that the entire value in the QRP trust passes to the heirs (because the life insurance can pay for the taxes due on the QRP).

An ESOP with the use of QRP property, FRNs and a margin account is a very unique and powerful tool for a clients looking to sell an interest in their company(s).

**Conclusion on ESOPs**

As stated in the beginning of this section, ESOPs “experts” will state that the transaction is an easy one to understand. The previous material should have illustrated that ESOPs as a plan might be easy to understand (the sale of stock to a trust where the seller can use a Section 1042 rollover to avoid tax), but the specifics of the plan are quite complex.

As a succession planning tool for certain small business owners, an ESOP has advantages that no other plan can offer. Clients are allowed to sell their C-Corporation stock to an ESOP, tax defer all the proceeds with qualified replacement property, and, if the client dies before taking the money out of the QRP trust, the heirs will receive a “stepped up basis” on the stock.

Clients who can fully understand ESOPs, their benefits, and application to various business owners, will be far ahead of the game when it comes time to evaluating the best way to transition out of their business.

If you think you might be able to use an ESOP to sell your company, defer the taxes, and receive tax free money through the use of FRNs, please give one of the authors a call for help.

**Section 9**

**Deferred Compensation for Non-Profits**

While deferred compensation can be a narrow topic in any particular community, we’ve found that around the country there are a number of clients who work for non-profits; and as it just so happens to be, one of the best deferred compensation plans in the marketplace that no one knows about involves a non-profit.

**What clients should read this Section of the material?**

Very simply, if you work for a non-profit and would like to move approximately 85 cents on every dollar in an income tax free manner to a tax free retirement vehicle, then you should read this Section of the material.
As a general statement, non-profits are unique in that they can actually create their own deferred compensation plan without much trouble at all. Think about it—if you work for a non-profit and make $300,000 a year, you could simply change your contract to defer $25,000+ a year (or whatever the number may be) where the non-profit would take that deferred money and invest it on your behalf to be paid to you at a later date.

The non-profit does not pay corporate tax so the $25,000 in our example would be allowed to grow tax free until its ultimate payment to the key executive.

That sounds wonderful. Why don’t more non-profits have these simple deferred compensation plans for their key employees? The main reason is that the key executive does not want his/her deferred compensation to be at risk to the non-profit’s creditors. Understand that, when the non-profit holds back that deferred compensation and invests it, the deferred compensation is an asset of the non-profit and is subject to its creditors. So if an employee over time deferred $1,000,000 and the non-profit went under, the employee’s $1,000,000 would be gone forever.

The other main reason is because the key employee does not want the non-profit to manage the money (for obvious reasons).

**A “Great” Plan**

If the above is no good, what will be discussed below is one of the best deferred compensation plans in the industry (which is virtually unknown).

What if an employee of a non-profit could defer $100,000 a year where $85,000 would be invested into a vehicle where it would grow tax free and come out tax free in retirement? What if that same deferred compensation plan actually paid back to the non-profit at the key employee’s death every dollar the key employee deferred, plus investment growth on that money (basically a free endowment)? Would that be something of interest to the employee and the non-profit? We think it would.

**How does this plan work?**

1) The key employee needs to re-negotiate his/her employment contract to lower his/her pay so the non-profit can free up money for investing.

2) The non-profit will use the money that the employee would like to defer and will invest that money into a limited liability company and will become the non-managing preferred member.

3) The employee will also become a member in the LLC and will become the non-preferred managing member (which means the employee will make all the investment and business decisions of the LLC).
4) When money is contributed by the non-profit, that money is used to purchase two (2) different life insurance policies. One policy is used only to pay back to the non-profit its initial investment plus a simple return using the long term Applicable Federal Rate (AFR). The remaining money will be used to fund a “cash building” universal life insurance policy where the money will grow tax free in the policy and will come out tax free via policy loans when the key employee hits retirement age.

We understand this concept is new to all readers and a little complicated. The best way to understand this concept is to look at a schematic.

![Diagram of the concept]

Steps for the above schematic

1) Employer and Employee fund the LLC (ER at $100,000 and EE at $5,000)

2) LLC purchases two life insurance policies.
   a) The preferred policy is funded with $15,000 a year for seven years and is used to pay back the non-profit its $100,000 plus simple interest at the employee’s death.
   b) The investment policy is funded with $90,000 a year for seven years. The cash in the life policy will grow income tax free.
3) Since the employee is the managing member, he/she can decide to have the LLC borrow money from the life insurance policy whenever he/she decides. These loans are income tax free; and through a simply basis adjustment, that loan can be transferred to the key employee INCOME TAX FREE.

The employee would typically allow the money to grow in the life policy income tax free until retirement and then borrow out of the policy X amount of dollars income tax free retirement income for 10-20 years.

4) When the employee dies, the preferred life insurance policy will pay back to the non-profit its initial investment plus investment growth. From the non-profit’s standpoint, this is a free endowment since the employee reduced his/her salary to allow the non-profit to have the money to fund the investment.

Also upon the death of the key employee, the loans taken from the investment policy will be paid back from the death benefit of that policy.

What was accomplished using this unique partnership arrangement?

- The key employee had $85,000 (out of the $100,000) invested into a life policy where the money will grow tax free and come out tax free in retirement. The alternative to this would be for the employee to take home $60,000 after tax to invest in a tax hostile brokerage account. While there are expenses in an insurance policy, the client had an additional $25,000 being invested every year.

- The non-profit received a free endowment.

- The assets in the LLC were protected from creditors (through the charging order protection afforded to LLC, see page 64 to read more about charging orders).

Depending on the age and health of the employee, this investment structure should yield between 75-125% more retirement income to the key employee than taking the money home, paying tax on it, and investing it in a brokerage account. There is no better plan in the marketplace.

**Conclusion on Non-Profit Deferred Compensation**

As the number illustrate, this non-profit deferred compensation plan is tough to beat. The only problem with it is that it is limited to a non-profit. If you are not an employee of a non-profit, you cannot use this particular plan.

Only a handful of attorneys in the country know this structure. Having said that, if you would like more information on this plan, please feel free to contact the one of the authors.
Section 10
Long Term Care Insurance

Reduce Your Taxes Today AND Provide for Potential Long Term Care Costs Tomorrow

None of us likes paying any more in taxes than necessary. As tax advisors for high income clients, we are always exploring new ways for you to reduce your income and estate taxes. The key to successful tax planning is finding the section of the Internal Revenue Code that offers you the largest deductions and provides you and your family the greatest benefits. The purpose of this section of the material is to introduce you to a way to reduce your income taxes today and enhance your retirement and estate plans along the way. The solution we will be discussing is the “Free Long Term Care Plan.”

What is Long Term Care Insurance and why do I need it?

Long Term Care Insurance (LTCI) covers health insurance costs for those people who cannot take care of themselves. These costs may include nursing-home care, in-home care, and other expenses. In some areas of the country, the cost of nursing-home care, or quality around-the-clock, in-home care may be $250 per day ($91,250 per year). Additionally, the U.S. Health Care Administration reports that costs are increasing 5.8% per year and are expected to more than triple in the next 20 years.

With the public’s increased life expectancy due to advancements in medicine, there is a greater chance that each person may suffer a debilitating illness that may require significant Long Term Care. With the trends of increasing life expectancies and increasing costs to medical expenses, the cost of Long Term Care can easily wipe out retirement savings and eliminate any inheritance you would have otherwise left your children or grandchildren.

Won’t the Government cover these Long Term Care costs?

No. Not the way you would like them to. Did you know that in California an individual does not qualify for LTC coverage until his/her available resources are worth LESS THAN $2,500? In addition, once that individual begins receiving LTC benefits, the state takes all but $30/week of income from the patient. In a nutshell, you will have to spend every last dollar of your savings before you get any help. Though you may have more than enough saved to pay for these types of expenses, your potential health problem could wipe out your entire inheritance, which you hoped would go to your children or grandchildren.
Incidentally, we see many clients buying LTCI on their parents because they know they will have to take care of them if the need arises. It can be a major financial and emotional problem to be getting ready to retire and have one of your parents or in-laws get sick and need $50,000-$100,000 per year of medical expenses. Even though this is usually done with after-tax dollars, it is a very wise wealth preservation strategy.

**I do not think I will need it**

Most individuals often do not want to bear the risk of self-insuring their Long Term Care costs. So why haven’t more clients purchased LTCI? In a word—Education. We see clients insure their lives, homes, cars, and income but not an event (disability) that has the second highest probability of occurring in one’s lifetime (second only to death). Why? Part of it is the “it is not going to happen to me” mentality and part of it is the thought of having to pay LTCI premiums for the next 20-40 years with only a chance that you will ever use the insurance.

*Would you consider paying for your LTCI if you could do so in a tax deductible manner and do so in a finite period like five or ten years?*  
*Would you consider paying for LTCI if you knew that your heirs would receive every dollar of that premium at a later date Income Tax Free?*

**The IRS Gave You a Break**

What the federal government did with regard to a business being able to deduct the premiums for LTCI was significant. Under HIPAA (Health Insurance Portability and Accountability Act of 1996), LTCI premiums are treated like health insurance premiums for the self-employed. That means an owner of a C-Corporation, S-Corporation, P.C., or LLC can now take a tax deduction for 100% of the LTCI (the deduction is limited for owner/employees in non-C-Corps).

There is no good reason for any client to pay for his/her LTCI on an after-tax basis with the changes in the LTCI laws. If you are paying for LTCI with after-tax dollars, you are paying twice as much as you have to for your LTCI.

*Would you purchase Long Term Care Insurance if it were FREE?*

If set up correctly, LTCI can literally be free to the client. How? With a return of premium rider. An example is the best way to illustrate the point.
**Problem:**

Doctor Smith, age 55, has an estate of $2,000,000 and an income of $400,000 a year. Dr. Smith is worried about possibly paying over $100,000 over his lifetime for LTC coverage for him and his wife. Dr. Smith also does not like buying insurance and does not want to pay LTCI for the next 30 years while he waits to become sick. Dr. Smith’s solution to his problem is through a (1) limited pay LTCI policy paid for through his medical office on a (2) tax deductible manner with a (3) return of premium rider.

**Solution:**

1) Client’s corporation pays a deductible premium of $8,985 a year for ten years (out-of-pocket cost for the physician: $5,391 a year);

2) Dr. Smith gets disabled at age 75 and needs home health care ($200 a day) until death at age 85. (Total LTC benefit for ten years = $730,000).

3) Dr. Smith dies at age 85 and his heirs receive the entire premium paid because of the return of premium rider. This amount = $89,850 which will pass income tax free to the heirs.*

*Some companies have a setoff on the return of premium rider for benefits paid.

**Bottom line**

The LTCI cost Dr. Smith $53,910 out of pocket over the ten-year pay period. His heirs receive $89,850 in cash (income tax free) from the LTCI company because of the return of premium rider, and his estate did not have to pay for the $730,000 in LTC costs incurred from age 75-85. Total Cost = $89,850; total Benefit $819,850.

By purchasing LTCI through the corporation with pre-tax dollars, Dr. Smith was able to protect his estate from LTC costs and was also able to return the entire premium to his heirs income tax free at death.

In this example (assuming that Dr. Smith’s estate was worth $4,000,000 prior to needing LTC), Dr. Smith’s estate would have been depleted by 25% without LTCI in place to protect the estate. Those clients, who are serious about asset protection and would rather leave assets to their children than to the IRS, should look closely at this option as a way to shield family assets from the devastating effects of LTC costs.

**Features of a good Long Term Care Policy**

The most important feature of a good LTCI policy is a financially sound insurance carrier. Do not consider purchasing the cheapest LTCI policy that you can find. LTCI carriers must have the financial strength to sustain their claims’ paying ability.
well into the future when the millions of baby boomers will begin needing LTCI benefits. In a nutshell, do not be pennywise and pound-foolish!

**Getting around the gifting rules**

Many clients over the age of 60 with sizable estates are told by their estate planning attorneys to start gifting money to an irrevocable trust in order to lessen the size of their estate (which is done to lessen the estate taxes due at death).

The problem with an aggressive gift program is that there is only an $11,000 per spouse per child gifting limit in 2007. So, if you have one child, between you and your spouse, you could only gift $22,000 a year to an irrevocable trust. That is peanuts for a large estate (especially a liquid estate when the stock market is on the rise).

If you are still working and if gifting makes sense to lower your estate taxes, then you can accomplish the same goal and better by purchasing LTCI through the corporation as a 100% tax deductible expense with the return of premium rider. Why? Because if you bought a very expensive LTCI policy (say a ten pay) you might have a premium of $50,000 a year. That premium (that was paid as a deductible expense) would be returned to your children income tax free at death.

**Summary:**

*Asset protection and wealth transfer all done in a tax deductible manner*

A tremendous opportunity exists to fund a LTCI policy through a business to protect a client’s wealth and to transfer money out of the business in a tax deductible manner. The provisions that allow owners of small companies to tax deduct the premiums for LTCI provide a vehicle for funding a huge future potential liability with present tax deductible dollars. If you are serious about having a complete estate plan that protects your heirs, LTCI should be one of your planning tools.
Section 11
Voluntary Employee Benefit Plans (VEBAs); Welfare Benefit Plans (419A(f)6 and A(f)5 Plans)

Introduction

How would you like to implement a benefit plan that allows for large corporate deductions?

How would you like a benefit plan where the benefits from the plan can come out totally tax free and potentially estate tax free?

How would you like a benefit plan that can be funded variably each year?

How would you like to be able to receive a 100% deduction for the payment of life insurance premiums?

How would you like your benefits from a plan to be 100% asset protected from creditors?

If all of the above sound beneficial then you might be a candidate to implement a VEBA or Welfare Benefit Plan (WBP).

How a WBP or VEBA works

In a nutshell, a company sets up a VEBA and on an annual basis makes tax deductible deposits payable to a trust (the trust is set up as a single employer trust and is administered by a 3rd party administrator). The trust invests the deposits with investment grade insurance companies (the trust buys life insurance). The money grows in the life insurance policies tax deferred until benefits are needed. When employees die, a death benefit is paid income and estate tax free from the VEBA trust. If other living benefits are needed (medical), they are paid to the employee (or retired employee) income tax free.

Cash value life insurance policies are typically used as the main investment in a VEBA because they provide a death benefit (that will pass income and estate tax free to the beneficiary(s)) and because the cash can be used for “other living benefits.” Other living benefits are typically post-retirement medical benefits.

It is basically a fact that everyone at some point in retirement is going to have medical expenses that are NOT covered by insurance. Clients typically pay for the medical benefits (drug costs, surgeries, doctor visits, etc.) with after-tax dollars (which is
very painful). With a VEBA, the small business owner can fund NOW in a deductible manner a plan where the benefit in retirement will be sizable and will be an income tax free benefit. Any dollar that comes from a VEBA for a qualified expense does so income tax free to the beneficiary.

Termination

A VEBA is NOT a retirement plan. VEBAs should not be set up to terminate. Having said that, if a company chooses to terminate the plan, the life insurance policies owned by the trust will be distributed to the employees. If there is any cash in a life insurance policy when distributed to an employee, the employee will have to pay income taxes on that cash value (fair market value).

New regulations

Welfare Benefit Plans under 419A(f)6 and Union plans formed under 419A(f)5 (where your company must unionize in order to use the plan) have been under close scrutiny from the IRS for years. “Abusive” promoters of the plan forced the IRS and Congress to act to curb the abuses by implementing new regulations covering the plans back in 2003.

Even with the accepted and conservative “single employer” 419e plans, there are abuses; and so it is imperative for clients to work with a consultant they know and trust when implementing such a plan.

Should you be using traditional VEBAs?

The simple answer in our opinion is yes, if:
- You would like to pay for your life insurance in a 100% tax deductible manner*;

- You would like to fund today in a tax deductible manner for future health insurance expenses where the benefit can come out of the trust income tax free;

- You would like to have your life insurance death benefit pass to the heirs income and estate tax free; and

- if you would like to have a benefit plan where the assets are protected from creditors.

A VEBA is not a good fit for you if you are looking for a supplemental retirement plan or if you have more than five-seven employees per owner (the costs will probably be prohibitive since term life insurance is purchased for the employees).

*Clients must recapture the “costs of insurance” each year as taxable income.

**WBPs to stay away from**

Other WBPs to watch out for are ones that tell you the money coming out of the WBP can do so “income tax free.” In our opinion, there is no way to get money out of a WBP income tax free unless you die or unless the money comes out for living benefits (medical). Also, stay away from plans where the policy is owned individually by the employees instead of the Trust.

If this is a topic that interests you, please give one of the authors a call to discuss.

**Summary and Thoughts on Income Tax Reduction**

We did not have space in this book to put in some of the more outlandish topics that, in our opinion, are straight out illegal tax avoidance plans. However, chances are good that in the next several years you will run into a plan that is not above board.

We would like to end this section of the book with a few comments we hope readers will take to heart when reviewing “income tax reduction” plans.

1) Always have an independent advisor look a plan over before moving forward. Your local advisor many times will not be qualified or have time to review a complicated tax transaction; and, if that is the case, find another unbiased advisor (even if you do not know them) to help review any income tax reduction plan. As CWPP™ advisors, we have had special training in the area of income tax reduction topics and are obviously familiar with the many topics covered in this book.
2) Make sure someone or an entity pays tax on the money you are deducting into an income tax reduction plan. If you are saying to yourself, isn’t the point of an income tax reduction plan to avoid paying tax, the answer is NO. Tax avoidance is illegal. With all of the tax topics discussed in a favorable light in this book, someone or entity pays personal or corporate tax on the money at some point. Sometimes there is a deferral or sometimes a corporation instead of the client pays the tax, but, ultimately, someone or entity will pay tax.

3) If you do not feel comfortable even after your advisors say a plan is technically sound, do not do it. It is better to sleep soundly at night than worry about whether the IRS is going to come get you (whether the fear is rightly founded or not).

4) If you get pitched an income tax reduction plan and cannot find anyone you know to review the plan, please give one of the authors a call. We would be happy to give you our opinion. Also, if you would like more information on any of the topics covered in this section of the book, please feel free to contact us as well.

5) Finally, when trying to reach Critical Capital Mass, a properly and conservatively planned “income tax reduction” plan can help you attain CCM years earlier than conventional post-tax investing.
Chapter Four
Personal Finances

Introduction

Personal finances are just that—personal. Some clients like to have their money actively traded (day traded) in hopes of getting 20+ percent returns in the market. Others like to invest fairly conservatively in order to protect their principal, understanding that with conservative investments 10+ percent returns annually probably are not going to materialize. Others do not have money to invest because they spend every penny they make.

This section of the material is not going to give you stock tips for where to invest your money. Instead, we are going to detail places you can invest your money outside of stocks and the pros and cons to those options. Life insurance is often used as an investment; however, we chose to discuss life insurance in the estate planning section of this material starting on page 116).

Section 1
Section 529 Plans

The Sensible Way to Save for College Education

Because readers of this book are typically in a group of high-income parents, they have created a two-fold problem when it comes to paying for their children’s education. First, because they are “high income,” their children believe by right that their parents must pay for college. Second, because high-income parents are in the highest income tax bracket, it costs an extra 40% or more to pay for college due to that bracket.

Are you looking for a way to save for your child’s or grandchild’s college education (tuition, books, and room and board)?

Do you like the idea of money growing INCOME TAX FREE?

Are you looking for a college savings plan that allows investments far beyond the $500 educational IRA?

Would you be interested in reducing your taxable estate without paying a gift tax and without giving up control of the money?
We created this section of the material to introduce you to the Section 529 Plan. These plans have been around for some time. You probably have heard of the original plan that allows you to put money into an account with the state for use at a later time IF your child goes to a school in the state where the money was contributed. Further, that school must be a state-run school, not a private school.

The new Section 529 Plans have been tweaked by Congress to allow you to contribute to a 529 Plan, have the money grow, and taken out income tax free as long as, when the money is taken out, it is used for college tuition, room and board, books, etc. Unlike the old plans, the money in a 529 Plan can be used to pay for ANY two-four year school that qualifies anywhere in the country (private or public).

With the average cost of a four-year education costing $47,000 for a public school and over $100,000 for a private college, it is no wonder parents are having trouble sleeping at night. Factor in inflation, and the numbers jump to $115,000 and $250,000 respectively in 20 years. That means the cost to a physician in the 40% tax bracket in 20 years will be $190,000 pre-tax to pay for a $115,000 four-year education and over $400,000 pre-tax to pay for a $250,000 four-year education. We all hope the cost of education does not go that high, but we use the 20-year projections to illustrate why you need to deal with the topic today.

What can be done? As we have stated above, the new Section 529 Plans are really the only viable option we know where a parent or grandparent can immediately put a significant amount of money away tax deferred every year to protect against the problem. If you have friends who are trying to put two children through college, ask them if they would have contributed 10-15 years earlier if there was an opportunity to do so into an income tax free vehicle where the money could come out and the gains would NOT be taxed.

We all can do compound math, but we think an example will be helpful.

If you had put $10,000 away into a Section 529 Plan starting in 2007 for five years and that money grew at an assumed 8% until 2021, you would have approximately $136,000 of which $86,736 would be growth. Normally, the growth would be taxed. With the new 529 Plans, the growth is not taxed, thereby freeing up an extra $34,694 if you were to take the money out in one lump sum at a parent/physician’s tax bracket of 40%. The five-year example would allow your child to take out $35,000 a year income tax free for four years and $19,905 income tax free in the fifth year to pay for tuition, books, and room and board. (Remember the money left in the 529 Plan continues to grow at 8% while in the plan).

Contrast this with the fact that you will have to find $58,333 a year pre-tax for four years and $33,175 in the fifth year pre-tax to provide the same value.
In a nutshell

You can contribute $10,000 post-tax a year for five years ($50,000) now while you are making a good income; or you can find approximately $58,333 pre-tax a year for four years and $33,175 for the 5th year (totaling $266,507) starting in year 2021 when we have no idea what you will be making in this ever uncertain world.

Our advice is simple—you must take advantage of the new Section 529 Plans if you are going to fund your child’s education.

Side note for grandparents

If you are a grandparent and you are trying to figure out a way to shrink your estate via aggressive gifting, charitable giving, or trusts in general, you should consider funding a Section 529 Plan for your grandchildren. It is a terrific way to immediately transfer wealth out of your estate while at the same time still having access to the money (with a 10% penalty if the money is not used for education). A Section 529 Plan can provide a life-long benefit to your grandchildren.

Asset protection

We have talked with several different companies that offer 529 Plans, and we cannot find one that will go on the record and state that money in a 529 Plan is asset protected. There are some states that have language in their 529 statutes that try to make their 529 Plans protected from creditors, but no one knows for sure if that will work. Our official position is that a 529 Plan is not asset protected; and we suggest that, if you are worried about asset protecting a 529 Plan, you use a state that has language attempting to asset protect their 529 Plan even though we are not certain if the language will hold up in a court of law.

Section 2
Life Insurance

Life insurance can sometimes work out as a nice POST-TAX investment (especially if you use Equity Harvesting (see page 249 of this section of the book for an explanation about Equity Harvesting).

Also, if there is a way to fund a life insurance policy in a tax favorable manner (like through a Section 79 plan or VEBA), we’d recommend looking into that first. To read more about the different types of life insurance, please turn to page 116.
Section 3
Annuities

As most people are aware, annuities are investments that are typically funded post-tax that are allowed to grow tax deferred. Below, we will explain the three most common types of annuities and give you our opinion of who is a candidate for each type of annuity.

There are two main reasons annuity companies continue to sell billions in annuities every year.

1) **Stock market slumps.**

When the stock market is down, annuity sales go up; and when the stock market is up, annuity sales go down. The reason is fairly simple—when the market is doing well, investors do not think they need the security of the annuity to guarantee their principal investment or the need to find a guaranteed return product. When the market is doing poorly, everyone jumps to some sort of guaranteed annuity to protect their principal investment while hoping to get a modest return.

2) **Older investors.**

With investors who are getting near retirement, many choose to put money in annuities with some guarantee to protect against not having enough money in retirement to live on. It is one thing for a young investor to choose an annuity to protect a long-term investment; but it is quite another for an older investor who, if he/she has a significant drop in wealth and/or dramatic lifestyle changes (not in a good manner), might not be able to retire as he/she planned due to a lack of funds.

If an older investor plans on retiring in two years (assuming a normal period of stock market growth of 8% over a period of years preceding retirement), he/she will be counting on some rate of return on his/her assets to live on when in retirement. If the stock market goes down significantly (like it did from years 1999-2002 +) and the wealth of a client (who is in the stock market) is not principal protected, the client might not be able to retire in the year planned; or, if in retirement, the client might have to cut back significantly on his/her lifestyle due to financial constraints or, even worse, might have to go back to work. This is the reason that many clients should consider buying annuities in their 401k/profit sharing plans and/or IRAs.

There are millions of Americans wishing they had put their money into guaranteed annuities prior to the crash of the stock market (specifically the NASDAQ) in 2000. If protecting your income stream in retirement is important to you, then you should consider one of the annuities discussed in the upcoming material.
Fixed Annuity

Fixed annuities are something that usually gets incorporated into a wealthy client’s estate plan later on in life. The scenario plays out over and over with high-end clients in or nearing retirement. Client, Dr. Smith, is 65 years old and has $1,000,000 in a brokerage account. Dr. Smith is afraid that the market might tank like it did in 2000; and if his brokerage account is not protected, he will not have enough money in retirement to live on. What does Dr. Smith do? He buys a guaranteed fixed annuity to protect his principal investment and orders the annuity to pay out for some specified period of time a guaranteed income.

How does a fixed annuity work?

Very simply—an investor pays to an annuity company (typically an insurance company) a sum of money. In return, the client will receive a guaranteed investment return for the life of the annuity (which also is accompanied by a guaranteed payout on a monthly or quarterly basis to the client). Money in the annuity is allowed to accumulate tax free. Tax free accumulation is not a huge issue for retirees with modest annuity balances who are looking to drain their annuities to zero in retirement with a fixed payout period.

Investment returns

The annuity company typically invests the money in a fixed annuity fairly conservatively. Many times, the investment returns mirror interest rates or are invested in conservative bonds. Overall, you will typically get the lowest rate of return (after all fees) with a fixed annuity due to the trade off of a guaranteed annuity payment.

What types of payouts are available?

Period certain – Clients can purchase a fixed annuity that pays them over a period certain such as 10, 15, or 20 years. Depending on your goals, a fixed payout period might be just what you are looking for. The annuity company when entering into the contract with you will promise to pay X amount for 10, 15, or 20 years (or whatever the negotiated term is). The client can budget for that money no matter what happens to the stock market.

When the payment period is over, there is no more money due to the client.
What if the client dies? It depends. Some period certain annuities will continue to pay the monthly or quarterly benefit to the beneficiary of the contract. Some period certain annuities will immediately pay the balance to the beneficiary while others will continue to pay a monthly benefit for that initially designated period. With the lump-sum payout to the beneficiaries at the annuitant’s death, the monthly or quarterly annuity payment while living will be less.

Drawbacks

Surrender charges – If you ever need the money from your fixed annuity in a lump sum for whatever reason, you can bank on the fact that there will be surrender charges in the first three to ten years of the annuity. If you have a fixed annuity and wonder what your surrender charges are and when and if they expire, simply call your annuity provider and they can get you that information.

Fees – As with any annuity, fees will eat up a portion of the money going into the annuity. The annuity company has to make money, and the agent who sold you the annuity is also getting paid a nice commission.

Low rates – One major drawback of a fixed annuity is the fact that you might get stuck with low rates of return. In 2004, interest rates were almost at historic lows. Low interest rates are great for home and business loans; but the return rates on fixed annuities seem to follow those interest rates, and yields from fixed annuities in 2004 were pathetically low. Once you get into a fixed annuity, you are stuck there for at least as long as you want to avoid the surrender charge for giving up the annuity or 1035 exchanging the annuity. If yield rates go up 5% for new fixed annuities in the year following your purchase of a fixed annuity, you will basically be forced to wait until your surrender charges evaporate to move your money to a different fixed annuity.

Variable Annuity

Billions of dollars each year are invested each year into variable annuities.

Characteristics

A variable annuity is simply a wrapper around an investment that allows it to grow tax deferred (although the initial investment is post-tax). The thrill for the client seems to be tax free growth; but when you look at a variable annuity closely, are you really getting what you are after? It depends.
No guarantees

For 95% of the variable annuities sold (unless you annuitize the variable annuity), you have no investment guarantees. If the stock market goes in the tank, so does your variable annuity. (This is starting to change as clients demand principal protection).

Annuitizing your variable annuity simply means that you no longer have the option of surrendering the annuity and getting your money back from the annuity company in a lump sum or 1035 exchanging the annuity to another company. Basically, when you annuitize a variable annuity, the insurance company then assumes all risks of investing your money and then promises to pay you an annuity benefit for a period certain or for your lifetime.

Different insurance companies do have guaranteed living benefits as well as death benefits. Depending on your objective, the need for either of these benefits may not be applicable. Getting the correct advice on variable annuities is very important (and hard to find) when analyzing a contract and its benefits.

Living and death benefit of variable annuities

Guaranteed living benefits can range from 5% to 8% of the original investment compounded annually. However, to take advantage of this particular benefit, you must annuitize the contract. That could be good or bad, depending on your situation. (In order to receive this guarantee with a variable annuity, you have to attach a “rider” to the contract, which does cost you additional fees each year).

Your goal should be to annuitize a contract as your last resort. Because, in most situations, once you annuitize a contract, you lose control over your money and the insurance company takes over the management of your money and promises to pay you a certain amount, usually monthly, for the rest of your life or for a period certain.

There are strategies on how to maximize the annuity payment; but, unfortunately, those strategies are too lengthy to be discussed in this book.

Your age and your objectives both play an important role on whether a variable annuity is appropriate for you. If you know 100% that you will be annuitizing the variable annuity at some point, then a variable annuity does not have that big of a downside. If, however, you would like to get your money back from the annuity company (and the growth on the annuity) at a later date or if you think you might 1035 exchange your annuity to another company, a variable annuity will provide no investment guarantee.
Other variable annuity riders

Besides the guaranteed investment rider, another available rider in some contracts allows you to look back over the life of the contract and take the highest anniversary account balance and **annuitize** that figure. Let’s say you invested $100,000 in 1995; and during the course of your contact, your account balance on an anniversary date was as high as $300,000 in 2010 and, subsequently, later dropped down to $90,000 in 2012. With this particular rider, you are allowed to look back and annuitize your account balance at the highest watermark, which was, in this situation, $300,000. **Fees are high**, but guarantees have costs associated with protecting an income stream for retirement.

Typically, people put their money into annuity contracts when the market is down, which, in our view, is a good idea. Why? Because you know you placed your money in the market at the best possible time—when it is down. This gives you the best chance of taking advantage of future upside swings in the market when it turns around. However, nobody has a crystal ball and knows when the market will change. Market timing is a loser's game, but that is another story.

Tax Advantages

Everyone thinks a variable annuity is some wonderful tax haven for money. In fact, you can pay more taxes on money coming out of an annuity than with traditional post-tax investing in a brokerage account. Assuming you had your brokerage account in an investment that did not create income (dividends) each year, the tax you would pay on stock when sold is the long-term capital gains rate of 15-20% (depending on your state).

In a variable annuity, you get a blended tax rate where all of the gains that come out of the annuity (above basis) are treated as ordinary income (and, therefore, taxed at your income tax at the time of distribution from the variable annuity). Many salesperson sell products and investments based on the fact that clients will be in a lower tax bracket when they retire. We believe most of our clients will never be in a lower tax bracket; and, therefore, when money comes out of the variable annuity, the client will pay income tax on the gains (a good thumbnail to use is 40%).

While investors can set up a brokerage account that has minimal taxes on the investment, most people instead have an active brokerage account that involves dividends and creates short-term capital gains (which are taxed as ordinary income). So, if we considered a blended rate of 31.25%, then the breakeven point would be at 14 years at 8% and 10 years at 12%. The longer the time horizon the better off you are putting your money into annuities. By breakeven, we mean that, until you reach the breakeven point, you would be better off not using an annuity from a tax standpoint; and after the breakeven point, an annuity will progressively work better than post-tax investing.
 Fees

Fees are another reason we are not a huge fan of variable annuities (unless the investment returns are high (which can not be guaranteed). The fees in a variable annuity if you are not getting a real tax advantage are wasteful. This would depend on your age and the number of years you wait before taking money out of your annuity.

With a fixed annuity, we mentally feel more comfortable with it since you have a guaranteed rate of return; and with an indexed annuity, the fees are lower due to the fact that the money is not invested in mutual funds (with separate loads) but instead peg an index which with some companies does not add any extra expense load to the annuity.

Beating the indexes

One final thought on the investment returns of variable annuities. Most variable products over the long run do not outperform the index funds (like the S&P 500 index). While everything has took a beating in the market (2000-2002), when comparing index funds to variable annuities, you will find that the majority of the time the indexes did better; and if you invested in an indexed annuity, your expenses in the annuity would have been less. Since it is not sexy to use index funds, many clients like their money in variable annuities; but for our money, we prefer to peg growth to the indexes and, when possible, use an annuity with a principal guarantee which you can get with an indexed annuity (see the next section of the book on the “New” annuity).

Conclusion

Variable annuities can work IF the stock market does not tank before you need to access your money and IF you are in a lower tax bracket after you retire. Variable annuities with the guarantee rider can also work for you if you know for a fact when you put your money into the annuity that you will at some point annuitize the contract (although some of the newer products are starting to allow the client to walk away without annuitizing). We are not writing this section of the book to bash annuities, which have a big role in estate planning. The key is using an advisor who knows all the different types of annuities and can put a plan together for you that is the most flexible and one that can maximize your investment returns.
Guaranteed Fixed/Equity Indexed Annuities (EIAs)

Why the “New” Annuities can save you Money vs. Traditional CDs, Savings Accounts, and Rollover IRAs

Explaining the Simple but Confusing EIA

After the stock market “crash” of 2000-2002 where many segments of the market went down over 50% (and the S&P 500 went down 43.88%), clients started realizing that the stock market really doesn’t return 10%+ every year. Millions of people lost billions of dollars in the market over that three-year stretch, and now those same clients are looking for alternative investments with principal protection.

The “new annuity” (hereinafter EIAs) are a nice but confusing option for the client to protect their investment dollars while still trying to participate in market growth.

What is the Number One principal protected investment used by clients? Certificates of Deposit (CDs). Why? CDs are simple—there is a guaranteed return on the investment, and the investment can be changed at the end of a term of months or years.

As most clients have figured out in, CD rates typically underperform the equity markets (as does any “fixed” return investment vehicle). Clients balk at the low return rates (especially when they know they have to pay income tax on the return on an annual basis) and would like to have something better.

What is better than fixed return vehicles? The quick and easy answer is anything that starts with the word “variable.” The only problem is that most variable investments (mutual funds being the most prevalent) have no principal guarantees.

What about EIAs?

EIAs are a bit of a hybrid between a variable investment tool with no guarantee and a fixed investment vehicle with a principal guarantee (and no upside growth potential). EIAs do not subject a client’s money to the risks of the market but still give a client the potential to benefit from upswings in the market.

In an EIA, the upswing in the market is typically capped at a certain number (9% a year as an example); and EIAs typically peg their growth to an index (such as the S&P 500). As will be explained below, the real question is how to determine which EIA to use.
The following is an example of what would have happened to money in a 9% annual cap (point to point) EIA with principal protection and growth pegged to the S&P 500 from 1992-2002 and a comparison to what the client would have had in a typical brokerage account with the same returns. We are assuming the money in the brokerage account had the typical capital gains and dividend taxes levied on the account every year as well as a 1% management fee.

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<tr>
<th>Investment Period</th>
<th>Balance at the end of 2002</th>
<th>Balance After Tax in lump sum (40% tax bracket)</th>
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<tr>
<td>Brokerage Account</td>
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<tr>
<td>$100,000 10 years</td>
<td>$123,750</td>
<td>$123,750</td>
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<tr>
<td>EIA with 9% Cap</td>
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<tr>
<td>$100,000 10 years</td>
<td>$172,000</td>
<td>$143,200</td>
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</table>

In the above example, the client not only received principal protection but actually ended up doing better than what he/she would have earned in a brokerage account even though the EIA had a 9% annual cap on earnings.

If you are saying to yourself the above example is misleading because every ten years the stock market is not going to have a “crash” like what happened in 2000-2002, we would agree with you. But as every advisor knows, no one can tell the future.

If we use the same ten-year time frame and instead use 1989-1999, the numbers would be as follows:

<table>
<thead>
<tr>
<th>Investment Period</th>
<th>Balance at the end of 1999</th>
<th>Balance After Tax in lump sum (40% tax bracket)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brokerage Account</td>
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<td></td>
</tr>
<tr>
<td>$100,000 10 years</td>
<td>$240,000</td>
<td>$240,000</td>
</tr>
<tr>
<td>EIA with 9% Cap</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$100,000 10 years</td>
<td>$204,500</td>
<td>$162,700</td>
</tr>
</tbody>
</table>

Investing in an “up” market in stocks/mutual funds is always going to be better for clients than investing in an EIA with a cap. However, for many clients, trying to get the best of both worlds (principal protection and upside growth) will be appealing for some, if not a great percentage, of their portfolios.
The different types of Indexed Annuities

Wading through the different types of EIA is very difficult. Almost every major insurance company has an EIA, and each one of their products seems to be different. EIAs and their caps vary depending on what type of valuation method is used. Most caps are offered with the option of “point-to-point” or “month-to-month” valuation.

Definitions

**Point-to-point** valuation simply means the annual crediting value will be locked in 12 months after the annuity is funded. For example, if an annuity was funded with $10,000, and on the 365th day the S&P was up 7%, the client would be credited with 7% growth. If the day before or the day after the anniversary date, the S&P was down to 5% growth, that number is immaterial when determining the amount credited for that particular year.

**Month-to-month** valuation simply takes the monthly return of the market and then averages that return for the year to come up with the final crediting number. Monthly valuation almost always returns to the client less than point to point valuation and, therefore, most insurance companies have higher annual caps with the month-to-month valued EIA (because their exposure is less).

Monthly cap annuities are very new to the industry. These annuities have a cap per month vs. an annual cap. For example, an annual cap annuity might have a cap of 9% and then lock those gains in every 12 months. A month-to-month cap might have a cap of 3% a month which could give an annual cap of 36%. This can be good and bad. If the measuring index has all of its gains in one month, the client would have an annual return of 3% (even if the measuring index went up 15% in that one month). On the other hand, if the measuring index had three up months at 3%, the client could have an annual return of 12%.

The following is a summary of various ways indexed annuities can be offered (we’ll be discussing annual point-to-point annuities only with growth pegged to the S&P 500).

**Traditional** -

To us, traditional means the EIA has a hard annual cap (ranging from 7-12+% depending on the year purchased) and a guaranteed investment return of zero (0). If the S&P 500 goes up 10% with a 10% cap, the client receives that return in that particular year. If the market goes up 20%, the client receives 10%; and if the S&P 500 returns negative -10%, the client is credited zero. The EIA also has a 100% participation rate (explained below).
Non 100% participating EIA –

Participation Rate is how much of the annual growth of a measuring index (S&P 500 most of the time) will be credited towards the amount of money in the EIA. In a traditional EIA, the participation rate is 100%, which means that 100% of the return will be credited to the money in the EIA. Some EIAs have less than 100% participation. Most of those policies, however, have higher caps or no caps at all on the measuring index.

For example, if a client had $100,000 in an EIA with a 75% participation rate and the S&P returned 25% for the year, the client would be credited with 75% of that growth, which is 18.75%.

At first blush, this type of EIA sounds much better for the client if the client believes the S&P 500 will have returns similar to past years where it spiked 15-35% in any given year (i.e., the old adage that the S&P 500 might average 8% a year, but it never returns 8% a year). If, however, the S&P 500 does not have those high spikes, the lower participation rate annuities will not perform better than EIAs with hard caps and a 100% participation.

EIAs with fees

The above two EIAs are typically sold as “no load” EIAs where there is no annual administration fee, service charge, certificate charge, or management fee. Many EIAs, however, do have such charges (hereinafter CC for certificate charge). CCs are almost always charged ONLY when the measuring index has a positive year.

For example, an EIA might offer a 100% participation rate with NO cap on returns and principal protection, which sounds wonderful. Unfortunately, that same annuity would typically have a CC of, let’s say, 2% annually. When you run the numbers, annuities with hard caps and no fees will outperform EIAs with better cap terms if the market does not have years with 20% plus returns.

EIAs with bonuses

Many of the EIAs in the marketplace will give the annuity owner a “bonus” for buying the EIA. A sampling of the current marketplace shows that one company has a 10% first-year bonus, which would mean that, if a client put $100,000 into the annuity, the account balance would be $110,000 to start off with. Another has a 1% bonus each year for the first 12 years (based on the first year’s premium), which would mean in the $100,000 example that the annuity company contributes into the EIA $1,000 a year for the client no matter what is happening with the measuring index.

Since insurance companies never lose money, there is always a catch when they give something for “free.” Typically, when a company offers bonuses, the surrender charges in the annuity are greater and for a longer period of time.
EIA contract changes

One of the reasons an EIA is difficult to evaluate is because the annuity company by contract can change many of the variables that make up an EIA. What can be changed?

1) **The Caps.** Most of the companies offering hard annual caps reserve the right to change those caps on an annual basis. The companies always have a bottom cap threshold they cannot go below. Clients need to understand this so they do not get upset when the 9% cap moves down to 7% in a down market.

Some companies will have multi-year caps. Companies, instead of having an annual cap, will have caps that stretch out for two or more years. For example, if the company has a two-year 15% cap, the client will not be credited more than 7.5% a year for the two-year window.

2) **Participation Rate.** Many companies reserve the right to change the participation rate annually. An EIA might start with a 100% participation rate in an up market; but when the market turns, that rate can be adjusted down to whatever minimum threshold the EIA contract language states.

One of the limited participation rate “no cap” EIAs in the current market has a ten-year window for that product where the 75% participation is calculated with a principal guarantee at the end of the tenth year. This is important because, without the annual guarantee of zero, the ten-year window will include down years that will be factored into the amount credited.

3) **Certificate Charges (fees).** Many companies have changeable CCs. If you look at some of the marketing material for an EIA, the chances are good that the CC indicated on the brochure is not the same as the CC the company is currently charging clients. We’ve seen one company where their cap was 8%, and the highest possible CC the company could use was 15%. With that scenario, if the measuring index returned 8% and the CC was 15%, the client would receive a zero return when the market was up 8%.

**Surrender charges**

All EIAs have surrender charges the client would pay if the client wanted to give up the annuity and take all the money. Those charges vary depending on the company but typically will start out very high the first few years (10-15%) and then scale down to zero. The shorter the surrender period, typically, the less an insurance agent will make on the sale.
Practical application for EIAs

There are really two types of investors who EIAs work best for—those who have money in fixed investment products (typically CDs) and those who are getting to an age where maintaining principal in an investment portfolio is important.

**CDs vs. EIAs**

The typical scenario. Say you have $25,000 in a CD or savings account, and your take-home pay is in excess of $250,000 a year. You mentally like to keep money in a CD or savings account so you can have ready access to it in case of an emergency. You do not end up needing the money for ten years; and at the end of tenth year, you have $33,595 (after you factor in paying tax on the gain every year).

If you had your money in an indexed annuity with a minimum guaranteed return rate of 0% but possible higher returns of 8%, you would have approximately $53,973 (at that 8% assumed rate of return). You have not paid taxes on the gain yet, but you were able to use all your money and have it grow tax deferred for that ten-year period. Further, if your circumstances change and you do not need the money available for short-term cash, you can allow the money to continue to grow tax deferred until retirement; and then you could annuitize the money and set yourself up for a guaranteed retirement benefit (something that could never be done with money in a savings account or CD).

The main downside with annuities as discussed earlier is that they typically have surrender charges for five-ten years should you withdraw your money or 1035 exchange the annuity to another company. To us, that is a non-issue. If you have $10,000-$100,000 in savings and you need short-term capital, use your line of credit through work or take out a home equity loan. The interest will be deductible; and for a short-term problem, that is a much better answer than leaving your money in a CD or savings account for ten+ years waiting for a cash flow problem to arise.

**Rollover IRAs**

Retiring clients (or those who are close to retirement) should consider EIAs as a way to protect their wealth while still participating in upward growth in the stock market. Rollover IRAs seem to be very in vogue, but most advisors who roll clients into IRAs at retirement do so and then put those clients into mutual funds with no principal guarantee. While the client does not need a tax deferred vehicle inside a tax deferred vehicle, EIAs still make sense to preserve principal in retirement so the client does not have their portfolio go backwards.

**Conclusion**

EIAs can be very beneficial to clients who are looking to maintain principal on investments while still participating in the upside growth of the stock market (with a CAP). EIAs try to get the client the best of both worlds and, in our opinion, do a good
job as long as the client understands that, in a steady up or big bull market, the EIA account balance will lag behind traditional stock or mutual fund investments.

Section 4
The Maximizer

Reach For Double Digit Investment Returns While Protecting Your Principal

Would you like to nearly double the return of the S&P 500 while at the same time 100% principally protecting 90% of your invested dollars?

What are your investment goals these days?

Are you still of the opinion that the stock market will average double-digit returns? Did the dismal investment returns of 2000-2003 serve as a wake-up call to you and remind you that the stock market actually does go backwards?

What are your investment goals these days?

We would submit to you that your investment goals should be to protect principal and go for growth when you can do so in the least risky manner possible (or in a manner that meets your risk threshold).

This Section of the book is not meant to bash the use of post-tax investing as a nice option for clients. It is meant to make you aware of another way to try to reach for 10%+ rates of return with less risk. Every client should have a balanced portfolio of stocks, mutual funds, bonds, etc. However, the Maximizer should be considered as part of that balanced portfolio.

How do you usually manage risk? 1) By sacrificing yield when investing in CDs, money markets, and treasuries (which are annually taxable investments). 2) By outsourcing risk when giving money to a stockbroker or money manager.

Most mutual funds provide no downside protection. Everyone seems to think Merrill Lynch is a great money management firm. Look what happened to some of their funds in 2001. What kind of protection did their clients receive? The S&P 500 was down 17% but that would have been much better than what happened at Merrill.

Merrill Lynch Mid-Cap Growth Fund – <36.6%>
Merrill Lynch Premier Growth Fund – <52.6%>
Merrill Lynch Focused Twenty Fund – <70.1%>
Merrill Lynch Fundamental Growth Fund – <19.4%>
Merrill Lynch Global Growth Fund – <26.3%>
The following are some of the problems with actively managed mutual funds: No downside protection, underperform the market, sometimes expensive – (whether the funds go up or down), lack of consistent results.

Studies show that most mutual funds underperform the market:

- 1,226 actively managed funds with 5-year track record – 1.9% less than S&P 500*
- 623 actively managed funds with 10-year track record – 1.7% less than S&P 500*
- 406 actively managed funds with 15-year track record – 1.5% less than S&P 500*
- Adjusted for “survivorship bias” – 1.5% worse.

“With returns corrected for survivorship bias, the average actively managed fund trails the market by about 3 percentage points per year.”**

* Morningstar Principia Pro, data through Dec 31, 2001. Funds identified were all domestic stock funds, excluding index funds and funds holding more than 20% in bonds.

“The sad truth of the matter is, that over time the vast majority – approximately 80% - of mutual funds underperform the overall stock market.”

The “Motley Fool”

What are the odds of beating the house? 46% if you play craps, 48% if you play blackjack. 44% if you play roulette. **20% if you are in actively traded mutual funds instead of index funds.**

Mutual funds can be very expensive: sales charges, 12b-1 fees, management fees, fund expenses, transaction costs, capital gains, and dividend taxes.

To say that many mutual funds are not consistent would be a dramatic understatement. The following is a mind-blowing example of how difficult it is to invest with certainty in the short run with mutual funds. Mutual funds work much better if clients have the discipline to buy and hold.

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<td>9</td>
<td>851</td>
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<td>10</td>
<td>793</td>
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</table>
Is it a fair statement that the average broker is telling you to buy funds ranked in the top 10 because those are the “good” funds to buy at any given time? What happened to your money if you got into one of the top 10 funds at the tail end of 1999? You would have lost a bundle.

Another simple example of how little we all know:

Which of the following companies would you have been recommended and wanted to purchase back in July 2003?

**Wal-Mart**: One of largest companies in the world; consistent earner; pays dividends.

**K-Mart**: Just emerging from bankruptcy; big marketing tie to Martha Stewart (who was looking at jail time); no anticipated dividends

- In July 2003, Wal-Mart stock was valued at $56.08
- In July 2003, K-Mart stock was valued at $24.20

Be honest. You would have chosen Wal-Mart all day long.

What happened?

- In July 2004, Wal-Mart stock was valued at $51.76
- In July 2004, K-Mart stock was valued at $76.80

If we are honest, do any of us really know what is going to happen with individual stocks or mutual funds? Not really. We simply know that the market as a whole will go up over time.

Many clients who want to get out of the stock and mutual fund picking game have switched to **index funds** with growth pegged to the S&P 500 or other indexes. Index funds are less expensive, but there is no downside protection.

We should all keep in mind the three “Rs.” No, not reading, writing and arithmetic. The three “Rs” we need to keep in mind are: Less “R”isk, more “R”eward, and quicker “R”ecovery. Wouldn’t it be nice to invest in something that had less risk, reward power in upside potential, and was set up to have a shorter recovery time after a down year?
The Maximizer: How does it work to reduce risk and rewards when investing?

The Maximizer is not a difficult concept to grasp. Clients use two investment vehicles: 1) equity indexed annuities (EIAs) (which you can read about on page 242), 2) call spread options on the S&P 500.

The stability of the concept comes from the EIA which has 100% principal protection. EIAs provide principal protection; so no matter what the measuring index returns (usually the S&P 500), the investment will never go backwards. The client participates in upside growth of the S&P 500, but there is a “cap” on that growth.

For our examples, let just assume the cap is 7.5%. Therefore, if the S&P 500 returns 10% in one year, the client’s return in the EIA is 7.5%. If the S&P 500 goes negative in a year with its return, the EIA does not lose money. This is stable and safe but will cap a client’s growth if the S&P 500 does well.

The upside in the topic comes from “options” which are purchased on the underlying investment index (typically the S&P 500). Options are not the easiest investment to understand, so let’s use an example.

Assume a client buys a $100,000 option on the S&P 500 index on January 1, 2007. Assume the cost of that option is 10% of the client’s total Maximizer investment and that the client has the “option” to sell the option at a strike price at 10% above and 10% below the purchase price. Further, assume that the client will realize an investment gain of approximately 85% of the growth of the index up to that strike price which is 10% higher than where it started.

Assume the S&P 500 index is at 1000 when the client purchases the option. On December 31, 2007, the option is valued. If on that date the S&P 500 value is 1100, that would mean that the index increased 10%. Therefore, the gain on the option is approximately $8,500. The client is returned the option cost of $10,000 plus the gain of $8,500.

What if the S&P 500 goes down? If the S&P 500 goes down more than 10%, the entire cost of the option is lost. That’s why options are considered a risky investment.

Getting back to how the Maximizer works—the client invests approximately 90% of money allocated to the plan in a principally guaranteed EIA. The client allocates 10% to purchasing options on the S&P 500. Let’s look at an example.
Assume: $100,000 portfolio 10% Risk

Examples: Assume a $100,000 portfolio, risk 10% in options, and an EIA with a 7.5% cap.

What if the S&P 500 goes up 5%?    What if the S&P 500 goes up 10%?

Annuity Grows 5.00% or $4,500    Annuity Grows 7.50% or $6,750
Option Grows 4.00% or 4,000        Option Grows 8.0% or 8,000
Total Return 8,500                  Total Return 14,750
Percent Return 8.50%                Percent Return 14.75%

In the previous examples, the S&P 500 went up and the Maximizer returns were significantly higher than what the S&P actually returned (with 90% of the money protected in the S&P 500).

What if the S&P 500 went up 20%?  What if the S&P 500 goes down 5%?

Annuity Grows 7.50% or $6,750    Annuity Stays Flat or $ 0
Option Grows 8.00% or 8,000        Option Loses 6.0% or -6,000
Total Return 14,750                Total Loss -6,000
Percent Return 14.75%              Percent Return -6.00%
Let’s look at a few hypothetical examples of what might happen over the next 10 years.

<table>
<thead>
<tr>
<th>Year</th>
<th>Projected S&amp;P Performance</th>
<th>Maximizer Approach</th>
<th>Mutual Fund</th>
<th>Matching Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10.00%</td>
<td>115,200</td>
<td>110,000</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>-4.00%</td>
<td>109,440</td>
<td>105,600</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>12.00%</td>
<td>126,075</td>
<td>118,272</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>7.00%</td>
<td>141,078</td>
<td>126,551</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>6.50%</td>
<td>156,667</td>
<td>134,777</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>-18.50%</td>
<td>141,000</td>
<td>109,843</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>8.50%</td>
<td>160,740</td>
<td>119,180</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>-22.50%</td>
<td>144,666</td>
<td>92,364</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>7.50%</td>
<td>163,111</td>
<td>99,292</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>12.00%</td>
<td>187,904</td>
<td>111,207</td>
<td></td>
</tr>
</tbody>
</table>

Avg Return 1.85%

As you can see from the examples, the Maximizer will work in our random investment environments (which is reality in and of itself) and outperforms investing in the stock market unless the market really does exceptionally well.

**How Fast Can You Recover From Down Years?**

While it might make sense that, if the stock market goes down 20% in one year you only need 20% to recover your lose, this is not the case. See the following numbers.
One of the unique things about the Maximizer approach is how much easier it is to “recover” from a bad year. Look at the following chart.

<table>
<thead>
<tr>
<th>If the market falls</th>
<th>To recover with equities</th>
<th>The following year</th>
<th>Recover with the Maximizer</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%</td>
<td>25%</td>
<td>6.50%</td>
<td></td>
</tr>
<tr>
<td>30%</td>
<td>46%</td>
<td>6.50%</td>
<td></td>
</tr>
<tr>
<td>40%</td>
<td>66%</td>
<td>6.50%</td>
<td></td>
</tr>
<tr>
<td>50%</td>
<td>100%</td>
<td>6.50%</td>
<td></td>
</tr>
</tbody>
</table>

**Summary on the Maximizer**

The Maximizer is truly a unique plan to help clients accomplish some of their most important financial goals. If your goals revolved around looking for an upside in the market with tremendous earning capabilities while still principally protecting the vast majority of your invested assets each year, you should take a strong look at incorporating this topic into your long-term financial plan.

The Maximizer concept was created by Jeff Cohen.

**Section 5**

**Equity Harvesting**

Equity harvesting is a concept that has been around for many years but only recently is coming into the mainstream.

The concept behind equity harvesting is simple—borrow money and invest it in something tax favorable. So the questions for readers are as follows:

1) If you could borrow money with an interest rate of less than 7% to invest, would you?

2) Would it help if you could write off the interest on the loan?

3) Would it help if the place where you invested the borrowed money was a tax favorable environment where the money could grow tax free and potentially come out tax free in retirement?

If you just read the above and do not have an interest in this topics, we suggest you re-read the questions again.

From a financial standpoint, the concept of borrowing money when you can write off the interest and invest the money in something tax favorable is just about a no brainer when done right.
Where do you find a lender who will lend you money to invest and what asset(s) are used as collateral? If you own a home, then you know the answer.

For brevity’s sake, we will discuss our favorite equity harvesting situation which revolves around a 1% cash flow mortgage program on the personal residence.

The 1% “Cash Flow” Option Arm Mortgage Program

The 1% cash flow mortgage program is designed for clients who would like to minimize their current monthly home mortgage payments while at the same time invest the saved money for future retirement savings.

This program is not designed for homeowners who are looking to reduce their monthly mortgage payments with an eye on paying off their home mortgage in the standard time frame 15-30 years.

The whole point of the 1% cash flow program is to minimize current costs, which frees up money for investing.

The 1% cash flow program has a 1% starting rate that stays low for five years. The payments (not the interest rate) of the arm increase at the rate of 7.5% a year (see the following chart for an example).

At the end of the 5th year (or any time after the third year without a penalty), the client can re-finance the loan back into a 1% program (or the client can keep the going interest rate on the loan or completely re-finance with any other loan program).

The numbers speak for themselves.

For the following example, assume a client (male, age 42) has a $400,000 mortgage on a home with a fair market value (FMV) of $500,000. The first chart shows what will happen to the client’s home mortgage payments with a 1% cash flow starting rate vs. a 6% 30-year conventional loan. The amortization with the 1% arm is 40 years.

<table>
<thead>
<tr>
<th>Cash Flow Analysis</th>
<th>30 Year @ 6.00%</th>
<th>1% Cash Flow Program</th>
<th>Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$28,778</td>
<td>$12,137</td>
<td>$16,641</td>
</tr>
<tr>
<td>Year 2</td>
<td>$28,778</td>
<td>$13,047</td>
<td>$15,731</td>
</tr>
<tr>
<td>Year 3</td>
<td>$28,778</td>
<td>$14,026</td>
<td>$14,753</td>
</tr>
<tr>
<td>Year 4</td>
<td>$28,778</td>
<td>$15,078</td>
<td>$13,701</td>
</tr>
<tr>
<td>Year 5</td>
<td>$28,778</td>
<td>$16,209</td>
<td>$12,570</td>
</tr>
<tr>
<td>5 Year Totals</td>
<td>$143,892</td>
<td>$70,497</td>
<td>$73,395</td>
</tr>
</tbody>
</table>
Remember that the client who is a candidate for the 1% arm is looking to lower the mortgage payments to as low as possible so the saved money can be invested. With the 1% program, the client freed up $73,395 of cash flow over the five-year window.

If the client invested the money saved from lowering the mortgage and had a return of 8%, the client would have $93,993 built up at the end of the fifth year (see the following chart).

<table>
<thead>
<tr>
<th>Cash flow Investment Analysis</th>
<th>Equity Indexed Annuity @ 8.00%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$17,972.64</td>
</tr>
<tr>
<td>Year 2</td>
<td>$36,399.99</td>
</tr>
<tr>
<td>Year 3</td>
<td>$55,244.69</td>
</tr>
<tr>
<td>Year 4</td>
<td>$74,460.87</td>
</tr>
<tr>
<td>Year 5</td>
<td>$93,993.03</td>
</tr>
</tbody>
</table>

In the example, we assumed a client used an indexed annuity as the investment which allows the money to grow tax deferred.

If the client at age 63 started taking money out of the indexed annuity, he would be able to take out $28,000 each year for 20 years (the growth above basis would be income taxed, thereby netting $18,450 a year after tax).

If the client took the money saved from the first five years and invested it into an equity indexed life insurance policy earning 7.9% a year, the client could take out of his life insurance policy $22,000 a year income tax free from age 63-82 (plus the client has a sizable death benefit while the policy is in place).

Remember the numbers above are simply from the savings on payments from the first five years. Also remember that the client is writing off the interest on the loan.

**Equity Harvesting**

Would a client refinance a property if he could have payments on a 1% loan and invest the borrowed money in a tax favorable environment? Many would say YES.

Example: Assume a client has a $1,000,000 home with no debt or very little debt. Assume the client decides to sell the home and buy a new home. In that process, assume that he removed $600,000 of equity from the sale of the home and invested it for retirement income later. Assume the client used the 1% cash flow program and is in the 40% tax bracket.
The following would be the interest payments on the loan for the first five years:

<table>
<thead>
<tr>
<th>Cash Flow Analysis</th>
<th>Payments Starting @ 1.00%</th>
<th>Cost Out of Pocket After Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$18,206</td>
<td>$10,923</td>
</tr>
<tr>
<td>Year 2</td>
<td>$19,571</td>
<td>$11,743</td>
</tr>
<tr>
<td>Year 3</td>
<td>$21,039</td>
<td>$12,623</td>
</tr>
<tr>
<td>Year 4</td>
<td>$22,617</td>
<td>$13,570</td>
</tr>
<tr>
<td>Year 5</td>
<td>$24,313</td>
<td>$14,588</td>
</tr>
<tr>
<td>5 Year Totals</td>
<td>$105,745</td>
<td>$63,447</td>
</tr>
</tbody>
</table>

If the client took the $600,000 and invested it returning 8% in an indexed annuity, the numbers would look as follows at the end of five years:

<table>
<thead>
<tr>
<th>Year</th>
<th>Start of Year Balance</th>
<th>Contribution</th>
<th>8.00% Growth</th>
<th>Year End Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$600,000</td>
<td>$0</td>
<td>$48,000</td>
<td>$648,000</td>
</tr>
<tr>
<td>2</td>
<td>$648,000</td>
<td>$0</td>
<td>$51,840</td>
<td>$699,840</td>
</tr>
<tr>
<td>3</td>
<td>$699,840</td>
<td>$0</td>
<td>$55,987</td>
<td>$755,827</td>
</tr>
<tr>
<td>4</td>
<td>$755,827</td>
<td>$0</td>
<td>$60,466</td>
<td>$816,293</td>
</tr>
<tr>
<td>5</td>
<td>$816,293</td>
<td>$0</td>
<td>$65,303</td>
<td>$881,597</td>
</tr>
</tbody>
</table>

If the money continued to grow at 8% until the client reached age 63, he could take out $296,000 each year for 20 years. The client would pay income taxes on the amount above basis in each payment. After income taxes on the growth at 40%, the client would be left with $159,000 a year.

If the client invested the $600,000 into an equity indexed life insurance policy earning 7.9% a year, the client could take out of the life insurance policy **$191,000 income tax free** for 20 years starting at age 63 (plus the client would have a sizable death benefit to protect the family). The following is an example of what you would see from a life insurance illustration based the life of this particular example client. The illustration will obviously look better or worse depending on the investment returns. This particular illustration comes from using an indexed equity life insurance policy where the growth is pegged to the S&P 500 index (see page 125 in this book where we explain equity indexed life insurance).
The following table shows the tax-free loans, cash surrender value, and death benefit for different ages:

<table>
<thead>
<tr>
<th>Age</th>
<th>Tax Free Loans</th>
<th>Cash Surrender Value</th>
<th>Death Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>63</td>
<td>$193,000</td>
<td>$2,099,000</td>
<td>$2,639,000</td>
</tr>
<tr>
<td>64</td>
<td>$193,000</td>
<td>$2,068,000</td>
<td>$2,607,000</td>
</tr>
<tr>
<td>65</td>
<td>$193,000</td>
<td>$2,035,000</td>
<td>$2,552,000</td>
</tr>
<tr>
<td>66</td>
<td>$193,000</td>
<td>$1,999,000</td>
<td>$2,531,000</td>
</tr>
<tr>
<td>67</td>
<td>$193,000</td>
<td>$1,960,000</td>
<td>$2,506,000</td>
</tr>
<tr>
<td>68</td>
<td>$193,000</td>
<td>$1,918,000</td>
<td>$2,476,000</td>
</tr>
<tr>
<td>69</td>
<td>$193,000</td>
<td>$1,873,000</td>
<td>$2,441,000</td>
</tr>
<tr>
<td>70</td>
<td>$193,000</td>
<td>$1,824,000</td>
<td>$2,358,000</td>
</tr>
<tr>
<td>71</td>
<td>$193,000</td>
<td>$1,772,000</td>
<td>$2,263,000</td>
</tr>
<tr>
<td>72</td>
<td>$193,000</td>
<td>$1,717,000</td>
<td>$2,153,000</td>
</tr>
<tr>
<td>73</td>
<td>$193,000</td>
<td>$1,658,000</td>
<td>$2,027,000</td>
</tr>
<tr>
<td>74</td>
<td>$193,000</td>
<td>$1,597,000</td>
<td>$1,883,000</td>
</tr>
<tr>
<td>75</td>
<td>$193,000</td>
<td>$1,533,000</td>
<td>$1,844,000</td>
</tr>
<tr>
<td>76</td>
<td>$193,000</td>
<td>$1,464,000</td>
<td>$1,803,000</td>
</tr>
<tr>
<td>77</td>
<td>$193,000</td>
<td>$1,390,000</td>
<td>$1,758,000</td>
</tr>
<tr>
<td>78</td>
<td>$193,000</td>
<td>$1,310,000</td>
<td>$1,711,000</td>
</tr>
<tr>
<td>79</td>
<td>$193,000</td>
<td>$1,224,000</td>
<td>$1,659,000</td>
</tr>
<tr>
<td>80</td>
<td>$193,000</td>
<td>$1,130,000</td>
<td>$1,603,000</td>
</tr>
<tr>
<td>81</td>
<td>$193,000</td>
<td>$1,028,000</td>
<td>$1,542,000</td>
</tr>
<tr>
<td>82</td>
<td>$193,000</td>
<td>$917,000</td>
<td>$1,476,000</td>
</tr>
<tr>
<td>87</td>
<td></td>
<td>$1,314,000</td>
<td>$2,092,000</td>
</tr>
<tr>
<td>94</td>
<td></td>
<td>$1,550,000</td>
<td>$2,468,000</td>
</tr>
</tbody>
</table>

So again, the question is, would you like to use a 1% program to build wealth for retirement? Most clients with equity in their houses would say yes. Most clients will want to lower their current mortgage payments and invest the difference in order to build more wealth for retirement.

Side note: While clients might want to use the borrowed money to invest in stocks or mutual funds, not only is that not advisable, but it is not allowed under the law. Additionally, it makes little sense to put borrowed money in an environment where it can go backwards and where there are annual tax consequences with dividend income and/or capital gains taxes upon sale.

Real World Planning

In the real world when clients use this loan, they traditionally will refinance back into the 1% arm every 3-5 years. This keeps their payments to a minimum and allows the maximum amount of money to be used for investment purposes.
While a client could use the money saved and invested to pay any deferred interest, most clients, when they refinance, will refinance the deferred interest (if any) into the new 1% arm. This allows the invested money to grow and to be used for retirement when the time comes.

Remember that the client’s home is appreciating at a minimum of 3.5%-10% a year and in many parts of the country at 10%+ a year. So while the client’s debt could increase with the 1% program when refinancing the home, the increase in equity more than offsets this debt.

**Summary**

From a financial standpoint (without emotion), the 1% cash flow program is virtually a no lose proposition for clients. Payments on money borrowed starts at 1% and that money is invested where, even in the worst case scenario over the long haul, the money should grow at 5% and more likely will grow at 8%.

Clients who can take the emotion out of the idea of paying down the debt on their home because it is better long term financially will gravitate to the 1% cash flow program. Those clients will not only refinance current debt in order to free up investment dollars but will also take equity out of their homes in order to build that retirement nest egg quicker.

If clients cannot objectively look at the numbers and will sleep better at night because they are paying off the debt on their homes, then they are not candidates to build wealth in an accelerated manner through the 1% cash flow program.

The 1% cash flow program is not a program you will typically be able to find with your local bank or mortgage broker. If you would like information on using the equity in your home to build a tax favorable retirement nest egg, please feel free to contact one of the authors.

**Section 6**

**Principal Guaranteed Investment Products**

Following three years of market declines (2000-2002 and counting), we are frequently asked if there are investment products available that allow an investor to stay invested in the stock market with some degree of safety. Although much of the market losses incurred by some investors may never be regained, there are products now available that guarantee or protect your investment principal and allow you to participate in the upside of the market.

These principal guaranteed or principal protected products fall into four basic categories: annuities, mutual funds, structured notes, and CDs. Most are issued by major, well-known insurance and investment banking firms and some even trade in the
secondary market and on major exchanges, which provides the investor with a degree of liquidity.

**Annuities**

As we discussed in some detail in prior sections, a few of the guaranteed annuity products we have encountered are *variable annuities* that have a five-to-ten year guarantee period. Simply put—if you want the principal investment guaranteed by the issuer, you need to remain in the annuity for that set time period. If you redeem your annuity before the end of the guarantee period, you most likely will face early withdrawal charges; and your principal may be less than the original amount invested. However, with most variable annuities, you have to annuitize the annuity to partake of the guarantee.

We looked long and hard to find a few quality carriers with a guaranteed variable annuity, and they are not easy to find. Unless the advisor selling the variable annuity really stays on top of things and unless the client understands the risk of loss or uses one of the few guaranteed variable annuities, we typically recommend guaranteed indexed annuities (the New Annuity) because there is not normally a limited guaranteed period; and you do not have to annuitize the annuity to take advantage of the guarantee.

The investment options in guaranteed annuities vary depending on the issuing insurance company. Some companies allow the investor to choose from a variety of mutual funds in which to invest the principal and insure it by attaching a rider to the annuity. These riders usually cost the investor a percentage of the amount invested. Other companies manage the principal amount for you by investing in stocks and bonds at the discretion of the money manager.

**Principal Protected Mutual Funds (PPMF)**

PPMFs are mutual fund stock investments that are insured against loss of principal by a third-party insurance company if held by the investor for a minimum number of years. PPMFs are "managed" mutual fund plans. That means a money manager utilizes combinations of mutual funds to attempt to maximize investor returns.

PPMFs are not easy to find. In our initial research, we were only able to confirm the existence of a dozen of these plans. This is not surprising because an adviser must be registered with the SEC and show evidence of an exemplary mutual fund risk management record for a period of at least five years to qualify for insurance. Then, he must find a company and convince it that his method of managing funds is worthy of their guarantee... no small task.
How does the PPMF work for the client?

Most PPMF managers have minimum investments of at least $50,000, though investments are more commonly in the range of $100,000 to $1,000,000 and are made within a pension or other type of retirement plan. If, at any time during the five-year contract, the investor wants to "lock in" the appreciated amount, he/she can do so by beginning a new contract that will begin on the new date with the appreciated investment. Lastly, he/she may withdraw 10% of the investment per year as long as it is not made within a restricted investment vehicle like a 401(k) or IRA.

Lock-in returns

One major firm allows you to lock in investment gains every three to four months by rolling the principal into a newly issued fund. This is a very nice twist to the guaranteed mutual fund due to the fact that your guaranteed basis will go up every three to four months if the market goes up. There is no downside risk with this option due to the fact that your original contribution is already guaranteed.

Investments returns can peg an index

Many of the new PPMFs are pegged to an index (similar to an EIA) where the mutual fund is offered at a set price (i.e., $10/share) and guarantees that price to the holder at the end of the guaranteed period, usually five to ten years from the issue date. For the most part, the returns on these funds are correlated to one of the three major indexes: the Dow 30, the S&P 500, or the NASDAQ 100. Based on where the index is at the time the fund is issued, the mutual fund return may be positive or negative at the end of the guaranteed period. However, at the expiration of the guaranteed period, the holder is entitled to the issue price (i.e., $10/share) plus appreciation, if any.

EXAMPLE 1: Fund issued at $10/share and the S&P index is at 1000. At the end of the guaranteed period, the S&P is at 1300. Fund redemption price should be $13 per share.

EXAMPLE 2: Fund issued at $10/share and the S&P 500 is at 1000. At the end of the guaranteed period, the S&P is at 800 (lower). The fund redemption price should be $10/share (the original investment amount).

Fees

Of course, the fees for guaranteed investments are higher than those of a regular investment. In most cases, the total cost of this type of plan is only 0.5%-1.0% more than a mutual fund portfolio that does not have the insurance. If you think paying a few dollars (potentially tax deductible dollars) to reduce the risk of your investment portfolio over time is a wise idea, then you should investigate this option.
Structured Notes

Structured Notes are securities that again are offered and guaranteed by many major investment firms. The pricing and return on these notes are much like the above mutual fund examples. The notes are usually offered at a set price with a set guarantee period. As with the mutual funds, the return is correlated to some type of market index. The difference between the insured mutual funds and the notes is liquidity. Most of the funds already issued can be bought or sold daily. However, as with most mutual funds, you get end-of-day pricing. Unlike mutual funds, Structured Notes trade like stocks on major exchanges and can be bought or sold during the day. This can be very useful when you have a severe market decline on a given day.

Certificate of Deposit (CD)

The last guaranteed product we would like to discuss is the easiest to understand. There are at least three banks that offer FDIC insured CDs that are guaranteed and perform much like the above notes and mutual funds. You can buy these CDs in increments of $1,000 and are FDIC insured up to $100,000 per bank. There is also a secondary market for these CDs, which provide the investor with liquidity. This type of CD has to be purchased from a licensed securities broker, so do not expect your local bank teller to be aware of them.

If there was ever a time in the last 20 years to look at guaranteed investments, now is the time. With continued uncertainty in the market (especially for the older investor), protecting principal with the potential for upside growth is important. Nobody knows what the future will bring; and if this type of investment product gives you peace of mind in what we think may be a choppy market for the next few years, then it is well worth considering.

One final thought: Some of these products may have cap or call features that limit market upside potential, and most have some type of fee involved. We have done extensive research on these products, and so should you. Read the prospectus and learn all the features. If you would like more information on these products, we would be happy to answer your questions.

Conclusion

Even though there is typically an extra fee with a PPMF or certainly with any annuity (especially the guaranteed annuities), for most investors (especially after the down years of 2000-2002+), having the peace of mind in knowing that their investment principal is guaranteed is well worth the extra minor yearly fees that are associated with insured investment products.
If you are over the age of 55 and intend to retire in five or less years, you should seriously look at changing over some of your liquid stocks and mutual funds to a product with a guarantee of principal.

Section 7
Stock Protection Strategy

What is investing nirvana?

Investing nirvana is investing in individual stocks where the investor gets to keep all upside growth IF the stocks go up in value while at the same time having not only the principal investment protected from downside risk but IF the individual stocks go in the tank, the investor still recognizes an investment gain of between 5-7% on the original investment.

Traditional investment protection options

- Principal Protected Mutual Funds (PPMF)

If you read the preceding section of this book on PPMFs, you might be saying to yourself—Isn’t that as close as we can get to investing nirvana? The answer is NO. There is a tremendous difference between an insured mutual fund (where usually hundreds of stocks are owned by the mutual fund) and somehow protecting one individual stock from downside risk.

- Guaranteed Annuities?

Aren’t guaranteed annuities principal protected? While it is true that your principal is protected with guaranteed annuities (and usually some guaranteed positive return), again you are not in individual stocks that will have much more potential for upside (and downside) growth. Further, with guaranteed annuities, you have to deal with surrender charges should you want access to your cash before a certain date.

- Certificates of Deposit (CDs)

CDs have principal protection (as well as guaranteed returns by banks) but again have no real upside potential like you would if you invested in individual stocks.

-Collar Loans

Collar loans protect a portion of the downside risk of a stock portfolio but significantly limit upside returns. In other words, both gains and losses are collared.
-Prepaid Variable Forward

Prepaid Variable Forwards protect some smaller portion of the downside and trigger an immediate capital gains tax. They also tend to limit upside returns as well.

**Can you have it all?**

What if there were a company that would be willing to give you 90% of the value of your stock portfolio (or any portion you choose to use for this concept) today in cash where the company would take a secured interest in your stock portfolio and if the stocks do very well, you can get the stock back? If the stocks go down the drain, (see WorldCom and Enron) you keep 90% of your original investment and the investment returns on that 90%.

The Stock Protection Strategy (SPS) uses a derivative backed, non-callable, and non-recourse stock loan to:

1) Create 90% liquidity without selling stocks and without paying capital gains taxes;

2) Protect your current stock portfolio from downside risk by not requiring any repayment of the loan or accrued interest;

3) Provide a more conservative vehicle for new stock investments;

4) Save estate **taxes** if death occurs during the loan period;

And of major importance-

5) Allow you to recover all of your stocks and all of the potential gains.

Sound too good to be true? It is not. The concept is a little complicated, but this part of the book will explain how you can hedge your investment portfolio in basically a no-lose situation.

**Market volatility and vulnerability**

From 2000-2002, the Dow Jones average had highs near 11,000 points and a low of near 7,000 points. That is a swing of nearly 40%. If you had money in the market during that period of time, chances are your investment portfolio decreased at least 30%; and if you happened to be in individual stocks (vs. mutual funds), you could have seen your portfolio decrease in excess of 50%.
If you talk to someone who lived through the great depression (and the stock market crash in the late 1920’s), you usually get the impression that that person lives more frugally than all the generations that followed. Why? Because people who have never lived through a real depression believe the economy will always provide for them, and they will never have to beg for food or wonder if they will be able to heat their houses or clothe their children.

We believe to a similar degree those investors who lived through the period of 2000-2002 will have a unique perspective on investing in the stock market going forward. For the young investor, prior to 2000, the thought of a prolonged period of negative stock market returns was something that could never be imagined. If you asked a younger investor what the average rate of return should be in the market prior to 2000, the investor would tell you 12% or more. As we all know, that is not reality; and, unfortunately, very few investors hedged their bets with the money invested in the stock market. As a consequence, millions of investors lost billions of dollars on paper.

**Older investors have double the problem**

For the older investor (age 50 and higher), the stock market decline in 2000-2002 was a major blow to his/her ability to retire in the manner they intended. If an older investor in 2000 thought he/she was going to live on an investment portfolio of $2,000,000 (which included money in a brokerage account as well as a pension plan/IRA), starting in 2003, that portfolio could be as little as $1,000,000 or less at the time the investor is ready to retire. For the older investor, a concept where a stock portfolio can be protected from downside risk so the older investor can retire in the manner they intended would be terrific. If that investor could also partake of the gains if the individual stock portfolio goes up significantly, that would be like icing on the cake and that is what the SPS can do.

**How does the Stock Protection Strategy (SPS) work?**

**Loan** – The client takes a cash loan from the SPS for 90% of his/her liquid stock/brokerage account.

**Investment** - The loan proceeds are typically invested in a fixed or indexed annuity that has a minimum rate of return.

**Collateral** - The SPS takes the individual stocks as collateral for the loan.

**Market returns** – The stock(s) held by the SPS are allowed to go up or down in the market as would normally happen in a stock portfolio.
Transaction conclusion –

Market goes up – The investor:
- Pays back the loan
- Recovers the stock(s)
- Recovers dividends
- Keeps all the upside

Market goes in the tank – The investor:
- Walks away from the loan with no repayment
- Pays no principal on the loan
- Pays no interest on the loan
- Keeps 90% of the loan proceeds
- Keeps the reinvestment (the annuity)

What did the investor accomplish? The investor “hedged” his/her portfolio so, if the market and their stocks went down significantly, the investor had an annuity that earned 3-10% on the investment AND had principal guarantee. If the market went up significantly, the investor paid back the loan and took his/her stocks back and all their gains.

As always, an example is the best way to understand the concept.

The following example spreadsheets involve $1,000,099 worth of highly appreciated stocks (three of them) with a basis of $250,025 collectively:

**Sample Portfolio**

<table>
<thead>
<tr>
<th>Stock Name</th>
<th>Shares</th>
<th>Price</th>
<th>Stock Value</th>
<th>Loan Amount (90% of stock value)</th>
<th>Est. Dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Parcel Service</td>
<td>5,615</td>
<td>$5,939</td>
<td>$333,475</td>
<td>$300,127</td>
<td>$4,735</td>
</tr>
<tr>
<td>Coca-Cola Company</td>
<td>8,100</td>
<td>$41.15</td>
<td>$333,315</td>
<td>$299,984</td>
<td>$6,533</td>
</tr>
<tr>
<td>Occidental Petroleum</td>
<td>11,450</td>
<td>$29.11</td>
<td>$333,310</td>
<td>$299,979</td>
<td>$11,999</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$1,000,099</strong></td>
<td></td>
<td><strong>$900,089</strong></td>
<td></td>
<td><strong>$23,267</strong></td>
</tr>
</tbody>
</table>
Loan Terms:  - Non-Callable (During loan term, lender cannot make you pre-pay the loan or put up additional collateral)
- Non-Recourse (At end of loan term, you do not have to re-pay)
- 120-month loan (could be as short as 24 months)

Interest 9.33% (9.74 APR)

Dividends If the stock(s) used in the SPS create dividends, the dividends will be used to offset the interest due.

Calculating Stock Return Give-Up to Cover Cost of Hedge:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Estimated Gross Dividends on Stock: (Annually)</td>
<td>$23,267</td>
</tr>
<tr>
<td>Total Estimated Portfolio Value:</td>
<td>$1,000,099</td>
</tr>
<tr>
<td>Average Estimated Annual Dividend Yield:</td>
<td>2.33%</td>
</tr>
<tr>
<td>($23,267/$1,000,099 x 100%)</td>
<td></td>
</tr>
<tr>
<td>Annual Interest</td>
<td>9.74%</td>
</tr>
<tr>
<td>Effective Annual Loan Interest</td>
<td>7.41%</td>
</tr>
<tr>
<td>(9.74%-2.33%)</td>
<td></td>
</tr>
<tr>
<td>Loan Term in Years</td>
<td>10</td>
</tr>
<tr>
<td>Assumed Annual Return on Reinvestment</td>
<td>7.00%</td>
</tr>
<tr>
<td>Additional Annual Return on Investment Needed to Break Even</td>
<td>0.41%</td>
</tr>
<tr>
<td>Loan to Value Ratio</td>
<td>90%</td>
</tr>
<tr>
<td>Annual Stock Return Give Up to Pay for Hedge</td>
<td>0.37%</td>
</tr>
</tbody>
</table>

The previous spreadsheet assumes $1,000,099 in stock with an annual dividend on the stock of $23,267. The interest rate of the loan on the $1,000,099 is normally 9.74%, but, with the dividend amount applied to the interest payment, the effective interest rate on the loan is 7.41%. The assumed rate of return is 7%, which is .41% short of a breakeven point to cover the loan costs. Taking into account that the loan was for $900,089 instead of the entire $1,000,099, the return shortage is not .41% but instead 90% of that or .37%.

Cost of the hedge

Remember that the SPS is a hedge against your individual stocks going down in a bad/bear market. The cost of the hedge in the previous spreadsheet is .37% annually. So, if you had a $900,089 loan and the loaned money returned 7%, you would be .37% short in investment returns each year to break even and to retain your principal.
Continuing with the Example: The following spreadsheet has two columns—one for what happens with a traditional stock sale and one for the SPS plan. The traditional stock sale assumes the investor sells his/her stocks in an effort to get into a more conservative investment, and the SPS side of the spreadsheet illustrates what happens when an investor takes a 90% loan against the stocks (and reinvests the 90% into a conservative investment) where the investor’s individual stocks are allowed to go up or down with the market (where the investor has the option of buying back the stock at the end of the loan if the stocks went up significantly).

Lastly, it is assumed that the initial stock portfolio grew over the loan period at 12% annually. It is further assumed that, if the client sold stock (and paid capital gains) and reinvested the remaining money in a more conservative investment, that investment would return 7% annually. Lastly, it is assumed that the money borrowed against the stock with the SPS (90% of the $1,000,099) also grows at 7% annually.

<table>
<thead>
<tr>
<th>Comparison between Stock Protection Strategy and traditional stock sale:</th>
<th>Stock Sale</th>
<th>SPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio Value Before Sale or Loan:</td>
<td>$1,000,099</td>
<td>$1,000,099</td>
</tr>
<tr>
<td>(Portfolio Basis assumed at $250,025)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Gains Tax Due Upon Sale of Stock</td>
<td>$150,015</td>
<td>$0</td>
</tr>
<tr>
<td>(Assumes 20% capital gains rate)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale/Loan Proceeds Reinvested</td>
<td>$850,084</td>
<td>$900,089</td>
</tr>
<tr>
<td>Reinvestment Term in Years</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Value of Net Proceeds at End of Term</td>
<td>$1,672,245</td>
<td>$1,770,612</td>
</tr>
<tr>
<td>(Assumes reinvestment return of 7%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated Interest Rate on Loan (APR):</td>
<td>0%</td>
<td>9.74%</td>
</tr>
<tr>
<td>Average Estimated Dividend Yield:</td>
<td>0%</td>
<td>2.33%</td>
</tr>
<tr>
<td>Estimated Effective Annual Loan Interest:</td>
<td>0%</td>
<td>7.41%</td>
</tr>
<tr>
<td>(9.74% - 2.33%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Value of Recovered Portfolio at End of Term</td>
<td>0</td>
<td>$3,106,157</td>
</tr>
<tr>
<td>(Assumes Portfolio growth of 12%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Loan Balance at End of Term:</td>
<td>0</td>
<td>($1,839,527)</td>
</tr>
<tr>
<td>Net to Clients at end of Term:</td>
<td>$1,672,245</td>
<td>$3,037,242</td>
</tr>
</tbody>
</table>
The $3,037,242 in the bottom right of the example comes from taking $1,770,612 + 1,266,630. The $1,266,630 comes from taking the value of the stock at the end of the term, $3,106,157, and subtracting the loan balance due of $1,839,527.

**What was Accomplished in the Previous Spreadsheet?**

In the left column, the client sold stock, paid capital gains, reinvested the money, and, after earning 7% annually on that money, had $1,672,245 at the end of the ten-year term.

In the right column, the client borrowed 90% of the value of his/her stock, reinvested it in a conservative 7% return investment, and, at the end of the term, that conservative investment was worth $1,770,612.

Additionally, with the assumed increase in value of the individual stocks in the SPS AND after paying off the balance on the loan, the client had an additional $1,266,630 in assets. When you add the secure investment that the client owns, which is worth $1,770,612, and the value of the stock (after paying back the loan), which is worth $1,266,630, the client had a **net gain of $1,364,997** by implementing the SPS.

More examples:

**Client holds stock that increases by 12% vs. the SPS**

If the client held the $1,000,099 in stock and IF the stock went up in value 12% each year for the ten-year period, the value of the stock at the end of the ten years would be $3,106,157.

We illustrated earlier that, if a client implements the SPS and the conservative reinvestment from the 90% loan returns 7% and, if the stock returns 12%, the client would have total assets (after paying back the loan) of $3,037,242.

The client, by holding the stock and **TAKING ALL THE DOWNSIDE RISK, ended up with $68,915 more in assets or 2.2% more as a total of the final assets owned by the client after holding the stock for ten years.**

The client took all the risk of three individual stocks and on a $3.1 million asset at the end of the ten-year period ended up with a measly $68,915 in extra assets or an extra 2.2% in overall assets.

If we were advising a client, old or young, it would be difficult to recommend that the client hold onto stock and take all the risk for a ten-year period on those stocks for a potential increased return of 2.2% on the overall asset.
More examples:

**Client holds stock that decreases in value (-12%) vs. the SPS**

If the client held the $1,000,099 in stock and IF the stock went down in value (-12%) each year for the ten-year period, the value of the stock at the end of the ten years would be **$278,529**.

We illustrated earlier that, if a client implements the SPS and the conservative reinvestment from the 90% loan returns 7% and if the stock returns 12%, the client would have total assets (after paying back the loan balance) of $3,037,242.

If we now assumed the stock held by the SPS earned negative (-12%), the client would have as an asset at the end of the ten-year period (the conservative investment that was purchased from the 90% loan on the stock) of $1,770,612. Since the stocks are in the tank, the client would either reposition the loan (out of the scope of this book) or let the loan collapse and lose the stock. Since the loan is non-callable and non-recourse, the lender simply keeps the stock; and the client keeps his/her $1,770,612 conservative investment.

The client again took the risk except this time the three stocks went in the tank. If the client did not implement the SPS, the client would have assets worth **$287,529**; and if the client implemented the SPS, the client would have assets worth **$1,770,612**. The SPS ended up 84% better than if the client would have held the stock and taken all the risk.

**Summation on the SPS**

While the SPS is a little difficult to explain in a few pages of a book, we hope to leave the reader with a few issues to consider when holding and investing significant amounts of individual stocks.

1) Investing in individual stocks can be both rewarding and tragic. Individual stocks have the greatest opportunity to increase or decrease your overall wealth.

2) The SPS is a nice way to re-invest 90% of a liquid stock portfolio without incurring capital gains.

3) Older investors should seriously consider whether having individual stocks is in his/her best interest. The market crash of 2000 has reminded us all that the stock market does not just return 12-15% every year; it actually can decrease and decrease significantly in value.

4) The SPS is a very creative way for the younger and older investor to hedge the stock market against downside risk (while giving up very little in extra growth if the individual stocks significantly increase in value).
Conclusion/Recommendations

If you are worried about market risk with individual stocks and would like to hedge that risk while not being forced to sell stock and pay capital gains or lose much in potential upside growth, the SPS is a nice option you should consider. The SPS is a way to insulate yourself from stock collapses beyond your control at companies like Enron and WorldCom, which should help every investor sleep better at night.

Section 8
Life Settlements

For many clients, the concept of selling an existing life insurance policy is new. Just asking the question sounds strange. Why would a client want to sell a life insurance policy? While readers of this book might not be the best candidates for a life settlement, chances are significant that the readers will have a parent or older friend or loved one who is a good candidate.

The reasoning behind Life Settlements (LS) is fairly simple. LS are for someone who purchased a life insurance policy in the past, no longer needs that particular policy, would like to sell the policy today for cash, and use the proceeds for any number of different purposes. Typically, the seller is over the age of 65, and they must receive more from a life settlement company than the “cash surrender value” (CSV) of the policy.

Statistics about the life settlement market

The U.S. Census Bureau in 2003 reported that 35.9 million individuals age 65 and over own a life insurance policy. Already, the face value of policies sold in Life Settlement transactions amounts to more than $2 billion according to Conning Research and Consulting, a financial-services firm in Hartford, Conn. The life-settlement industry is growing at an annual rate of just under 20%.

This market is only going to increase as the baby boomers start to reach age 65 and beyond. With the fact that our society is getting older, understanding and dealing with the topic of life settlements is vitally important for anyone who is trying to have the best long term estate and financial plan for themselves or a loved one.

Why sell a life insurance policy?

We think a better question is: Why should clients keep life insurance policies they have no need for? That question brings up why and when should someone buy a life insurance policy. The main reasons are: 1) To protect the family in case the “breadwinner” dies; 2) To pay for estate taxes; 3) To help offset expenses associated with replacing a key executive of a corporation.
When determining if a life settlement is a good option for a client, a client must determine if the original need for the life insurance still exists.

**What Type of Life Insurance Can be Sold via a Life Settlement?**

Any “individual” life insurance policy can be sold through a life settlement. This includes: -term; -whole life; -universal life; -variable; and -second-to-die. For the policy to be something a purchasing company would find worthwhile, the policy should generally have a minimum of $100,000 of initial face for the death benefit.

As a good rule of thumb, the client should be over the age of 65 years old and it is helpful, in order to receive the highest possible purchase price, for the client to have had a change in health since the policy was issued (health has deteriorated). Also, it is typically required that the policy be in force for at least two years and that the client is expected to live for at least two years. Further, the purchaser would ideally like to see a client with a life expectancy of less than 12 years.

**When would clients consider selling a life insurance policy?**

1) When Clients have insurance and/or estate planning needs that have changed, which makes their current policy(s) inadequate or excessive for their current or future needs.

An example of this would be a client who bought the insurance to cover estate taxes and, for various financial reasons, the client’s estate is small enough that estate taxes are not an issue. A second example would be if the intended beneficiary of the policy predeceased the client.

2) When premiums on the policy are no longer affordable.

Some clients get to a point where their income significantly decreases, and they can no longer continue to pay the life insurance premiums. The clients can “surrender” the policy, decrease the death benefit and premiums, or the client could choose to sell the policy for cash.

3) When clients choose to realize the current value of their policy(s) now rather than continuing to pay on a policy from which they will never receive benefits.

An example of this would be clients who have been paying premiums on policies for years not because they actually have a need for the insurance but simply because they were mentally conditioned to pay and no one told them they could stop. Once clients realize the ability to stop paying and the ability to sell the policy for cash in hand, many will opt for the cash now and no future premiums.
4) When clients wish to live out the remaining years of life without a change in lifestyle.

This is the classic situation where a client has been paying on a policy for 20+ years and is now in retirement. Because of a high spending lifestyle, the client does not have enough money to live as they did prior to retirement. In order to help the client maintain that lifestyle, the client can sell their 20+ year old life policy for a nice amount of cash. Then that cash can be re-invested (maybe in an immediate annuity) so the client can have a guaranteed cash flow for the remaining years of life.

5) When clients need capital to pay for medical treatments or procedures.

Unfortunately, this is becoming far too common. Many clients (or their parents) cannot afford their health insurance bills (which includes prescription drugs). If clients knew that they could sell their life policies for more than the cash surrender value, many would so they could have enough money for proper medical care.

Who is involved in Life Settlements?

1) The Policyholder (our client); 2) A Life Settlement Broker (someone an insurance agent typically goes to for help in finding a purchaser; 3) The Provider (the purchaser). The Provider is typically a bank or other lending institution.

Tax considerations

Life Settlement payments may be taxable depending on the cost basis of the policy, the cash surrender value, and the amount received from the Life Settlement. If the settlement amount is less than the cost basis, there should not be a tax liability. An example is the best way to show the tax consequences.

**TAXATION DIAGRAM**

This chart explains the three tier system. Assume a $1,000,000 Policy issued 10 years ago and a $400,000 Settlement Amount Paid to Policy Owner. The policy owner paid $150,000 in premiums over 10 years.

- $225,000
  - Taxed as
  - Long Term
  - Capital Gain

- $25,000
  - Taxed as
  - Ordinary Income

$175,000 CSV (Tax Basis Plus Earnings)
$150,000 Tax Basis (i.e. past premiums paid)
Examples of Life Settlements

Term Conversion

Dr. Smith's 20-year term policy was reaching its conversion deadline. He is now 79 and was recently diagnosed with coronary artery disease. Dr. Smith cannot afford to convert the policy, and letting his $250,000 policy lapse would leave him nothing.

Dr. Smith applied to a Life Settlement company, and his policy was sold for $75,000. Dr. Smith was able to recover all of the premiums he had paid into the policy, plus a nice profit. Dr. Smith could then use the money to pay bills, go play golf on vacation, or put money away for later in retirement.

Unplanned Health Change

Roger was 76 and had just suffered a stroke, which left him permanently disabled. His family was unprepared for this. After learning of the Medicaid requirements and the cost of a care facility, the family was unsure how they were going to pay for his care.

Fortunately, his CWPP™ advisor suggested that Roger look into a Life Settlement when it was learned that he owned a $500,000 life insurance policy. Roger decided to sell the policy for a $250,000 settlement and eliminated the future premium payments on that policy. These funds covered the three years Roger lived in a nursing home facility before dying. The remaining cash was distributed to Roger’s original beneficiaries.

Additional Insurance Needed

An elderly couple had a $2.2 million policy held in an insurance trust that covered the wife. Due to good investments, their estate had increased quite a bit and now the death benefit on the policy was inadequate to cover the couples’ growing estate tax problems.

Their CWPP™ suggested that the clients sell the life policy to help fund the purchase of a new $4 million joint survivorship policy. A qualified Life Settlement broker was able to negotiate a $450,000 purchase price. Since the husband was in perfect health, the premiums on the survivorship policy were very affordable and were actually less than premiums on the policy sold.

Key-Man

A company owns a $5 million policy on an older executive who had retired three years earlier. The surrender value was $600,000; and since the company no longer wished to make the $90,000 per year premium payments, the company was considering surrendering the policy for its cash surrender value (CSV).
Their CWPP™, when learning of the situation, suggested that the client consider a Life Settlement. The company was offered $1,000,000 for the sale of the policy and netted $950,000 after taxes, almost doubling the cash surrender value. The tax calculations are omitted since the case is a mythical case and for brevity purposes.

**Summary of Life Settlements**

While the topic of Life Settlements is not in the mainstream (yet), it is becoming much more prevalent as our society ages. Many clients have had changes in their lives that could make a Life Settlement advisable. Now that you know what they are and how they work, hopefully, if you or a loved one can benefit from a Life Settlement, you’ll be able to bring up the topic and provide assistance.

For a free 25-page summary on this topic, please feel free to contact one of the authors.

### Section 9

**Private Placement Life Insurance (PPLI)**

PPLI is an intriguing concept to help those clients who have sizable brokerage accounts reduce the capital gains taxes and taxes on dividends that are paid annually with most brokerage accounts. PPLI can also pass wealth to the client’s heirs in a tax favorable manner.

**What is PPLI?**

PPLI is an individually negotiated life insurance policy that can be with a domestic insurance company or, more typically, with an offshore insurance company. We like to think of PPLI as a shell product that houses an investment.

**What are the potential benefits of PPLI?**

- Tax free appreciation of investments
- Investment flexibility, including the ability to appoint your own investment manager
- Substantial liquidity in the investment account
- Low-cost borrowing from the investment account
- Low costs due to small or no sales loads and other administrative costs
- Increased asset protection
- Tax free death benefits to heirs
How does PPLI differ from traditional life insurance policies?

The main difference with PPLI over traditional life policies is where the money can be invested. With a traditional policy (even a variable life policy), the consumer is limited typically to name brand mutual funds. With PPLI, the client can invest in almost anything that includes:

- Individual publicly traded stocks
- Privately owned stock (which can include start up companies or private venture capital funds).
- Hard assets (such as real estate and small businesses)

Segregated account

Almost all PPLI policies are held in separate “segregated” accounts at the life insurance company. That means the money in your policy is not subject to other creditors of the life insurance company. It is sort of like putting the money in your PPLI policy into a safety deposit box at the insurance company where no one, not even the insurance company itself, can access your funds for the benefit of another insured or creditor of the company.

Investment options

While previously we listed the types of investments money in a PPLI can be invested in, we need to more fully explain why this can be beneficial to clients with sizable brokerage accounts.

Domestic PPLI – Typically, with a domestic (in the United States) PPLI policy, the insurance company will have institutional mutual funds for the client to choose from. PPLI at first glance will sound like variable life (see page 120 for an explanation of variable life); but because PPLI is meant to house literally millions in investment dollars and because of the low insurance costs, PPLI is much different and more economically feasible than traditional variable life.

Some domestic PPLI policies will allow you to choose your own money manager as long as that manager is at a reputable institution.

Foreign PPLI – With “offshore” PPLI policies, the insurance company typically will require you to choose your own fund manager where the qualification requirements for that fund manager are not nearly as stringent as a domestic PPLI policy would have. Additionally, with a foreign PPLI, you will have much more latitude in the investments you hold inside your PPLI policy. Foreign PPLI policies are more popular for an investor looking to get into hedge funds or private company stock as investments.
Expenses

Because PPLI is an individually negotiated policy, there are set fees. However, typically with PPLI, there are no up-front loads that go to pay insurance agents. The insurance company is typically charging the lowest possible insurance rates for the life insurance (sometimes break-even rates) to attract big money clients to the company.

Annual Fee – Because PPLI is really more of an investment rather than a traditional life insurance policy, the company charges typical money management fees of between .5% to 1.65% annually on the cash value in the policy (the money being managed).

Cost of Insurance – The cost of insurance is the cost the investor has to pay to cover the death benefit over and above the cash in the policy. So, if a client put $5,000,000 cash into a PPLI as an investment, the policy might have a $10,000,000 benefit. The cost of insurance would be to cover the difference between the $5,000,000 cash value and the $10,000,000 death benefit.

Many insurance companies do not try to make a profit off the life insurance, and so the costs for the additional $5,000,000 in the above example will be lower than could be found in a traditional life insurance policy.

More Fees – If there are separate money management fees to get into a particular type of investment (say a mutual fund or hedge fund with a front-end load), those expenses are taken out of the cash value in the policy.

Asset protection

In some states like Texas and Florida, life insurance is asset protected by state statute; and so, whether you had a normal universal life policy with a million-dollar death benefit or a twenty-million-dollar PPLI policy, the cash value in the policy is protected from creditors.

For clients in states where life insurance is not protected from creditors, PPLI policies, if structured correctly, can provide tremendous asset protection. The main asset protection feature that is utilized is through an offshore LLC. Typically, an offshore PPLI is used because of the flexibility of where cash in the policy can be invested.

If you are going offshore, you might go to Nevis, which is a favorite island used for asset protection due to its anti-creditor laws. In Nevis, you would create an LLC, and you would capitalize that LLC with the money you wanted to direct into a PPLI policy. The LLC itself would buy the policy, and then the policy would be asset protected just like any asset would be in a Nevis LLC (see page 73 for more information on offshore protection).
Tax savings of PPLI

Today, most people who invest do so on a post-tax basis and give their money to a local stockbroker or day trade it themselves on the Internet. The main problem with traditional investing revolves around all the taxes (short-term and long-term capital gains and income taxes on dividends) that go along with post-tax investing.

Money that is invested inside any life insurance policy does so without capital gains taxes or dividend taxes. That is just one nice aspect of having cash grow inside a life insurance policy (which we do not typically advocate as a post-tax investment).

Because of the special nature of PPLI policies, low costs, and flexible investments, PPLI policies are mainly used because money can be actively managed without incurring any annual taxes on the investment. Most advisors use a 31% blended capital gains (short and long term taken into account) and dividend tax rate on post-tax investing. That means every year you end up paying taxes on some portion of your investment account and, certainly, will pay capital gains taxes once your stocks or mutual funds are sold.

The real reason clients use PPLI

With a PPLI (like any life insurance policy), the owner of the policy can take “tax free” loans from the policy where, when the client dies, the loan is paid back. In essence what PPLI allows a client to do is to put large amounts of money into a life insurance policy (with low expenses) where money can be actively managed and the client can get access to the cash without paying taxes of any kind on the money.

When you take into consideration all the tax savings on the investment side of things, the savings dwarf the minimal amount of life insurance costs inside the policy.

Estate taxes

Typically, the death benefit from a PPLI policy will be included in your estate when you die. The death benefit will pay income and capital gains tax free to the beneficiaries, but they will have to pay estate taxes.

Who is a candidate to use a PPLI policy?

A candidate to use a PPLI policy is anyone who has $1 million or more in a brokerage account who would like the account to grow without capital gains or dividend taxes and would like the ability to borrow money tax free from the life insurance policy. Also, the client would typically want to have the death benefit ultimately pass to the heirs’ income tax free. Because your local broker can continue to manage your money, you are simply moving a brokerage account (which is not tax friendly) into a PPLI policy.
where no taxes will be due on investment returns or when the cash is accessed via policy
loans.

As with many of the topics in this book, there are not too many consultants in a
local area who will have access to the reputable companies selling PPLI. If you would
like further information on this topic, please feel free to contact one of the authors.

Section 10
Hedge Funds

Most people think a hedge fund is like a mutual fund on steroids that they cannot
afford to get into.

While hedge funds can return significantly higher or lower rates of returns than a
normal moderate or aggressive mutual fund, the goal of most hedge funds is to retain
principal and take advantage of upside potential in the market when possible.

What does it cost to get into a typical hedge fund?

The typical requirements are between $250,000 and $10,000,000 for an initial
investment depending on the hedge fund. With the entry fee into a hedge fund being so
high, the majority of investors cannot participate and the majority of the clients who do
have the money do not typically wish to put that high a percentage of their liquid
portfolio into a hedge fund due to the perceived volatility with the topic.

We are not hedge fund experts, but we did want to include sort of a Hedge Fund
101 in this book so you can learn a little bit about the topic to see if it is something you
want to look into further. Plus, if you want to join a hedge fund without the big $250,000
down stroke, we will discuss how to get that accomplished.

Management costs of a hedge fund

Clients with money are always interested in what things cost; and with a topic that
has great potential for wealth creation, most of the time, upside potential comes with a
cost. For most hedge funds, the costs are 1-1.5% annually on the assets under
management and 20% of the gains made during the year. So, in essence, the hedge
fund managers have all the incentives to protect the principal and grow the fund as much
as possible. Additionally, if the hedge fund gets negative returns during a given year, the
20% fee on gains does not kick in until the deficiency from prior year(s) is made up.

Remember that hedge funds are supposedly the elite of the elite investor managers
who are supposed to generate returns in excess of the stock market indexes. For that,
there is a premium; and it usually is 20% of the growth. If that is too pricey after looking
at the track record of investment returns for the hedge fund, then you should not indulge yourself with the topic.

Many different kinds of hedge funds

We would consider some hedge funds conservative and protective of capital, which is in contrast to a roll-the-dice fund looking to hit a home run each year with its investments.

Hedge fund strategies

Depending on your tolerance for risk and understanding of the equity and bond markets, you will gravitate to one hedge fund over another. The following is a list of strategies hedge funds use when investing your money.

- **Selling short** - selling shares without owning them, hoping to buy them back at a future date at a lower price in the expectation that their price will drop.
- **Using arbitrage** - seeking to exploit pricing inefficiencies between related securities - for example, long convertible bonds and short the underlying issuer’s equity.
- **Trading options or derivatives** - contracts whose values are based on the performance of any underlying financial asset, index, or other investment.
- **Investing “on the come”** - when anticipating a merger transaction, hostile takeover, spin-off, exiting of bankruptcy proceedings, etc., of a particular company.
- **Investing in deeply discounted securities** - of companies about to enter or exit financial distress or bankruptcy, often below liquidation value.

We are not an advocate of one investment plan over another; and we would suggest that, when doing research on the topic, you check the credentials of the people running the hedge fund and go with a manager who has a nice, long track record.

How to get into a hedge fund without investing $250,000 +

Virtually, all hedge funds have a limit on the number of investors they can have in their funds; and, therefore, the limit drives the minimum initial account balances of between $250,000 and $10,000,000.

If you look hard enough in the hedge fund marketplace, you will find hedge fund managers who will take you on as a client under the same assumptions as a normal hedge fund but will simply manage a single account under your name with a power of attorney appointment allowing the manager to trade your money as he/she sees fit.
Usually these types of managers will have limits on the amount of clients they take as well; but, if set up correctly, you could have a certain percentage of your post-tax investment portfolio in a hedge fund without having to find $500,000 to get in.

**Conclusion**

Hedge funds can be a nice way to have a certain percentage of your portfolio grow at rates well in excess of the stock market indexes and even aggressive growth funds. Make sure you do your due diligence before investing and, if possible, do not let a hedge fund exceed 20% of your entire stock market portfolio. Diversification is good (as we all have found out from 2000-2003).

**Section 11**

**Ponzi Scheme**

We found the following on the Internet the other day on a web site called Useless Information—stuff you never needed to know but your life would be incomplete without it.

\[
\text{“Have I got a deal for you!} \\
\text{I can double your money in just ninety days, guaranteed.} \\
\text{Nonsense, you say!} \\
\text{What? You do not trust me?} \\
\text{I promise that it can be done.”}
\]

A man called Charles Ponzi delivered such a promise back in 1920.

We will try to summarize the long story of Charles Ponzi; and when we are done, we think you will understand why we included the story in this book.

Ponzi, after coming over on the boat from Italy, started working odd jobs to get by. In 1917, he moved to Boston where he took a job answering and typing foreign mail. In 1919, Ponzi had finally found the investment plan that was going to make him rich. One day, Ponzi sent a letter to a businessman in Spain; and when the businessman wrote back to Ponzi, he included an international postal reply coupon. Ponzi took that international reply coupon to the U.S. Post Office and exchanged it for U.S. stamps.

**The light goes on!**

Ponzi noticed that a postal coupon purchased for one (1) cent (U.S. money) in Spain could be exchanged for six (6) cents in the U.S. That is when the light bulb went on, and that day the Ponzi scheme unwittingly was born. Ponzi figured that he could buy $100 worth of stamps in Spain and then exchange them in the U.S. for $600 worth of...
stamps. Ponzi then would simply sell the stamps and make a bundle, thinking that there could not be a better investment anywhere in the world.

Ponzi then implemented his plan by converting his U.S. money to foreign currency. Then he hired agents overseas to buy stamps from certain countries where the exchange rates were favorable when compared to the U.S. Then the foreign stamps would be exchanged in the U.S. and sold for an enormous profit. Ponzi claimed to all who would listen that he could create investment transactions where the net profits would be in excess of 300% in a very short period of time (45 days).

Did Ponzi really accomplish his lofty investment goals? NO. The red tape of dealing with different postal offices and the long delays in transferring money destroyed all of Ponzi’s imagined profits.

There is one problem!

Even though the scheme failed, because Ponzi had bragged about his great idea to all that would listen, everyone wanted to give him their money; and Ponzi obliged. Word about the fail-safe investment opportunity that promised to make a 50%+ profit in 45 days spread like wildfire. Ponzi had people waiting in line outside his business just to give him money to invest. Thousands of people purchased a promissory note from Ponzi in amounts ranging from $10 to $50,000 (which in those days was a large chunk of money).

Why would people give Ponzi the money for a flawed plan?

The main reason is because the early investors did see a healthy return on their money as promised. Ponzi used money from new investors to pay earlier investors, which made even more people want to give Ponzi money as the word spread. Legend has it that, Ponzi, back in those days, was taking in $1 million a week at the high point of his scheme. (This is the classic pyramid scheme).

Ponzi, like all newly rich men, lived lavishly. Unfortunately, all good (or bad depending on your point of view) Ponzi schemes must come to an end; and it did for Ponzi in 1920.

The Ponzi scheme crashes!

The Boston Post published a headline story telling readers of the scheme and how rotten it was, and Ponzi had people knocking down his door to get their money back. Eventually, all the money Ponzi had (which was not nearly enough to pay all the creditors) was given back to the angry mob; and Ponzi was declared bankrupt in the fall of 1920.
Ponzi was arrested and, after the arrest, admitted that he had a criminal record, which included forgery charges. (Shocking!) Ponzi spent three-and-a-half years in a federal prison; and after getting out, Ponzi was then sentenced to seven–nine years in a Massachusetts jail. Ponzi posted bond before going to the Massachusetts jail and then skipped town.

**Same old tricks!**

You would think Ponzi would see the writing on the wall and would have headed back to Italy. Nope. Ponzi showed up in Florida where he had a new Ponzi scheme involving real estate. Ponzi was buying real estate for $16 an acre and subdividing each acre into twenty-three lots and selling them for $10 apiece.

While that might sound like good business today, we forgot to add that he promised investors that their $10 investment would turn into over five million dollars in less than two years.

**What happened to Ponzi?**

After spending time in several different state jails, Ponzi was ultimately deported back to Italy. Interestingly enough, Ponzi received a sendoff fit for a rock star from many of the fans from his original Ponzi scheme (obviously, the fans were early investors who made money).

Ultimately, Ponzi became a ward of the country of Brazil (the country he lived in when he died) where he died unemployed and broke.

**Moral of the story?**

We should not have to tell many clients the moral of the story since many high-income clients are notorious for being taken advantage of by scam artists. The moral of the story is that, if it sounds to good to be true, it probably is. We run into that to some extent on some of the income tax reduction topics we deal with and take pride in dealing with topics that are not often vetoed by CPAs or attorneys who do true due diligence when reviewing the topics.

**Real life Ponzi scheme**

One reason we wanted to include the Ponzi story is because author Rocco DeFrancesco knew a few people who got swindled by such a scheme. The other reason we wanted to include this story was to remind clients that there are bad people out there who will sell you anything if it will make them money. There is nothing wrong with saying no to an investment if it does not pass your smell test.
The Ponzi scheme that took some of our business acquaintances went as follows. A money manager is referred to you by a friend who tells you that you must give this particular money manager some part of your portfolio because he has been returning 20-40% returns on the friend’s money. Additionally, the manager has had a 20-year track record of never losing money in the market and has averaged 35% returns over the last 10 years.

**The courting**

The friend gives you the name and number of the money manager, and you call him to check things out. Sure enough, the money manager gives you a printout of all the stocks he has purchased over the last ten years and the investment returns. You are blown away with the guy’s knowledge and his track record and the fact that he named several other people you knew who had their money with him, retired, cashed in their accounts, and had phenomenal returns.

You are sold, and you ask the manager what the minimum investment is? He says a minimum of $250,000; but for you (because you were a referral from a friend), he’ll knock it down to a $100,000 initial investment.

You cut the money manager a check, and then you are off to the races. You cannot wait to spend all the money the manager is going to make for you. Time passes and, sure enough, you get account statements indicating that your money is soaring in what appears to be a mediocre stock market. You are not suspicious because of the terrific track record and list of clients with the money manager, and you are now thinking of adding a new wing to your house with all your newfound wealth.

**The investment returns**

It has been three years now, and your most recent statement indicates that your money has already doubled. Life is wonderful. You have no need for the money; and since the manager has done such a good job with the money, you let it ride.

**The crash**

One day you come home from work, and your spouse tells you about a terrible story on the front page of the newspaper wherein the story discusses how a gutless, backstabbing money manager skipped town with $25,000,000 of investors’ money through a Ponzi scheme. You casually ask if they listed the name of the scammer; and when the words come out of the spouse’s mouth stating the name of your wonderful money manager, you instantly faint and hit the floor.
How could this happen?

It is actually very simple. Your money manager watched the market each day; and at the close of the market each day, he decided where to put your money. Your money on paper went into all the positive stocks (with an occasional clunker); and on paper, you had no reason to think the money manager was a scammer. He gave you very professional account statements, and his office was right downtown where everyone (including the police, SEC, and FBI) could see. It is easy to play the market when you choose the stocks you want to invest in after the market has closed.

How to prevent getting swindled by a Ponzi scheme

As it turns out, the real life money manager of the Ponzi scheme we just discussed did not even have a valid securities license. He had one at one point 20 years ago, but no one checked to make sure he was licensed to sell securities. A lack of license or revocation of license is the first tip off that you do not want that person managing your money.

Do your due diligence on the consultants giving you advice. It is much more important with money managers, but it is also important to check up on your CPA and attorney. You cannot be too careful these days.

How did the real life story end?

The money manager to date still has not been found. The FBI found less than $1 million in various accounts, which was given back in some form to duped investors. No one is really sure how many millions the money manager skipped town with. Word was that he had some very high-profile clients who refused to admit they got swindled for fear of how the public would perceive them.

Conclusion

Be careful when dealing with investment schemes and “advanced” tax topics. We have seen many clients get into plans that we know are not legal from a tax standpoint. Just because a company has nice marketing material (audio tapes and PowerPoint presentations) does not mean the company is credible.

We know of clients who had millions with viatical settlements when the company that invested the money allegedly embezzled it all. We have heard of clients doing the offshore credit card scams. We have heard of clients doing stock-basis-boost programs we know will not pass IRS muster. We know of clients who became employees of an Irish Leasing Company to defer income taxes. Finally, we know for a fact that many tax reduction plans were sold on the basis of a multi-million dollar client being allowed to take tax free loans from a life insurance policy because, under someone’s mythical rules,
the client is entitled to hardship loans to pay for college tuition or to take vacations or, basically, for whatever they want to use the money for.

While you may not have heard about some of the scams we listed in the previous paragraph, just wait; and chances are someone will be at your door talking about the next plan that you have to get into or you will miss the boat. Sometimes missing the boat is a good idea (see the people who missed their voyage on the Titanic).
Chapter Five
Business Management

Ways to Run a More Efficient and Financially Sound Business

Introduction

It is amazing at how many highly profitable businesses are not well run when it comes to some of the most basic business management topics. High-income business owners seem to make money in spite of the fact that they waste thousands of dollars on several of the topics covered in this chapter. Many of those who read this book will be professionals (physicians, attorneys, accountants). Most professionals are thought of as “smart” people; but one thing they do not receive in college, law, medical, or MBA school is how to run a business from an office manager’s standpoint. The same holds true for the self-made business owners many of whom did not go to college.

Most of the time, businesses have a “manager” of sorts who takes care of the day-to-day issues of the business. Sometimes this is the business owner; but many times, it is someone who was promoted internally who has no formal background in running a company. Even those businesses who hired someone who is supposed to be a manager do not deal specifically with some of the issues in this section of the book.

In this section of the book, we will try to point out areas where your company (large or small) might be able to improve upon when it comes to a variety of cost-saving topics.

While business management might not be the most exciting topic to read about, wasteful management practices in your business could be costing you tens of thousands of dollars; and, therefore, we thought the inclusion of this material in a wealth preservation book was warranted.

Section 1
Choice of Corporate Entity

Do you know what type of entity your business is? It would surprise readers that a good many clients have no idea what kind of corporate entity their business is and how that can affect them.

The vast majority of clients who know what kind of corporation their business is do not know why their business was set up as a C- or S-Corporation or a P.C. or LLC?
This section of the material is going to explain the types of corporate structures available and why a client would want to choose one over another.

Types of Corporations

C-Corporation

The typical discussion we have with clients about a C-Corp is that no one wants to use a C-Corp because everyone wants to avoid a corporate tax each year. A C-Corp is not a “pass through” entity meaning that any income left in the company’s bank account at the end of the year is taxed at the corporate tax rate (35% a year for professionals). If a corporate tax is paid and then the money is distributed to the owners, the owners also pay ordinary income tax on the money coming out of the C-Corp no matter if the income is dividend income or W-2 income; and that will give you the classic double tax that everyone wants to avoid.

The issue of a double tax in most businesses in our minds is a non-issue (unless the CPA and client are asleep at the corporate wheel). Every medium-to-small business owner takes every dollar out of the corporate bank account and pays it to themselves at the end of each year in the form of W-2 income (which avoids the corporate tax).

Pros to a C-Corp

Owners of a C-Corp can 100% tax deduct Long Term Care Insurance (LTCI) on a discriminatory basis for the key employees. Long term care is the number one worry clients should protect against in their estate plans. We recommend long term care insurance in every estate plan we put together for clients. Typically, however, clients do not want to buy LTCI because they do not think they will need the insurance and because it is expensive.

We recommend that clients purchase LTCI through a C-Corp where the client can take a 100% tax deduction for the insurance where, through the use of a return-of-premium option, every penny paid as a deductible expense can go to the employees’ heirs income tax free at death. We call the concept “free LTCI.” This concept can be implemented in a C-Corp on a totally discriminatory basis where the staff or other non-key employees need not be covered. To read more about this topic, please turn to page 225 in the income tax reduction section of this book.
S-Corporation

An S-Corp is a “pass through” entity. Pass through means that income in the company will pass through to the owners each year no matter if it is left in the corporate bank account or not. Unlike a C-Corp, if money is in the corporate bank account at the corporate year end (typically December 31st), the owners of an S-Corp will be seen as having taken the income out of the company and will be taxed on that money in the year it was earned.

An example we see quite often (and do not think makes much sense) is when business owners get year-end bonus checks but do not receive them until the second or third week of January. We have talked to many clients who thought, because a bonus check is issued in January, the income would be taxed in the year the check was issued. That is not correct; the income is taxable in the year it was earned (the year the money hit the corporate bank account regardless of when the money was distributed out as income to the client(s)). Because the company is an S-Corp, the money can stay in the corporation and not incur the corporate tax that would be incurred if the corporation were a C-Corp (although the money will be taxed in the year received at the personal income tax rate of the owner(s)).

Pros to an S-Corp

The main benefit to an S-Corp is the ability of its owners to take partner distributions. If your company is an S-Corporation, you have the ability to take upwards of 40% of your income as a partner distribution (the number ranges from 10-40% depending on what your CPA advises). Why would an owner want to take a partner distribution? To minimize taxes. How?

When a corporation gives partner distributions, the partners receiving that income will avoid paying 1.45% in Medicare taxes AND the corporation will avoid paying a matching 1.45% in Medicare taxes (a match) for a total savings of 2.9% in taxes on the money taken as a partner distribution.

For example, if an owner makes $500,000 and takes $200,000 of that money as a partner distribution, the owner would save $2,900 a year as would the corporation (an expense that gets line-item expensed to each owner) for a total savings of $5,800 in taxes a year per owner.

If a business owner takes partner distributions, the partner then will typically have to pay quarterly estimated taxes on that money. Many clients see the payment of estimated taxes as a bother; and if that is an issue you would like to avoid, please contact us for how to avoid paying estimated taxes (the taxes will still be due but not on a quarterly basis).
Limited Liability Company (LLC)

An LLC is an entity that is not used very often for professional practices and is a common entity for non-professional entities. An LLC (NOT an S- or C-Corp) is the main tool we use for asset protection (to help clients protect their real estate and brokerage accounts from lawsuits). Most clients are unaware of the fact that an LLC can be treated as an S- or C-Corp for tax purposes, thereby having the same advantages listed previously for S- or C-Corps.

In some states, if an election is not made to treat the LLC as an S- or C-Corp for tax purposes, the LLC will be treated like a partnership (but with all the asset protection features that accompany an LLC).

Professional Corporation (P.C.)

P.C.s function similar to LLCs except only professionals like physicians, attorneys, and CPAs can form P.C.s (in Texas P.A.s are used instead of P.C.s). A P.C. can and will be treated as either an S- or C-Corp or a partnership for tax purposes, again taking advantage of the issues listed above.

Partnership or Sole Proprietorship (SP)

We do not recommend either of these two entities for any business. While it is true that a corporation does not protect professionals individually for malpractice suits, a corporation (which neither a partnership nor SP is) does protect the owner individually from slip-and-fall cases or any other kind of lawsuit that would typically be filed against a corporation by your local personal injury attorney.

We cannot give a client one reason to remain a partnership or an SP.

As far as taxes are concerned, the total amount of taxes paid in a sole proprietorship is equal to what in total is paid by an owner in a C-Corp (only in regards to payroll taxes). This is yet another reason to have your business treated as an S-Corp.

Recommendation

Most local advisors do not give recommendations that make sense to clients when it comes to picking a corporate entity. Our recommendation is very simple—if a client wants to write off supplemental disability insurance (Equity Disability Trust) as an income tax reduction topic or if the client wants to take a 100% deduction to pay for long term care insurance, then the practice should be a C-Corp. If not, then an S-Corporation or an LLC or P.C. treated like an S-Corp will allow business owners to take partner distributions and lessen their Medicare taxes.
What if one owner out of ten wants to be a C-Corp and the other nine do not? Then we would recommend the Perfect Corporate Structure (see page 295 in this section of the book to read about the Perfect Corporate Structure) which would allow each owner in a “professional” company to create his/her own P.C., (treated as an S- or C-Corp) wherein each owner chooses to be paid as they see fit and take corporate deductions as they see fit (which is helpful when implementing income tax reduction topics like an Equity Trust, LTCI, and others).

Caution

There is one problematic issue with a C-Corp that generates money for owners of the company from work NOT done personally by the owners.

What work and why is that a problem? If a company has money coming in from ancillary sources such as MRI, physical therapy, selling pharmaceuticals (using physicians as an example), or if the owners make money from non-owner employees, that income **could be double taxed as “unreasonable compensation.”**

An example is the easiest way to explain the potential problem.

Assume Dr. Smith is an orthopedic surgeon with an MRI in his office and two non-partner physicians working for him. Dr. Smith from his own billing (of his own patients) makes $600,000 in earned income (W-2 income). Dr. Smith, however, takes home as W-2 income $800,000 because he makes an extra $100,000 from his MRI and $100,000 on his employee physicians. While the scenario sounds great for Dr. Smith (all physicians should make $200,000 extra in their practices from other sources), the IRS has been taking the stance in some situations that the extra $200,000 is **unreasonable compensation** on Dr. Smith’s part (for his normal professional services) and, therefore, that $200,000 should be taxed at the C-Corp level before being distributed to Dr. Smith.

Unreasonable compensation in the example of Dr. Smith basically means that he did not personally generate the money (from seeing patients); and the money was really earned by the C-Corp and, therefore, the IRS is now trying to tax the ancillary income at the C-Corp level (35% for professional companies in 2006) before it gets distributed to the physician as income.

The potential double taxation issue with ancillary income in a C-Corp could be devastating in some circumstances, and we wanted you to be aware of the potential problem. Our suggestion would be that, if you have a professional company that has significant ancillary income, you had better not be a C-Corp. If you are, we would suggest converting to an S-Corporation or P.C., or P.A., where you would not have the same problem.
Section 2
Retained Earnings Rescue

When a corporation that has retained earnings finally gets to the point of deciding that there is no reason to continue to retain the earnings, what options does the corporation have to remove those earnings from the company?

The main option most clients and their advisors are familiar with is to simply have the company pay to the owners of the company a year-end bonus. That bonus is a deduction for the company but 100% taxable income to the employee. Bonusing out retained earnings is a painful thing to do since the company already paid a sizable corporate tax on the earnings when retained. This classic double tax situation makes business owners cringe.

Is there a better option than simply bonusing out retained earnings to the business owners or key employees?

Would the business owner like to use a technique where on average 85 cents of every retained dollar could come out of the company income tax free where it would be transferred into an investment where it would grow tax free and come out tax free in retirement? The answer is absolutely.

How? Using a preferred/non-preferred LLC structure. This structure was discussed in the deferred compensation chapter. Please turn to page 221 and read about this structure before continuing.

Using this technique to remove retained earnings from the company works virtually identical to the non-profit deferred compensation solution. The only difference is that the company with retained earnings will take the place of the non-profit.
What happened with the above schematic?

1) The company funded as an investment an LLC with $1,000,000 of retained earnings. The company will be paid back its $1,000,000 investment and a long-term rate of return pegged to the long-term AFR interest rate (using simple interest). The return is guaranteed by the preferred life insurance policy purchased by the LLC using 15% of the retained earnings invested.

2) $850,000 of the $1,000,000 retained earnings was invested in a cash value life insurance policy that is specifically designed to build wealth.

The employee/owner is the managing member of the LLC and has the option of having the LLC borrow the money out of the life insurance policy income tax free (usually when he/she is in retirement). The LLC will pass the tax free borrowed money to the employee/owner through special allocations.

The loan from the life insurance policy will be paid back to the life insurance company at the death of the key employee through a reduction in death benefit (meaning the loan does not have to be repaid out of pocket by the owner/employee or his estate).

Again, what was accomplished? The owner of a C-Corporation removed 85 cents on the dollar of retained earnings where that money will be able to grow tax free and come out of the life insurance policy tax free when the owner is in retirement.
Without using the above technique, the owner would ultimately have to take the retained earnings home as W-2 income that could subject that income to 40%+ income taxes.

**What if the business owner is already near retirement age?**

If the owner of a corporation with retained earnings is already near retirement (60+ years old), it will be difficult to use a life insurance policy as a good investment for retirement plan purposes (the costs for the death benefit will be too high). The business owner can still use the preferred/non-preferred LLC in two different ways to remove the retained earnings in a tax favorable manner.

1) The non-preferred managing member could be the business owner’s son or daughter (or both). Why would this make sense? Most clients who have this dilemma who are close to retirement have sizable estates and estate tax problems. They have no need for additional retirement income and cannot gift enough money out of the estate to lessen the estate tax problem.

If a child becomes the non-preferred managing member where his/her life is used to purchase the insurance, a nice estate transfer can be accomplished. Affectively, the parent/business owner who would normally have to take the retained earnings out of the company, pay tax on it, and then try to gift it to the children can simply transfer it to a child through the LLC without gift or income taxes. This is a powerful estate planning solution that also solves the retained earnings problem.

2) The non-preferred managing member could be an irrevocable life insurance trust (ILIT). Why would this make sense for the older client? Again, the business owner probably has a large estate and, therefore, estate tax problem. The traditional way to solve an estate tax problem is to purchase life insurance. The problem with buying life insurance in most traditional estate plans is that a client has to pay sizable premiums that also create gift tax problems when gifting that premium to an ILIT.

When using the preferred/non-preferred LLC structure, instead of buying a cash building policy for retirement income, the LLC would buy the largest guaranteed death benefit possible on the life of the retiring business owner. When the business owner dies, the LLC (which is owned partially by the ILIT) will receive a sizable death benefit that will pass income and estate tax free to the heirs.

The use of an ILIT in the LLC structure with retained earnings has two powerful benefits:

- The premium for the life policy in the LLC was affectively paid with pre-tax dollars (remember that the business owner would have normally taken the retained earnings out and paid tax on it before gifting to an ILIT);
- There was no gift tax issue to deal with when funding the life policy in the LLC. Normally, when a client funds a sizable premium for a policy owned by an ILIT, the client must use his/her gift tax credit or pay a large gift tax. There is NO gift occurring with the LLC technique and, therefore, no gift tax issues.

**Conclusion on retained earnings rescue**

There are thousands of clients who are owners of C-Corporations who have retained earnings and are disgusted with the thought of taking the retained earnings home and paying ordinary income tax on that money (the classic double tax).

With the preferred LLC structure, clients can affectively remove approximately 85% of the retained earnings out of the company without tax where the business owner can have access to the money income tax free in retirement.

In the event the business owner is too old to use life insurance effectively as a retirement tool, the LLC structure could be used to move money to a child income and estate tax free by having a child or an ILIT be the non-managing member.

There are only a handful of attorneys around the country who are familiar with the simple structure. If you have an interest in finding one, please contact one of the authors.

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**Section 3**

**The Perfect Professional Corporate Structure**

If the following scenario sounds too familiar, then you should consider the Perfect Corporate Structure.

**The all too common scenario** (for offices with 2-150+ owners)

Dr. John Smith, age 40, making $500,000 a year in income, after researching income tax reduction solutions/supplemental benefit plans, decided that he would like to implement such a plan. Dr. Smith is terribly excited about a plan that will allow him to put away $75,000 a year in a tax favorable manner for use at a later time.

Dr. Smith works in a 20-physician practice and, after researching the tax reduction plan, goes to his partners and tells them that he wants to implement a plan and tells the partners that they will not have to pay for the plan and the plan does not require the inclusion of any other physician or the employees. However, the plan, like all non-qualified income tax reduction plans, requires a “corporate deduction,” and Dr. Smith, therefore, needs to have the partners approve the use of the corporation to implement the plan.
Dr. Smith even tells the partners he is willing to indemnify the corporation should there ever be any adverse consequences of implementing the plan.

Out of the 20 physicians in the group, five are younger, non-partners who are also interested in the plan. Unfortunately, five of the founding members (who also make up the Corporate Board for the group) are over the age of 55 and decide among themselves after little or no review of the plan that there is no upside to them and, therefore, tell Dr. Smith that they do not think it is a good idea and that they will not vote to allow him to implement the plan.

Dr. Smith is beside himself and joins the thousands of physicians around the country in a similar situation where they work in medical practices (or hospitals) either as owners or as employees where the main physicians or the CEO who runs the group VETO any plan that does not have an upside for those physicians or the organization as a whole.

The above scenario is a sad situation that we have seen all too often in medical, legal, and accounting practices. Many of the calls we receive on advanced topics are from professionals in groups in excess of five owners; and out of those who want to implement advanced income tax reduction plans, over half of them run into problems with their partners when asking for permission to implement a plan through the corporation.

The Perfect Corporate Structure is fairly simple and several professional offices around the country already have the structure. Most multi-owner professional practices have a main company (usually a C- or S-Corp) that employs both the principal owners and all the employees. Let’s call that the “mother” company. If an owner wants to implement any kind of income tax reduction plan, it must be done inside the “mother” company; and, therefore, there must be an agreement of the partners to allow one or more owners to implement such a plan. As we have stated above, it is virtually impossible to get five plus owners to agree to anything; and, therefore, one owner has little chance of getting an agreement to implement any kind of advanced plan.

With just the “mother” company in place, all the employees take their income from the “mother” company, usually via W-2 income.

The Perfect Corporate Structure exchanges a Professional Corporation (P.C.) for the owner as the entity to receive income that the owner would normally receive. So, instead of the owner receiving a W-2 paycheck from the “mother” company, the “mother” company would instead cut that paycheck to owner’s P.C., where the P.C. would, in turn, cut the paycheck.
Is it complicated to create a P.C. and have it paid instead of the physician?

Absolutely not. If Dr. Smith in our example has a contract with his medical office that says “Dr. Smith” will get paid whatever he is to be paid, Dr. Smith would simply re-do the contract to state that Dr. Smith’s P.C. will be paid his normal W-2 income (plus the normal matching corporate payroll taxes the “mother” company would pay on his behalf) as a consulting fee.

In Dr. Smith’s 20-physician group, Dr. Smith could be the only one being paid through a P.C. or any or all of the other physicians (either owners or employee physicians) can do so as well.

Once Dr. Smith has money in his own P.C., he can choose to do whatever he wants with that money without asking permission of the partners in the “mother” physician practice.

We have talked with practices lately where the clients are not allowed to write off any portion of their automobile lease payment, their cell phones, or food. In the Perfect Corporate Structure, each individual owner can make that determination for him/herself.

The biggest benefit to the “Perfect Corporate Structure” is the ability of each owner to implement their own income tax reduction plan without having to beg for approval from the partners in the “mother” corporation. As you will read in this book, we discuss several different income tax reduction plans, almost all of which can be implemented in an individual P.C.

Why wait? If you are in a company where you have no ability to do individual tax planning, you are costing yourself thousands in income taxes that could be saved or deferred via a supplemental benefit plan.
Conclusion

The Perfect Corporate Structure is simple to implement and works to save owners of professional practices headaches, which in the long run can save disgruntled owners from leaving and starting competing practices.

Section 4
Health Insurance

Besides rising commercial, residential, and property/auto insurance premiums and paying income taxes, the number one complaint of office managers and business owners is the rising cost of health insurance.

From a scale of 1-10, 1 being boring and 10 being exciting, talking about health insurance is below a 5. Having said that, the seminars on health insurance seem to receive some of the best turnouts, and there are always more questions from the audience than with any other topic.

The material that follows will discuss why health care costs are rising and several practical ways your office can attempt to curb the seemingly annual increases in cost.
Why Costs Are Rising

Today there are over 50 million Americans who are not insured, and that number is rising. Why is that number so large? Your first thought may be that the cost is too high for someone to have health insurance. Well, that is part of the story. Accessibility and cost are both factors when it comes to purchasing health insurance, not only for the small employer but also for the individual, sole proprietor, and large employer as well. In 1996, President Bill Clinton signed the Health Insurance Portability and Accountability Act, better known as HIPAA or the Kennedy-Kassabaum bill.

HIPAA/Kennedy-Kassabaum Bill

HIPAA was developed to help reduce the number of uninsured Americans and enable them to acquire health insurance. The act has actually resulted in the exact opposite. For the individual or sole proprietor, the act accomplished nothing. HIPAA only addresses the small employer—those employers who employ 2-50 employees. Therefore, for those who are employed by companies with more than 50 employees, nothing really has changed.

The main emphasis behind HIPAA was to allow an employee to be able to leave employer A and go to employer B and automatically be eligible for employer B’s health insurance plan regardless of his/her medical conditions. All preexisting conditions would be waived. It also allows employer A to move their current health insurance plan to another health insurance company. The new health insurance company must accept the employer’s request to allow the insurance company to insure his or her company. Regardless of the current medical conditions of the employer’s employees, the insurance company cannot decline the employer’s request to be insured.

What HIPAA does not address is what the insurance company can charge the employer. Some states have dollar amount caps on how much above manual book rates (the insurance company’s base rates) an insurance company can charge in premiums.

For example, when an agent submits a group who just received a 30% increase with 15 employees and 4 of those employees have ongoing medical conditions, once the new insurance company reviews the employees’ applications, the insurance company reserves the right to increase their base rate premium. Usually with an ongoing medical condition, the insurance company charges considerably higher rates so that changing companies becomes cost prohibitive for the employer to accept the new premium; and, therefore, the employer must stay with its current insurance company. This is by no means a better solution for the employer.

In the previous scenario, what has HIPAA accomplished? Yes, the employer can hire new employees and allow them to come onto their health insurance plan; but HIPAA has also caused insurance companies to increase their standard rates to make up for the fact that, by law, insurance companies cannot turn down new employees with expensive
health problems. If you are an employer and your employees do not have any ongoing medical conditions and you are shopping your health insurance because you received a 30% increase from your current insurance company, the new business standard rates (base rate) from the new insurance company are not competitive because of their rate adjustment on new business.

When HIPAA was enacted, the health insurance industry felt they were going to be inundated with many unhealthy people. Therefore, all insurance companies raised their base rates significantly for all new business. So, if an employer has a healthy group of employees and wants to shop his or her rates, there is a good chance they will not get competitive rates because of the increase in base rates due to the HIPAA scare. Even though HIPAA has helped with the accessibility problem for the small employer, the problem of an already high premium has been magnified.

**COBRA**

COBRA stands for the “Consolidated Omnibus Budget Reconciliation Act.” COBRA amended the Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974 to require that certain health plans provide “qualified beneficiaries” with the option of continuing health care coverage upon the occurrence of a “qualifying event.” The length of time that such continuation coverage is provided depends upon the type of qualifying event that occurred, and the initial continuation period may be lengthened or shortened depending on the occurrence of certain events during that period. COBRA provisions also address:

1. The type of continuation coverage that must be offered to a qualified beneficiary;
2. The process by which a qualified beneficiary must be informed of his or her right to elect COBRA coverage;
3. The qualified beneficiary’s responsibilities regarding electing; and
4. Paying for such coverage and the manner in which a qualified beneficiary pays for continuation coverage.

Finally, COBRA provides for various penalties and noncompliance with its provisions.

COBRA, too, has seen some changes due to HIPAA and other changes in 1999. COBRA can cause an employer’s premium to increase significantly. Most employers think that when an unhealthy employee who has had a number of significant claims terminates employment, it will help when the employer begins shopping their health insurance plan. If the employee elects COBRA, he or she is still part of the employer’s health insurance plan and can be for up to 18 months (36 months if disabled).
Having someone on your health plan who is not actually working for you but is affecting your health insurance rates is hard for an employer to understand. We heard a story of an agent who had a client where the employer hired a new employee. Three days after becoming eligible for health insurance, the employee terminated her employment. The employee had a great number of health problems. The employee, of course, elected COBRA.

The terminated employee then submitted over $85,000 in claims in a short period of time and eventually became totally disabled. She then extended her COBRA benefit for an additional 18 months. The employer had an 18-month “long-term” problem that affected the employer’s health insurance premiums in a very negative manner. This scenario happens frequently. Even though an employee you thought was costing you money in regards to your health insurance premium terminates employment, it does not necessarily mean they stop costing you money. Again, COBRA is a good thing for the employee but not necessarily good for the employer.

**Plans Covered by COBRA**

COBRA applies to employers who have employed 20 or more employees on a typical business day in the preceding year. Both full-time and part-time employees are counted in determining the number of employees an employer has. Each part-time employee is counted as a fraction of an employee.

**Those Eligible for Coverage**

An employee and dependent(s) who lose coverage due to the following reasons may continue coverage for up to 18 months:

1. Employee quits employer for any reason;
2. Employee is fired for any reason other than gross misconduct;
3. Employee loses coverage due to strike;
4. Employee loses coverage due to reduction of hours;
5. Employee loses coverage for reasons other than gross misconduct.

A dependent who loses coverage due to the following reasons can continue coverage for up to 36 months:

1. Death of employee;
2. Divorce from employee;
3. Legal separation (if decree does not require employee to continue coverage on spouse and/or children);
4. Dependent child reaches maximum age under plan;
5. Any other reason the dependent is no longer considered an eligible dependent.
An employee or his/her dependent is required to advise the company of a dependent status change within 36 days of occurrence in order for the dependent to continue coverage under the COBRA provision of the plan.

The employer may charge individuals electing coverage under the COBRA provision of the plan 102% of the premium.

If an employee elects continuation of coverage and during the eighteen months of coverage a covered dependent loses coverage for any of the reasons above, the dependent can continue coverage for up to, but no more than, a total of 36 months from the original qualifying event.

**Time Frames**

The employer or plan administrator must advise eligible employees and dependents of their eligibility for continuation within **fourteen days** of the employee’s termination.

The employee/dependents must notify the employer of dependents who are no longer considered eligible by the plan within **sixty days** of the date they are no longer eligible if the dependent wants to continue coverage.

Eligible employees/dependents must elect continuation and sign an election form within sixty days of notification by employer or within sixty days of loss of coverage, whichever is later.

Eligible employees/dependents must submit required premiums within 45 days of the date the election form is submitted.

Eligible employees/dependents must submit future premiums within 31 days of premium due date.

Understanding COBRA and its rules is very important. It is the employer’s responsibility to know the rules. If the employer does not follow the time-frame rules, they are opening themselves up to a lawsuit and could potentially be responsible for ALL the health costs of the terminated employee for a period of 18 months (and this would come directly out of the cash flow of the employer).

**Health Insurance Strategies**

*Practical Tips for Reducing the Cost of Your Business’s Health Insurance*

If your office is anything like most other medium-to-small businesses, you have been receiving significant rate increases with your health insurance over the last four
years. This section of the book’s material has been created to give the reader a few tips and options for decreasing the costs of your office’s health insurance.

**Fully Insured**

This type of insurance plan has been around since health insurance plans have been written. This type of plan requires the employer to pay a set premium per month, and the insurance company is at risk to pay all claims submitted on behalf of the insured. The insured's cost share with the insurance company by way of deductibles, co-pays, and co-insurance. If an employer gets a significant increase in their health insurance premium, they can either cost shift to the employees by way of increasing deductibles, co-pays, and co-insurance or pay the increased premium themselves. Depending on what part of the country you are located, the cost increases in fully insured health plans have been averaging 20-50% a year and will continue at least until 2008.

**Change the Deductibles and Co-pays**

One agent told the following story:

“To keep the costs down in the medical office I used to run, I decided that we would change our deductible from $500 a year to $1,000 (that move saved us over $1,000 a month in premium). I told the staff that the office would pick up the second part of that $1,000 deductible so, in essence, the cost to the employee would be the same. We ran the numbers and 85% of our employees would have had to reach the $1,000 deductible for the cost to be higher than paying the higher premiums for a plan with a $500 deductible.

In the two years that I was at the medical practice after I changed the deductible and co-pays, I only had one employee give me a bill to pay for any part of the second $500 part of the deductible. I do not know if the employees forgot or if everyone was healthy, but I know the office saved a significant amount of money.”

**Partially Self-Funded Plans**

Partially Self-Funded Plans allow the employer to become and act as an insurance company to a degree. In a Partially Self-Funded Plan, the employer funds minor claims out of their own cash flow. The employer buys insurance from a reinsurance company to fund for any large catastrophic claims. The employer also pays an administrator to process and pay claims, disburse Explanation of Benefits (EOBs) to the employees, and does all other administration work on behalf of the employer.

If funded properly and actuarially sound, a Partially Self-Funded Plan may save the employer a tremendous amount of money. To put it into perspective, a fully insured
carrier wants to make a 25% margin on all of their accounts. In a Partially Self-Funded Plan that 25% margin stays with the employer and not the insurance company.

Viability for your business

Just a few years ago, a Partially Self-Funded Plan would not be financially viable unless you had at least 100 employees. Because of the nature of the fully insured market and the increases we have seen, Partially Self-Funded Plans have been competitive for those employers under 100. We know a health insurance agency who has three clients who each have less than 15 employees who have plans that are partially self-funded. Each of these plans averaged a 30% cost savings in their first year.

With a Partially Self-Funded Plan, the employer also has the liberty of designing his or her own plan because the state does not mandate in a Partially Self-Funded Plan what the employer can and cannot cover. Employers love the freedom and flexibility to have an opportunity to improve their benefits and at the same time the potential to save on premiums.

Why are Partially Self-Funded Plans not being used?

There are two reasons why we think Partially Self-Funded Plans are not being used more. First, your average insurance agent does not do enough research to know that there are only a handful of companies in the country that will self-insure fewer than 100 employees. Second, those agents who switch their current clients to Partially Self-Funded Plans will take approximately a 50% commission decrease when moving clients from a Fully Insured Plan to a Partially Self-Funded Plan.

While we hope our agents are looking out for our own good, it certainly is plausible that agents will not switch clients to Partially Self-Funded Plans because of their self-need to keep their income higher.

If your office has more than twenty employees, we strongly suggest obtaining a Partially Self-Funded quote for your health insurance.

Section 125 Plans

Another way to reduce cost associated with a health insurance plan is to implement a Flexible Benefit Plan or Cafeteria Plan. Internal Revenue Code (IRC) Section 125 permits employees to pay their share of the cost of qualified benefits with pre-tax income. This means the employee does not have to pay Federal Income Tax or Social Security Tax on their contributions. The employer saves on matching Social Security contributions and on other taxes based on payroll. This is accomplished by installing a Cafeteria Plan, also called a Flexible Benefit Plan, as defined by the IRS.
The types of Cafeteria Plans allowed by Section 125 vary greatly, but the simplest and most cost effective is the Premium Only Plan (POP). Implementation of a POP primarily involves changing some of the administrative procedures within the existing employee benefit plan structure. Any size company’s total taxable payroll will be reduced by the amount of the employee premium contributions. As the total payroll is reduced, so are associated employer required payroll tax liabilities.

The savings depend on the total company payroll and the dollars employees contribute toward their benefits. Employees who contribute to the POP reduce their taxable income by the amount of their premium contributions, so they actually pay less income and social security taxes.

A flexible benefit plan saves payroll taxes for the employer simply by converting employee-paid insurance premiums to a pre-tax status. POP is an easy way to enhance your employee benefit package while at the same time saving you and your employee’s money. Health insurance (medical, dental, vision), Disability Insurance, and Group Term Life Insurance are all examples of premiums that can be paid for on a pre-tax basis. This results in a lower payroll tax scenario for the employer and an increase in employee take-home pay.

**Employer Savings Example:**

<table>
<thead>
<tr>
<th></th>
<th>W/O POP</th>
<th>With POP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Payroll</td>
<td>$500,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Pre-tax Employee Premiums</td>
<td>$0</td>
<td>$(25,000)</td>
</tr>
<tr>
<td>Net Taxable Payroll</td>
<td>$500,000</td>
<td>$475,000 FICA</td>
</tr>
<tr>
<td>Tax @ 7.65%</td>
<td>$38,250</td>
<td>$36,337 Payroll</td>
</tr>
<tr>
<td>Tax Savings With POP</td>
<td></td>
<td>$1,913</td>
</tr>
</tbody>
</table>

**Employee Savings Example:**

<table>
<thead>
<tr>
<th></th>
<th>W/O POP</th>
<th>With POP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Income</td>
<td>$30,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>POP Premium Contributions</td>
<td>$0</td>
<td>$(2,400)</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$30,000</td>
<td>$27,600</td>
</tr>
<tr>
<td>Estimated Taxes @ 30%</td>
<td>$(9,000)</td>
<td>$(8,280) After-tax</td>
</tr>
<tr>
<td>Premium Contribution</td>
<td>$(2,400)</td>
<td>$0</td>
</tr>
<tr>
<td>Net Take-home Pay</td>
<td>$18,600</td>
<td>$19,320</td>
</tr>
</tbody>
</table>

**INCREASED Take-home Pay With POP:** $720

While a Section 125 plan does not actually lower the cost of insurance, it can save both the employee and the employer on taxes paid. As is the case with all of the topics in this book, we are interested in getting information to the reader that can help educate and motivate the reader to save money. Health insurance costs are going to continue to rise and an annual review of your business’s health insurance premium and policy is a must.
Health Savings Account (HSA) (formerly Medical Savings Accounts)

Save Money on Health Insurance Costs While Providing Dental, Eye Care, and More with an HSA

Health Savings Accounts (HSAs) are a significantly underutilized tool by health insurance agents when trying to trim health insurance cost for the small employer.

What is an HSA?

An HSA is a separate account set up in conjunction with your office’s health insurance account that enables the employer or employee to contribute money tax deferred into a savings account to be used at a later time for a variety of health care costs.

What can the HSA Money be used for?

The money in an HSA can be used to pay an employee’s deductible and co-pays as well as a number of other health insurance costs not normally covered under traditional small employer health insurance plans. Those expenses not normally covered include: contact lenses, prescriptive glasses, dental treatments, orthodontics, drugs, psychiatrists, and the list goes on and on.

Why use an HSA?

There are three main reasons.

1) There is a great possibility you can lower your health insurance premiums for the office (sometimes in excess of 50%).

2) Your business can offer added benefits for your employees without any extra out-of-pocket costs.

3) If the money contributed to the HSA is not used during a calendar year, that money not only rolls for use during a later year but, at age 65, the money can be used as a supplemental retirement income.

As it stands today, most businesses do not cover dental or eye care for their employees. If your business could offer some form of dental and eye care coverage, it would be held in the highest regard by employees in the local community.
How Does an HSA Work to Save Your Business Money?

Today, most businesses have health insurance deductibles between $250-$500 per person. That means the maximum annual exposure to the employee is $250-$500 (and any co-pays). Based on the health of your business’s employees and the deductible, a health insurance company quotes your business both a family and an individual premium. Those premiums are getting higher and higher in a very difficult health insurance market.

HSAs are based on the concept of high deductibles. That’s right—high deductibles. Employee-only deductibles must be between $1,000-$2,550 a year and family deductibles must be between $2,000-$5,150. The key is that with the higher deductibles, the employee and family insurance premiums will be significantly lower.

The first impression of a change to a high deductible plan is negative by the employee and employer. No one wants to be responsible for that extra high deductible. The key to success with a high deductible plan is through the incorporation of the HSA. An employer or employee can fund the HSA to cover the extra cost of the deductible.

Why Would Anyone Entertain Such Madness?

Long-term savings and extra benefits. Right now, once health insurance premiums are paid, the money will never come back to the employer or employee. With an HSA, if the money is not used inside the HSA, the employee gets to keep the money as his/her own for future medical expenses. Once enough money is deferred into the HSA to cover the deductible, an employer can choose to stop contributing to the HSA, thereby significantly decreasing the annual health insurance/HSA expenses. An example is the best way to show the long-term benefits of an HSA.

Example:

Assume that with a small business health plan the family premium is $700 a month with a $500 deductible. Also, assume that a family premium with a $5,150 deductible is $250 a month. Assume the family premium is for a doctor/owner of a medical practice.
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total premium</strong> for Doctor Smith for 1 year</td>
<td>$8,400 with a $500 deductible plan</td>
</tr>
<tr>
<td><strong>Total annual savings in premium for Dr. Smith</strong></td>
<td>$3,000 with a $5,150 deductible plan</td>
</tr>
<tr>
<td><strong>Dr. Smith’s total contribution to an HSA for one year</strong></td>
<td>$5,150 (deductible)</td>
</tr>
<tr>
<td><strong>Total out-of-pocket cost for Dr. Smith which include the HSA contribution (pre-tax)</strong></td>
<td>$8,150 ($3,000 + $5,150)</td>
</tr>
<tr>
<td><strong>Annual out-of-pocket savings using an HSA plus a high deductible plan over the $500 deductible plan</strong></td>
<td>$8,400 - $8,150 = $250</td>
</tr>
<tr>
<td><strong>Assuming Dr. Smith spent $600 for his deductible and co-pays on $1,500 worth of real medical expenses in the traditional plan</strong></td>
<td>$600 out of pocket for deductible and co-pays (non-deductible)</td>
</tr>
<tr>
<td><strong>Amount pulled out of the HSA to cover the $1,500 costs</strong></td>
<td>$1,500 (deductible through the HSA)</td>
</tr>
<tr>
<td><strong>Total overall costs (pre-tax) of the $500 deductible plan</strong></td>
<td>$8,400 in premium (deductible expense)</td>
</tr>
<tr>
<td><strong>Total overall costs (pre-tax) of the HSA plan</strong></td>
<td>$3,000 in premium (deductible expense)</td>
</tr>
<tr>
<td><strong>Total cost savings (pre-tax) with the HSA</strong></td>
<td>$1,250</td>
</tr>
<tr>
<td><strong>Total assets at the end of the year with the $500 deductible plan</strong></td>
<td>$0</td>
</tr>
<tr>
<td><strong>Total assets at the end of the year in the HSA account ($5,150-$1,500)</strong></td>
<td>$3,650</td>
</tr>
</tbody>
</table>

In the above example, three good things happen.

1) The total out-of-pocket expenses for the health insurance and the HSA costs are $250 a year lower than the traditional $500 deductible non-HSA plan.

2) Dr. Smith’s family only used $1,500 of the $5,150 in the HSA account, and $3,650 stays in the HSA account that is owned by Dr. Smith.

3) Just as important is the fact that, IF the physician’s family is relatively healthy in years to come, the money accumulated in the HSA can roll to the next year, thereby cutting the next year’s out-of-pocket costs of the doctor. The doctor could also continue to fund the HSA at $5,150 a year to stockpile money in the HSA for other medical expenses (orthodontics) or for supplemental retirement benefits and, ultimately, that money can be used in retirement (like an IRA).

If the above example is a real world example, then why don’t all businesses have HSA accounts in conjunction with their group health plans? There are three main reasons.

1) Most insurance agents despise the concept of HSAs. When an agent lowers the premium for a client, the agent takes a significant pay cut. The agent makes nothing on money contributed to the HSA.

2) FEAR. Most employers don’t have the guts to implement a plan that raises the employee’s deductibles to $2,550 a year (for an individual). If fully explained to the employees, the employees should jump at the chance to have an HSA implemented in
their office. Why? The business is going to cover the difference between the old deductible and new deductible; and if at the end of the year the employee did not need to use the money in the HSA for deductibles, then that money becomes the employee’s.

3) Businesses with several sick employees (employees who always hit their deductible and then some every year) will have a hard time making the HSA concept cost effective due to prohibitively high insurance premiums and the fact that the HSA account will be drained every year for those sick employees.

This material does not give all the details behind implementing an HSA, but the material should make you aware of other options out there that your office should look at when trying to save money on a very difficult topic.

Section 5
Professional Employer Organization (PEO)

Professional Employer Organizations (PEOs) can save medical offices money on Group Health Insurance, Worker’s Compensation Insurance, and Income Taxes and outsource your office’s Human Resources (OSHA) compliance issues/liability.

Professional Employer Organizations are a nice way for many businesses to save money:

1) Health Insurance
2) Worker’s Compensation Insurance
3) Income Taxes

PEOs are also a terrific way to outsource the issue/liability of OSHA compliance and employee liability, which includes sexual harassment and wrongful termination.

What is a PEO?

A PEO is a company created to house/employ employees and to provide benefits to those employees. Small employers (less than 150 employees) have very little, if any, negotiating power with either health insurance carriers or worker’s compensation carriers. This has been evidenced painfully in the last several years with small employers receiving sometimes 75% increases on both health insurance and worker’s compensation insurance premiums.

The PEO was created to house/employ your employees. In effect, your current employees would become employees of a large PEO; and they would be leased back to your business where they would work under the business and its supervisors as they do normally.
Cost Savings

When your employees become employees of a 20,000+ employee PEO, your employees then fall under the health insurance plan of a 20,000 employee PEO that has tremendous leverage with which to negotiate health insurance premiums. That holds true also with the worker’s compensation insurance.

Additionally, the PEO would also do the payroll for your office; and your business would simply cut one service fee check on a bi-weekly or monthly basis to the PEO who would, in turn, pay the employees including the owners as your current business does today. By having a payroll service, you can be confident that your business is never going to incur another penalty for paying payroll taxes late (which happens to most businesses doing payroll in house at least once every two years).

Human Resources Compliance (HR) or OSHA Compliance

Most small-to–medium-size employers do not have the resources (or choose not to allocate resources) to hire a full-time HR/OSHA compliance officer. While having a nurse or the office manager take care of the HR/OSHA compliance burden is nice, what would be better is if that burden and liability was completely outsourced to a third party.

By having your employees become employees of the PEO, the PEO then has the burden and liability of the HR/OSHA compliance issues.

Cost of the PEO

CNA Insurance Co. used to have a very interesting “pitch” when it came to selling their PEO. CNA’s pitch was that their service fee was $300 a year and that CNA made their money from the commissions on the health and worker’s compensation insurance. Being a skeptic at heart, we did not believe that; and we did our own research to figure out where CNA was really making their money.

Most PEOs make their money from a spread on the payroll. By that we mean, if a nurse made $30,000 a year and the fee for the year for that employee was 1%, the cost would be $300. The problem with that scenario is that, if there is no cap, the rank-in-file employees with varying incomes will have varying amounts taken out of their paycheck to pay for the PEO fee. Additionally, there are typically no “caps” for high-income earners; so if a physician made a million dollars a year in W-2 income, the fee would be $10,000 that came out of that physician’s pocket if the fee was 1%.

Needless to say, when we figured out how CNA really made their money, it was evident that the PEO was not going to save clients enough money on health insurance and worker’s compensation insurance to justify the fee.
A Better PEO

We recently found a PEO that has a cap on their fees for high-income earners. The cap is a bit variable depending on the size of the practice, but typically the fees will decrease many times that of the normal PEO that does not have a cap on their fees.

Typically, when you run the numbers with the fees being capped, the PEO can save your business enough on health insurance and worker’s compensation insurance to justify its use.

Conclusion

If your office has been hammered by run-away health insurance costs and worker’s compensation costs, your office should seriously consider looking at a PEO.

If your office likes the concept of outsourcing the HR/OSHA compliance issues and liabilities, then you should look into a PEO.

If your office would like to outsource the payroll responsibilities and liabilities, then you should look into a PEO.

Income Tax Reduction

Lastly and possibly most important for clients in the high-income tax bracket is the fact that one particular PEO in the country has the ability to incorporate a special employee benefit plan that will work to reduce current income taxes and build a tax favorable retirement nest egg.

(This Plan allows key employees to reduce their income from $25,000 to upwards of $500,000 a year where 90% of that money goes into a supplemental benefit plan for use in retirement. The income tax savings are unparalleled as is the amount of money available from the Plan in retirement).

For more information on PEOs and how to reduce your taxes through a PEO, please contact one of the authors.
Section 6
Qualified Retirement Plans

Does Your Business Have the Right Pension Plan? (401(k)/Profit Sharing/Defined Benefit Plan)

If you are an employee or business owner in a business of any size, the chances are good that you have a pension plan of some kind already in place. The first part of the materials in this section are for those who do not have a plan in place or those who want to review the plan setup of their current pension plan.

Setting up a Typical 401(k)/Profit Sharing Plan (PSP)

Goals - What Do You Want From Your Pension Plan?

Businesses will differ in what they want from their pension plan. In general, the goal of a pension plan is to put money away for retirement tax deferred (you do not pay taxes on the money until you withdraw the money at retirement). In a business where there are highly compensated owners and several non-highly compensated employees, the goal of the pension plan should be to maximize the amount of money the owners can put away every year while minimizing the amount of money the owners must put into the plan for their employees.

That may sound like a harsh or cold statement; however, those are the cold realities of life with employees in a small business. (We are going to work from the assumption that employees do not go to work at medium-to-small businesses because of the pension plan offered by the business. If you believe you need to offer significant benefits to the employees through your pension plan in order to entice qualified employees to work at your business, then this section may not be for you.)

Typical Setup for a 401(k) Plan

Usually an insurance company, banking institution, mutual fund family, benefit consultant, or a brokerage firm will be chosen as the company to set up and administer your 401(k) Plan. The company should sit down with the owners and go through, at a minimum, the following list of options for the plan:

1. What will be the minimum age allowed for participation?

Typically, 21 is used as a minimum age.
2. How long must someone work for the company before they can participate in the 401(k) Plan?

Typically, the waiting period is one year.

3. When will a new employee start vesting in the plan?

Most companies use a sliding vesting schedule. For example: After you work for the company one year, you can start contributing your own money into the plan. The year you start contributing, the company also starts contributing on your behalf. Typically, you will not start to vest in money the company has contributed on your behalf for at least one year. That means, if the company contributed $1,000 on your behalf your first eligible year and you quit the day after that money was put into the plan on your behalf, you may not get to keep any of that money. It depends on whether or not you are vested. Typical plans will allow 20% vesting after one year, 20% after the second year, and each succeeding year until you are 100% vested at the sixth year. You are always 100% vested in money you put into the plan.

4. What is the maximum contribution the employees will be allowed to contribute to the plan?

Typically, this will range from 10-15% of pay.

5. Is the employer going to match what the employee contributes to the plan?

With some plans, in order to allow the owners to maximize the amount they put into the 401(k) Plan for themselves, they must have participation from the employees. In order to help that process, the employer sometimes will match what the employee puts into the plan. For example, if the employee puts $10 into the plan and the plan has a 50% match, the employer during that year will put in $5 for the employee. In addition, the employer may cap the amount of the match. A typical cap rate would be 6% of pay. If an employee put 15% of his/her pay into the plan, the employer would only have to match the first 6% of that employee’s pay. (If you allow your employees to immediately vest in the money put into the plan by the company, a match might not be necessary. The pros and cons of a match should be discussed in great detail with your pension consultant.)

6. What kind of investments are going to be used in the plan?

Typically, most businesses will use mutual funds as the main option for investments. Depending on who is running your plan, mutual funds that give a variety of options will be offered. (i.e., aggressive, conservative, international, bond, small cap, large cap, index fund, money market funds, etc.) The company chosen to set up and run your 401(k) Plan should have a consultant sit down with all your employees and owners to help them determine which of the available funds their money should be put in. As trustees of the plan, the owners have a fiduciary duty to the employee to make sure that
the investment options available to the employees are sound. (Fiduciary duties of the owners are a hot topic right now. It is important legally to make sure the owners have met all their fiduciary duties to the plan participants.)

7. How often will the participants of the plan be able to switch investments option? (For example: you might want to switch your money from an international fund to a domestic bond fund).

It used to be commonplace to tell clients that trading quarterly is sufficient; however, with the volatile marketplace, it is becoming increasingly important to allow employees to change their investment in a more timely fashion. Having said that, the more options you give your employees, the more expensive your plan will be from the administrative side.

8. How often will the participants receive financial statements?

We would submit that quarterly statements are sufficient. Again, the more statements, the more the plan will cost.

9. Will the plan allow for withdrawals other than at retirement?

Some plans allow loans to be taken out by participants. Typically, plans permit withdrawals of employee dollars in cases of financial hardship.


Plans typically have a range of information-sharing devices to improve employees’ understanding of the 401(k) Plan. Most employers view these devices as worthwhile for their positive effects on plan participation, contribution levels, and investment allocation decisions.

The above options are given in a plan that is self-directed. A self-directed 401(k) Plan allows each individual employee to choose among the investment options (usually mutual funds) where their money is going. The employee may have help in determining where they want to put their money, but ultimately the employee decides where his/her money is invested. (i.e., into conservative mutual funds (money market) or risky funds (potential for high growth, but also potential for low growth or losses)). More elaborate 401(k) Plans can allow a broker to manage your money for you, but that service is more expensive, for both the employer and employee.

**Differences between a 401(k) Plan and a Traditional Profit Sharing Plan**

1. The asset management fees (internal expense of the mutual funds and payment for administration of the plan) of a Profit Sharing Plan are typically paid by the employer: whereas, in a 401(k) Plan, the majority of the costs are typically spread out...
among the participants. (Administrative expenses like annual tax preparation of the 5500's are usually paid for by the employer)

2. The employee will not be allowed to contribute any of his or her own money into a typical Profit Sharing Plan, whereas with the 401(k) Plan, the employee may contribute up to 15% of his/her own income into the plan for his/her own benefit. (Total contributions cannot exceed $45,000 (in 2007)).

3. In a typical Profit Sharing Plan, the employee has little or no input as to where and how the money is being invested; whereas a 401(k) Plan is usually set up so that the employee directs what kind of investments his/her money goes into. (i.e., conservative or aggressive).

4. There is a shifting to some extent of the employer’s fiduciary duty to make sure that the money in the plan is being invested prudently. In a self-directed 401(k) Plan, the employee picks where the money is deposited, usually with the help of an expert from the company administering the plan.

5. Lastly, and possibly most important, a well-crafted, integrated 401(k) Plan/Profit Sharing Plan should allow the owners to put the maximum amount of money away for themselves while minimizing what must be contributed for the employees.

What to Ask When Shopping for a 401(k) or Pension Plan

It is amazing how many 401(k)/Profit Sharing Plan providers there are in this country. If you tried to review each one of them, it would be a full-time job for many many months. This part of the material should help you avoid some of the frustration you will inevitably go through when reviewing various pension plans in the marketplace. Importantly, we will give you tips for how to determine how the fees in your plan are structured and how much you business will really be paying for their services.

Before addressing the different types of fees incurred in a 401(k) Plan, we need to explain the difference between a “bundled” product and an “un-bundled” product. Simply put, a bundled product uses a company (usually an insurance company, mutual fund company, or larger bank) that is able to do the work for all the administrative chores listed below as well as any other option a plan creator wants to offer in a 401(k) Plan. Basically, that one company does everything; and you do not have to find different companies to take care of the 5500s, the periodic account statements, the education of the employees, and the list goes on. The problem when reviewing bundled products is that it is very difficult to figure out exactly how much the companies are going to charge your business for their services. Most businesses owner felt like the fees are “hidden.”
The different types of fees charged in administering a 401(k) Plan are:

(1) **Administrative/Recordkeeping Fees:**

Setup and/or conversion fees are usually charged when either setting up a new plan or converting an existing plan to a different company. (As a side note, be sure to review the *surrender charges* of any potential pension plan provider. Some providers will not let you switch away from their plan in a timely manner without significant financial penalties). A 401(k) Plan must have:

(a) **Plan document** as part of the setup of that plan.

(b) **Annual reports** *(5500s)* must be submitted annually to be in compliance with the federal laws regulating 401(k) Plans.

(c) **Periodic account statements** to plan participants. These statements typically show the participant where his/her money is invested and the growth of his/her investments.

Depending on whether you have purchased a bundled or unbundled 401k product, you may have to pay an itemized fee for the items listed above.

In a self-directed 401(k) Plan, it is the duty of the trustees to give the participants enough information so that an informed decision can be made when they are deciding where to put their retirement money. This education usually comes from a professional planner; and depending on whether or not you have a bundled or unbundled 401(k) product, you may have to pay an itemized fee for this service. (There are many other fees that could be incurred depending on the options you have in your plan. We have listed the fees that you typically find in all or most 401(k) setups. Usually, with bundled products, you are given many more options for an all-in-one price.)

(2) **Investment Related fees:**

**Expense ratios:** If you own a mutual fund, you should be familiar with the term expense ratios. Expense ratios are charged in all mutual funds. The expense ratio is the percent of your assets the company charges you to have your money invested in any particular fund. For example, if you had $100 in a mutual fund with an expense ratio of 1.5% and for the year your mutual fund neither lost money nor gained money, you would end up paying $1.50 as an expense for having your money in that mutual fund for that particular year. Expense ratios are extremely important and will greatly affect the annual expenses of your plan.

**An insurance company typically charges other asset fees** as additional charges for their plan management services and benefits they provide to the plan. Other asset fees are extremely important and will be talked about in greater detail below.
The Good, the Bad, and the Ugly when it comes to “Bundled” Pension Plans:

The Good

Having a bundled product is easy. Typically, the plan provider does everything. The provider helps pick the investment options that will be offered in the plan. The provider will “enroll” your employees by bringing qualified people to your place of work to educate them and help them pick the right investments. The provider will usually provide an 800 number for your employees to access so when they have questions they can get answers from professional advisors. Many providers allow your employees to trade on-line. The provider will do all the necessary paperwork, including monthly or quarterly statements for each individual, the required testing to make sure your plan is in compliance with all the necessary laws, and the 5500s. The provider will also create a plan document that meets your office’s particular needs. Some providers send newsletters to plan participants and provide software so that the employees can have continuing education on retirement issues. *A bundled product is easy for the office administrator and user friendly to the employees and owners participating in the plan.*

The Bad

Investment options available from the provider are usually limited. Many of the major companies selling a bundled product are insurance companies and large banks, which have their own “in-house” mutual funds. Typically, you are allowed to have a limited amount of outside funds available in which to invest; however, the insurance companies would prefer you use their funds. We gathered information from several insurance companies and banks, and we were surprised how few actually listed the expense ratios of the mutual funds that were available through their plans.

In a bundled product, which may have a “wrap” fee (discussed below), it is difficult to get full disclosure of how much it will actually cost your office to use a particular company’s product. We have seen pension experts from insurance companies tell clients that their company only charges $300 a year for administering the plan. With an **un-bundled** product, plan administration (all the quarterly statements, the plan document, the annual testing and the 5500s) costs most businesses in excess of $5,500 a year. Sometimes you feel like you have to beg the person pitching you a pension plan to break out all the costs in the plan so you can properly evaluate whether it would be cost effective for your business to use their plan. Instead of learning from the salesperson where the fees were really coming from, we had to have an outside pension expert tell us where to find all the “hidden” fees. Therefore, the bad—extreme confusion as to where the fees are and how much a particular plan will cost your business. If you can find an insurance company that will show their fees up front and fully explain how much you will be paying for their services, consider yourself lucky.
The Ugly

The ugly really is a consequence of having a plan in place where you do not know where the fees are and how much you are paying. Typically, with a bundled product, you have what in the business is called a “wrap” fee. The “wrap” fee is typically disclosed to the plan sponsor (the owners); however, information about the portion of the “wrap” fee devoted to the elements of expense (mortality and expense risk fees, distribution, services, investment management) is generally not disclosed. Since the typical wrapped account is an annuity, it is qualified as an insurance investment and not required to be registered or to disclose fees in the detail required of mutual funds under the securities law. One main problem with a bundled product that has a “wrap” fee is that most of the fees are netted out of the money invested. By netting out the expenses, you do not feel the pain of paying the expenses because you do not cut a check for the expenses; instead, it is deducted from the total asset pool. The distinction between investment management fees and other types of fees is blurred.

“Wrap” fees (excluding the investment management fee) usually depends on the number of people in your plan. These fees are typically between 50 basis points and 200 basis points or .05% -2% of your total assets invested. While the above may be somewhat confusing, the following is an example and should help drive home the importance of understanding all the fees in a particular pension setup.

Example:

Assume you have $2,000,000 in pension plans A and B.

Plan A uses a fully bundled product with a “wrap” fee and Plan B uses an unbundled product.

Plan A uses mutual funds offered by an insurance company that are “in-house” funds.
Plan B uses a variety of name brand funds like Fidelity, T-Rowe Price, Vanguard, etc. Assume that the “in-house” funds give the same return on investments as the name brand funds.

Plan A has average investment management fees/internal expense ratios of 1.8% for their funds.

Plan B has average investment management fees of 1.2%.

Plan A has a “wrap” fee of 1.2% to pay for the complete administration of the plan.

Plan B pays an outside TPA $6,000 a year to administer the plan.
The difference in costs will amaze you. Plan A has total costs for the year of approximately $60,000. Plan B has total costs for the year of approximately $30,000. It is difficult to quantify exactly how much more Plan A will cost over a 20-year period because, as the assets grow, the amount saved on administering the plan will be greater every year for Plan B.

Now assume that Plan A has an average rate of return on investments of 7% and Plan B has an average rate of return of 9%. The amount of extra money earned for Plan B the first year will be $40,000.

While it is important to have a plan where fees are low, it is always better to pay a little more in annual expenses if the additional return on your investments will be more than those extra expenses. For example: If Plan A returned 2% more a year in average investment returns then Plan B, the first year the extra investment income (collectively) for plan A would be that same $40,000, which actually makes Plan A $10,000 less expensive in the first year.

**Conclusion**

Know your expenses for administering your pension plan and the internal expense ratios for each mutual fund offered in the plan. If you have a bundled product or are looking at a bundled product, especially if a “wrap” fee is included, ask the provider or potential provider to break out each cost and show them to you on paper. If the salesperson tells you it will only cost you $300 a year to administer the plan, run away. Equally as important as knowing the expenses in the plan is having a detailed history on the mutual funds offered. Going with “in-house” funds is okay if they can show you a ten-year history that indicates the funds have competed well with the name brand funds. *Ideally, it would be better to use a company that did not use “in-house” funds within the pension product.*

Finally, there is nothing per se wrong with bundled products or “wrap” fees as long as you know what you are getting and how much you are paying.

With the worries about Social Security, employees will look towards their 401(k) Plans as a significant portion of their retirement income. As a manager or business owner, a working knowledge of your 401(k) Plans is a must. If you have not reviewed your pension plan in the last few years, we suggest finding time on your schedule to do just that.
Defined Benefit Plan

Starting back on January 1, 2000, businesses can use Defined Benefit Plans to enhance their retirement savings. Defined Benefit Pension Plans are traditional plans that promise workers a specific monthly benefit at retirement. The amount of the benefit is known in advance and is usually based on factors such as age, earnings, and years of service. The plan may state this promised benefit as a percentage of salary and years of service with the company (for example, 1% of final pay times years of service) or as a specific dollar amount and years of service (for example, $30 per month at retirement for every year a person has worked for the company) or as an exact dollar amount (for example, $100 per month at retirement). In order to be able to pay the benefits workers are earning, employers are required to make contributions to the plans. Revenues gained through the investment of the plan assets supplement these contributions. The employer bears the investment risk and normally professional money managers make the investments.

Defined Benefit Plans were widely used in the 1970's and early 1980's. Unfortunately, tax law changes and negative IRS reaction prompted many small, closely held corporations to choose a different kind of retirement plan. Changes to the tax code have been made so Defined Benefit Plans should become popular again. Why? Beginning on January 1, 2000, businesses can fund for the maximum retirement benefit allowable under both defined contribution plans (401(k) plans) and Defined Benefit Plans for their employees. The following example should help illustrate our point.

<table>
<thead>
<tr>
<th>Physician Age</th>
<th>Defined Benefit Funding</th>
<th>Defined Contribution Funding</th>
<th>Combined Plans Funding</th>
<th>Potential Federal Tax Savings @40% Bracket</th>
</tr>
</thead>
<tbody>
<tr>
<td>45</td>
<td>$31,544</td>
<td>$40,000</td>
<td>$71,544</td>
<td>$28,617</td>
</tr>
<tr>
<td>50</td>
<td>$53,686</td>
<td>$40,000</td>
<td>$93,686</td>
<td>$37,474</td>
</tr>
<tr>
<td>55</td>
<td>$94,804</td>
<td>$40,000</td>
<td>$134,804</td>
<td>$53,921</td>
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<tr>
<td>60</td>
<td>$133,004</td>
<td>$40,000</td>
<td>$173,004</td>
<td>$69,201</td>
</tr>
<tr>
<td>65</td>
<td>$187,130</td>
<td>$40,000</td>
<td>$227,130</td>
<td>$90,852</td>
</tr>
</tbody>
</table>

The maximum contributions numbers to a Defined Benefit Plan will vary depending on a number of circumstances.

Defined Benefit Plans are not for every office. Benefits to younger employees are minimal, and there are different rules governing Defined Benefit Plans than the traditional 401(k) Plans that may not appeal to your business. We have included this small and lightly detailed section on Defined Benefit Plans so you know they are now a viable option for your business as of January 1, 2000. For a detailed discussion about Defined Benefit Plans, please turn to page 193 in the income tax reduction portion of the book.
Pitfalls to Avoid When Funding Your 401(k) or Profit Sharing Plan

We recently heard of a very scary situation concerning a business’s pension plan, and we thought we would briefly discuss two pitfalls you want to avoid when funding your office’s pension plan.

First, never wait more than ten days after each paycheck to send money to your pension plan provider. Believe it or not, the Department of Labor (DOL) has found that small businesses sometimes use their employee’s pension plan money to help fund their business throughout the year.

For example, if you have bi-weekly pay periods that typically have $2,000 worth of employee contributions as their payroll deductions, you should send that $2,000 check to your pension provider within a few days after the paychecks are distributed. The employer then must fund the pension plan sometime during the following year, or the employer will run into significant problems with the DOL in addition to problems from delaying the funding of each paycheck.

Second, businesses need to be aware of the fact that their particular pension plan may not allow for discretionary funding on an annual basis. For example, some businesses have a pension plan that allows for discretionary funding, thereby allowing the owners to decide at the end of every year if they wanted to contribute to the Profit Sharing portion of their pension plan. If, in one year, the owners chose not to contribute, there would be no adverse consequences from the DOL (although the employees would be upset).

What you want to avoid is a situation where you think your plan document allows for discretionary funding when it does not. If, for some reason, you choose not to contribute to a pension plan for your employees when your plan document makes funding mandatory, you run the risk that your business will be subject to massive fines and repayment for money that should have been contributed.

If you do not know whether your plan allows for discretionary funding, find out soon. If your plan does not allow for discretionary funding, change your plan document immediately. What you want are options from your plan document, not a hammer for the DOL to hit you over the head with in the case of an inadvertent situation where your plan was not funded.
**412(i) Defined Benefit Plans**

For a discussion about 412(i) Defined Benefit Plans that can allow business owners to put away sometimes several hundred thousand dollars each year into a tax deductible qualified plan, please see the income tax reduction section of the book on page 193.

**Section 7**

**Employee Handbooks**

Why does a small business with one or two owners and four to ten employees need an Employee Handbook? For the same reason an office with 20 owners and 60 employees needs one: protection, certainty, and effectiveness.

A good handbook helps you manage fairly. When there are complaints about the guidelines in the handbook, you can blame the nameless attorney who put it together for your office. Specifically, the main reasons for having a handbook are to establish an “at will” employment relationship, describe a clear code of conduct for all employees, and inform staff of rules and benefits.

**Employment at Will**

“Employment at Will” is a legal term of importance to any employer. From a legal perspective, it is perhaps the main reason for having a handbook in that it protects the practice against unwanted lawsuits. The at-will clause allows the employer to terminate an unsatisfactory employee for any reason—with or without cause and without notice—and allows the employee to quit work for any reason without notice or cause. Without such a provision, employees who are let go may assert that they had a contractual relationship with the employer that required “just cause” for termination (defined by state statute and case law). If you are currently in a situation in which you need to know what just cause is, then reading this book may be a little too late.

A terminated employee will still be able to file for unemployment benefits, which can be opposed by the employer if the employee was fired for just cause; but the employee should not be able to successfully sue the employer to get his/her job back or for the more significant damages that accompany a wrongful termination lawsuit.

The following is the “at-will” paragraph from a typical Employee Handbook:
This handbook does not create a contract of employment between Bloomington Bone & Joint Clinic, P.C., and its employees. Although we hope that your employment relationship with Bloomington Bone & Joint Clinic, P.C., will be long term, either you or the Company may terminate this relationship at any time, for any reason, with or without cause or notice. Our relationship remains at will notwithstanding any provision in this handbook to the contrary. No supervisor, manager, or representative of Bone & Joint Clinic, P.C., other than the president has the authority to enter into any agreement with you regarding the terms of your employment that changes our at-will relationship or deviates from the provisions in this handbook.

The previous paragraph is listed on the very first page of that business’s handbook and is bolded and underlined just as you see above.

**Code of Conduct**

Another main reason for having a handbook is to provide a Code of Conduct for all staff to follow in the office. The handbook should be given to every employee, including owners. Why do you give the handbook to owners? The Code of Conduct has a harassment policy, and many of the harassment lawsuits in businesses come from owners sexually harassing their staff.

Clear Codes of Conduct give employees confidence that, if they act appropriately, they will not be penalized. While this may appear to contradict employment at will, a technically correct handbook provides both a code of conduct and the ability to let an employee go without fear of litigation. The following was the harassment section from the handbook we put together:

**Harassment**

It is the policy of XYZ Clinic, P.C., to provide an environment free from sexual and sex-based harassment. It is against the policy of the Company for any employee, whether a manager, supervisor, or co-worker to sexually harass another employee. Sexual harassment or sex-based harassment occurs when the unwelcome physical conduct of a sexual nature becomes a condition of an employee’s continued employment, affects other employment decisions regarding the employees, or creates an intimidating, hostile, or offensive working environment.

Sexual and sex-based harassment may include:

I. Requests for sexual favors;

II. Unwanted physical contact, including touching, pinching, or brushing the body;
III. Verbal harassment, such as sexual innuendoes, suggestive comments, jokes of a sexual nature, sexual propositions, and threats;

IV. Non-verbal conduct, such as displays of sexually suggestive objects or pictures, leering, whistling, or obscene gestures, and

V. Acts of physical aggression, intimidation, hostility, threats, or unequal treatment based on sex (even if not sexual in nature).

In providing a productive working environment, XYZ Clinic, P.C., believes that its employees should be able to enjoy a workplace free from all forms of discrimination, including harassment on the basis of race, color, religion, gender, national origin, age, and disability. It is XYZ Clinic, P.C.’s, policy to provide an environment free from such harassment.

It is against the policy of the Company for any employee, whether a manager, supervisor, or coworker to harass another employee. Prohibited harassment occurs when verbal or physical conduct that defames or shows hostility toward an individual because of his or her race, color, religion, gender, national origin, age or disability, or that of the individual's relatives, friends, or associates, creates or is intended to create an intimidating, hostile, or offensive working environment interferes or is intended to interfere with an individual's work performance or otherwise adversely affects an individual's employment opportunities.

Any employee who believes he or she has been sexually harassed or discriminated against or harassed because of one’s race, color, religion, gender, national origin, age, or disability should report the conduct immediately to the Director of Operations.

A thorough and impartial investigation of all complaints will be conducted in a timely and confidential manner. Any employee of the Company who has been found, after appropriate investigation, to have sexually harassed, discriminated against, or harassed another employee because of one’s race, color, religion, gender, national origin, age, or disability will be subject to disciplinary action up to and including termination.

Any business will be much better positioned in a harassment lawsuit if harassment is explicitly prohibited in a handbook.
Rules and Benefits

A handbook should provide employees with rules and benefits of the office. Having rules and benefits in writing allows an administrator to manage staff easily in a non-confrontational manner. While there may be resistance to a first-time handbook (depending on whether benefits are being cut, increased, or merely codified), you will soon find that the handbook eliminates debates and disagreements in the office. An administrator with a comprehensive, specific handbook will not worry about different treatment of different employees. When a question arises, the administrator or owner can refer to the handbook and implement the course of action prescribed.

Most business owners and managers are unaware of how important the process is to allow employees to take time off. Owners of businesses especially do not grasp the importance of the process because they do not have to ask to take time off. Owners typically work as long as necessary to get the job done and then take time off whenever they feel like it. If an owner wants to come in late or leave early on a particular day, it was not a problem as long as the work got done. Most employees in businesses are hourly workers and therefore, it is important to have a good process for the employees to put in to take time off.

The following is the procedure you can use when allowing your employees to ask for time off. First, any time an employee needs to take time off for any reason, they should fill out the following form and have it signed by their manager or the owner of the company if there is no manager.

**Paid/Non-Paid Time Off Request Form**

Name: ___________________________________________________
Date/Dates of Time ___________________
Requested:______________________________________
Number of Hours/or Time Range Requested: ____________________
Type of Request: ___________ Paid___________ Not Paid.
Apply To: ________Vacation ________Personal ________Sick
Employee Signature: ____________________
Date of Request: _____________________ Time: ______________
Approval Signature: ______________________

The above request form went hand in hand with the handbook’s section dealing with Time-Off Requests.

**Request For Time Off**

All time off shall be requested in writing on forms provided by the Director of Operations. Time off must be pre-approved, dated, and returned to the requesting employee. All requested time off must be used with accrued paid time. Once accrued paid time is exhausted, then time off
without pay must also be requested in writing. Time-off requests for the present year will be accepted starting the first working day of the new year for that year's time.

-Each employee will be allowed additional time off (such as the time before, time after, or both) for the holidays listed above.

-If the personnel working in each department (insurance and billing, nurses, and employees working in check-in and check-out) cannot agree on who shall use each particular day before and after each holiday, the Director of Operations shall at his discretion allocate who is to receive each day. The Director of Operations may create and use a "DRAW" system, thereby having a random selection to decide which employees will receive the days preceding and following the above stated holidays.

Employees are instructed to make sure they get all time-off requests cleared within their own department before ever filling out a time-off request for the manager’s signature. Making the employee clear the time-off request within their own department accomplishes three goals. First, the manager (or owner) is not really approving the time-off request; their fellow employees are instead. Second, making each department deal with the time-off issue forces the employees in each department to rely on each other and that helps avoid resentment for time-off requests. It is difficult for one employee to get upset with another for a time-off request when the upset employee must ask for help later on for his/her time-off requests. Third, having the requests in writing allows both the employee and the administrator to avoid confusion and confrontation should there be a dispute over personal, sick, or vacation time used.

Some businesses have strange and not terribly helpful rules when it comes to sick time and personal time. We’ve seen businesses where the employees were allowed two weeks sick/personal time. Sick time was replenished at an employee’s anniversary date, and the employees could use personal time whenever they wanted to for as long as they wanted. Employees in this situation who do not completely use their personal time prior to their anniversary will typically put in for an entire paid week off as “personal” time. In essence, some employees were using their sick/personal time as an extra week of vacation.

If you have this terrible setup in your business, the following is a correction for the problem:
Personal/Sick Days

XYZ Clinic, P.C., recognizes that an employee's inability to work because of illness, injury, or personal matters may cause economic hardship. For this reason, the Company provides paid personal/sick days to full-time employees.

Personal/sick days are granted to full-time employees after completion of their training period. Employees will receive a total of ten (10) days paid per year.

Personal/sick days are figured at the rate of .75 per month with one extra day computed the month of the employee's birthday.

Personal/sick days may be accumulated and carried over at the end of the year, but an employee may accrue and use no more than 30 days per year. There is no monetary reimbursement for unused days.

An employee shall only be allowed to use up to five (5) personal days a year. If an employee does not use one of his/her personal days during their calendar, that personal time becomes sick time and then accrues with the rest of the unused sick time.

If an employee quits working for XYZ Clinic, P.C., and has used or has been paid for sick time or personal time not accrued, the amount of overpayment for the used but unaccrued sick or personal time shall be withheld from the employee’s last paycheck.

Personal time may only be used in four-(4) hour intervals. Less than four (4) hours of personal time may be used but not more than four (4) unless otherwise approved by the Director of Operations. If personal time is used during a pay period where an employee works more than 80 hours, the employee’s overtime will be reduced to straight pay for the amount of personal time used during that pay period.

An employee needing a personal day is required to notify the Director of Operations as soon as possible so adequate coverage can be arranged.

Personal days cannot be used to take vacations. If you have any questions concerning the use of personal days, please see the Director of Operations for clarification.

By only allowing employees to use four (4) hours of personal time at one time (unless an exception is granted), the manager or owner does not have to ask them why they needed the time off. Further, employees, will typically end up with significant
personal time unused at the end of their year, whereas before an employee would typically use every hour of personal time as extra vacation time at the end of the year.

**Overtime and Vacation**

**Vacation**

After you have been with XYZ Clinic, P.C., for one year, you are entitled to two weeks (ten days) paid vacation time. After six months of service, you may take one week of vacation time (five days) with pay. After five years of service you are entitled to one day per year worked, accruing to a total of three weeks (fifteen days) at ten years of employment.

Vacation time may be taken at any time during the calendar year with the approval of The Director of Operations. The Director of Operations will make every effort to permit the employee to take vacation at the requested time. However, the Director of Operations must provide for adequate staffing levels; and employees should cooperate when scheduling vacation leave. Requests should be made as far in advance as possible in order to help guarantee time off.

If a conflict occurs when scheduling vacation leave within a department, the Director of Operations will have discretion to set the vacation schedule based on his/her best judgment.

Because vacation provides a period of needed rest and recreation, each employee is expected to take his/her full-allocated vacation **during the year it is earned**. Unused vacation time will be lost if not used. Further, if vacation time is used during a pay period where an employee works more than 80 hours, the employee’s **overtime** will be reduced to straight pay for the amount of vacation time used during that pay period.

The vacation time and personal time paragraphs may or may not be similar to the policies in your business. However, deciding not to pay employees time-and-a-half for 80+ hours worth of work when the reason the employee has over 80 hours is due to his/her use of personal or vacation time is an important issue. An example better illustrates my point. Assume you have an employee who works 82 hours during a particular two-week pay period. Also, assume that the employee used four (4) hours of personal time during the normal 80-hour pay period. Under the office’s handbook described above, that employee would be paid for 82 “straight” hours of work as opposed to 80 hours plus two (2) hours at time and a half.
Equal Opportunity Employer

In today’s sensitive working environment, your handbook should include a section stating that your office is an Equal Opportunity Employer. The Equal Opportunity Employer section means that you will recruit, hire, train, and promote people in all job titles without regard to race, color, religion, national origin, sex, age (except where sex or age is a bona-fide occupational qualification, as defined by law), or physical or mental disability.

Signature Page

Every handbook should have a page at the end for the employee to acknowledge receipt of the handbook with a signature.

**ACKNOWLEDGEMENT AND RECEIPT OF HANDBOOK**

I, Joanna Smith, acknowledge that I received a copy of Bloomington Bone & Joint Clinic, P.C.’s, EMPLOYEE HANDBOOK. I understand that I have an obligation to familiarize myself with its contents and the provisions of this handbook, policy manual, work rules, practices, and/or procedure of the Bloomington Bone & Joint Clinic, P.C.

I understand that nothing in this handbook constitutes a contract of employment or guarantee of benefits, that my employment is for no definite duration, and is an employment-at-will relationship. As such, I enjoy the right to terminate my employment with or without cause or notice at any time; and my employer reserves the right to do the same.

SIGNATURE:________________________

WITNESS:_________________________________

The business manager should witness the signature of the employee. The signature page should be copied and placed in the employee’s personnel file. We suggest handing the handbook out at the end of the day so that the employee does not use an hour of work to go through the handbook.

Other Possible Provisions

EMPLOYMENT STATUS, TRAINING PERIOD, GENERAL RULES AND REGULATIONS, PARKING AND ACCESS TO PREMISES, ATTENDANCE POLICY, SAFETY POLICY, NON-FRATERNIZATION POLICY, HOURS OF WORK POLICY, TIME RECORD, HEALTH INSURANCE, WORKSHOPS AND SEMINARS, COMPUTATION OF TIME, PAY PERIODS, EMPLOYEE RECORDS, LOST PAYCHECK, CONFIDENTIAL INFORMATION, NON-SMOKING ENVIRONMENT, PERSONAL APPEARANCE, PERSONAL PHONE CALLS, FOOD AND DRINK,
HOUSEKEEPING, CIVIC RESPONSIBILITY, MILITARY LEAVE, GARNISHMENT, LEAVE OF ABSENCE WITHOUT PAY, OTHER ABSENCES, MATERNITY LEAVE, BEREAVEMENT LEAVE, SALARY INCREASES, JOB PERFORMANCE APPRAISAL, GRIEVANCE PROCEDURE, and TERMINATION.

**Does Your Business Need a New Handbook?**

If your existing handbook contains the elements described in detail above, you can probably get away with an update to your existing handbook. If not, you may be better off starting from scratch with help from an attorney.

Theoretically, you could purchase a formbook and customize a handbook for your office: but unless you have a legal background, we do not recommend this. There are many fine points involved in creating a handbook and many ways an attorney can help you save money on issues such as overtime, sick time, personal time, etc. While it is expensive to consult an attorney, in this case it is worth it.

Finally, whether you are creating a handbook from scratch or replacing an outdated one, we advise making your handbook as inclusive and specific as possible. A clear, comprehensive handbook can indeed be an administrator’s best friend.
Chapter Six
Reaching Critical Capital Mass (CCM)

Examples of what a Comprehensive Asset Protection, Estate Plan, and Income Tax Reduction Plan Should Look Like

In the following pages, we will cover what clients of different ages need to do in order to reach Critical Capital Mass (CCM). The following different types of clients will be covered: 1) a client just starting working, 2) a client who has been in working for 5 years, 3) a client who has been working for 15 years, and 4) a client who is 60 years old.

We are going to assume that the examples below are clients who are married. While that is not always the case, most high income and/or net worth clients are married and, even if they are not, most of the advice will be the same whether the client is married or not.

We are further going to assume that the clients discussed below are professionals with “personal” liability. If you are not a professional, the vast majority of the information below will still apply to you (assuming you make decent money or have a growing or sizable net worth).

1) Client just getting started

The typical client who just graduated from college (law school, medical school), has a decent amount of student loans, very little in built-up wealth or assets, and his/her first job making a decent amount of money. Many times the client will be married with a spouse who is also making decent money from work.

Assets:

- Two used automobiles with no debt;
- New house with a significant mortgage (due to little money for a down payment);
  - A lot of personal property (junk) accumulated over the last ten years;
  - One child, age 4.

Assume this client makes $150,000 a year or has a combined income with the spouse of in excess of that amount.

Recommended Plan:

Asset Protection

There is very little need for asset protection because there are no assets to protect.
The client should make sure he/she has the maximum amount of disability insurance (DI) to protect the family in case of a disability. The younger you are when DI can be purchased the better so that the lowest possible premium can be obtained.

**Income Tax Reduction**

It is unlikely in this example that the client will have any disposable income to transfer to an income tax reduction plan. The client would typically start out as an employee and will not be vested in the new employer’s pension plan for usually one year. Typically, the client would be allowed to make a voluntary 401(k) Plan contribution that would come out of his/her paycheck (which is limited to $15,000 a year in 2006).

If this client could possibly allocate $25,000 a year towards an income tax reduction plan in addition to a 401(k) plan, we would recommend the ABC Plan (due to its flexibility in funding).

**Estate Plan**

Chances are significant that this client only has a will and nothing else. This client should immediately implement, in addition to a will, marital A&B trusts and durable powers of attorney as basic estate planning tools.

The client probably only has $500,000 in term life insurance, which should immediately be increased to $2,000,000. We would also strongly recommend Return of Premium Term instead of traditional term life insurance.

**Financial Plan**

It is unlikely the client has any significant brokerage accounts or balances in his/her bank accounts. Due to the young age of the client, if he/she wants to give some post-tax money to a broker, that would be fine.

We would, however, like to see the client contribute to a Section 529 Plan to fund for the education of the only child. Money in a 529 Plan is funded post-tax and is available if needed in a catastrophic situation to pay normal living expenses of the family. Assuming the money is not needed for family living expenses, the goal of funding for the child’s education will be started.

The client should take a home-equity loan out on his/her new house and pay off the student loans. Interest on student loans is not tax deductible where the interest on a home-equity loan is.
2) **Client who has been in working for five years**

The typical client who has been working for five years is getting to the point where most of the debt is gone (except for a home mortgage and possibly an automobile); and the client, if a professional, is now a partner in the medical, legal, accounting, or other professional practice. As a partner, the income of the client goes up as well.

**Assets:**

- Two new automobiles with minimal debt;
- New house with a moderate mortgage (when taking into consideration what the client makes);
  - $50,000 in a brokerage account;
- 2 waverunners
- Two children, ages 8 and 4.

For this example, let’s assume the client now makes $500,000 a year in W-2 income. Half-a-million dollars is too little for many clients and too much for many, but for the example, it should be a happy medium for applicability purposes for the reader.

**Recommended Plan:**

**Asset Protection**

Like example Number 1, this client is in the accumulation phase of assets. There are no large assets to protect besides the marital home (which should be owned as tenants by the entirety if possible to asset protect the home’s equity and it would be a good idea from an asset protection and financial planning point of view to use the 1% cash flow arm home mortgage coupled with “equity harvesting” to raise money for investing).

If the client is worried about protecting his/her brokerage account, that account could be transferred to an LLC; but at this point, that is a judgment call for the client to determine if the cost of the LLC can be justified.

The client should seriously consider moving the waverunners to an LLC. Moving the waverunners to an LLC would not be done to protect the assets from loss but instead from the tremendous liability that goes along with being an owner of them. Once the waverunners are in the LLC, a potential creditor (someone injured from the use of the waverunners) would have as his/her sole remedy the assets inside the LLC and not the rest of the assets of this client.

The client should make sure he/she has the maximum amount of disability insurance (DI). If this client were interested in getting the “maximum” amount of DI coverage, we would recommend pension plan protection DI and/or business overhead expense insurance. The younger you are when DI can be purchased the better, and the client would want to protect his family in the event of a disability.
**Income Tax Reduction**

In this example, the client is starting to get to the point where he/she can seriously look at an income tax reduction plan. If we assume the client is a small business owner, the client is now fully vested in the practice’s 401(k)/Profit Sharing Plan and the client should be contributing between $30,000-$45,000 to that pension plan (which is dictated by how much the partners vote to contribute on behalf of the staff).

How lavish the client and his/her family live will dictate how much disposable income the client has to contribute to a supplemental benefit plan. If the client owns a small business and wants to start slowly with minimal dollar amounts, we would strongly recommend the ABC Plan. The ABC Plan would be the most flexible income tax reduction plan because the client can choose to implement it as he/she sees fit each year.

If the client wanted to retire early, then funding of between $50,000-$100,000 a year to a supplemental benefit plan would be warranted (usually with a funding period of 5-10 years).

By contributing to a supplemental benefit plan, the client will reach Critical Capital Mass many years earlier than by investing post-tax in the stock market.

**Estate Plan**

Chances are significant that this client only has a will and nothing else. This client should immediately implement, in addition to a will, marital A&B trusts and durable powers of attorney as basic estate planning tools.

The client probably only has $500,000 in term life insurance which should immediately be increased to $2,000,000. We would also recommend Return of Premium Term instead of traditional term life insurance (unless the client implements the equity harvesting concept where a cash building policy would be purchased).

The client should start to consider funding for long term care insurance (in a tax-deductible manner if possible).

**Financial Plan**

This client has $50,000 in a brokerage account. We would suggest transferring some or all of that money to a Section 529 Plan to fund for the college tuition and expenses of the children. The money would be available to the family, if needed, but with the new income, that is not likely.

If funding for college education early is not a priority, then having a local stockbroker manage the money is fine. Some clients like to keep that money in a bank account in case of an emergency (which we are not a huge fan of because the amount of
money is not significant). Basically, the money could be invested just about anywhere except penny stocks; and it could be justified because of the very young age of the client.

3) **Client who has been in working for fifteen years**

The typical client who has been working for fifteen years is getting to the point where most of the debt is gone (except for a home mortgage and possibly an automobile), and the client is now starting to accumulate significant wealth and assets.

Assets:

- Two new automobiles with minimal debt;
- New home worth $600,000 with a $300,000 mortgage;
- $500,000 in a brokerage account;
- 2 waverunners
- $350,000 motor yacht (with loan amount of $200,000)
- Two children, ages 18 and 14.
- Ownership in an office building with little equity
- Vacation condo in Florida worth $200,000 (with $100,000 mortgage)
- Universal life insurance policy with a $2,000,000 death benefit and $40,000 in cash surrender value (owned individually)
- $700,000 in the business’s pension plan

For this example, let’s assume the client now makes $500,000 a year in W-2 income. Half-a-million dollars is too little for many clients and too much for others; but, for the example, it should be a happy medium for applicability purposes for the reader.

**Recommended Plan:**

**Asset Protection**

Unlike examples Numbers 1 and 2, this client has accumulated several assets that will continue to grow in size. There are a few large assets to protect besides the marital home (if allowed in his/her state, the marital home should be owned as tenants by the entirety to asset protect the home’s equity; and it would be a good idea from an asset protection and financial planning point of view to use the 1% cash flow home mortgage to raise money for investing).

**Title**

**Personal residence**

Tenants by the Entireties

(Most states do not have T by E as a way to own the home and even if the client lives in one of those states, we would strongly recommend that he/she us the 1% CFA mortgage (or an interest only mortgage) coupled with “equity harvesting.” This will protect the house by placing a debt shield on it and equity harvesting is also a terrific investment due to the ability to write off the interest*)
Reaching Critical Capital Mass

<table>
<thead>
<tr>
<th>Brokerage Account</th>
<th>LLC #1</th>
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<tbody>
<tr>
<td>If the vacation condo were ever rented, the brokerage account would get its own LLC.</td>
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<table>
<thead>
<tr>
<th>Vacation Condo</th>
<th>LLC #1</th>
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<tbody>
<tr>
<td>(Unless rented and then a separate LLC should be considered)</td>
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<table>
<thead>
<tr>
<th>Office Building</th>
<th>LLC #2</th>
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<tr>
<th>2 Waverunners</th>
<th>LLC #3</th>
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<tr>
<th>Motor Yacht</th>
<th>LLC #4</th>
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<table>
<thead>
<tr>
<th>401(k)/Profit Sharing</th>
<th>Qualified retirement money is federally protected</th>
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</table>

The client’s **brokerage account** is the most liquid asset in the entire estate and must be protected. A domestic LLC should suffice; but if the client wants to spend the money, an offshore LLC or trust could be warranted.

The **vacation condo** has $100,000 in equity, and it will be appreciating in value. The condo could go in the same LLC as the brokerage account as long as the condo is not rented. If the client rents the condo, then it should be in its own LLC. Lastly, if the client believes the vacation condo will stay in the family for years to come, then a family limited partnership (FLP) should be considered with a gifting program to transfer to the children 98% of the non-voting interest in the FLP. The FLP will asset protect the condo and lessen the size of the client’s estate without giving up control of the asset until death.

The client should move the **waverunners** to an LLC. Moving the waverunners to an LLC would not be done to protect the assets from loss but instead from the tremendous liability that goes along with being an owner of them. Once the waverunners are in the LLC, a potential creditor (someone injured from the use of the waverunners) would have as their sole remedy the assets inside the LLC and not the rest of the assets of this client.

The **motor yacht** should be owned by its own LLC due to the individual liability it poses to the owners as well as to asset protect the value of the asset.

The **office building** should be owned by an LLC. If not, it should be transferred immediately. The interest in the LLC can be owned by the client individually because of the asset protection features of the LLC.

The money in the client’s **401(k)/Profit Sharing Plan** is asset protected by federal law.
The client should make sure he/she has the maximum amount of disability insurance (DI).

**Income Tax Reduction**

In this example, the client should have already started a supplemental benefit plan that can reduce his/her income taxes (401(k)/Profit Sharing).

We would recommend a Defined Benefit Plan or 412(i) Plan if there were few employees. In addition, the ABC Plan would be a good option so the client can reduce his/her income by at least an additional $50,000 a year and more likely $100,000 a year. If the client were concerned with flexibility in funding, we would recommend the ABC Plan. If the client is a C-Corporation, the client could also look to use a Section 79 Plan as an additional wealth-building tool.

By contributing to a supplemental benefit plan, the client will reach Critical Capital Mass many years earlier than by investing post-tax in the stock market.

**Estate Plan**

Chances are significant that this client only has a will and A&B marital trusts. This client should consider adding durable powers of attorney as a basic estate-planning tool.

This client has a Universal Life (UL) insurance policy with a $2,000,000 death benefit and $40,000 in cash surrender value. The UL policy should be inside an Irrevocable Life Insurance Trust (ILIT) so the benefit can pass income and estate tax free to the beneficiary(s). The spouse could be one of the direct beneficiaries of the death benefit or could be a beneficiary of the ILIT at the discretion of the trustee if needed. Future premiums would be gifted to the ILIT, which would, in turn, pay the premiums.

Ideally, we would rather see a client paying for life insurance premiums pre-tax or in a tax-favorable manner. For this client, we would recommend that the client look to a VEBA or Section 79 Plan if the circumstances were right.

The client should seriously consider transferring the vacation condo and possibly the personal residence into a Family Limited Partnership (FLP) where the client can start to give the value of the assets to the children when the client sees fit (if he does not plan to sell the residence).

The client should start to consider funding for long term care insurance (in a tax-deductible manner if possible).
Financial Plan

This client has $500,000 in a brokerage account. Due to the age of the children, funding a 529 Plan at this point is not terribly beneficial.

How the $500,000 is invested will depend on what advice is given. If the client likes his/her money actively traded, then a stockbroker should manage the money. If the client does not want risky investments, then some of the money could be transferred to an indexed annuity with a minimum guarantee and growth pegged to a stock market index.

If the client wants to get aggressive with protection he/she could use the Maximizer or if he wanted to have fun with some of the money, he/she could try a hedge fund as an investment.

Bottom line is that the client should diversify his/her post-tax investments and not keep them all in one pot. As the client gets older, moving money to a principal protected account will be very important.

4) A Client who is sixty-five-years old

A sixty-five-years old client is usually thinking about retirement and most of the time is close to Critical Capital Mass. Many clients simply enjoy working (although the potential for negligence suits for professionals takes away from that enjoyment). The sixty-year-old client has the greatest need for a proper asset protection plan, estate plan, and financial plan and is at a point in his life where charitable giving should be explored.

Assets:

- Two new automobiles with minimal debt;
- House that is worth $500,000 with almost no mortgage;
- $750,000 in a brokerage account;
- $350,000 motor yacht (with no debt)
- Two children, ages 34 and 30.
- Ownership in commercial property with $500,000 equity (and a $100,000 basis)
- Vacation condo in Florida worth $400,000 (with no mortgage)
- Universal life insurance policy with a $2,000,000 death benefit and $300,000 in cash surrender value (owned individually)
- $750,000 in the business’s pension plan
- $750,000 in an IRA.

For this example, let’s assume the client makes $500,000 a year in W-2 income. Half-a-million dollars is too little for many clients and too much for others; but, for the example, it should be a happy medium for applicability purposes for the reader.
**Recommended Plan:**

**Asset Protection**

Unlike examples Numbers 1, 2 and 3, this client has accumulated significant assets that will continue to grow in size.

<table>
<thead>
<tr>
<th>Title</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal residence</td>
<td>Tenants by The Entireties</td>
</tr>
</tbody>
</table>

(The client has no debt on the house and might want to consider the 1% cash flow home mortgage program to raise money for investment in a tax favorable manner (since the client can write off the interest on that debt*).)

<table>
<thead>
<tr>
<th>Brokerage Account</th>
<th>LLC #1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vacation Condo</td>
<td>Family Limited Partnership</td>
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</table>

(Unless rented and then a separate LLC should be considered)

<table>
<thead>
<tr>
<th>Commercial Property</th>
<th>LLC #2</th>
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<tbody>
<tr>
<td>Motor Yacht</td>
<td>LLC #3</td>
</tr>
<tr>
<td>401(k)/Profit Sharing</td>
<td>Qualified retirement money is federally protected</td>
</tr>
<tr>
<td>IRA</td>
<td>Roll into the pension plan at work</td>
</tr>
</tbody>
</table>

(IRAs are specifically protected from creditors in some states. If this client is not in one of those states, he/she should roll the IRA into the medical office’s pension plan)

| Universal Life Policy  | Irrevocable Life Insurance Trust* |

The client’s brokerage account is the most liquid asset in the entire estate and must be protected. A domestic LLC should suffice; but, if the client wants to spend the money, an offshore LLC or offshore asset protection trust could be warranted.

The vacation condo, unless rented, should probably be transferred to an FLP for asset protection and estate planning. If the client believes the condo will be sold at some point, then an LLC might be used instead of an FLP. The FLP will asset protect the condo and lessen the size of the client’s estate without giving up control of the asset until death.
The motor yacht should be owned by its own LLC due to the individual liability it poses to the owners as well as to asset protect the value of the asset.

The commercial property should be owned by an LLC. If not, it should be transferred immediately. The interest in the LLC can be owned by the client individually because of the asset protection features of the LLC.

The money in the client’s 401(k)/Profit Sharing Plan is asset protected by federal law.

The client should roll the IRA into the business’s pension plan or potentially into a new Profit Sharing Plan created inside the FLP. By moving the money in the IRA into a Profit Sharing Plan, the client then will completely asset protect the money.

The Universal Life (UL) policy is asset protected in some states. While that’s interesting, the life policy is in the client’s estate and he/she has an estate tax problem. The client could gift the UL policy to an irrevocable life insurance trust (ILIT) so the cash value and death benefit will be asset protected and to assure that the death benefit will pass income and estate tax free to the heirs. The problem is that there will be a gift tax upon transfer or he/she will have to use part of the one time estate tax exemption to avoid the tax. A better option would be for the client to sell the policy to a life settlement company for approximately $450,000 and buy a new 2nd to die policy inside an ILIT. The new policy will be less expensive than the current one and there will be less of a gift tax or no gift tax implication when funding the new policy. Plus the client pockets a significant amount of cash while still maintaining the insurance.

Disability insurance (DI) is not that important a topic for this client.

**Income Tax Reduction**

In this example, the client already has significant money in qualified retirement plans and in a brokerage account. Income tax reduction is still important because the client needs his/her income less now than at any time in the past.

Many of the income tax reduction solutions will not work for the older client because those solutions use life insurance as an investment (which is difficult when starting after age 60). The main option for this client will be the ABC Plan, which will allow the client to reduce his/her income by several thousand dollars a year.

This client should also strongly consider charitable giving as a way to reduce the size of his/her estate (and therefore estate taxes) and as a way to receive a current income tax deduction. We would recommend the CGA that we discuss in the Charitable Planning part of this book on page 202.
Reaching Critical Capital Mass

Estate Plan

With a client who is sixty years old, we would hope that by now he/she would have a will and A&B marital trusts. If not, the client should implement both immediately. The client should consider adding durable powers of attorney as a basic estate-planning tool.

This client should strongly consider using a Life Settlement to get out of his/her Universal Life (UL) insurance policy (which has a $2,000,000 death benefit and $300,000 in cash surrender value). Using the money from a Life Settlement, the client could purchase a 2nd to die life insurance policy owned by an ILIT. If a Life Settlement does not work, the client should consider gifting the policy to an Irrevocable Life Insurance Trust (ILIT) so the death benefit can pass income and estate tax free to the beneficiary. The spouse could be one of the beneficiaries at the discretion of the trustee if needed. Future premiums (if needed) would be gifted to the ILIT, which would, in turn, pay the premiums.

This client (if insurable) could simply surrender the UL insurance policy for $300,000 and purchase a new policy. The new policy could be purchased in a VEBA through a Section 79 Plan or the old-fashioned way (by gifting money to an ILIT, which would then buy the insurance).

The client should seriously consider transferring the vacation condo and possibly the personal residence into a Family Limited Partnership (FLP) where the client can start to gift the value of the assets to the children when the client sees fit (which can be done at a discount with the FLP). When using an FLP, the client can gift upwards of 99% of the value of the FLP to the children without giving up control of the assets inside the FLP. The key is to use the FLP to lower the size of the estate and to minimize the amount of estate taxes due at the client’s death.

The client should immediately start funding for long term care insurance (in a tax-deductible manner if possible).

Financial Plan

This client has $750,000 in a brokerage account. If that brokerage account consisted of a handful of individual stocks, we would have the client consider the Stock Protection Strategy (SPS) to hedge the downside risk of those individual stocks. If the client’s brokerage money is in mutual funds, the client should consider selling some or all of the mutual funds and moving his money to a principal guaranteed investment.

This client could also consider gifting some of his appreciated stock to a Charitable Gift Annuity. By using a CGA, the client will receive an immediate income tax deduction and will fund his/her charitable planning goals. In addition, with wealth replacement life insurance, the client can pass to his children (via a death benefit) the
same or greater amount of the gift. In addition, the client will create guaranteed income down the road that will be paid by the charity.

If the client does not have a charitable intent and has no need for some of the money in the brokerage account, that money could be moved to the FLP and gifted to the children at a discount.

The client also has significant money in an IRA and pension plan. That money is most likely in mutual funds. While we typically do not recommend annuities in qualified plans (because there is no need for tax deferral since the money is already in a tax deferred plan), however, for this client, the use of an Equity Indexed Annuity (EIA) would make sense to create a balanced portfolio (that will protect the client from significant downturns in the stock market just prior to retirement). The client could also use the Maximizer to protect this money and still give the client significant upside potential in the market.

This client has many options, and the bottom line is that the client should diversify his/her post-tax investments and not keep them all in one pot; and at 60 years old, the client should seriously consider principal guaranteed investments.

**Summation**

The previous four examples are just that; every client has a different asset mix, different family situation, and different long-term goals. The previous examples illustrate typical situations we see around the country and the advice we might give to clients in similar circumstances.

Every client’s ultimate goal should be to reach Critical Capital Mass, and this book outlines all the tools you have at your disposal to reach that goal.

When you review or revise your asset protection, estate, and financial plan, make sure you use consultants who give you individual advice instead of canned answers that they give to every client no matter what the circumstances.

Hopefully, by reading this book, you have learned many things that you can apply to your personal situation to make sure your assets are protected from creditors, the IRS, and from stock market risk.
Help From the Authors

Most of the topics discussed in this book are ones that your local advisors are not familiar with. The typical topics your local advisor(s) will not be familiar with are: The ABC Plan, the 1% cash flow arm (equity harvesting), A/R Factoring or Leveraging, Closely Held Insurance Companies, Section 79 Plans, The Maximizer, the New Index Equity Annuity, Indexed Universal Life policies, Return of Premium Term Life Insurance, Leveraged Life, Charitable Gift Annuities, pension plan DI protection, Long Term Care Insurance, Swiss Annuities, Life Settlements, Viatical Settlements, 412i plans, the Stock Protection Strategy, 419 Plans/VEBAs, ESOPs, Irish Leasing Companies, Private Placement Life Insurance, Hedge Funds, PEOs, and Charging Orders.

Implementation is a key component of putting together an asset protection plan, income or estate tax reduction plan and so it is important to work with an advisor who will understand the topics discussed in this entire book and have what it takes to follow through until implementation is complete.

Unfortunately, for the vast majority of clients around the country, it will be nearly impossible to find an advisor who knows the topics discussed in this book.

As stated earlier, the authors of this book are unique in many ways when it comes to being able to provide advice on “advanced” planning topics for high income and/or net worth clients. Each one of the co-authors are Certified Wealth Preservation Planners (CWPP™). One of the Co-Authors is the founder of the Wealth Preservation Institute (www.thewpi.org) and the creator of the CWPP™ certification course.

In short, while is it possible to get help from a local advisor on some of the issues in this book, in order to have a complete plan put in place to help readers become completely asset protected and help them reach Critical Capital Mass, it is always best to work with a pre-certified advisor who you know can get the job done right.

In order to contact the co-author of this book who is in your local area, please turn to page ix for contact information. Your local CWPP advisor will be able to determine in short order whether you are properly protected and, if not, what needs to be done to ensure that your assets are protected, your estate plan is in order and that your overall plan is done in as tax favorable a manner as possible.

If you do not believe your local advisors can put together a road map to help you reach Critical Capital Mass, (which is most likely the case since you chose to read this book) please give one of the authors a call and we would be happy to help you create that road map.
Seminars

We are also available to give seminars on the topics covered in this book. We can do seminars for local associations (medical, legal, accounting, or other), hospitals, Independent Physician Associations (IPAs), and private seminars.

Free Review of Your Asset Protection, Income or Estate Tax Reduction Plan, or Estate or Financial Plan (or lack thereof)

For a free analysis to any purchaser of this book, you simply need to fill out and fax or send to one of the author’s offices the following questionnaire. Within three business days, someone will return to the reader a multi-page analysis detailing if your plan is in order and, if not, what changes you should consider making.

The questionnaire will be kept strictly confidential.
Critical Capital Mass Worksheet

A worksheet to determine how much in unnecessary income taxes you are paying

1) Estimate your annual living expenses (food, clothing, travel, entertainment, automobile, rent, college funding, mortgage (with your mortgage, calculate the after-tax costs due to the income tax deduction on your personal taxes), etc…

   Living Expenses (after tax) $_____________ (a)

2) Divide your annual living costs by sixty percent (.6) to calculate how much taxable income you need to take home each month to pay your living expenses.

   Living Expenses (a) $_____________ ÷ .6 = $_____________ (b)

3) Estimate your “net” practice or business income after all expenses (do not deduct your personal income (this number should be your take-home income before income taxes or matching payroll taxes)).

   $_____________ (c)

4) Calculate your total pre-tax income.

   Pre-tax income from medical practice (c) $_____________

   Any outside pre-tax income (rents, speaking fees) $_____________

   Spouse’s pre-tax income $_____________

   Total pre-tax income (add the above three) $_____________ (d)

5) Subtract living expenses from pre-tax income

   Total annual pre-tax income (d) $_____________

   Minus annual living expenses (b) $_____________

   “Surplus” pre-tax earnings $_____________ (e)

6) Multiply “surplus” pre-tax income times 40% to calculate estimated annual losses to unnecessary income taxes.

   $_____________ (e) X 40% = $_____________
Personal & Confidential Information

Name: _______________________________    Birth date: __ __ / __ __ / __ __ __ __
Spouse Name: _________________________    Birth date: __ __ / __ __ / __ __ __ __
Occupation: _____________________________   Income: _________________________
Spouse Occupation: _______________________   Income: _________________________
Home Address: _____________________________________________________________
City/State/Zip: _____________________________________________________________
Work Phone: ___________________  Cell Phone: _________________Fax: _____________
Home Phone: _____________________   Email:___________________________________
# of Children: ___  Ages: __________ # of Grandchildren: _______ Ages: __________
Yrs. until retirement: ____   Monthly (after tax) income required in retirement: ____
Anticipated long-term investment return: ________________________________________

Business/Practice Information:   Gross Revenue: ______________________________
Accounts Receivables ($): _____________ # of employees: ____________________

Balance Sheet

<table>
<thead>
<tr>
<th>Asset (or Liability)</th>
<th>Fair Market Value (face for annuities death benefit for life insurance)</th>
<th>Date Purchased</th>
<th>Cost basis, equity, or cash value</th>
<th>How is Asset Held? Own name, jointly, living trust, LP, other?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pensions &amp; Profit Sharing Plans &amp; IRAs</td>
<td></td>
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<tr>
<td>Home</td>
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<tr>
<td>Real Estate Holdings</td>
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<tr>
<td>Brokerage Accounts, Bank Accounts, CDs</td>
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<tr>
<td>Business Interests, Ltd Partnerships, etc.</td>
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<tr>
<td>Disability Coverage</td>
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<tr>
<td>Life insurance: cash value/face amount</td>
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<tr>
<td>Long-Term Care</td>
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</table>
**Prior Planning**

<table>
<thead>
<tr>
<th>Document</th>
<th>Y/N</th>
<th>Year Last Updated</th>
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</thead>
<tbody>
<tr>
<td>Last Will &amp; Testament(s)</td>
<td></td>
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<tr>
<td>Revocable Living Trust(s)</td>
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<td></td>
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<tr>
<td>Irrevocable Life Insurance Trust(s)</td>
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<tr>
<td>Qualified Personal Residence Trust(s)</td>
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<tr>
<td>Family Limited Partnership(s)</td>
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<tr>
<td>Family Limited Liability Company(ies)</td>
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<tr>
<td>Charitable Lead/Remainder Trust(s)</td>
<td></td>
<td></td>
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<tr>
<td>Split Dollar or Buy-Sell Agreement(s)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other:</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Concerns**

Please rank each concern on a scale of 1 to 10. (1 = not concerned, 10 = very concerned):

- _____ Planning For Parents/Elders
- _____ Reducing Capital Gains Taxes on Investments
- _____ Diversifying an Investment Portfolio
- _____ Planning for Retirement
- _____ Protecting Family Income against Disability/Death
- _____ Protecting Wealth from Potential Lawsuits
- _____ Protecting My Pension from the 83% Tax Trap
- _____ Life Insurance Needs
- _____ Reducing Estate Taxes
- _____ Business Succession Planning
- _____ Minimizing Income Tax Liabilities
- _____ Charitable Planning
Help From The Authors

________________________________________________________________________

Professional Advisors

If we work together, we may wish to coordinate the planning with your other trusted advisors. This can often make the planning seamless and less expensive for you. We will not share your information on this form with them without your permission.

Your Accountant
Name: __________________________ Firm: ________________________________
Address: __________________________________________________________________
City/State/Zip: ______________________________________________________________
Work Phone: __________________ For how long: _____________________________

Your Attorney
Name: __________________________ Firm: ________________________________
Address: __________________________________________________________________
City/State/Zip: ______________________________________________________________
Work Phone: __________________ For how long: _____________________________

Your Investment Advisor/Broker
Name: __________________________ Firm: ________________________________
Address: __________________________________________________________________
City/State/Zip: ______________________________________________________________
Work Phone: __________________ For how long: _____________________________

Your Insurance Agent/Broker/Financial Planner
Name: __________________________ Firm: ________________________________
Address: __________________________________________________________________
City/State/Zip: ______________________________________________________________
Work Phone: __________________ For how long: _____________________________
Integrated Planning Solutions

Estate Distribution Analysis

DIRECTIONS:

At the time of your death, how much would you like to leave to the following entities? Please fill out how much in dollars ($$$) and as a percentage (%) you would like to leave to Charity, Children, and Taxes.

Charity $__________
Charity % = _____%

Children $__________
Children % = ____%

Taxes $__________
Taxes % = _____%