C.A.L.M.01
Summary of Issues and Suggestions for
Joe Client

This summary is based on information provided from the accompanying document: C.A.L.M.01 - Asset Protection & Wealth Management Questionnaire: Personal & Confidential Information.

The purpose of this summary is to point out what is right and wrong with Mr. Smith's asset protection and estate plan, capital gains/income tax reduction, and financial plan.

This is not a "legal" memo and is not meant to give legal advice. It is intended to provide guidance for the Member to take further action with a group of C.A.L.M. - Certified Advisors (lawyers, financial planners, and accountants).

1) Asset Protection

Your Home –Your home is worth $750,000 with debt of $250,000. Your state has an unlimited homestead exemption for the value of your home. Whether you have a $100,000 home or a $1,000,000+ home, it is protected from creditors (with the exception of the new bankruptcy laws that require you live in the home for three years for it to be exempt from a bankruptcy).

Because of the laws of your state, many people pay off their homes as an asset protection tool. That's fine, but it is not a good financial decision due to the ability to grow wealth using the money that instead was used to pay down the mortgage (classic equity harvesting).

You should run the numbers with your C.A.L.M. advisor to see how beneficial Equity Harvesting can be to grow your wealth. Then you can make the decision as to whether it would be better to have maximum debt on your home or no debt. See the attached e-version of **The Home Equity Management Guidebook** where you can read about the power of equity harvesting.

Qualified Plan - The good news is that the money in an ERISA qualified plan is federally asset protected from creditors. The bad news is that to date you have not funded very much into such plans. It appears right now you are making minimal contributions to your qualified plan on your behalf in the amount of $14,000. You are allowed to fund as much as $45,000 a year. Depending on the structure of your business's qualified plan, when getting closer to the $45,000 number you may have to contribute much more money for the employees and that sometimes is a deterrent to "max-out" such a plan.

At your age, you should consider a Super 401(k) plan. It's a combo plan between a 401(k), cash balance and defined benefit plan. Based on the makeup of your employee base, you should be able to put away well in excess of $100,000 with minimal funding for the employees. Such a plan would "carve-out" the highly-compensated older employees which will skew the numbers in your favor.

Real Estate – You have a rental home of some sort worth $65,000 with no debt on it. This asset is not protected from creditors and what's probably worse is that the rest of your estate is not protected from the liability of the rental. If there is an accident (slip and fall, fire, etc) on that property and the damages from a negligence suit are more than your liability coverage, a creditor is going to go after your other assets including your businesses. This property should be owned by a multi-member limited liability company (LLC) for asset protection purposes (formed in a state like AK, NM, NV, or AZ which has the proper charging order language in their statute).

Life Insurance — You have only term insurance and therefore "protecting" cash value life insurance is not an issue for you. Your term insurance has no real value to a creditor. That's the good news. The bad news is that you really should have permanent insurance as you already have an estate tax problem that will continue to grow as your wealth grows.

Bank Account/Brokerage Accounts – It looks as though you have $2,000,000 or so in a personal bank/brokerage account owned jointly with your spouse. This money is not asset protected. As a general statement, you only want to keep as much in your personal account as you need to in order to pay normal living expenses. This includes money for vacations, automobiles not run through the business, and other miscellaneous purchases.

The following are the viable ways to protect liquid wealth.

1) You can transfer it to an LLC or FLP setup in the correct jurisdiction. This will give you good domestic protection if you are looking to keep the money in stocks and mutual funds.

General information about FLPs and LLCs and why they are used as asset protection tools for domestic stocks and real estate.

The reason we recommend FLPs or LLCs is the remedy that a creditor can receive if a lawsuit is filed against you personally. The remedy is a "charging order" which basically gets a creditor nothing except the ability to wait for a distribution from your FLP or LLC (which will never come). Additionally, the creditor will receive the tax bill for any income generated in the FLP or LLC. We call this phantom income, and it is something that will deter a creditor from going after assets owned in FLPs or LLCs. To read more about charging orders, please turn to page 66 of the Doctor's Book.

Where should the FLPs be formed? You can form them in FL or AZ, NV, NM, AK, and a few other states. We typically recommend AK, NM, AZ, or NV because each has

good charging order language and a history of the statutes being on the books longer. Also, the annual costs are very low.

2) You can transfer the money to a **cash value life insurance policy**. Cash value life insurance is protected in your state and it can work as a nice tax favorable wealth building tool.

3) Use an **International LLC**. International LLCs work similar to a domestic LLC with the remedy a creditor can obtain (a charging order) except the process to go after the money in an International LLC is more painful/difficult for the creditor.

4) **Transfer the money to an Offshore Asset Protection Trust** (OPAT) (where the money stays in a domestic LLC until such time as you have a claim (if you have one) and then the money is removed to the offshore jurisdiction). Offshore is the **best** way to asset protect money from creditors and divorce, but many people do not understand offshore so they stick with domestic planning.

Clients use OAPTs because, to date, one has never been broken (not by the IRS, DOL, or by private claimants who have tried to break them). Once your money is in an OAPT (again the money stays domestically in an LLC or FLP until or unless a claim is filed), you can be assured that no creditor will ever get that money. To read more about OAPTs and other offshore asset protection tools, go to http://assetprotectionsociety.org/client/?a=PG:703

It is strongly recommended that you incorporate some form of offshore asset protection plan in the near future to protect your liquid wealth.

Your Corporate Entity—When discussing corporate entities, we will be discussing your main business which you indicate is a C-Corporation. A C-Corporation will protect your personal assets from the business done by your C-Corp. That's the whole point of having a corporation, i.e., limited liability.

Having said that, the value of your C-Corporation stock is not protected from your personal creditors. Therefore, if you are sued personally, a creditor could successfully go after your interest in the C-Corporation. The remedy to your current C-Corporation would be to have it owned by a properly setup LLC or FLP. Also, due to the size of your estate and the cash flow of your company, you may look at using an Intentionally Defective Trust in conjunction with an FLP to lessen the size of your estate for estate tax purposes (without giving up control) and move wealth to the heir in a gift tax favorable manner. Without more information about your short- and long-term goals, commenting on the use of an IDGT would be premature.

Because you have a C-Corp, it is vital to determine if you have retained earnings. If you have retained earnings in your C-Corp you should determine if you need it. If not, it's a tax dilemma to remove the retained earning and if you determine your C-Corp. has

retained earnings, this memo can be amended to show you how to remove it in a tax favorable manner.

Charitable planning - You currently make contributions to a local community Foundation which allows money to funnel to a donor advisor fund so you can have some input as to how the gifted dollars are used? That's good planning. The question is however, do you want to gift money to a structure like a charitable remainder trust (CRT) where you receive an income stream back from the charity and a sizable income tax deduction? With a CRT you can control the money in the CRT and use it as you see fit without asking anyone's permission (such as a local charity).

If it is important to give to charity and you would like to hedge your bet with your long-term retirement needs while having total control of the gifted money, you should consider using a CRT instead of gifting outright to a Foundation.

2) Estate Planning

You basically have no estate plan.

Your lack of basic estate planning tools should be addressed immediately. You should engage an attorney to draw up a new will which can be integrated with durable powers of attorney (medical and legal), and a living trust. Your assets should be owned by the **living trust** (which would include any FLP, LLC or C-Corp interest). This helps avoid probate fees and will help minimize estate taxes for you and your family. If you create several LLCs for asset protection purposes, they should be owned by your living trusts (unless you use an OAPT)

The **will** is VERY important due to the fact that you have minor children. If you both die in an accident (and I had it happen to family friends), there will be a battle over your children by multiple parties. To save your children the grief, you need to implement a will immediately and choose who will receive custody of the children in the event of death.

The **durable powers** of attorney will allow the appropriate person to act for you (or your wife) on a legal basis (to pay bills, make business decisions, etc.) if you become incapacitated. Medical powers will dictate how or if you should sustain life in the event you become temporarily mentally incapacitated or basically brain dead or so physically debilitated that a decision needs to be made about sustaining your life. Typically, you would be the attorney in fact for your spouse and vice-versa.

Based on the size of your estate and the fact that it will continue to grow, it is recommended that you should purchase life insurance policy(s) which should be owned by an **irrevocable life insurance trust** (ILIT). When your life insurance is owned by and ILIT, the death benefit will pass income and estate tax free to your heirs.

Long Term Care Insurance ("LTCI") - The number one expense of the elderly general public is the cost of long-term care. The chances are greater than 50% that you will need long-term care at some point in your life; and when you do, it will be very, very expensive. With your health condition the chances of you having LTC expenses is much higher than the average client.

Ideally, the best way to buy LTCI is through a company. This can be done in a 100% tax deductible and discriminatory manner in a C-Corporation. While not many companies today are C-Corporations, yours happens to be a C-Corp. This mean you can buy LTCI on yourself without having to purchase it on any of your employees and you'll be able to take a 100% tax deduction for it.

As your age, the insurance will not be too expensive and it is recommended that you short pay the premium in 10 years. Additionally, you should consider adding a return of premium rider to the LTCI which does drive up the costs, but every dollar you pay as a deductible premium dollar will pass to your heir income tax free at your death. This is sometimes referred to as "free" LTCI. Even though you paid the premium, your heirs get that money back at death.

Post-retirement medical expenses can also be provided through a tax-deductible single employer VEBAs (and the benefits also come out income tax free). This will be discussed in the income tax planning section of the memo.

Captive Insurance Companies (CICs)

A CIC can be a terrific estate planning tool for you and your family. Most clients typically will see a CIC as an income tax reduction/wealth building tool (and it can be), but for your situation, a CIC can also be a very nice wealth transfer tool.

I will not discuss in this memo exactly how a CIC functions. You can read about it in the Doctor's book on page 209. Generally speaking however, a CIC is your own little insurance company. The CIC would sell multiple types of insurance to your company which would pay the insurance premiums in a 100% tax deductible manner. The insurance purchased is the type you could purchase in the open market but choose not to because the risk of loss is low. When you add up all several different kinds of insurance you could purchase but don't, the premiums allotted to the CIC for your company should be $200,000+ a year. The exact amount will be determined by an actuary and will typically be limited by how much you want to deduct each year.

While you could own the CIC in your name, one option will be to have it owned in full or part by your children or a trust for the benefit of your children. Why? Because, with the CIC you will be removing a tax deductible dollar from the company and moving it gift and estate tax free to a CIC owned by your heirs or a trust for their benefit. It is a tremendous wealth transfer tool.

If setup correctly, even though the CIC could be owned by your heirs, with the incorporation of a simple LLC structure and a cash building life insurance policy, you would be able to have access to the cash in the CIC income tax free in retirement.

CICs and Life Insurance. The CIC can also be used to purchase life insurance on your life. This could be done for multiple reasons: 1) you want to maximize the ultimate value of the CIC at your death (no better way to guarantee that cash will be in a CIC at your death). 2) As stated, you could use a simple LLC structure where you could actually have access to the cash value of the life insurance policies (income tax free) purchased by the CIC. It's a bit too complicated to explain in this memo, but know that it is a viable option if you wanted to hedge your bet against needing income from the CIC even though it is owned by a trust for the benefit of your heirs.

3) Income Tax Reduction Planning

You put down on your questionnaire that one of your top concerns is income tax planning.

While not an income tax reduction plan, one tool you will want to consider using for tax-favorable wealth building is a **<u>Roth 401(k) plan</u>**. A Roth 401(k) plan is a much better option vs. a tax deductible 401(k). While it is painful to pay taxes on a contribution to a Roth, once the money is in a Roth, it can grow tax free and be removed tax free in retirement. While no one can predict what income tax brackets will be like when you are in retirement, we do know that today income tax rates are near historic lows, and so funding a Roth 401(k) plan should help you maximize the amount of after-tax income you have available in retirement.

Roth or traditional 401(k) plans are nice, but the amount of money you can contribute is severally limited. Therefore, you should really look at a defined benefit plan to increase your ability to deduct funds into a qualified retirement plan.

2) A **Defined Benefit Plan or a 412(i) DB plan**. This will allow much larger deductions than a 401k/profit sharing plan. It is likely that you could defer well over $100,000 a year into an asset protected qualified plan through a DB or 412(i) plan. One issue you may have with your company will be the number of employees. The more the employees the higher the cost of a DB plan. Therefore, when you look at a DB plan and have the numbers run, you should look at implementing a "carve-out" plan where you place the higher compensated and older EEs in the 401(k) profit sharing plan and the younger lower paid EEs into the DB plan with yourself. That way you can legally discriminate and create a more economically beneficial structure.

3) **Single Employer VEBA**. As stated in the estate planning section, the implementation of a VEBA through your company can be a good idea. You can fund such a plan today in a tax deductible manner where the money can grow tax free and be removed tax free for post-retirement medical benefits. As stated earlier, one of your largest costs in retirement

will be your medical expense and through a properly setup singe employer VEBA, you can fund for that expense today with tax deductible dollars.

“Advanced” Income Tax Planning - Most clients do not merit a discussion about truly advanced income tax planning. The facts of your situation do merit such a discussion.

More sophisticated planning can create a situation where income from your business can be deducted with simple Section 162 deductions where the majority of the money will then grow income-tax free and where you will have access to the money in an income-tax free manner in retirement.

Captive Insurance Company (CIC).

Based on your CALM questionnaire, it has been determined that the most powerful income, capital gains, and estate tax reduction tool as well as wealth building tool at your disposal is a CIC.

What is a CIC? It’s literally your own insurance company. CICs have been around for years and while most of the major corporations have them and while they are a viable tool for small businesses, due to the lack of familiarity with the topic by most CPAs, attorneys and financial planners, few small business clients who could use them actually have them.

Generally speaking, CICs can cover liabilities a company has but typically chooses not to insure against. For example, through a CIC, your company could purchase loss of license insurance, sexual harassment insurance, business overhead insurance, etc.

Why use a CIC and what are the benefits? In addition to the insurance coverage provided by a CIC, small captives use usually revolve around advanced estate tax planning, income tax planning and tax favorable retirement planning. Depending on the structure, multiple objectives can be accomplished.

How does a CIC function? Once a CIC is setup and the insurance coverage and amount of premium established, a business simply makes **tax deductible** premium payments to the CIC. The CIC receives them “**tax-free**” and invests the money to be used for any potential payouts from the issued coverage.

If premiums invested in the CIC generate annual taxable returns, the CIC is taxed on that income at the C-Corporation tax rate. For this reason “tax-favorable” wealth building tools are used as investments in the CIC (tax free bonds, tax favorable brokerage accounts and cash value life insurance (high cash value)). If there are no or few claims, the amount of money accumulated in a CIC can be significant (several million dollars).

Who should own a CIC? The answer depends on the client’s circumstances and goals with his/her estate and retirement plan. The classic structure for many is to have the client own the CIC so that in retirement the client can access the money in the captive in

a tax favorable manner. From an asset protection perspective, it would be wise for a client to have his/her CIC owned by an offshore asset protection trust (OPAT). Money coming out of a captive in retirement usually does so at the long-term capital gains rate (vs. at a client's income tax rate like a qualified retirement plan).

For clients with current and future estate tax problems, the classic structure is to have an irrevocable trust own some or all of the CIC. This way, when a business pays premium payments to the CIC, money is being moved out of the client's estate that same day and is done without gift or estate taxes.

A CIC for estate tax transfer is one of the most powerful tools a business owner has at his/her disposal. What other tool can move $1.00 out of a business with no income, estate or gift tax? Clients typically take $1.00 home and pay 35-45% income tax on it and then figure out the best way to remove the remaining 55-65 cents from the estate without gift and estate taxes.

Without going into too much detail, CICs can be structured so that they are entirely owned by an irrevocable trust for the benefit of the heirs where the client setting up the captive still has access to the CIC reserves income tax free in retirement.

What is recommended for your personal situation? Based on your questionnaire, it is recommended that you setup a CIC and budget premiums of $200,000+ for at least 5-7 years into a CIC owned by an irrevocable trust where the structure allows you to access the cash in the CIC in retirement tax free should you choose to do so or need the money.

The following are "rough" numbers compiled so you could see what the outcome of using a CIC might look like.

If you paid $250,000 premiums for five years, after annual administration fees are deducted from assets in the CIC each year, you would have $**1,080,034** in cash in the captive if the recommend wealth building tool is used (an over-funded high cash value life policy with growth pegged to the S&P 500) (the assumed rate of return for these numbers is 8%). The initial death benefit of the policy is $3.3 million (all of which would be out of your estate for estate tax purposes).

If you did not implement a CIC structure, you normally would have taken your $250,000 income home and, after paying 40% in income taxes, invested it in the stock market. If that money grew in the market at a gross 8% rate of return, using conservative annual expenses on that growth, you would have approximately **$920,000** in the account.

The reason there is more wealth in the CIC is due to the fact that more money is able to be invested and the fact that the money is growing tax free inside the cash value life insurance policy. Extrapolating it out 15 years, the life insurance policy owned by the CIC would have $1.765 million in cash and the brokerage account would have $1.56 million in cash. The benefit of the CIC over a brokerage account is that the money in the

CIC is outside of your estate although postured to allow you to have access to the money if needed tax free in retirement.

Summary of the benefits of a CIC for your situation

1) If setup properly, the CIC moves every premium dollar out of your estate income, gift and estate tax free immediately upon payment.

2) A CIC can be setup to use as a supplemental retirement vehicle and if setup properly, even though the CIC is owned by a trust for the benefit of your heirs, you can have access to the money in the CIC tax free in retirement.

3) A CIC is a terrific way to buy life insurance that is needed for your estate plan as the CIC can buy it with tax deductible dollars where the death benefit will pass outside of your estate.

If you do not want to have the CIC owned by a trust for the benefit of your heirs and instead want to own it personally so you are assured that you can use the money in the CIC in retirement (which is still a tax favorable play), the amount of money you will be able to take out of the CIC will be significantly more than what you would have by taking home taxable income and investing it in the stock market. If you choose to go this route, it is recommended that the CIC be owned by an OAPT.

Long-Term Care Insurance — As stated earlier, because your company is a C-Corp., you can purchase LTCI in a discriminatory manner where 100% of the premium is tax deductible to your company. Based on your situation, it is an easy decision to purchase this type of insurance.

4) Financial Planning

Giving you advice on your "financial" plan not the focus of a C.A.L.M. 1 memo. Additionally, your C.A.L.M. advisor, Jim Smith, is very competent and can help you in this area.

In addition to stocks and mutual funds that you will accumulate when you have a proper 401(k)/PSP/defined benefit plan, you might also consider Equity Harvesting as a way to grow your wealth in a tax favorable manner.

Equity Harvesting.

Equity Harvesting is a terrific way for someone in your position to build wealth. Instead of explaining it in the memo, it is recommended that you completely read the Home Equity Management Guidebook which gives a full explanation of how to build wealth using the equity in your home.

Summary

The following are the Level 1 memo recommendations that you should speak with your C.A.L.M.-certified advisor about.

1. Your most glaring need is your estate plan. You should immediately implement a new will that integrates with your new durable powers of attorney, living trusts and ILIT.
2. Your asset protection issues are pressing as well. You need to immediately decide how you want to protect your $2,000,000 brokerage account. It is recommended that you transfer much of that money to a domestic FLP which will then be owned by an OAPT. This is the best way to know that your money will not be taken by any lawsuit or even from divorce.
3. You need to move your rental property into a properly setup multi-member LLC formed in the "correct" state.
4. Part of your asset protection plan should be to fund some amount of money into a qualified retirement plan (which is asset protected from creditors). How much you contribute will be driven by the expenses for the employees and whether you choose to use a CIC. If you decide to continue to aggressively fund a qualified retirement plan, you should implement a carve out defined benefit plan to minimize the amount of contributions for the employees.
5. For both your estate and income tax reduction plans, you should consider a CRT instead of outright gifting to the Foundation. With a CRT you will receive a nice income tax deduction and a stream of income. Additionally, you'll have total control of how the money in the CRT is used for charitable purposes.
6. You should take steps to replace your term life insurance with "permanent" insurance. Your options are to 1) gift money to an ILIT so a policy can be purchased, 2) implement an equity harvesting plan which would require the purchase of a new policy, or 3) if a decision is made to form a CIC owned by a trust for the benefit of your heirs, after funding, the CIC could purchase a policy on your life.
   For now, keep the term policy until a decision can be made. It is recommended that you do in fact, harvest equity out of your home and reposition that into a low-expense high-cash value life insurance policy. This new policy can then be used for current death benefit coverage for the family.
7. Because you have a C-Corp., you should purchase a 10-pay long-term care insurance policy in a 100% tax deductible manner through the company. You can do so in a discriminatory manner just for yourself. It is also recommended that you consider adding a return of premium rider so every dollar paid in premium is returned to your heirs tax free at death.
8. Single Employer VEBA. Because one of the largest expenses in retirement will be your post-retirement medical, you should implement a VEBA. With a VEBA you can fund today in a tax deductible manner for those expenses where in the money can grow tax free and can be removed tax free from the VEBA in retirement for qualifying medical expenses.

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9. Equity Harvesting. One of the most powerful wealth building tools you have at your disposal is the ability to harvest equity from your home to fund a low expense cash building life insurance policy. When you read the Home Equity Management Guidebook, you will see the real world numbers for how the concept works to help clients build a tax favorable retirement nest egg. Consult with your C.A.L.M. advisor who can run illustrations and determine the proper way to implement this strategy.
10. CICs. You should create a CIC for two reasons. 1) reduce income taxes and build wealth in a tax favorable entity. You should be able to take $200,000-$300,000+ deductions into your own captive for at least five years. If structured properly the money in the CIC can grow tax free and also be removed in a tax favorable manner in retirement. 2) you should consider having the CIC owned by a trust for the benefit of your heirs. Doing so will allow you to remove literally millions of tax deductible dollars from your estate gift and estate tax free where if properly structured, you will have access to much of the money in the CIC tax free in retirement. This is your best wealth building and estate planning tool.
11. You should determine if you have retained earnings in the C-Corp. If you do, then this memo should be amended to deal with rescuing that money.
12. At some point you'll be a candidate for an intentionally defective trust to transition your business and help with your overall estate plan, but you are not there at this point yet.

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Nothing in this memo should be interpreted as giving legal advice. Before any steps are taken when it comes to a legal matter, you should consult with a local attorney or more preferably a C.A.L.M. Certified attorney.