"Asset Protection" Protecting The Personal Residence

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Protecting the personal residence

- The biggest asset of many of our clients is their residence.
- Sometimes it takes 30+ years to create a debt free house or one with significant equity.
- Protecting the personal residence is one of the most difficult topics when it comes to helping a client become totally asset protected.

Tools to protect the residence

- **<u>Homestead Exemption</u>**
- As discussed in more detail in Part I, 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 (however large it may be).
- There are laws being bantered about that would limit the ability of a state to protect the residence in a bankruptcy case.
- Since most of the country does not live in states like Florida or Texas, the <u>homestead exemption is of little help</u> to those who have more than $5,000-$10,000 of equity in their homes.

Tenants by the Entireties

- Also as discussed in Part I, 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 <u>creditor cannot force the sale of either spouse’s interest</u> 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, you and your client’s marital residences can be protected.
- Most states do not have T by E as an option.

Problems with T by E

- 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.
- 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 married and has significant equity in his/her residence.

What about divorce?

- When a client gets divorced, the minute the divorce is final whichever spouse got the house no longer owns the house titled as tenants by the entireties.

Qualified Personal Residence Trust (QPRT)

- A QPRT is a trust set up where the personal residence is gifted, typically to the children, in an irrevocable manner.
- The person gifting the house to a QPRT gets to live in the house rent free for a specified period of years.
- 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.
- If the person gifting the house survives to the end of the term, the residence will pass estate tax free to the heirs.

QPRT continued

- 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 and can take the deduction for the interest.
- 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.

QPRT Example

- 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 gift and estate tax credit to pass the house to the QPRT gift tax free.

Example continued

- 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.

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, as though the QPRT was never put in place.
- 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 a QPRT.
  - **USE IT AS A LAST RESORT OR DON'T USE IT AT ALL.**

LLCs/FLPs to Protect the residence

- 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.
- Many advisors these days have at least read about why people use LLCs or FLPs for asset protection, i.e., the charging order protection and recommend an LLC or FLP as “the” tool.

Should LLCs/FLPs be used? NO!

- 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 owner(s) must live in the house and own it personally for 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.
- 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 would result in an increase in property taxes of over 50%.
- **DO NOT USE AN LLC OR FLP TO PROTECT THE RESIDENCE.**

Debt Shields (Equity Stripping)

- While debt shields and equity stripping sound fancy or exotic, the terms simply stand for taking out a large loan on an important asset that does not have debt (or very little 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 Stripping Work?

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

Continued

- 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 re-financed debt allowed on the property (to qualify for the interest deduction) is $100,000.
- The IRS's position on the interest deduction basically tells us that the investment is too favorable and is something clients should look into.

Getting around the $100,000 re-financed debt limit

- There is a way around the $100,000 limit on debt - **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 another $500,000 home with a $500,000 loan.
- The entire interest payment on that loan would be deductible. Then the client can take the proceeds from the sale of the previous house and invest it for retirement savings.

Insurance as an investment

- 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 stripping program, the money from the loan will be invested into a cash-building life insurance policy where the death benefit is at the minimum rate to prevent a MEC.
- The client when in retirement can take “tax free” loans from the life policy.

Is Equity Stripping Financially Viable? Let's look at an Example

- Assume Dr. Smith, age 45 (OBGYN), has a house with $600,000 of equity and his wife wants a new house. They sell the house and buy a new one with $600,000 of debt. (The equity was invested in other property that is asset protected).
- 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 can pay $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).

Example continued

- Dr. Smith purchased a life policy specifically for equity stripping with a $2.1 million dollar death benefit.
- If we use reasonable assumptions on growth in the policy, the life policy at the end of the fifth year should have $609,000 of "cash surrender value." In the event he decided he did not want to have the loan any longer he would have the cash to pay it off.

Example continued (retirement income)

- If Dr. Smith waited until age 65 to pay back the loan using our given assumptions, he would be able to not only pay back the loan but also take $51,800 of **income tax free loans each year for 15 years** from the life insurance policy.

Equity Indexed Life

- If a client wanted a better policy, the client could fund $600,000 into an EILIP.
- If the client wanted to pay off the loan when he turned 65, he could do so and receive $120,000 a year income tax free via policy loans for 15 years.

1% Option Arm Mortgage

- The 1% option arm is designed to keep debt on the property for years to come.
- The client would reduce their monthly mortgage payments to the minimum.
- This would free up even more money to be invested.
- The $600,000 + money saved from lowering the mortgage payments can be invested in either the specially designed whole life policy, an EILIP or even an indexed annuity.

“Equity Harvesting”

- Would a client refinance a property if they could have payments on a 1% loan and invest the borrowed money in a tax favorable environment*?
- Many would say YES.
- ES is all about the numbers. If client is adverse to debt they will not like ES.
- If a clients wants to maximize their assets to create the largest retirement nest egg, then they will love ES.
- We are simply taking dead equity out of an asset (typically a home) and investing it somewhere where the money can grow tax free and potentially come out tax free.

- Subject to IRS Publication 936.

- 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 invest it for retirement income later.
- Assume the client used the 1% option arm and is in the 40% tax bracket.

Out of Pocket Interest

Option Arm Cash Flow Analysis	Option Arm @ 1.000%	Cost Out of Pocket After Tax
Year 1	$18,206	$10,923
Year 2	$19,571	$11,743
Year 3	$21,039	$12,623
Year 4	$22,617	$13,570
Year 5	$24,313	$14,588
5 Year Totals	**$105,745**	**$63,447**

Investing in life insurance.

- 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).

Who is the best candidate for EH?

- The more money the better.
- Those with less money (taking into consideration the asset protection issues) are better off paying down the debt on their house NOT using EH as “the one” major investment they have.
- That’s the problem with the Doug Andrew’s Missed Fortune 101 book.
  - It is pitched to everyone as the answer.
  - He even says you should not put money into a 401k plan (which is fine advice for a 10 million dollar client).

Summary on Equity Harvesting

- Equity stripping/harvesting is a very powerful tool especially when coupled with the 1% option arm.
- This is a tool that you can use for yourself and for many of your clients.
- It's something that few advisors are talking about with clients.
  - Because financial planners, insurance agents and CPAs/accountants don't usually sell mortgages
  - Mortgage brokers do not usually sell LI.
- And virtually no one deals with the 1% CFA.
- This concept can make you unique and make yourself significant amounts of extra money.

Overview for the Professional Designation: CWPP™ (Certified Wealth Preservation Planner)

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What do Advisors want?

- To earn more money?
- To have more knowledge than other advisors?
- To provide better advice to clients on multiple topics?
- To be more credible than other advisors?
- A team of advisors for support and back office when dealing with “advanced” planning.
- The ability to market to CPA, Attorneys and physicians through continuing education credit.
- Are these of interest to you?
  – If so you are a candidate to become an APP™ or CWPP™

The WPI and CWPP™/APP™

- What is the Wealth Preservation Institute (WPI)?
  - The **only** educational entity in the country devoted to provide education on **"advanced" planning (**asset protection, tax and estate planning)
  - The **only** entity in the country focusing on topics that apply mainly to the **high income/net worth client**.
  - Certifying entity for the CWPP™ designation.
- The CWPP™ course is a 24 hour certification program which can be taken all online or in person.
- The Asset Protection Planner designation is for those simply want to deal with AP (12 hours).

Marketing

- The WPI helps is certified advisors market in two several very unique ways.
- 1) The ability to become an instant author through a 340+ page "ghost book." You can read the table of contents at http://www.thewpi.org/newindex.php?dept=51&pid=495
- The WPI will allow CWPP™ advisors to give CPE continuing education courses on a local level to CPAs and accountants.
- The WPI has a number of articles that CWPP™ advisors can use to place in local medical, accounting, legal and other business journals.

Topics

- What topics are covered in the CWPP™ course?
- **Asset protection (3 hours)**

  -Domestic

  -Offshore
- **Deferred Compensation (4 hours)**

  -WealthBuilder® Annuity; Traditional NQDC and the Leveraged Bonus Plan®

  -Qualified plans/412(i) plans

  -ESOPs

  -IRAs
- **Business Planning (6 hours)**

  -Account Receivables (A/R) Leveraging

  -VEBAs and 419A(f)(6) Plans

  -Section 79 Plans

  -Closely Held Insurance Companies

  -Corporate Structure

Continued

- **Estate Planning (8 hours)**
  -Basic
  -“Advanced”
  - Life Insurance
  -Premium Financed Life Insurance
  - Medicaid Planning
  -Qualified Pension Insurance Partnership®
  (Mitigating the 75% Tax Trap)
  -Charitable planning
  -Long Term Care Insurance
- **Personal Finance (4 hours)**
  -Annuities
  -Life Settlements
  -Reverse Mortgages
  -Private Annuity Trust

Next Seminar?

- The next in person seminar is in San Diego on the 14-16th of March.
- The course can be taken completely online.
- Keep checking back to www.thewpi.org for posting.
- Group discounts. If you have 5 or more advisors who want to take the course, please contact The WPI for information on course discounts.

Questions?

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