A TEAM-BASED APPROACH TO
ADVANCED FINANCIAL PLANNING

YOUR
EXPERT
TEAM

PAUL CARROLL, CFP®, JAY KNIGHTON II, JD
& BERNARD ABERCROMBIE, CPA

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Your Expert Team

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For Helen, Vanessa, Lynne, our teams, and our clients.

A special thanks to Barry Reynolds, who was a valuable resource in developing this book.

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PREFACE

When I initially set out to write a book about the Expert Team, I wasn't sure how it would unfold. However, I am extremely pleased with the results and it has been my honor to work with the professionals that joined me to talk about the advanced planning concepts we bring into play with our clients when we incorporate an Expert Team into our Wealth Management process. What is an Expert Team and how does it dovetail into the process? To understand that, you have to have a clear picture of Wealth Management and all that it entails.

At our firm, we define Wealth Management as investment consulting, advanced planning, and expert relationship management. If you go to any kind of advisor, be it a financial advisor, financial planner, Wealth Manager, or an investment consultant, you're going to get some kind of investment advice. Some advisors will give better advice than others, but what really separates the good advisors from the great advisors, is advanced planning and expert relationship management.

Advanced planning is composed of four elements: wealth enhancement, which is mitigating your taxes; wealth transfer, which is taking care of your heirs; wealth protection, which is making sure your assets are not unjustly taken; and charitable planning, which is maximizing your impact when making a difference in the world.

In addition to advanced planning, Wealth Management includes expert relationship management. We act as our clients' personal chief financial officer. It is unreasonable to expect anyone to be an expert in all of these fields, so what we do is quarterback a team of professionals that are highly regarded in their specific field. We call it our "Expert Team," and have found it to help provide invaluable guidance and input.

I love the Expert Team concept because when we put together our team, we're able to bring all of these professionals to the table and brainstorm the four areas of advanced planning. This synergistic process allows us to come up with the best approach to protecting your wealth. For example, maybe the CPA will say, "I think we should do X-Y-Z. It'll minimize their taxes this year." Then the insurance person might say, "Yes, but we could do A-B-C over a three-year stretch, and though the taxes are slightly higher this year, they'll lower over the combined three years." Next, the estate and/or business attorney might say, "In fact, if we did it within a trust, not only would we minimize taxes for the next three years, we would provide additional asset protection." Individual professionals can do a great job working alone, but when they work as a team, the total value of the process is greater than the sum of the parts. We believe this synergistic process adds significant value to the client experience.

In my opinion, the expert team members that have joined me to bring you this book are the best in their class. There are other great advisors, of course, but I believe these guys are certainly in the top tier of their field.

We began with a round-table discussion and held structured conversations on wealth enhancement, wealth transfer, wealth protection, and charitable planning. The information that we compiled during these discussions was transcribed and written into this book. Whether you work with any member of our team or some other firm and/or another advisor, we believe the concepts herein will be of significant value to you.

Because Wealth Management and wealth enhancement is largely about mitigating taxes, we brought in Bernard Abercrombie, a respected CPA in The Woodlands, Texas. He's been doing this for a long time, and is very active in the community and organizations such as The Woodlands Area Economic Development Partnership. Special thanks also to Barry Reynolds, for his valued contributions to this manuscript.

For wealth transfer, we worked with Jay Knighton from Knighton & Stone, PLLC. Jay is one of the brightest up-and-coming lawyers that I've seen in a long time. He is board certified in estate planning and probate and has a master's in taxation law. Jay is one of the few attorneys who understand both the tax and the legal side of the issues. He also has a commitment to community and fellowship, and is an active member of the Rotary Club and other worthwhile entities here in The Woodlands.

Wealth protection often requires a combination of both legal and insurance skills. We draw from a stable of skilled insurance practitioners when putting together our expert team for a client. As for charitable planning, all members of the team are important to the outcome.

A question that is often raised due to this team approach, is just who is your trusted advisor? The answer? We all are. Though the Wealth Manager is the logical quarterback of the team, this is a function of the compensation model more than any special ability. The other expert team members are typically compensated by the hour and, as such, would prove to be expensive quarterbacks. Be that as it may, no one team member is more skilled or important than the other.

I think you're going to find that the information in this book is of great value. I hope you get at least one nugget from reading this book: it may be asset protection, it may be tax mitigation, or it may be taking care of your heirs. But just one nugget will make your investment and time reading this book time very well spent.

Thank you, and as always, I wish you the best of success.

Paul Carroll, CFP®

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INTRODUCTION

Wealth and finances can be very confusing! The confusion stems from the number of rules and the myriad of strategies, all of which provide advantages (and some disadvantages). Yet, with a team approach to managing your wealth and finances, you can begin the journey to financial wellbeing. A team approach creates the method for you to sift through the sometimes overwhelming planning strategies in order to select the appropriate plan for you and your family, and helps you tailor the strategies to your needs. Your team helps qualify, select, and implement all aspects of financial planning that are in your best interests.

Knowledge gathered from a team consisting of a professional Wealth Manager with a CFP® designation, a life insurance agent, a Certified Public Accountant, and a lawyer that specializes in estate planning, fills the pages of this book. Together they share their wisdom and knowledge regarding financial wellbeing. Collectively, they intertwine their area of expertise with one another to create a solid plan for their clientele.

By carefully reviewing the principals set forth in this book, you too, can create a team. Your team of advisors will meet as a group to review your financial and family situation in order to create strategies and opportunities for you to implement. Your team will then help you with recommendations based upon your personal situation. Your optimal team will rely upon one another and their specific knowledge of your family dynamics to devise short-term and long-term plans for you.

Creating your team and implementing strategies is only the beginning. You and your family should regularly meet with your advisors to ensure you remain on the course set by your planning, and to steadily transfer that knowledge and plan to your next generation. Over time, your team will have the best understanding of your financial situation, which creates a very powerful resource to help your family address all manners of situations in the future.

As you progress through this book, you will begin to understand the link between the four key aspects of wealth planning: wealth enhancement, wealth transfer, wealth protection, and charitable planning. With the knowledge in this book and your trusted team of advisors, you too, can select appropriate strategies for yourself and future generations.

I.

WEALTH ENHANCEMENT

Wealth enhancement looks at how to mitigate taxes and increase your cash flow. You have worked hard for your money, and taxes can take a big chunk out of your wealth, so it is important to try to minimize your tax bite as much as possible.

Taxes Always Seem To Go Up

Globally, taxes tend to rise until a disruption occurs. For example, in the United States, marginal taxes were increasing during the 1970s and early 1980s. When Reagan came to power, there was a complete reset of tax complexity and tax rates.[1] These shakeups happen throughout the world, not just in the United States.

To look at this issue, we first need to examine wages. There are two methods of examining income. You can examine the median wage or the average wage. The median wage is at the 50th percentile. This means 50 percent of the people are above this wage and 50 percent are below. The median wage, $29,930 in 2015, is significantly lower than the average wage, $46,120 in 2015.[2] Most people make less than the average wage because the average wage is skewed by the amount of wealth held by the top income earners.

The natural tendency in democracies is for the government to accumulate mechanisms to redistribute wealth from those deemed wealthy, to the non-wealthy—from the haves, to the have-nots. These are the social wealth redistribution programs run by the government and they can cause unintended consequences. Intelligent discourse can be lost when people become emotionally involved with these public policy issues.

Given the extent of these wealth transfers, the question arises as to at what point governments are killing the goose that lays the golden egg. It is true that a minority has the greatest wealth, but a huge percentage of the wealth that everyone enjoys flows from this wealth. There will always be an imbalance of wealth in society. The question is, what is a healthy imbalance versus an unhealthy imbalance?

The Pareto Principle (the 80-20 rule) applies throughout the world. Even though an imbalance will always exist, it needs to be a healthy imbalance. What is happening in some South American countries is an unhealthy balance. You have walled compounds for the wealthy and barrios on the mountainsides for the poor.

The biggest challenge for the future is demographic. The problems caused by demographics are very easy to predict given the high dependency ratio that is developing in many countries. A dependency ratio is how many workers there are per people dependent on those workers. Children and the elderly are typically dependent on workers in society.

The old-age dependency ratio of modern Western societies is alarming. Even though there are less children, there are a lot more elderly, whom are much more expensive to care for than children. This is placing an enormous burden on the "Sandwich Generation"—the generation that must support their parents as well as their children. The old-age dependency ratio in 2014 for the United States was roughly 22 percent, but is expected to increase to about 37 percent in 2060.[3]

These demographic changes will grow to become an enormous burden on Social Security, Medicare, and the Medicaid systems. Although these programs are not going away anytime soon—especially since the people who benefit from these systems are reliable voters—the programs will face significant challenges in the future.

To keep the economy moving, there needs to be more workers, and a pipeline to get them into the country. If the birth rate in your country is 2.1 or higher, then you have an adequate flow of replacement workers. If it is lower, you need to find replacement workers somewhere else. Most Western countries are falling below replacement level. Demographers expect that sometime in the 2050s the global population will actually level off, and that those countries with a negative birthrate will offset those with a positive birthrate.[4]

While from a resource viewpoint, this may be a good thing. From an economic point of view, it changes the rules. It is extremely difficult to care for everyone if you do not have enough workers. When discussing immigration, pundits focus on what they are costing the country today. This present-day cost is nothing compared to what it will cost if a country does not have replacement workers twenty years from now. The older a generation becomes, the more expensive their care becomes. Meanwhile, the economic productivity falls.

One of the challenges for Western countries is that after decades of putting up walls, these Western countries are now in a global competition for talent. Where 9/11 hurt the United States the most was the long-term economic effects of the significantly increased barriers for entry by skilled immigrants. Job creation comes from entrepreneurs. Disproportionately, many entrepreneurs are immigrants or the children of immigrants. “Despite the fact that they constitute only 12 percent of the U.S. population, immigrants have started 52 percent of Silicon Valley’s technology companies and contributed to more than 25 percent of our global patents,” according to Vivek Wadhwa, author of “Why Skilled Immigrants Are Leaving the U.S.”[5]

One of the keys to the United States maintaining its economic strength is to ensure that there is a bigger return on effort for coming to the United States. Talent is going to naturally flow in the direction of the best return. Unfortunately, for the States, other countries are doing a better job of recruiting skilled immigrants. The return is better in other countries.[6]

However, the United States is not the only country having trouble with demographics. China has had to revise its one-child policy and Russia is viewed as a sick, old man with significantly negative population growth.

One issue that demographics affect the most is your "personal discount rate." Your personal discount rate is the required rate of return for you to make an investment in your education, in your business, or in a stock or bond. Longer life expectancies are resulting in a lower personal discount rate. We see this in global markets—greater efficiencies with lower aggregate returns.[7] This is not going to change anytime soon for two reasons: the discount rate effect of longevity and the burdens that are on society. The fundamentals are changing, and they are going to change in a way that really hurts the elderly. Not only are the elderly living longer, but their financial resources are going to earn less. The cost of their care is skyrocketing. Statistically, society expends a huge amount of resources during the last six months of a person's life.[8] This is not only a personal issue, but a societal issue as well.

These issues suggest that there will be increasing pressure on tax revenues, particularly among the one demographic group traditionally opposed to tax increases—elderly voters. It is likely that this voting segment will vote in their own interest, which will be to increase the burden on the next generation by reforming tax benefits for seniors as much as the political landscape allows.

Preparing Your Own Tax Returns

A number of people may feel that they can fill out their own tax returns and that there is no need to pay someone to do it for you. The problem is that you will often miss deductions that you are legally allowed to take because either you don't understand the tax code well enough or you are being overly cautious. Often the money you lose due to an improperly prepared tax return would have more than paid the fees for a tax professional to look over your taxes.

When doing your own taxes, you will often come across a question that you are unsure of how to answer. Unfortunately, if you do have a tax question, you can spend hours on the phone with the IRS before you are able to find an answer. Even if you do get to talk to a real person from the IRS, that person may not have the answers. Also, if you are a high net-worth individual, the IRS agent will often not be familiar with the nuanced issue you might have.

Most people who work for the IRS are not highly compensated. As a result, the truly talented tax people will not be working there. It is no longer a good marketing strategy to claim to have worked for the IRS, since many IRS agents do not have a good understanding of the tax code or how to deal with complicated issues.

Another problem you may run into when attempting to find answers about your own tax return is that you never get to speak to the same IRS agent twice. Typically, you will get the agent's name and badge number and your conversation with the agent will be recorded. Unfortunately, this recording is not kept forever. As a result, anything the agent told you is lost and it all comes down to hearsay. You can claim that you only did what an IRS agent told you, but you won`t have any proof.

One mistake that people often make when doing their own taxes is forgetting to report their stock transactions. Some people have the mistaken belief that the IRS already knows about the transactions, so they don't think that they need to report the gains or losses they've made on their stock transactions. As a result, they usually haven't reported these gains or losses for a number of years and have huge tax bills looming. The IRS only has information on the sale of the transactions, not on the gains or losses of the transactions. You must report this information to the IRS. For expatriates, the problem is compounded by global taxation, and professional help is essential to cope with varying and often opposed tax codes.

Another common problem for people that file their own taxes is that they don't offset the cost basis of their investment, or only offset part of it. The cost basis is the original price of the stock they purchased taking into account any dividends, stock splits, and capital distributions. The IRS will often flag returns where the cost basis isn't reported.

There can also be some confusion over what is deemed to be a short-term or long-term gain. Some investments have a holding period of greater than a year and others don't. Whether the gain is short-term or long-term can have a dramatic effect on your taxes.

There is a fine line between being too cautious and being too aggressive. Often, non-professionals don`t know where that line is. From a planning perspective, it is all about probability. It pays to be a bit aggressive from a tax perspective, while still staying within the confines of the tax law, since the IRS's audit rate is around 1 percent. This audit rate will probably be even lower as proposed cutbacks continue to affect the agency.

Balancing Growth with Taxes – A Team Approach

You want your portfolio to grow but you also need to take into account the taxes you will need to pay on that growth. Often, financial advisors are just looking at growth and don't even consider the tax impact of your investment decisions.

With a team approach, you have a financial planner and a CPA working together to ensure that you look at your deductions along with your growth, as well as what you've actually made and lost. Unfortunately, most financial planners do not work closely with CPAs or estate tax attorneys (beyond making referrals, of course).

Tax planning is a lot more than simply filing a tax return. You need a CPA who is up to date on the tax law changes in order to save you as much money as possible. Unfortunately, there are a lot of rules to keep up with so there is a higher probability that a CPA can make errors that will cost you money by not getting all of your deductions. You may have a CPA do your tax return, but your CPA should also be giving you strategic tax advice. You need to determine if your CPA will simply file your tax return or if he or she will help you plan for your future as well.

A team approach can be very helpful because members of the team can coordinate the handling of specialized issues. A CPA may be able to take you only so far. An expert team can help cover all your bases. As a group, if the team members disagree with what should be done, they can get together to come up with a plan that covers all of the team members concerns and gives the client the best overall situation.

Two-Year Baseline

The key to any wealth enhancement plan is to review the tax returns for the past two years before doing a current-year tax assessment. This will give the team a baseline regarding how much tax you have paid for the last two years as well as a good understanding of your financial situation. This review will also help identify problem areas that you can address in the present tax year in order to save you from having to pay more money in taxes.

Often, tax returns have not been prepared properly which can result in significant losses of your wealth to taxes. The two-year baseline can identify problems, such as not maximizing your 401(k) or your 403(b). The identification of problems opens the door to figuring out how to correct the issues and maximize your wealth when preparing for the current year's tax return.

It can be difficult to be motivated to come in early to have your tax returns looked at. Most people will wait until just before the tax season to begin the two-year tax review. This doesn't leave a lot of time and it is usually better to start the process in the summer months. This will allow your tax preparer the chance to delve deeper into your tax liabilities from the previous years and see what could have been done to mitigate taxes.

Starting early also gives you more leeway when it comes to planning new strategies to limit your tax. If you start too late, you may not be able to implement some of the strategies until the following year.

When deciding on the best time to contact your financial advisors, it is important to remember that for most CPAs, the tax season has become a year-round season. A number of returns are getting extensions because the documents the clients require are arriving later and later. Congress waits until the last minute to make changes to the tax code and then the IRS needs to make changes to their tax software. This often delays the process further.[9]

For example, K-1s are coming primarily from partnerships and not S-Corps. K-1s are used to report your income from a partnership. For master limited partnerships (MLPs), the K-1s are not due until April 15, but because of the complexity of the tax situation, most K-1s need to be extended and are not due until September 15. We expect these due dates will be changed soon. Even with the extension, it can be difficult for your tax preparer because there is no indication of what the K-1 will look like.

This means you need to give your expert team enough time to look carefully at your situation and devise appropriate strategies to limit your tax exposure. Often, you will need to fill out a tax organizer before seeing your accountant. The tax organizer can be difficult to fill in properly so be prepared to have your accountant ask you a few questions, especially if your tax situation is complicated.

Remember, do not wait until the last minute because it could end up costing you money.

Wealth Enhancement Strategies

There are a number of wealth enhancement strategies that you can follow when attempting to mitigate your taxes. We have listed some of the most useful methods to give you a better understanding of what these strategies are.

Timing Your Income and Bonuses

Given some of the changes in the tax system, it is important to look at the timing of your income as well as your deductions.

If you are able to delay some of your income until the following tax year, it may save you a lot of money. For example, when it comes to buying and selling an investment, if your investment has increased in value, you will have to pay tax on that increase. If you can shift the sale of your investment to the following year, you can save on your tax bill if your taxable income is not going to be as great as this year.

Many people at this level do not have many deductions because they are being hit by a reduction in the deductions they can take as their income rises. These reductions are called phase-outs. Most people aren't aware of these reductions and it can cost them a lot in lost deductions. For example, a large family with four or five children loses over $20,000 worth of deductions when the principle breadwinner is in the 39.6 percent tax bracket.[10]

Finally, there were two new taxes implemented in the 2013 tax year: the 3.8 percent Medicare tax on investments and the 0.9 percent tax on self-employed income and wages that also applies to high-income earners and may have an impact on when to take income.

Deductions with a Small Business

One way that a family can increase their deductions is to open a small business that someone else in the family can operate. You need to be careful anytime you decide to do this to ensure that the IRS does not classify the business as a hobby. If the business is classified as a hobby, then you are not allowed to use the business for deductions.

The IRS will look at the business to see if it is making a profit. Even if you do not make a profit, you can still claim a deduction if you can show a profit motive. A profit motive means you are obviously trying to make a profit with the business. The IRS will be looking to see if you are attempting to make a profit on the business and not operating it simply to get a business deduction.

You need to be able to show that you are trying to make a profit even if you are unsuccessful. The IRS will not only look at the profit you have made but also the money you have invested in the company. If you have invested a lot of money in the business and are still not making a profit, you may be able to avoid the hobby label.

The IRS allows losses for two years over a five-year period, but the burden of proof that you are operating a business shifts to the taxpayer after two years of losses. The problem arises in the fact that less than half of all businesses will survive the first five years.[11] If the business goes bankrupt, the IRS typically allows those losses to be deducted.

This does not mean that you are able to start a business, let it go bankrupt, and then start a new business in the same area. The IRS will take a close look at the new business and see how closely it aligns to the first business. If they are closely connected, then the IRS will claim that it is the same business. Of course, this does not happen often because most people will realize they are in a losing situation with the company and that the deductions they get as a result of the business are not that large.

Within the context of starting a new business venture, the main deduction for a home business is for a home office and that is typically less than $1500. The IRS has made it simple to claim this deduction and you no longer have to keep track of utility costs, insurance costs, or similar costs. Real estate taxes and mortgage interest are moved to Schedule A (the form where you itemize your deductions) and are fully deductible.

Forever Tax and Never Tax

One step everyone needs to take is to look at what your income distribution will look like ten years from now. There is some income that you will always need to pay tax on (the forever tax) and there is some income that you will never have to pay tax on (the never tax). You need to strike a balance between the two types of taxes.

The never tax is facilitated by the Roth Two-Step (sometimes known as a back-door Roth contribution). Many people do a non-deductible contribution to a Traditional IRA one year, and then do the two-step conversion to their Roth IRA in the same year or the following year. There are a number of regulations you need to be aware of when attempting to do this, which is why you may need a professional to help you.

In addition to the Roth Two-Step, there is the Traditional IRA to Roth conversion. Deciding to use Roth IRA conversions depends on your tax bracket. One of the first things you need to do is find the income threshold that will move you into a higher tax bracket. If you anticipate that your existing tax bracket will be less than your tax rate in retirement, then a Roth conversion is clearly warranted.

You may decide not to convert to a Roth IRA if you have a lot of capital gains. If you are in the 15 percent tax bracket, you will want to take capital gains at the reduced rate that is available.

The increase of the Medicare tax on passive income (3.8%) is not going to affect many people, but it will affect people who are in the top 1 percent.[12] The government does not want to increase baseline taxes, so it uses other methods to gather more tax, primarily through phase-outs and surcharges. The 3.8 percent Medicare tax is one of these ways. The other way is to phase out deductions.

There exists a life insurance[13] solution which can also be a "never tax". Through the loan component of a life insurance plan, you can pull money out and avoid taxation.[14] The effectiveness of this strategy is largely driven by the loan rate applied, the interest credited, and product expenses. Life insurance can be an efficient product but the problem arises with the expenses and surrender charges. It can take up to fifteen years before you break even on an expensive policy.[15] Some companies waive surrender charges in return for lower growth. In this case, you will have better access to your money because you do not have a surrender charge. It is also liquid, credit approved, and tax-deferred growth. Unfortunately, there is an inverse correlation between product expenses and producer income. In our opinion, the best products are less aggressively "sold."

One trap that exists within some insurance products is what we like to call the "Ticking Tax Bomb". In essence, IRS rules state that when the loan value within a policy equals the cash value, the policy lapses and is no longer in force. You will then receive a 1099 and no longer have your tax deferral. You have an immediate and unpleasant taxable event without resources in the policy to pay the tax.

Phasing Out the Mortgage Deduction

Phasing out mortgage deductions is a contentious issue. Most economists believe that real estate deductions were one of the contributing factors to the 2008 crash.[16] Given this view, people may argue that the real estate deduction should be eliminated. In fact, for every dollar spent on public housing, seven tax dollars are spent on upper-middle class mortgage interest deductions.[17]

More and more upper-income families are buying second homes. One rationale for the purchase of a second home is today's low interest rates, which become even lower when you factor in the 39.6 percent tax savings for top-bracket taxpayers. People would rather put their hard-earned cash back into the market or other investment opportunity. Instead of buying properties outright, they are taking out mortgages because of the low interest rate.

Master Limited Partnerships

A master limited partnership (MLP) is a publically traded limited partnership. MLPs may not be a great option for your individual retirement account (IRA) because you cannot pass through the deductions in an IRA.[18] In fact, you could be jeopardizing your entire IRA unless your advisors can guarantee that there is no unrelated business taxable income (UBTI) associated with your IRA.

Many people do not want an MLP with a K-1 even though MLPs without a K-1 are significantly less valuable. A K-1 is distributed by the partnership detailing any loses or gains the partnership experienced.

If you do decide to get an MLP, you need to identify three to five high-quality individual MLPs that have K-1s, and ensure that the cost of the K-1 is justified by the value of the pass-through income. Pass-through income allows you to avoid paying taxes at a corporate level. Instead, the income is passed to the individual owner who is then taxed at an individual level.

Since both passive and active losses are passed through, and passive losses are suspended, you can lose some benefit and create extra work for your CPA. The cost of tax preparation and future depreciation recapture needs to be factored into the decision when you are buying or selling an MLP. A K-1 can take up to an hour of tax preparation, depending on the K-1's complexity, resulting in extra costs for the investor.

When you do find a small number of high-quality MLPs, you're not going to re-balance them because the re-balancing causes the recapture of depreciation. If you don't have a K-1, there is almost no point in having an MLP because a significant component of the value of the MLP is the tax value of depreciation and depletion allowances, and its avoidance of double-taxation.

Setting Up Corporate Entities

Whenever you set up a new business, you need to decide whether to make it a C-Corporation, an LLC (limited liability company), a sole proprietorship, or a partnership. In addition, some of these options overlap and an S-Corporation election may also be appropriate. These decisions will have an impact on your tax status. Your choices also impact your level of asset protection and your liability limitations.

Many people believe that once they've decided on how to set up their new business, the entity they have chosen will determine how they will be taxed. That used to be the case but now you can choose how you would like to be taxed. You can form any entity you want and then tell the IRS how you would like to be taxed. If you don't make a decision regarding how you are taxed, then you are just put into a default category, which may not be the best tax option for you.

You can set up an LLC and then elect to be taxed as either a C-Corporation or as an S-Corporation. An S-Corporation only pays taxes once. The shareholders or partners are given income through the S-Corporation. They then have to pay taxes on the income they receive. A C-Corporation requires that the company pay taxes on its income and then the shareholders or partners pay taxes again on the dividend income they receive from the company. A C-Corporation essentially has to pay taxes twice on the same income. There are sometimes good reasons for choosing a C-Corporation over an S-Corporation and your CPA should help you with that decision.[19] The decision will partly rely on how labor intensive your business is, the type of business it is, and how many employees you have.

Typically, if your company only has one employee (you) and you are acting as a consultant, your company will be an S-Corp. This will allow you to pay yourself a reasonable salary based on the Social Security wage base and let the rest of the income pass through the distribution of earnings. These distributions will not be subject to the Medicare tax so you will save 2.9 percent above the ever-increasing social security wage base.[20] The IRS appears to have generally taken the stance that if you pay yourself the maximum Social Security wage base, they're typically satisfied. If the IRS thinks you are taking significantly less than a reasonable income and it's below the Social Security wage base, they may try to make an example out of you.

If you have a business which provides a second source of income and you are already paying Medicare tax and Social Security, you're still going to have to pay Medicare taxes with an S-Corporation. A requirement of an S-Corporation is that you have to pay yourself a salary. This occurs even if you're a disregarded entity.

Being Disregarded – Avoiding the S-Corp Election

Disregarded means that you don't have to file a separate tax return for that entity. If it's an LLC that was formed for investment purposes, all the capital gains, interest, and dividends will go straight to your schedule

B and schedule D. If it's an LLC that is disregarded and it's for a rental property, it goes to schedule E in your personal return, and if it's a business, it will go to your schedule C. You're treated as if you don't have an entity—it's disregarded. You still get all the legal protections for an LLC at the state level but all the income flows through as if you've never created a company.

One type of company that will typically be disregarded is a real estate holding LLC because there's no additional tax associated with Social Security and Medicare unless you're a real estate professional.

Defined Benefit Plans – Traditional Retirement Plans

Having an income as a small business owner set at the social security wage base limit is often considered to be a relatively safe harbor. However, if you have a defined contribution plan, you might want to actually have a higher income. This income could be as high as $270,000. Contributions to a defined benefit plan can result in even greater savings. For example, if you have a Simplified Employee Pension plan (SEP) that allows you to put $54,000 into the SEP plan, you will have to pay the 2.9, or even 3.8 percent, Medicare tax to get the $54,000 deduction on your ordinary income on the plan.

You can also use your 401(k) as a profit-sharing plan. If you have employees, profit sharing can really incentivize them. A 401(k) is primarily a profit sharing plan that's evolved into a retirement savings plan. It's an anomalous part of the code from 1978 that was repurposed in the 1980s to allow you to create a profit sharing plan and make it act like a retirement plan. Profit sharing used to only work with a single employee, but now that the 401(k) and profit sharing are linked, you can get a 401(k) for all your employees and still establish a defined benefit profit sharing arrangement.[21]

There's a limit on the income that can be used to determine defined benefit or defined contribution benefits. Anything above $270,000 is not allowed. If you don't have many years to retirement, you can put a lot of money into a defined benefit plan because what's defined is the benefit and then you back the contributions out of that.

The defined benefit plan gives you a powerful tax deduction. One problem with having a 401(k) in place and doing an additional profit sharing or defined benefit plan is that you need to cover all the employees in your firm. However, when employees leave the firm, they don't get to keep their defined benefit plan. They lose the benefit and the money stays invested in the plan, reducing subsequent contribution requirements.

For a professional with a high cash flow, a defined benefit plan is very powerful, but there is a danger. The danger is that once you start a defined benefit plan, you can't stop it and the cash-flow demands can be very big. For example, if you have a plan that requires a contribution of $250,000 a year, the funding formula may require you to put in even more money the following year because of a drop in interest rates. If your contribution increases to $300,000 and you don't have enough money to cover this payment, it blows the plan out. You may end up having to borrow money to meet the payment for the defined benefit plan because if you miss one year, the plan is gone. Once the plan is gone, the money is returned and can cause significant income tax penalties—up to 50 percent, in addition to taxes on the earnings.[22]

It's also important to ensure that your group is small enough for a defined benefit or else you may run into trouble. A business with four or five employees is the perfect size for a defined benefit plan. However, if you have a much bigger group, you can run into trouble. This is what is happening to a number of public employers. The defined benefit plan is basically a pension, and if an organization runs into bad years and can't make the payments, the pension could become bankrupt or insolvent. It may also be unfunded.

To protect yourself, you need to minimize the required contributions. You need to be extremely confident that no matter what, you can make that payment. For example, if you set a payment of $250,000 a year but this payment is based on variable income, you may need to drop the payment down to account for bad years. You may want to drop the payment down to $100,000 because it is so punitive to not make the payment.

Taxes and the Affordable Care Act

As a result of the Affordable Care Act, the cost of preparing tax returns is increasing, and this increase is being passed on to the consumer. Your CPA now has to check if you or your family had health insurance and check into any subsidies you may have received. The CPA then needs to calculate any penalties or credits that you might have. For example, you may have used 2012 as a base year to calculate what your estimated income for the year will be. Using 2012 as the base, you may have estimated that you were going to make $20,000 for the year. If, after doing your tax return, you discover you actually made $30,000, you are going to have to pay back part of your subsidy because you were subsidized at $20,000.

There are thirteen hardship rules for non-coverage but these can be a bit strange.[23] For example, unemployment is not a hardship since the government assumes you can still pay for health insurance with money you receive from your unemployment benefits. If you get evicted for not paying your rent and you don't have to have health insurance, that's a hardship. If you're homeless or you're an illegal alien with a tax ID number, you don't have to have insurance for your children even though they have Social Security numbers. If you do in fact qualify for a hardship and plan to claim exemption for non-coverage, you would need to complete and attach IRS Form 8965 to your tax return.[24]

While this chapter has given you a number of strategies to enhance your wealth, only the well-coordinated input from your expert team can provide an optimized solution for your personal situation.

In the next chapter, we are going to take a look at how to transfer your wealth to your heirs. We will look at strategies to maximize the amount that will go to your heirs, and how to protect that amount.

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Unless noted, all numbers reflect 2017 tax code.

II.

WEALTH TRANSFER

Wealth transfer looks at how to transfer your wealth to your heirs to ensure that they receive the maximum amount. You have worked hard to accumulate your wealth, but now you need to figure out how to protect it and transfer it to your heirs.

Wealth transfer is the second of the four cornerstones of advance planning.

Estate Planning

Not surprisingly, the amount of estate planning you need is largely driven by the size of your estate. If you have a 1.8 million dollar estate, you do not need as much estate planning because the estate tax will not be a factor. If you have a 6 million dollar estate, you will need more estate tax planning. The planning you did ten years ago may not be appropriate for your situation today. Since the estate tax exemptions have increased over the past ten years, you may not need as much estate tax planning.

You may begin to feel overwhelmed with all the information and detail you get from your advisors. Often advisors will helpfully push their clients to some extent to do what needs to be done, such as signing the appropriate documents and submitting them. Your advisors are doing this because there is some urgency to the situation. You are not protected until these documents are signed and submitted.

You may decide that the best way to deal with this is to break things down into smaller sections so you don't feel overwhelmed. Often the first step is estate planning, but you may also need business planning and risk mitigation. In conjunction with your advisors, you need to deal with the most important things first and then deal with the less important things later.

Often, you may want to deal with estate planning first and then look to asset protection later. While this might make the situation more palatable to deal with, it may also cost more money. It's important to remember that just because you have met with an attorney does not mean that everything is done and you are protected. Your lawyer still needs to draft the documents and you still need to sign them before everything is taken care of. Just talking about something is not enough.

Most people don't understand all the financial aspects of advanced planning and are not interested in understanding them, but if you have any questions, don't be afraid to ask. Your advisors will explain the reasoning behind setting up certain entities, but at some point, it will come down to trust—which can be difficult given the number of bad practitioners offering their services.

There are a lot of moving parts to estate planning that may not be apparent to you. It is the responsibility of your advisors to take care of these. This is where having a dedicated team of professionals backed by a Wealth Manager can be of great value.

Where Should the Money Go?

The first step to planning for the transfer of your wealth is figuring out what your wealth transfer preferences are. There are two main questions that you need to answer in order to figure this out: Where is your wealth going and who is it going to? Basically, you're looking at who gets what.

An attorney can help you figure out how to transfer your wealth to a spouse or to your children, but you need to help the attorney get to this point by letting him or her know who you want to give your property to. An attorney can't tell you the best way to transfer your wealth if they don't know who you want to transfer your wealth to.

This does not mean you will discuss minute specifics, such as who you want to give your watch to. What you do need to do is look at how you are going to divide your assets. You need to decide if you want all of your assets to go to your surviving spouse, or if you want to divide it between your children and your surviving spouse. If you're transferring some or all of your wealth to your children, you need to decide whether they all get an equal share or if there are different percentages. Knowing this information will help your attorney figure out the best way to get your wealth to the places you want it to go.

Often, before a meeting with your attorney, you may be asked to fill out a short questionnaire that will help you figure out the answer to these questions. The questionnaire will probably not cover every contingency in your particular circumstances but it will get you thinking about the answers. For example, the questionnaire might not mention your aunt, even though you want your aunt to receive some of your property. In this situation, the questionnaire would have brought these issues to mind and you can simply mention your aunt to your attorney.

People tend to avoid making these decisions because they simply do not want to think about these issues. It can be difficult to figure out who gets your property, particularly when your spouse does not agree with your choices. Often, people feel it is easier to just not bother to plan instead of dealing with the issues of who gets what. Even if you have come to a decision regarding the division of your assets, you still need to decide who is going to be the executor of your estate.

You may feel that your heirs can work this out on their own after you have died, however, if you do not make these decisions, then the courts will make them for you. State law will dictate where your property goes if you do not do it. A judge is going to determine who is going to administer your estate and manage the property for your beneficiaries.

You typically do not want a judge making any of those decisions because you never know who they are going to select. Sometimes, the beneficiaries can get together and pick someone to administer the estate but everyone needs to agree and this can cause a lot of strife. It is much better if you make this decision beforehand.

No Children

If you have children, it can be pretty easy to figure out who gets your money, but what happens if you don't have children? Most people will choose to leave their money to a charity instead. With a charity as a recipient, smart handling of your IRA accounts comes with tax advantages. Normally, any withdrawals made by the charity are viewed as ordinary income and they are forced over time in the form of Required Minimum Distributions. To avoid these taxes, you can gift your IRA to a charity as a testamentary gift. To do this, you need to name a charity as a beneficiary of your IRA. The charity can take custody of the estate, liquidate it, and not have to pay any income tax on the sale. We will discuss charities in more detail in the last chapter of the book, Charitable Planning.

IRA Distributions for Life Insurance

Of course, you can also give money to a charity and to your family. One way of doing this is through life insurance. You can use the required distributions from your IRA to cover the payments for a whole life or some other insurance policy. At death, the IRA will go to a charity and the insurance policy will pay out to the beneficiaries. If you do this, you may actually end up with more money going to your heirs than if you had just kept everything in an IRA. This way, your heirs don't have to worry about liquidating your assets, they just get tax-free cash. It's clean and easy.

Trust Company

If your children are too young to manage the inherited property on their own, you need to decide who (or what) is going to do it for them. One option you may want to consider is using a trust company to administer the estate. This helps avoid strife in the family because it takes people's emotions out of the situation. You don't have to pick one of your children over the others. The problem with a trust company is that they can be expensive. A trust company will charge one percent on average as well as investment management fees; though this will still be cheaper than having someone manage the estate who doesn't know what they are doing, causing you to lose all your money.

Instead of a trust company, a cheaper option may be to look at a hybrid solution. If you have a custodian that can act as a fiduciary advisor (Schwab or Fidelity for example), that entity can act as the trustee, and your existing advisor can continue to manage the estate. This is the same as a trust company doing both functions, but it can be a lot cheaper.

Trusts are not just for when your children are too young to manage their own funds. Trusts can also be set up for any occasion where you are concerned about the ability of your heirs to manage funds. You may have a special needs child, your spouse may not be good at managing wealth, or your child may be in an unhealthy relationship. You need to take these things into account and discuss them with your attorney so you can come up with the best plan possible to deal with these situations.

This is where a team approach is valuable. Often, your situation has already been discussed with other members of the team (i.e., a CPA, insurance professional, or financial advisor) which makes it easier to discuss. You need to discuss these issues with your team because they can help you come up with solutions to deal with them. Your lawyer can use trusts or draft estate-planning documents to take this and any other concern into account.

Communication

You may do excellent planning regarding the transfer of your wealth but you need to make sure that you communicate this plan to the people who are going to be recipients of that planning. If the reasoning behind certain moves is never explained to people, they won't know why you planned things a certain way or recognize how it can be changed. You need to discuss exactly how your assets are going to be divided and who the beneficiaries are, so everyone understands what is happening and why.

Step-Up In Basis

One of the most important advantages you have when it comes to wealth transfer is the step-up in basis. This means that an asset gets valued at the current market rate when the asset is transferred to an heir, instead of at the rate the asset was bought at. This helps minimize capital gains tax. For example, if your father bought some stock at $5.00 a share and, after your father's death, these shares were passed to you, your cost basis would be the current market value. This means that if the new value of the shares was $20.00 a share, any capital gains tax you pay on the shares will be calculated on a price of $20.00 a share instead of the $5.00 that your father paid. So, if you sell the shares at $21.00, you only pay taxes on a dollar a share instead of $16.00 a share.

Texas is a community property state. This means that when a spouse dies, all of the property that was owned by the couple is stepped-up in basis to fair market value on the date of death.[1] This is a big advantage because the remaining spouse can gift the assets or do other things with them. When the remaining spouse dies, the heirs get another step-up. This means you can transfer the assets without having a capital gain impact.

You need to make sure what the rules are in your state of residence because each state is different. Many states have more challenging probate rules, which have gotten national attention. Given this situation, people often decide that they need to deal with wealth-transfer issues before the person dies. This can be expensive.

Another option after the death of a spouse is that once the surviving spouse gets the step-up in basis, the surviving spouse can then gift the stepped-up assets into a grant or trust. The first step-up is usually going to be the biggest increase. It's important to get this step-up because the surviving spouse will probably go through the assets much quicker, particularly if the deceased spouse was the primary wage earner. The stepped-up asset gives the survivor the assets he or she is going to need to live, so he or she will probably turn them over a lot faster and not hold on to them for long term.

You need to be very careful about gifting assets when both spouses are alive. It may be better to hold onto them and give cash instead. The assets are not getting any kind of step-up by being gifted. Also, don't give the highly appreciated assets away because there is a very valuable tax benefit that comes with the step-up received at death. In most cases, it is better to not transfer assets until death because of this step-up. Every time there's a death, the assets get the step-up in basis. An exemption is gifting appreciated assets to charity.

The step-up does not apply to tax-deferred accounts. It only applies to investment property—things that are subject to taxes if you buy and sell them. Some examples of investment property are land, stocks, and bonds.

Tax-deferred Accounts

There is no step-up with tax-deferred accounts. One of the problems with tax-deferred accounts is that taxable capital gains may be preferable! A large capital gain in an IRA is converted to ordinary income. If a person owns significant assets in retirement and they are drawing on their IRA, they are actually going to pay more tax on those capital gains than if they just had them in a taxable account and deferred them. Regardless of whether they had a step-up, they will be able to offset capital losses some years. That's why it is preferable to have ordinary income investments in an IRA and capital gain investments outside of the IRA to the extent that's possible. We call this "Tax Location of assets."

Trusts

There are a number of different trusts that you can set up to help transfer your wealth to your heirs. We will look at some of the more popular options.

Bypass Trust

If you have assets that are going to grow beyond your remaining estate tax exemption, you may want to set up a bypass trust. With a bypass trust, you gift some or all of your assets to your heirs in the form of a trust upon your death. These trust assets may be held for the benefit of your partner for the duration of your partner's life. When your partner dies, the trust then passes to your heirs.

The downside to setting up a trust like this is that you are not going to get the step-up in the assets you transferred to the trust at your death. There's an interplay with the assets you should put in a trust and the ones that would be better not in a trust. Right now, a couple has an estate tax of 40 percent on assets over $10,980,000 if utilizing the code optimally.[2] Given the various tax rates, you should determine whether your assets should go into a multigenerational trust or to a person in order to minimize your tax burden.

Tax rules undergo frequent changes so you need to look at your current planning and see if things need to be changed. Ten years ago, the rules were a bit different and a lot of people employed bypass trusts in their planning documents in an effort to minimize estate taxes. With recent changes, you may not need to use a bypass trust anymore.

Special Needs Trusts

Even if you have a special needs child, you don't necessarily need a special needs trust when other trusts can give the same benefits. You need a special needs trust when the beneficiary is receiving some kind of benefit from a charity or a government agency. It can be difficult to qualify for these benefits, either because you have too many assets or the paperwork is just too difficult to figure out.

A special needs trust permits someone to manage the trust property for the beneficiary and still let the beneficiary qualify for government benefits or any other benefits without including those trust assets in the asset testing that the government programs use for qualification. It's a special trust but it is very restrictive.

It's easy for practitioners to just lump everybody into this kind of trust, but a lot of people, such as highly functioning autistic individuals, don't need those benefits, and they are probably not going to qualify anyway, so they don't really need a special needs trust.

Basically, you only need to set up a special needs trust if you are trying to qualify for some state or federal benefit. Special needs trusts are for unique situations where people obviously don't have the money or where you have to protect a little bit of your assets because the asset rules are so tight. Even some of the poorest people won't qualify because they own a dollar more in their account than they need to.

Medicare and Medicaid Trusts

Often, people will try to qualify for Medicaid even though they don't really need it. They can afford to pay for their own room and specialist doctors, which is not something they will typically get with Medicaid. If you have the funds, you want to use those assets to get very good assistance if it is needed.

Often, elderly people will try to take assets out of their portfolio so Medicaid will pay for long-term care. With the new rules, the government looks at your assets for the past three to five years, so the chances of this working have been severely limited. You need to have no assets to get Medicaid to pay for long-term care.

You may also want to look at the care you would receive with Medicaid and what you need to do to qualify before making a decision regarding Medicaid. You are not necessarily going to get worse care because you are in a Medicaid facility, but many facilities have different levels of quality. The average life expectancy of a person going into a nursing home is a little over one year, but this can be a bit misleading. The average may be around one year, but the median is around 150 days. The average is increased because a small percentage of people may stay in a nursing home for multiple years. Often, a new nursing home will have a lot of people who are younger but over time they end up with long-term care patients.[3] For example, if a nursing home has six beds, five people may die making room for more patients but that sixth patient continues to live. Then, of the next five people in the remaining five beds available, only four people die, leaving even less beds available. Eventually, the nursing home will be filled with long-term patients. After about five or seven years, many of these people start running out of resources and they are flipped over to Medicaid. Most nursing homes will not want to accept a new patient on Medicaid although they will retain an existing patient who flipped over to Medicaid. These facilities make a profit on the clients that die early. They don't want to take on a patient who may continue to live for a long time and be on Medicaid from the very start.

When most people decide to move a loved one into a nursing home, it is because things are unmanageable at home. In the past, you used to be able to buy a three-year long-term care policy and would receive a benefit for three years. During this time, you would unwind your assets and within three years, you would go on Medicaid. This was not the best strategy, but it was what the industry was pushing. Now that the law has changed to five years, things have changed. It's up to professionals to guide clients away from this option because it can cause a lot of headaches trying to spend down your money when it might actually be better, from a tax perspective, to wait until you have passed instead of gifting everything to people while you are still alive. Keep in mind that these agencies have the ability to "claw back" transfers that don't meet strict criteria.

Correct Titling of Assets and Funding of Trusts

There are two steps to every estate plan. A good analogy is opening a checking account; it takes two steps. You need to fill out the paperwork to open the account, and then you need to put the money in the checking account or else there's no point.

This is similar to estate plans. You sign the plan but then you need to take the necessary steps to implement it properly. If you are setting up a trust, then you have to transfer assets into this trust. You also need to set up beneficiary designations and coordinate those designations with the estate plan. In addition, you need to ensure that accounts are properly titled if you are setting up a trust, and you even need to look at asset protection using an entity.

This is the biggest problem area with doing everything by yourself. You can typically find the documents online and fill everything out, but it's the attorney who ensures that all the titles are transferred properly. You can set up an LLC to protect yourself legally but if you don't set it up properly, it won't offer any protection. For example, if you set up an LLC but don't title anything into it, then it is basically just a shelf entity, which offers no protection. The LLC doesn't own anything. This is like having a safe but not putting your valuables in there and just leaving them on the bookshelf.

Even though your advisors can fill out the documents, you still need to sign and submit the documents. All your advisors can do is send you a letter requesting that you sign and submit the documents—they cannot do this for you.

Often, people will do a lot of estate planning but then none of the property is transferred where it was supposed to go. If things aren't titled properly, the probate can be contested. People who were expecting to be designated beneficiaries can discover assets were not setup correctly and then attempt to contest the estate. All of these problems could have been avoided if things were titled properly.

Most people are not going to be able to transfer this properly themselves and this is why it is important to find competent professionals who can help you ensure everything is done correctly.

There's more to estate planning than just having a piece of paper that you can show up in court with. You need to protect your assets and ensure that they go where you want them to go.

Many professionals are too focused on selling their product and not on the client's overall plan. They don't want to say anything to the client that is going to ruffle the client's feathers so that they lose the sale. You need to find a professional that will tell you the cold, hard truth and you need to be prepared to listen to that truth. You are hiring them to make recommendations to you and you need to be open to what they are telling you. If you want to do things by yourself, it's not recommended. Advanced planning is too important and should be left to the professionals. In fact, many professionals may not want to work with people who want to do everything themselves because there will be too many problems and arguments. Many professionals who have been in the business for a long time are more than willing to turn down a client they think will be difficult to work with.

Trusts and IRAs

There can be some confusion over how to set up beneficiaries with IRAs. Sometimes, a person is the primary beneficiary of an IRA and the trust is a contingent beneficiary, but at times this doesn't work and the trust needs to be the primary beneficiary.

To make the trust the primary beneficiary, you need to ensure that the trust has the correct qualified language. In order to have the correct language, there needs to be language in the trust instrument referencing treasury regulation 1.409A.[4] Since it is a relatively new law, many advisors do not realize that trusts can own qualified deferred income plans.

One problem with not having the correct language in your trust is that your family will have to liquidate the assets within five years of your death. Some lawyers will just tell clients to put everything in the trust, but then you are going to end up with a five-year unwinding period. Having to liquidate within five years is problematic because accelerated disbursements may push your heirs into a higher tax bracket, and trust income tax rates can be higher than an individual rate.

Beneficiaries

If you want to ensure that your assets go to the people that you want them to go to, you need to designate them as beneficiaries. It's important to designate the beneficiaries of your assets or else the government will do this for you. You need to ensure that they are listed properly in the documentation and you need to keep up with any changes in your circumstances that may necessitate a change in the designated beneficiaries.

Beneficiaries and Divorce

If you are divorced, you may want to look at re-establishing your beneficiary designations. The divorce will typically write the ex-spouse out of any designation but it can cause some confusion, so it's better to re-establish your beneficiaries. If you still want your ex-spouse to receive some benefits (e.g., to take care of any children), you will have to re-establish your spouse as a designated beneficiary after the date of your divorce.

Disclaiming a Trust

Whenever a trust is in place, it is important to include contingent beneficiaries because a designated beneficiary can reject the designation by disclaiming it. There are a number of reasons why a person might want to disclaim the designation. You may want to disclaim the designation in order to place funds in a trust if that makes more sense from a financial perspective. You may want to put high-growth assets in a trust to limit tax exposure. You may also want to disclaim the designation so you can pass the money to your grandkids.

There are ways where you can disclaim the beneficiary IRA. For example, if a surviving spouse looks at the IRA and decides that the revenue is not needed right now, then the spouse can disclaim it and it will go into a trust.

Business Succession

Often you may have a lot of wealth tied up in your closely held business. The problem is that there may be no market for your business when you want to sell it. If this is the case, you need to make your own succession plan and find someone who is willing to buy what you've created. This can be very difficult. You may be able to generate interest from within your organization or, with luck, an outsider who has an interest in your industry.

Setting up a business succession plan is one of the hardest things to do. Just because you want to sell your business doesn't mean you will find someone who wants to buy it. If you can't find a buyer on your own, you may want to list your business with a broker.

Many people may want to put all of their money into their business and view this as their retirement plan. Given that very few people are actually able to sell their business, this may not be such a good idea. Most businesses just go under when the owner dies. The doors are shut because there is no market to buy the business or the business wasn't set up properly.

You could look into developing a self-managing company, since the only kind of company you can really sell is one that can survive without you. Unfortunately, of all the small businesses in America, we believe that less than five percent are truly self-managing companies.

You may decide to give your business to your heirs or sell the business's assets. These options are more likely to occur than selling the business as a whole. The other thing to be aware of is that even if you can sell your business, it might not be wise to do so from a tax perspective. You will lose all the tax benefits that you get from owning a business. In fact, in some situations, the residual benefits you get for owning a company may outweigh your actual salary. Business succession is a very difficult, complicated area and you definitely need to look at discussing the problem with professionals.

If you do decide to sell your company (and you have a buyer), you still need to work out all the little details.

To help understand the complexity of selling a business, you can think of a business as being a cardboard box that spits out cash. For a lot of business owners, some of that cash is their income. That's not going to be there if they are not there. It's the net cash you need to be concerned with. If you take that net cash, the amount you will have after you have sold that business, you can figure out a net present value. Now you have something to sell and a valuation. In our experience, when someone buys a business, what they see is a box with cash coming out the bottom and they are going to discount that cash by as much as 25 percent. We've also seen many potential buyers discount that cash by as much as 35 or 40 percent. You need to look at the real value of your business versus what someone takes for their income. Often the real value in a business is the cash flow and this is gone when you are. Also, no one may be interested in running your business once you are gone. Your spouse may be supporting you as you run your business, but that doesn't mean your spouse wants to run it when you're gone.

Often, people just want to pass the business on to their children. The fact of the matter is, if you are a successful entrepreneur with a business that generates over a million dollars a year in revenue, you are one of less than 4 percent of all businesses in the country to do this.[5] The statistical probably that your children are going to do as well as you did is horrible. The statistical probably that your grandkids will also be able to do it is close to zero. Statistically, 97 percent of family businesses do not survive past the third generation.[6]

Inheritance Sustainability

Most people want to keep the wealth in the family. This is interesting given the fact that most studies show this is wishful thinking—there is a 90 percent probability that your wealth won't make it through the third generation.[7]

Part of this can be put down to inadequate planning but it also has to do with the fact that less than 1 percent of the population is truly wired to accumulate significant wealth. The chances that your children are the same are very low.

The situations where wealth is preserved turns out to be situations where control of the assets was not in the kid's hands. If your children are going to control your estate, the odds are you won't have any money left within one or two generations.

For example, if you have three kids and divide your assets among them and they each have three kids of their own and divide the assets again, the money is going to be gone quickly. Some people bow out of society as soon as they get their inheritance and just live off the money until it's gone. If you look at what they are doing before they get the wealth, they will probably do the same thing when they inherit your wealth. That behavior is not going to change.

There are probably only a few exceptions to this rule. Someone may have an idea in the back of their head that they haven't shared with anybody, the money then gives them the opportunity to implement the idea.

If you have three children, it can often be best to simply divide the assets into three instead of trying to keep it in one trust. If everything is in one trust, this can lead to a lot of infighting since all three children probably have different goals and desires. One may want to buy a house, one may want to send their kids to private school, and the third may want to accumulate wealth.

The low probability of passing your wealth down through the generations is related to the proportion of entrepreneurs there are in the world. There is a big difference between someone who is a good saver and someone who is an entrepreneur. It is the entrepreneurs who are the wealth creators and only a small percentage of the population are entrepreneurs. For example, if you take three brothers, all three of them probably have a different perspective on money. It is unlikely that more than one is a true entrepreneur.

Buy/Sell Life Insurance

If you have found someone suitable to continue your business, such as an employee, then they probably don't have the money to buy the business even if they wanted to. To deal with this situation, you may have to deal with a formal buy/sell life insurance agreement.

One of the big problems with selling a business is that the owner is typically the life force behind the business and once the owner is gone, the business withers and dies. With a buy/sell agreement, you have an insurance policy funded by the company that provides principal members of the firm with the resources to buy the business from the estate. This gives the surviving spouse money that represents the value of the company—even though the company probably depreciated in value fast.

Another issue you may come across is how to handle the division of assets when all your wealth is tied up in the business but some family members had or want nothing to do with the business. For example, what are you going to do if your son worked in your business for his whole life but your two daughters had nothing to do with the company? It's not really fair to just divide the company into thirds because your son has done all the work. Again, a buy/sell agreement can help here. You can leave the company to your son and the daughters will get the life insurance benefit.

Often, when you are looking at what your business is worth, you will discover that it's not worth that much. With a buy/sell agreement, you can pre-determine the price and it's usually a lot more that what the business is actually worth. As long as you fund the buy/sell agreement at a higher level, your heirs or partners are not going to complain. You do not need to know the exact value of your business for a buy/sell agreement. You just need to set the value above the estimated value.

On the other hand, sometimes it just doesn't make sense to enter a buy/sell agreement. For example, you may want to enter into a buy/sell agreement with one of your employees with the benefits going to your wife. But your spouse may already be getting a lot of death benefits and there is no need to sell the company when your spouse could become a shareholder and hire the employee as a general manager.

End of Life Issues

Even though it is not a traditional part of estate planning, you may want to document any end of life choices you may have. This is important if differences of opinion exist within the family. For example, a person may want to be cremated, but the family is against cremation. Another example can occur when there is a second marriage. The family may want the deceased to be buried next to the old spouse but the deceased may have preferred to be buried next to the new spouse in a different graveyard.

Any problems that can have a negative effect on the estate need to be addressed in the estate plan. Most advisors will ask, after going through the financial details, if there is anything else you are concerned about or that the advisors need to be aware of. This is the time to bring these concerns up.

Now that we have addressed the importance of planning for your wealth transfer, we will discuss the third aspect of advanced financial planning: wealth protection.

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Unless noted, all numbers reflect 2017 tax code.

III.

WEALTH PROTECTION

As the name implies, wealth protection deals with protecting your wealth. You want to ensure that your wealth is not unjustly taken. The biggest threat to your assets is a lawsuit and the first step in understanding your threat level is to identify your exposure to risk. Lawsuits could arise from general business practices, car accidents, employees, or from an employee sexual harassment suit where the owner, as well as the company, is brought into the suit. There are a number of ways to mitigate this risk with advance planning.

One of the first steps in wealth protection is figuring out how much asset protection you need. You may already have all the protection you need. All of your assets might be tied up in your house, IRA, life insurance or annuity. All of this is already protected. You might have around $2 million worth of assets but only $200,000 of it is unprotected. You could take some of this money and pay off your house or get a good umbrella policy. You can move your unprotected assets into products for asset protection first and pay off your house. After you've done all you can in this area, you should look at an umbrella policy.

There are three basic areas you need to look at when determining your risk of losing your wealth through a lawsuit. One of the first areas you need to look at is what assets do you own that someone can come and take. The second area, which is very popular with business owners, is the legitimate transaction issue. Are you entering into a business transaction that's rife with either fraud or high risk with low reward? This is a big deal when it comes to wealth protection with high net worth people because they get bombarded with multiple deals.

Various deals can be hard for some people to turn down but you should focus on your area of expertise even if you have the money to invest in a deal. Don't assume that just because your friends are in a particular investment that it is a good deal. Don't follow the herd. The herd mentality can lead people to make bad investments or investments at the wrong time. You need to ensure due diligence was done on any investment. If you ask the right questions, you can get rid of half the deals that are presented to you because you will realize they are no good. Just as you would check out your financial advisors (through references and background checks), you should use the same diligence when it comes to business deals.

For example, many people want to buy second homes and think about turning them into vacation rentals. Unfortunately, they have not done their homework and do not realize the consequences of using the house more than fourteen days a year. They think they will be able to write off huge amounts of losses, but this is not necessarily true. A lot of people are unaware that if they depreciate the house and they sell it later, they get a recoup on that depreciation. You have to recapture depreciation even if you don't depreciate your house.

The third area you need to look at is cyber security. Identity theft can be a big problem that can take a lot of time, effort and energy to protect yourself against.

High-Risk Assets

One way to help ensure that your assets are not taken unjustly is to control avoidable risk, such as your behaviour. You may want to buy high-risk assets, such as a plane or a boat, for personal use. These have a high risk and you need to think about the consequences of an accident and how that might affect your personal wealth.

High-risk assets need their own entity for wealth protection, even if you're not planning to rent them. Even though your high-risk asset is for private use only, you still need to put it into an LLC. A number of people will put boats into LLCs that just sit there. They then file franchise tax forms every year. There's no deduction or anything else for doing this, but it will help protect your wealth. If you're using the boat or plane as part of your business, then you have a legitimate deduction for owning the asset.

There are limitations to what an LLC can do to protect your assets. If a commercial pilot flying a small plane has an accident, odds are something went wrong with the plane. If a novice pilot has an accident, odds are the pilot did something wrong. If you're at fault, there is a limitation to the protection that you have. You are always going to be liable for your personal torts, but we can contain that liability.

If your buddy or your kids have taken the boat out and there's a mechanical failure or some other type of liability that's plain or specific to the boat, then the LLC is going to provide protection. An LLC will also protect your assets if you're sued because of a bad business deal, or because you rear-end somebody. It is very difficult for someone to reach through your LLC to get at your assets.

You need to remember that an LLC is not a get out of jail free card. An LLC contains liability and protects your asset but it doesn't protect you from being liable for user error. An LLC does not mean you won't be liable for anything.

You don't necessarily need to form an LLC. You can get the same type of asset protection with larger insurance policies on certain assets. For example, if you use a car and driver for business purposes, you can have the car registered in the corporation's name. You can increase the commercial liability insurance on the car to help protect yourself. If your driver is in an accident, the injured party can't go through the driver to get at you. They can only go through the driver to the company since most people won't bother suing a driver who only makes $30,000 a year. They may try to sue the company but your insurance should handle this.

Two Lines of Defense: Insurance and Entities

In some respects, your insurance and the formation of an entity are your first and second lines of defense. You need both to be completely protected. Insurance is the first line of defense and the entity is the backstop. If the plaintiff doesn't want to take the settlement insurance money, there is nothing else they can get at.

If the liability is small enough or if the insurance limits are high enough, most plaintiff lawyers will go after the easy money—the insurance money. They don't bother going after the individual defendant because forming the entity has given you an extra layer of protection. The entity has moved the target from you to the insurance company.

You need multiple lines of defense because one form of protection is not going to cover every situation. You want to make it harder and more work for a lawyer to sue you for your assets. Most lawyers won't make money wasting enormous resources going after what will probably be a dead end. When the lawyers see these lines of defense, they'll go back to the plaintiff and tell them what the insurance will pay. If the plaintiff wants more and still wants to come after you, the lawyer will probably want to be paid by the hour instead of on a contingency basis, which will cost the plaintiff a lot more.

There are some people who will be so charged and motivated that they will go with this hourly fee, but a really good rule of thumb is that if a lawyer is telling the plaintiff they won't take the case on retainer, they probably don't want to go down that track.

If you have a liability policy that's large enough, it's going to keep the wolves off of you most of the time. At the end of the day, if you have insurance in place, that's what everyone is going to chase. There are two good reasons why you need to have a large amount of liability insurance. The first reason is that you get representation from the carriers at no charge. They will represent you in any cause, except for individual torts and fraud, because the insurance company does not want to write a check. If the plaintiff has a strong case, the insurance company might settle the case so they don't waste money defending the case. The insurance company can decide to settle even if you don't want to—it's their money so it's their decision. Often the more time that has passed since an accident, the more likely there is to be a settlement.

If the insurance carrier is in another state, the company may hire local lawyers. This can make a settlement even easier because all the lawyers know each other.

You may be tempted to only get one of these defences—either an insurance policy or an entity. You may feel that you don't want to pay the insurance because you have an entity, or you don't want to put in an extra tax return for an entity because you have a lot of insurance. This is a mistake because both defences offer different protections.

Many people don't want to pay more to have more insurance but this is the wrong way to look at the situation. If you have more insurance, it means you have more sophisticated attorneys defending the insurance claim because the company doesn't want to write the check. Just because you have a $5 million policy doesn't mean the insurance company is going to write a $5 million check without a fight. You need the extra insurance for those situations that are extremely bad. The insurance company is not going to pay out $3 million for a simple fender bender, even if you have that much liability in your policy. The extra liability is for situations that are much more serious, for example if you cause a five-car pileup. If you don't have the heftier insurance policy, the plaintiffs are going to come after everything you have, instead of just the insurance. The plaintiff's lawyer will know what your insurance caps are because this is part of the immediate disclosure information that comes out but that doesn't mean the plaintiff will get this amount.

If you've got an entity or non-entity that you're using for your business and you don't have enough asset protection, plaintiffs are going to go after your personal assets if the liability limits on your insurance is too small. Your liability limits need to be high enough to deter plaintiffs from even looking at the entity, but the entity is often still recommended for further protection if necessary.

This extra protection is necessary if you have commercial property, a second home or a million dollars in savings or investments. It's not for a person who only has a small home and minimal savings. Most of that will be protected through a homestead exemption.

The combination of an LLC and a large liability policy is about as solid a defense as you can get. You may not want to pay a plaintiff anything, but remember it's not your money. It's the insurance company's money because you paid the premiums.

LLCs and Limited Partnerships

An LLC is much easier to set up because the formation fees are much lower. You can also tax an LLC almost any way you desire. You can tax it as a partnership, a corporation, or as a disregarded entity.

An LLC is a single entity. They are valid all across the nation and have an operating structure similar to a corporation. It is very easy to operate. It provides full asset protection and liability limits. It adds a third layer of protection. If you are sued personally, the plaintiff can't take your LLC ownership interest like they could with a corporation. If you have a C-Corporation and you are sued personally, the plaintiff won't be able to take your home or IRAs, but they will be able to take the stock from your company.

Limited partnerships (LP) have been around a lot longer. LPs were created in the 50s as an alternative to corporations. An LP should always have two entities but you don't always see them set up this way. You should have a limited partnership that owns the asset and a general partner that makes all the decisions and segregates liability away from the LP assets. For example, if the LP owns five rental homes and an accident occurs with one of the rental homes, that liability attaches to everything within the LP and to the general partner of the LP.

The general partner contains liability and the limited partners receive the profits. The limited partners have no say in management but they can vote for the general manager. The LP is very strong except for the person who ends up being general manager. The trick is to make an LLC the general partner, so that when that liability flows to the general partner, it's captured within the LLC which has no assets.

Sometimes, LPs are formed where there is no general partner. Everyone is a general partner. This can be a mistake. If they are sued and the plaintiff takes over their general partnership interest, then the plaintiff can vote to liquidate the LP and pay themselves funds. If everyone is a general partner, it removes a valuable level of protection.

Often, these entities are not set up just for wealth protection but also for operational protection. By setting up these entities, you are forced to change your behaviour and run your finances in a more organized manner.

This particular strategy of entity structure also helps with privacy because you can call the entity anything you want. None of your portfolio assets or real estate assets will show up in your personal name. It's in an entity that only you know the name of.

By setting up these protection entities, you are centralizing management and control of your property. For example, if you have real estate holdings and pass away, your kids don't own a 1/4 undivided interest in the real estate, they will own 1/4 of the entity that owns the real estate. They will have to vote to make effective decisions with that property. This keeps property in the family a lot longer, and the centralized management and control lets you set up a Cash Bucket management system that will help preserve assets.

If you have under $5 million in exposed assets and investments, then the LLC is a good option. If you have more than $5 million, then it is much better to go with an LP-LLC combined entity.

LLCs for Real Estate

An LLC can also be valuable in the area of real estate, especially if the real estate is in another state. This is really important if the state is not probate friendly, such as California or Colorado. You can set up a living trust to get by probate issues, but you can save the cost of setting up a living trust with an LLC since you will need an LLC anyway. The LLC converts real estate, or real property, into personal property through the mechanism of the LLC.

If you have a farm and you're trying to figure out how to split the interest in the farm, you can create five deeds, but maybe five bits of a farm aren't worth the combination of the whole farm. The whole is worth more than the sum of the parts. In that case, each of the people who owns their share owns so many shares in the LLC.

Often, if there are four or five heirs to a farm, at least one or two of them want nothing to do with it, whereas, another one or two want to keep it. The LLC gives you a mechanism where one heir can buy out the other(s). An LLC can also have a requirement for a voting majority. The minority cannot impose their will on the majority.

If there is not an LLC, then one heir can sell out, causing numerous problems for the remaining heirs. For example, if three or four children inherit your property and one of them needs money, this can cause a lot of problems. The one child who owns a 1/4 undivided interest in the land could sell it to a large corporation. Then the corporation sues to partition the land. Since the corporation has more money and can hire better experts, they're going to get the more valuable section (the frontage road or the beach side, for example). Then the other heirs get tired of the whole thing and end up selling as well. That's how big tracts are busted all the time.

If you put your farm or other property in an entity, the person who wants to sell has to get a super majority percent of the vote of the other owners to enforce a sale. These are often called Family LPs (or FLIPs) because you can set a higher standard for voting requirements to dissolve the company. The heirs who need cash can't sell their LP interest. The LP can loan the person money or buy the person out.

With an LLC, you do not lose your interest in the LLC if you are sued so you won't lose your property. If you sell your property within the LLC, you can lose the distributions you receive. You will also need to take into account the charging order in the case of a lawsuit. The charging order basically means that if you make distributions from that entity to yourself, then you lose those distributions. You still own the company, you're just not ever going to make distributions.

Setting Up an LLC

You may want to do this yourself to save some fees, but the chances are you are going to do something wrong. You may be able to set up an LLC, but you will have probably made a mistake somewhere along the line which negates your protection. Even people who are in the field don't do everything themselves. They will do what they can and then seek out the necessary professional to do the rest. This is why a team approach to advanced planning is so important. You can be referred to other members of the team to address specific issues.

It's only a one-time fee to set up an LLC, so doesn't it make sense to pay so that your LLC is set up properly and your assets are protected? A significant percent of people who do things themselves will make a mistake. Your assets are important so pay to protect them.

Review of the LLC

Once you've set everything up, the work doesn't stop. You still need to do a regular review of the entity to ensure it is still doing what it needs to do. Your assets might be different or worth a lot more since you first set up the LLC and this needs to be addressed. You will have to take a look at the purpose of the assets as well as their value. An annual review is also a good idea because legislation is constantly changing. This means that what you set up originally may no longer be the most effective way of doing things.

When reviewing an entity, you will need to determine whether you have the right kind of entity for your specific asset and how you are taxing it. You need to check if your old tax setup is still valid or if changes need to be made. You may even need to look at your future plans and see how legislation changes affect those plans.

Books and Records Review

If you have an LLC, your advisors may want to take a look at your books. This can help your advisors determine if there are any problems with the LLC. If any problems are noticed, you will probably be referred to a lawyer to take care of them. Some holes in your LLC are easily fixed. For example, if you haven't been holding annual meetings, you can simply take your spouse out for dinner, discuss some business and have the company pay for it. You then need to record that you had the meeting.

Ensuring You and Your Wages Are Protected

If you're making a lot of money, you need to find a place to put it all. This is particularly important for people, such as doctors, attorneys, or architects, who have liability associated with the type of work they do. Once you have earned your money, you need to move it somewhere to protect it. You need the protection of an LLC. An LLC gives you the most flexibility when it comes to tax issues. It can even be a disregarded entity meaning that it is as if the money was still in your hands but you still get all the legal protection.

A lot of people attempt to set up LLCs on their own with the forms they get off the Internet. While the forms can be relatively easy to fill out, if you don't follow the correct procedures, you have no protection. You need to follow the correct methods for withdrawing income using the correct percentages.

Costs of an LLC and LP

It can seem like we've recommended a lot but the cost is relatively small compared to the protection you will get. If you need to set up an LP and an LLC, you are generally looking at $5,000–$10,000 depending on your assets and operations. The high figure is the worst-case scenario and typically doesn't happen all the time. This cost, spread out over a lifetime, does not amount to a lot. For basic maintenance and ongoing costs, you should be looking at as little as $100 a year.

The Cash Bucket: Accessing Your Money

One way to set things up so that you still have ready cash on hand is to establish what we call a "Cash Bucket". This Cash Bucket is a regular taxable account that has no protection. You can then set up an LLC and an LP. You can set it up so the LLC is 1 percent general manager of the business LP and the individual directly owns 99 percent of the business LP.

When you first deposit money into a newly created entity, you're not buying stock. You're establishing basis in your company and there is no tax impact of creating basis. When the money comes out, you will have to draw 99 percent directly and 1 percent through the LLC. Failure to do this properly violates the ownership provisions of the company.

This is where people run into trouble. If you're not managing the cash flows correctly, you're opening yourself to a legal attack. Whenever there is a lawsuit, the first thing lawyers are going to do is analyze these entities to determine if they can be attacked. One of the first things a plaintiff lawyer will do is look at how the entities were set up and how the money was moved. The lawyer wants to see if things were done in a way that would invalidate the protections.

For example, if you have an LLC that is being taxed as an S-Corporation, you need to take a salary. You need to move money from the entity to your personal account to pay for personal expenses. You can't use the entity to pay for your property taxes or other personal expenses. You don't want to co-mingle personal and business expenses. You should set up the entities so that the only way you can get cash out of the LP is through the LLC and the Cash Bucket.

If you set up an LP, you are not allowed to pay salaries to the partners in the company. However, guaranteed payments for services are permitted, though they are subject to self-employment taxes. You can then distribute the rest of the money any way you want as long as the partners agree on the distribution of losses and profits. If there is money left over, you need to distribute it based on the percentage of ownership. You have to give all the partners some distribution. You can't take it all. No matter how much a person owns in your company, you need to distribute the leftover money based on these percentages, even if they are as low as 5 percent.

The thing to remember is that you can't use your new entity like a piggy bank. This is one of the reasons for having a personal Cash Bucket with a certain amount of liquidity. You want the Cash Bucket to look like the place where the money is coming from even if you have to occasionally refill it. An LLC is for long-term investments.

A team approach will help ensure that everything is done properly. It takes a team approach to make sure that the entity is formed correctly and it's funded (i.e., you've transferred property to it). Then the advisors need to make sure you are taking the money out properly. You need to set up some internal mechanisms to ensure compliance with LLC/LP laws. This is important because this is the kind of stuff plaintiff lawyers will check. Then you need a CPA to make sure that all the entries are entered correctly for accounting purposes and that there is a real clean set of books. Savvy plaintiffs are looking for mistakes. If you do things improperly, the plaintiff's lawyer can "pierce the veil". This means plaintiffs can pierce your walls of protection and get to your assets.

Liquidity Through Insurance

If you need liquidity but are not interested in setting up a Cash Bucket, you may want to look at some life insurance contracts that waive the surrender charges. This creates a huge amount of liquidity after the cost of insurance. You gain creditor protection and it's liquid. It will not provide a lot of growth, but your money is available should you need it.

If you do this, you need to ensure that the correct caveats create immediate liquidity. Not all policies do this. Some insurance policies have a lot of negatives attached to them. For example, they may have a large surrender charge. For the first year, even though you have put up a lot of money, not a lot is available. If you can find an insurance policy that waives this surrender fee and makes 93–95 percent of what you put into it available immediately, then it is a legitimate vehicle to help protect your assets and still give you a lot of liquidity.

This type of insurance policy would be used for times when you might need a large amount of cash available and don't want to invest it for a long term. You could also put this money into an LLC. If the insurance policy will give you more growth than short–term municipal bonds, then this may be the way to go. If it isn't, then you may prefer setting up an LLC.

Unprotected Money

People always want to protect their money but it's actually a good thing to have some unprotected money available. This will allow you to claim that these entities are not just for asset protection. If everything is protected, you've created the argument for the plaintiff that all these mechanisms are abusive.

You should look at keeping six to twelve months of living expenses in your personal name to eliminate the argument that you did everything for asset protection. You can also take this a step further and put some money into a cash-flow insurance contract that will give you creditor protection but will still give you immediate liquidity. It also gives you legitimacy because you can claim that it's a life insurance policy and not simply used for asset protection. You can argue that you need life insurance and you simply chose to buy a permanent policy.

When you take the money out of this policy, you have a couple of options. You can take a withdrawal up to your basis or you can do a loan. When you do a loan, there's a net zero cost loan where the insurance company will credit you 4 percent and then bill you 4 percent. It's done this way because the IRS says there has to be an interest charged and a payback schedule. The interest is going to be billed directly by the carrier and payback is the day you die, if not sooner by payoff. Not all policies permit net zero cost loans.

If you take basis out, there are no tax implications. Basically, most people take out money up to basis and then take a loan on the rest. The insurance company is loaning funds backed by what you have in that policy.

This type of insurance policy is another way you can protect yourself if you are worried that there might be a lawsuit coming or if you just have a lot of cash lying around and want a place to put it. You just need to make sure that it's the right product because some companies will charge as much as a 2 percent spread. Loans with a spread can result in what is sometimes called a "tax bomb" in the future. There are a number of companies that will bill you 4 percent and then credit you 4 percent internally so that it doesn't cost you anything.

Lawsuits

When it comes to protecting your assets from lawsuits, there are optimal and sub-optimal strategies. The optimal strategy, of course, is to have all your protections in place before the event that triggered the lawsuit occurs. If the event occurs, and you haven't gone the optimal route, then you can try the sub-optimal strategies. The sub-optimal strategies are basically just trying to implement these protection strategies after the fact. If you follow these sub-optimal strategies, you need to institute them as soon as possible.

There is some confusion over when you are able to take advantage of these strategies to protect your assets if you know there is a lawsuit coming your way. The case law is all over the place. Some commentators will say you can't avail yourself of these protections once the lawsuit is filed, some will say when the judgement is entered and some will say when you know or should have known a lawsuit was on the way. Even if you haven't availed yourself of these protections, you can always attempt to do it because it's another hurdle the plaintiff will have to jump over. It may not work, but it also may.

This does not mean that you should simply wait until you are sued before implementing these strategies. Your protection will be much stronger if the strategies are implemented before there is any concern about a lawsuit. It's a mistake to wait until after the event to look for protection.

Many plaintiff attorneys will be able to look at when you placed your assets into an entity and claim that you did this for the sole purpose of protecting your assets. This is called fraudulent transfer and convenience. While there are no punitive consequences to doing this, the courts can unwind the protection and make the assets available for attack. Since there are no punitive measures, if you don't have any protections in place, you can try to put them in place but they may not hold up.

If you try to implement these strategies after the fact, you should attempt to do it in such a manner that it looks like there's an alternative reason behind why you are doing it. You need a reason other than protecting your assets from a lawsuit to put your assets into an entity. If you don't have another reason, you are more likely to be accused of fraudulent transfer.

If you have a legitimate reason for transferring assets, it will give you stronger protection. For example, if you are about to be sued and you have a term life insurance contract, you may be able to convert that to a permanent insurance contract. You can then put more money into this cash value contract in an attempt to protect some of your assets.

Sometimes, you may be inclined to take a risk and see if you can get away with not protecting your assets because you are concerned about the cost. However, it will cost you a lot more if something happens. For example, if you don't have workman's compensation and something happens to one of your employees, you are going to be liable. Even if that employee was doing something stupid, you are still liable. Someone's stupidity is not a defense. You should look at having workman's compensation for all your employees regardless of whether they work on a construction site or work in an office. Worker's compensation immediately waives liability and this is what you are buying.

If something happens and you don't have insurance, it's too late. You can still buy insurance but it will be for the next incident, not this one. If you don't get insurance, your advisors will probably strongly request that you get it. If you still don't get it, they may ask that you sign a form stating you were informed of the necessity of getting insurance but still refused to do it. If you don't have to sign a form, they may still send you a letter or copies of meeting notes. Your advisors will do this because their clients may attempt to claim they were never warned about these concerns.

Other Wealth Protection Measures

In addition to the strategies mentioned, there are also a couple of other strategies that you can employ to protect your wealth.

Umbrella & Accident Insurance

As previously mentioned, we usually recommend that you get umbrella insurance. It's very cheap and provides a lot of protection over and above your regular policies.

Accident insurance can also help protect your wealth. The costs are usually nominal and can be the difference between running through your assets and having enough to be able to maintain your assets should you be injured.

Hiring Your Spouse

For tax purposes, if you are running a husband and wife entrepreneur company, you should make sure that both spouses are taking a salary. The salary of one of the spouses does not need to be a lot but this will allow your spouse to pay into Social Security. If your spouse becomes disabled, Social Security will pay a benefit.

You need to make sure that you pay enough to cover forty quarters in order to qualify for any benefit. You want to make sure that you can still get the benefit but not increase your company's taxes. The amount you need to make per quarter is only $1500. The return on investment for this minimal contribution is huge because Social Security is highly biased towards those who make the least amount of money. Social Security is not an investment. It’s a transfer of wealth that society has agreed to.

Of course, to get this benefit, you need to ensure that your spousal benefits don’t wipe this benefit out.

Asset Protection Trusts

Some states do not permit the creation of asset protection trusts while you are alive. While you are alive, you have to place your assets into LLCs and LPs. Once you have passed away, your advisors can shift the assets into trusts for a surviving spouse or for your children to protect property. These trusts can be even more powerful than an LLC or an LP because in an LLC or LP, a plaintiff can still pierce the protection given the right circumstances.

A trust will also help protect the assets in the case your heirs divorce. If the inheritance is still in an LLC or LP, they own a personal asset in which half automatically belongs to the spouse—even if the spouse hasn’t worked in the business at all. An asset protection trust can provide three basic protections: protection from divorce, protection from estate taxes, and protection from lawsuits.

Even though the Federal Government has passed a recent rule that allows you to double up on the lifetime estate tax exemption (the portability rule), this rule does not give you the benefits of a bypass trust, a lifetime trust or a family trust.

These trusts go by different names, family bypass trust, credit shelter trust, trust for children, but they are all lifetime trusts. These trusts provide asset protection for subsequent generations. You have a trustee who acts similar to a president of a company that transfers assets and distributes them to the beneficiary for the beneficiary to use. As long as you maintain that structure, trusts can own anything—business centers, real estate, cash and investments, or life insurance. Whatever the asset is, that asset is protected.

If you set up an asset protection trust, your heirs are the beneficiaries of the trust, not the owners. The trust is the actual owner of the assets. This means that since you are not the owner and someone sues you, they can't get to the assets because you don't own the assets.

The key to being protected with a trust is that you have put your money in the trust for someone else's benefit. If the trust is for your own benefit, these protections are not there. People can still attempt to go after the assets.

Many people think that a living trust will keep you completely protected, but a living trust offers no estate tax protection or any type of tax protection at all.

Life Insurance Trusts for Estate Tax

If you are a higher wealth individual, even with the new portability rules, you may still have to pay estate tax. To help you protect against this, you can decide to create an Irrevocable Life Insurance Trust (ILIT).

You buy the policy in the name of the trust, not you. You gift the money you need to pay the premiums to the trust. The trustee, or manager of the trust, pays the premium.

The mechanism that allows this to work is as follows: The money you are gifting to a trust can be accessed for a short time by your children. This window of time is usually around thirty days. By allowing the recipients a month's time to access your money, they have constructive receipt. You, of course, need to tell them not to take the money now.

When you buy a life insurance contract, you need to ensure that the trust has sufficient funds to cover the ongoing insurance premiums. Often agents do not want to state how much you really need to pay and will just get the smallest amount to get by. Once the agents are past the three-year charge-back window, they care less at that point.

Restructuring Inheritance Plans

You need to pay attention to your financial plan and adjust it to meet changing circumstances. You will need to deal with changes in the legislation or changing life circumstances. Often, you may only have basic documentation that was prepared years ago. As things change, you need to ensure that you are still adequately protected. Your wealth may have grown substantially over the past ten years and you may no longer be utilizing the necessary trusts to protect your assets for your kids.

The laws concerning inheritance have changed over the years. In the 1950s, you couldn't put a lot of money into trusts, but now you can put over $10 million in a trust that has numerous protection benefits. In fact, you may not need all the complexity that was built into your estate plans years ago because the size of the exemptions has increased.

You also need to look at your estate plans after you have moved. Different states have different laws. One of the first things you will need to do upon moving to a different state is update your will. For example, different states have different methods for deciding who is going to be named your child's guardian in the case of your death. You need to ensure that your wishes are still going to be followed in the new state.

Often, if you don't have a will, where you die and the type of family you have will determine where your assets are going. If you have children from the same relationship, the assets will go to your spouse. But if you have a blended family, then only 50 percent of the assets go to your spouse and the other 50 percent may go to the children from a previous relationship. This can lead to a number of contentious issues, particularly, if the children and new spouse don't like each other. They can end up fighting over what to do with the assets. For example, the spouse may want to live in the house but the children want to sell it and get the money.

Cyber Insurance

As an individual, you have a lot of protection from identity theft, but these protections do not exist for businesses. Sixty percent of small businesses that get hacked by cyber criminals file for bankruptcy within twelve months.[1]

Your business computers can be targeted by ransomware or by overseas hackers breaking into your computer. This is an area that needs a lot more attention and you need to become concerned about it. Often, if you don't discover the fraud within twenty-four hours, you have no rights other than going to the country where the hacker resides and trying to pursue the hacker there.

There are a number of ways a hacked business can be robbed. The more obvious method involves hackers wiring funds out of your accounts. A less obvious method involves hackers causing harm or creating liability for the business by doing damage to the business's clients. For example, Target was attacked through an air-conditioning vendor that Target themselves contracted because an employee of the air-conditioning vendor opened a phishing email that allowed the hackers to access Target's network.[2] The small business became jointly liable for over $10 million because of the liability that resulted from this $2 billion fraud. The air conditioning company didn't even know they had been hacked. At no point until after the successful robbery at Target and the subsequent forensics was it determined that the company had been hacked.

Right now, it can be hard to find cyber insurance since most people don't know about it, but it exists. There are also other ways to protect yourself. You can contract with a company whose job it is to monitor your company for threats. They literally monitor the traffic going in and out of the computer monitor, the virus software is updated, and they monitor password integrity.

Not only will this help protect you from being hacked, it will also give you another line of defense should you be sued because you were hacked. The cyber protections you put in can help limit the damage in the lawsuit. You can argue that you've done everything possible and there was nothing else you could have done to protect yourself and your computers.

If you follow a few basic cyber security steps, you will reduce your threat exposure by up to 85 percent.[3] And if you follow the steps in Efficient Wealth Management's whitepaper, "*Intelligent Wealth Protection*", we believe you'll reduce your risk by around 95 percent.

Endnotes

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Unless noted, all numbers reflect 2017 tax code.

IV.

CHARITABLE PLANNING

Charitable planning looks at methods to maximize the impact of your charitable giving. Most people confuse charitable planning with tax planning. People view charitable planning as a way to save taxes instead of a way to give your assets away to another organization that can control it and use it in a way that benefits the charitable organization. Charitable planning involves giving wealth away; whereas, tax planning looks at retaining wealth and passing it on to your children.

You often hear different statistics regarding the number of people who want to do charitable planning. Some statistics claim that two-thirds of people want to do charitable planning while other statistics have stated the rate is closer to one-third. The difference between the two numbers probably relates to the confusion over what charitable planning actually means.

You need to decide whether you would rather create a trust that your kids are unable to touch but feeds them, or a charitable trust. People who get involved in charities find that not only do they get emotional gain out of it, but that it is also good for their children. Having children actively involved in helping others teaches them values. It's better than giving them all of your money.

How different people deal with charitable planning can have a lot to do with the stage of wealth they are in. If you have first-generation wealth, you're probably in an accumulation stage. You produce money and want to produce more. If you have fifth-generation wealth, there's a much different mindset. You are more into a protect-and-distribute mind frame.

When you are focusing on accumulation, you are more concerned about limiting taxes because you realize that you are going to have to pay as much as 43 percent in taxes on your income. Charitable planning becomes a way to limit these taxes.

From a tax perspective, it's getting less and less attractive to be charitable. Ten years ago, it was much more attractive to be charitable.

The amount of money that you can give to an organization depends on the type of organization you give to. You can give up to 50 percent of your income to one type of organization but only 30 percent to a different type of organization to get a tax deduction. Most 501(c)(3) organizations (non-profit organizations) are eligible for deductions limited to 50 percent of your income. If the organization is a fraternity or a military organization, you can only give 30 percent of your income to the organization. The 30 percent contribution typically applies to private foundations where there is less control and reliability of gifting.

Donor-Advised Funds

Donor-advised funds allow you to have your own charitable fund and direct where the fund will invest. With a donor-advised fund, you can direct the fund to support specific organizations. As a result, you will retain control of both the management and disbursement of assets. You also don't need IRS approval to setup a donor-advised fund. A donor-advised fund will allow you to save twice. You can save when you give away highly appreciated assets to get a deduction and you can have the charitable contribution deductible in the first year.

Donor-advised funds let you control and manage the investments. You don't even have to distribute anything every single year. You could skip years and not make any distributions.

The key is to recognize that while you can invest money in your donor-advised fund, you can never take it back. It is an irrevocable gift. Donor-advised funds are a good option for clients who have just gotten pushed up into a new tax bracket or it's just a year where they need to defer income and they want to donate to charity.

You can use your donor-advised fund to invest in a number of different areas but it can depend on the platform you're on. It's important to understand that you've lost control over your investments. If you have set up a donor-advised fund with a custodian like Schwab, they can choose where to direct the investment. The probability of this happening is probably less than 1/10th of 1 percent, but if Schwab says, "No. We don't want to do that. We're going to use your money to fund this school system over here," they can do that. As a result, you don't have control. Schwab obviously doesn't plan to do this because they'd lose business overnight, but it can be done.

More and more people who are not in the super high wealth category are willing to have a donor-advised fund because they can direct the donation. They have a charitable intent of giving 10 percent of their income, but they have moved away from just giving the 10 percent to their church. They still give 10 percent to charity through the donor-advised fund, but they can move the donations around. They can give to the church one year, and to the humane society the next year. They can also give to numerous different charities in one year.

There are limitations to what kind of charity you can donate to with a donor-advised fund. The IRS publishes a list of 501(c)(3) entities every year that get the full deduction. If it's not on the list, you can't donate to it through a donor-advised fund. For example, there is no charitable donation allowed just because your child decides they want to be in NFFA and raise a cow. Unless you're giving to the National FFA organization directly, and you do not have any control over the donation, you cannot donate.

If you are in a low-income situation, then it is probably best for you to not use a donor-advised fund. It would be better to just give it away. If you are not itemizing deductions, there's no value.

Donor-advised funds are best used with individuals, not corporations. Corporations don't get the deductions. A C-Corporation is limited to a 10 percent income tax deduction whereas in an S-Corporation or partnership, the deductions get passed through from the K-1 to the individual, often with greater tax benefit.

Donor-advised funds are geared more toward cutting taxes. If you are more interested in further controlling the direction of the charitable giving, you might create a foundation.

Capital Gains and Donor-Advised Funds

If you have a stock with a gain and you put it into a donor-advised fund, the gain stays in the donor-advised fund. The gain is not recognized and is not taxed. It also improves the charitable intent so it is much better to pick highly appreciating stocks for a donor-advised fund. When the donor-advised fund sells a stock, it is just as if a charitable organization was selling the stock and it is never taxed.

Charitable Foundations

You would create a foundation if you wanted to use the money for a very specific purpose or if there is not an organization already set up to do the same thing. For example, you would use a foundation to create a scholarship to fund underprivileged children in your area to go to any school. Even if there were another organization already set up to do this, you would need to set up a foundation if you wanted to keep control over the money.

Even with a foundation, after a few generations you may end up losing control of the foundation because you will have a board of trustees that may decide to take the foundation in a different direction. The reason for this could be for private reasons or for public policy reasons such as the foundation was supporting something that is no longer socially acceptable.

A foundation is also a good way to get other donors to contribute to your cause. In fact, this is one of the few ways to grow your foundation without having to put more money into it yourself. One thing to remember is that 501(c)(3) organizations are prohibited from taking a gift for a specific person. Your 501(c)(3) would be in violation of its charter if they took money earmarked for a specific person.

With a donor-advised fund, you have fewer moving parts and less reporting to do than you have with a foundation, but donor-advised funds may not work for every situation.

Donating Stocks

You can give stocks straight to charity and most charitable organizations will know how to handle the stocks. You don't need to worry that the organization won't be able to deal with the complexity of the donation. For example, if you give stocks to a church, the church will have no problem converting the stock to cash.

Many people think giving cash is better than giving publicly traded stock. They believe charitable organizations actually prefer cash, but this is not necessarily true. Giving cash does not mean you are giving more to the charity. With stock, the charity can decide what's best for the organization. The charitable organization can take the appreciated stock and sell it or they can put it in their portfolio and reap the dividends.

The thing to remember when donating stock is that you are getting the fair market value when you sell it. This means you are not getting the amount it cost you to buy it, you are getting the amount you sell it for. As a result, you can't just take the bad, poor performing stock in your portfolio and donate it. It's actually better to take those losses in your own portfolio.

Marginal Taxes – Rate Reduction

Marginal taxes can be important when gifting in respect to reducing your taxes. Marginal taxes have the greatest impact once taxpayers' income enters the range of $300,000 to $700,000, due to the impact of deduction phase-outs.[1] As a result of the marginal tax rate, your average tax rate actually climbs and then comes back down. If you can use gifting to drop your marginal tax rate, it can be a very powerful tool, especially if you're going to gift anyway in the future. If you're going to gift some of your estate, you can do it now and reap some of the benefits of the tax breaks.

Other Charitable Giving Tools

There are a number of other charitable giving tools available that you may be able to use. There is the Grantor Retained Annuity Trust (GRAT), the Charitable Remainder Annuity Trust (CRAT), the Charitable Lead Annuity Trust (CLAT), the Charitable Lead Trust (CLT), and the Charitable Remainder Trust (CRT).

These can be a bit confusing and you need to have a high net worth to even begin to be interested in these different mechanisms. They are a way to put money aside, send proceeds to someone else, and then get the money back later. You can use a rolling GRAT with some of these trusts. This is different from 501(c)(3) organizations and the donor-advised fund where you are no longer able to get the money back.

One method is to create a grantor retained annuity trust. In this type of trust the grantor retains an interest in whatever is left over after a certain term. During the term, the investment growth within the trust that exceeds the growth rate set by the IRS can transfer to the beneficiary with no gift issues. In other words, you can create this trust, hold the investments in it, and if the rate of return is higher than the rate set by the IRS, all that growth can be transferred to somebody else without it being a gift. At the end of the term, which can't exceed 20 years, the grantor gets that money back. You can set up a rolling GRAT and just keep it going and going, although, the IRS has tightened up the rules around GRATs because GRATs are not really charitable planning and have more to do with wealth transfer.

A charitable remainder trust is a GRAT where the beneficiary is a charity. With a charitable remainder annuity trust, you create a trust and put your assets into it. If the rate of return on those assets in one year exceeds a certain rate set by the IRS, the charity gets that stream of payments and you get what's left over after the term of ten years. Using this trust is a way to get some of your money back.

With the charitable remainder trust, you get the stream of payments and then the charity gets what's left over. This is the reverse of a charitable lead trust. In the charitable lead trust, the charity is getting the income stream and you are getting the rest.

You also get a tax deduction on the present value of the remainder interest. Depending on your life expectancy, 50 percent or 30 percent of the money you put in is deductible. If you're afraid to give up control of your assets, you can still take the tax break now, assuming that upon your death you want a certain amount of money to go to certain causes, by setting up a charitable remainder trust. A safe withdrawal rate for most people is about 4 percent, so if you get a 5–6 percent charitable remainder trust, you wouldn't have taken more money anyway.

The problem arises in that the money you take out is subject to income tax; though it's only taxable when it is pulled out of the charitable remainder trust. A lot of these strategies have been replaced with donor-advised funds.

Life Insurance and Charity

If you are not super wealthy but still want to be charitable and can't afford to give up any control or don't need a big deduction, you can always use a life insurance contract. It's an easy way to leave money behind and you don't necessarily have to outlay a lot of money if you buy a term or whole life product.

Almost no one thinks they'll live as long as they probably will. Even life insurance companies are constantly extending longevity in their insurance calculations. In 2009, Congress forced all the carriers to stop using a 1980 mortality table and to start using a 2001 mortality table. Up until 2009, they all used a 1980 mortality table.[2] The new table showed that people were living twenty-one years longer. As a result, premiums plummeted. Insurance companies finally accepted (with a little help from Congress) that people are living longer and quit charging the 1980 rates—it only took them 29 years!

Longevity is going to be more of an issue as time goes by. Life insurance is a way that you can still leave something for others without accruing a bunch of wealth or compromising your own lifestyle by having to fund an entity.

There's a big difference between charitable planning and tax planning. The intent is very important, because the money once gifted is gone. It's typically not going to come back if you're doing charitable planning. You always have to sit down with your tax preparer and look at where you pay, how it works, and how the deduction works. A regular tax preparer, such as a CPA, will know how to handle these details, because there are phase outs and other types of issues with charitable giving that you need to plan for. Your expert team can provide a multi-disciplinary approach to help you balance your tax and charitable goals.

You should now have a fairly good understanding of the four parts to advanced planning. Although this book has increased your knowledge, you still shouldn't run off and do everything yourself. Talk to your team, ask questions and let them help figure out what is best for you.

Endnotes

1. Kitces, Michael. "Pease Phaseout Should Not Discourage Charitable Giving." *Nerd's Eye View*, 19 Mar. 2016, www.kitces.com/blog/why-the-phaseout-of-itemized-deductions-should-not-discourage-charitable-giving/.

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Unless noted, all numbers reflect 2017 tax code.

CONCLUSION

As we've seen in this book, what's often simply called Wealth Management is much more. We define Wealth Management as investment consulting with advanced planning and expert relationship management. As we consider advanced planning and the activities that are involved, we can see the importance of a consultative approach; working with a team of professionals that not only helps our clients protect their wealth, but also mitigates their taxes, takes care of their heirs, and protects their assets from being unjustly taken. This multidisciplinary approach with top-tier professionals enables us to maximize the impact of our advanced planning for our clients.

We hope that you find the content in this book illuminating. Of course, we always recommend that you seek professional advice before taking action based on specific recommendations, but even if you're not working with our team, hopefully what you've gotten from this book is the importance of putting together a team of professionals that works collaboratively with your future in mind. From all of us at Efficient Wealth Management, Abercrombie & Associates, and Knighton & Stone, we wish you all the best of success.

ABOUT PAUL CARROLL, CFP®

Efficient Wealth Management is a boutique wealth management firm founded in 2005 by Paul Carroll, CFP®. Efficient Wealth Management was seen as a venue for Paul to serve his clients, not through the traditional broker-dealer avenue, but as a consultative, trusted advisor looking for holistic solutions to a complex wealth management plan. His vision was to create a client-centric firm that places service before sales.

As the founder and CEO, Paul leads a team of wealth managers in building and executing financial plans for high net worth individuals and families. By establishing and maintaining open lines of communication, Paul stays up to date on clients' lives so that he can proactively provide guidance and direction as they navigate the challenges and opportunities presented to them.

While not with clients, Paul spends time working on the development of his team, the firm, and the community. Both internally and externally, he takes pride in seeing the success of others. As a member of the Board of Directors of the Cynthia Woods Mitchell Pavilion, Paul draws on his knowledge and experience to serve the community.

To learn more, please visit www.EfficientWealthManagement.com

ABOUT JAY KNIGHTON II, JD

Knighton & Stone, PLLC began with a vision to provide full service estate planning, business planning, taxation, and commercial litigation support to Texas residents and businesses. Since its beginning in 2001, the firm continues its full service estate and business planning, tax planning, and commercial litigation tradition, but has expanded to service clients not only in Texas, but throughout the Western Hemisphere.

Jay Knighton, JD and the other attorneys at Knighton & Stone, PLLC each have the background, experience, and know-how to structure transactions and planning, and dedicate themselves to informing, protecting, and guiding their clients through their most important decisions. Throughout the process, they craft powerful strategies to help their clients achieve their goals and successfully resolve legal matters.

Knighton & Stone, PLLC has a commitment to superior client service that drives their work. They build their relationships on teamwork, not only within their firm but also with their clients. They listen to concerns first, then encourage direct, but creative and innovative thinking to satisfy their client's objectives. The end result is to deliver on the promise of superior client service by anticipating needs, providing value, committing to help, and delivering to client satisfaction.

To learn more, please visit www.KnightonStone.com

ABOUT BERNARD ABERCROMBIE, CPA

Abercrombie & Associates, PC is a CPA firm located in The Woodlands, Texas established in 1981. As Co- Managing Partner, Bernard Abercrombie works in a consulting capacity to identify issues and potential improvements in regards to business entity structuring, mergers and acquisitions, and advanced estate planning for affluent individuals, entrepreneurs, health and medical professionals, and small to midsize businesses in a wide array of industries.

Bernard and his firm also advise their clients with complex issues related to due diligence, sales of businesses, internationally owned U.S. companies, controlled foreign corporations, foreign asset ownership, start-ups, generational business transfers, family limited partnerships, series LLCs, multi-state taxation of businesses and individuals, divorce issues, defective grantor trusts, estates, CRUTs, and ILITs.

In addition to tax compliance, tax planning, entity structuring, and dealing with specialized compliance issues related to certain internationally related IRS forms such as Forms 5471, 5472, 3520, 8938, 2555, FinCEN 114 and 1042, Abercrombie & Associates, PC also performs audits, reviews, and compilations in accordance with GAAP.

Bernard Abercrombie has a passion for working with business owners and entrepreneurs and seeks to help them have every opportunity to succeed, while minimizing income, estate, and gift taxes.

To learn more, please visit www.AbercrombieCPA.com