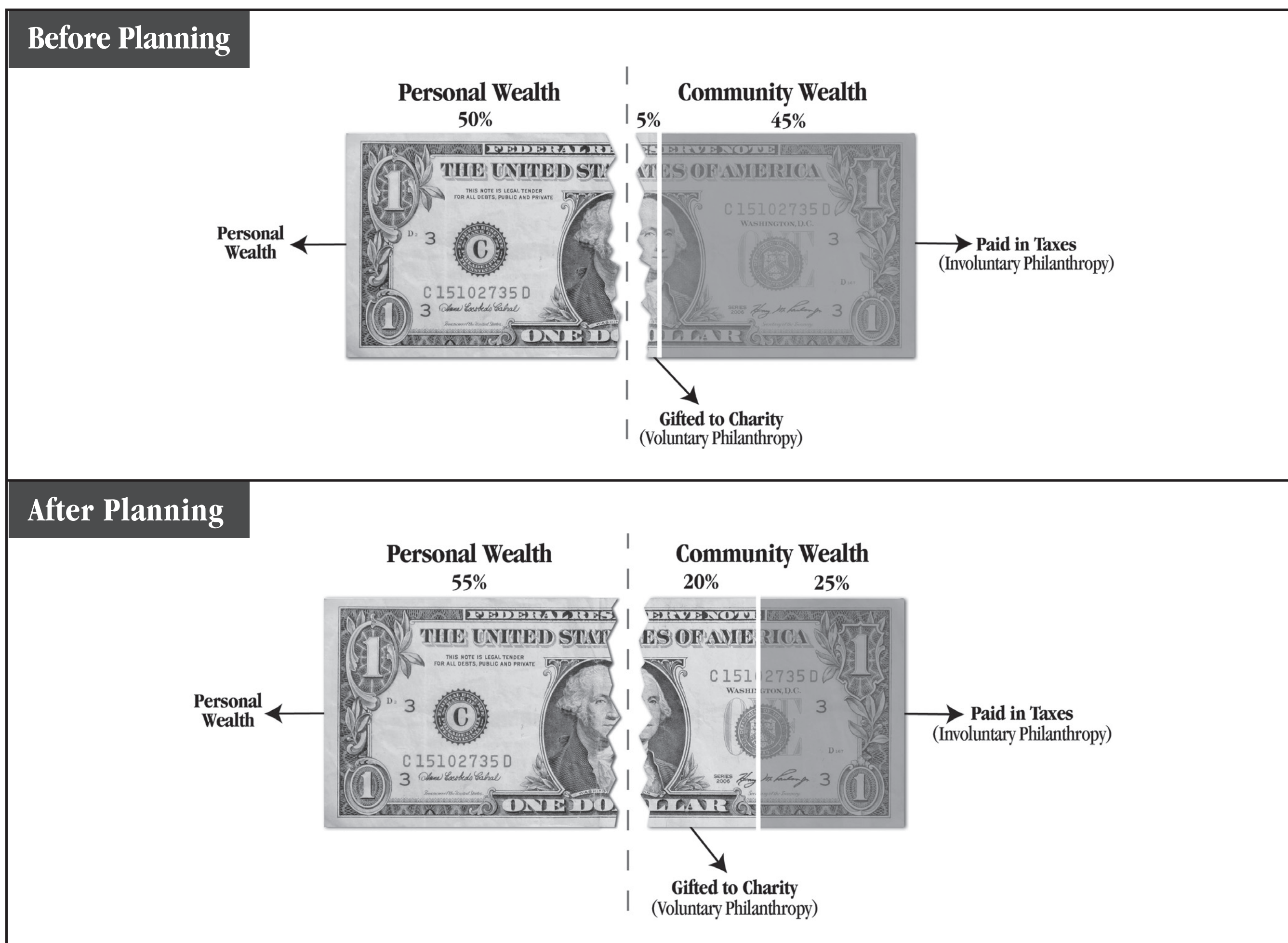
The Best Zero Tax Planning Tools

Convert Involuntary Philanthropy (Taxes) to Voluntary Philanthropy (Gifts to Favorite Charities) while Increasing Personal Wealth Available for Retirement and Family



BY TIM VOORHEES, JD, MBA

This special excerpt of *The Best Zero Tax Planning Tools* contains only the Preface and Chapter One. To order the entire book, please visit www.ZeroTaxCounsel.com.

Preface

Studies show that Americans now typically spend more than four months of every year working to pay taxes.[1] Over-worked taxpayers come to wealth advisers[2] with a strong desire to minimize taxes and increase after-tax returns. As this book will illustrate, qualified advisers can offer their clients myriad solutions for reducing their taxes while increasing the wealth available for retirement income, transfers to family members, and charitable giving.

Given the wide array of available tax-reduction solutions, why do so few clients implement zero tax plans? The answer is likely found among six common, misconstrued objections to zero tax planning:

1. Avoiding taxes is wrong.
2. Saving future taxes is not a motivator.
3. Hiring a team of advisers is too expensive.
4. Transferring wealth to irrevocable trusts is scary.
5. Integrating zero tax planning instruments seems too expensive, risky, and complicated.
6. Preparing the next generation requires too much effort.

My team's success in implementing hundreds of zero tax plans over 30 years proves there are good solutions to the above problems. This preface responds briefly to these objections, while setting the stage for a deeper discussion in the following chapters.

Avoiding taxes is not wrong!

In a famous legal opinion, US Supreme Court Justice Louis D. Brandeis encouraged taxpayers to take advantage of the tax benefits given to Americans. The following quote highlights the social policies guiding Congress when it makes tax-advantaged legal and financial instruments available:

> *"I live in Alexandria, Virginia. Near the Supreme Court chamber is a toll bridge across the Potomac. When in a rush I pay the Dollar toll and get home early. However, I usually drive a free bridge outside the downtown section of the city, and cross the Potomac on a free bridge. The bridge was placed outside the downtown Washington D.C. area to serve a useful social service: getting drivers to drive the extra mile to help alleviate congestion during rush hour. If I went over the toll bridge and through the barrier without paying the toll, I would be committing tax evasion. If, however, I drive the extra mile and drive outside the city of Washington, I am using a legitimate, logical and suitable method of tax avoidance, and I am performing a useful social service by doing so. For my tax evasion, I should be punished. For my tax avoidance, I should be commended. The tragedy of life today is that so few people know that the free bridge even exists."* [3]

Saving future taxes is just one motivation for doing zero tax planning!

Zero tax planning involves much more than just estate tax planning. Traditional estate planning focuses on saving taxes after the client dies. Many clients do not want to plan for such future events because the likelihood of death seems too remote, or the wealth-transfer decisions seem too daunting.

Fortunately, zero tax planning involves much more than just saving estate taxes. A well-structured plan can zero-out estate, gift, and Generation Skipping Transfer (GST) taxes while reducing income, capital gains, and other current taxes. Moreover, a qualified team of zero tax planners can illustrate how tax savings fund a better lifestyle for clients and their children while giving the clients greater influence in the community through charitable giving. The non-financial family and community benefits of zero tax planning can provide great motivation to do the planning now—especially when the present income tax savings will typically be much greater than the present costs of the planning.

Hiring a team of advisers is not too expensive!

Zero tax planning synergistically combines the benefits of legal, investment, insurance, and other types of planning. This synergy can result in teamwork that produces an overall better result than if each adviser on the team were working toward the same goals individually.

While hiring advisers from multiple firms can add costs and complications, clients will find that one-stop planning firms can keep costs relatively low by training and equipping all advisory team members to support shared values in a proven process. The client pays just one planning fee for the whole team. While a third-party CPA or fiduciary should review the plan, the total costs for the planning and review are typically less than 1% of the enhanced cash flow and wealth transfer benefits.

To keep zero tax planning costs low, clients can start with simple but powerful combinations of charitable and non-charitable trusts. For example, advisers routinely design Charitable Remainder Trusts (CRTs) to integrate with insurance trusts (otherwise known as Wealth Replacement Trusts or WRTs) to help clients realize large income tax deductions, tax-deferred growth, capital gains tax savings, estate tax savings, and tax-favored retirement income. The blending of the CRT and WRT tax benefits and cash flows can result in fewer taxes, more for retirement income, more for family, and more for favorite charities. While the client must usually pay both a legal adviser and financial adviser to facilitate the drafting and funding of the CRT and WRT, the total costs are typically only about 1% of the tax savings.

Fees related to zero tax planning may be tax deductible as business expenses or charitable write-offs. Given how the after-tax benefits of zero tax planning can exceed the after-tax costs by a factor of 100 to 1, tax payers have substantial incentives to hire teams of advisers who know how to zero-out unnecessary taxes.

Transferring wealth to irrevocable trusts need not be scary!

Zero tax planning frequently involves complementing a revocable living trust with appropriate irrevocable trusts. Clients fear irrevocable unhappiness if an irrevocable trust is designed inappropriately.

Fortunately, professional advisers have effective ways of designing and drafting irrevocable trusts with great flexibility while retaining the tax benefits. Moreover, astute advisers will fund the irrevocable trusts with LLCs and other vehicles that help clients retain ample voting and distribution rights.

Wise clients realize that, ultimately, every person's retirement will end, and all assets not used will transfer to other people or organizations. Depending on how they are designed, irrevocable trusts can facilitate that inevitable transfer while helping each client retain reasonable ownership, cash flow, management, and control rights during his or her lifetime.

Prudent, irrevocable trust planning helps clients generate more robust and predictable cash flow while seeing how their wealth can pass tax efficiently to preferred beneficiaries. Attorneys can draft the irrevocable instruments with ample flexibility while preserving benefits that easily out-weigh the costs. For these reasons, irrevocable trust planning usually provides great peace of mind and helps clients enjoy much lower stress levels once trusts are drafted and funded.

Integrating zero tax planning instruments is not too expensive, risky, or complicated!

When clients see the potential benefits of zero tax planning instruments, they often express strong interest in implementing the available techniques. However, this enthusiasm may wane when they consider the issues attendant to integrating new wealth-transfer strategies with existing estate or income-tax-planning methods. Even greater concerns may arise when clients learn they may have to create irrevocable trusts in order to realize the largest tax benefits. In order to assuage these fears, an experienced wealth adviser[4] must reflect a client's deepest concerns and highest hopes in a document that unites and inspires members of a planning team. We call this document a Blueprint. This Blueprint should harmonize the wisest counsel of the CPA, lawyer, financial planner and other advisers convened to help the client maximize

tax-efficient lifetime income, transfers to heirs, and gifts to favorite charities. A qualified wealth adviser knows how to rank and quantify goals so that advisers on a planning team can work together effectively when selecting, designing, drafting, and funding the proper combination of trusts. Such counselors have proven processes for designing legal and financial instruments that address hard technical (e.g., tax, financial, and legal) issues without neglecting the soft emotional, relational, and spiritual concerns. The wealth adviser knows how to summarize all of the most suitable techniques for each client on a one-page flow-chart while supporting the flow chart with financial statements, legal document summaries, project management timelines and other essential information needed to help that client's advisory team members communicate effectively.

As their trusts are drafted and funded in accordance with a Blueprint, clients can see how they should have more after-tax retirement income—as well as greater after-tax capital—available for family and favorite charities. Clients can have the peace of mind inherent in a summary of annual after-tax cash flow and wealth transfer amounts. If their advisers can accurately illustrate both the income and balance sheet impact of the proposed strategies across time, clients should have a simple and realistic way to assess the benefits of the zero tax plan. As advisers show their clients how the proposed strategies generate both tax savings, as well as an array of non-tax benefits, clients have much more clarity about their futures and the ability to fund their dreams. Their lives become much simpler when they can refer to a simple, one-page flowchart with strategies blessed by all of their most trusted advisers.

Preparing the next generation can provide great benefits to justify the effort!

King Solomon warned, "An inheritance quickly gained at the beginning will not be blessed at the end."[5] Heirs given money typically have a strong inclination toward spending the money on possessions, pleasures, or other purposes without lasting significance. Psychologists specializing in "sudden wealth syndrome" acknowledge that heirs, like lottery winners, tend to blow their windfall. Many studies document how most wealth is lost by the end of the second or third generation as a family goes from "shirtsleeves to shirtsleeves."[6]

Clearly, the traditional estate planning process results in clients paying too much in taxes and in trust beneficiaries experiencing too many "bad heir days." The emphasis on zeroing-out taxes has supplanted the wise preparation of successor managers and beneficiaries. In other words, too many tax advisers focus clients on improving the after-tax inheritance for heirs without first confirming that the heirs have the maturity to steward a larger inheritance. For understandable reasons, 70% of estate plans fail by the end of the second generation, and 91% fail by the end of the third generation.[7]

Fortunately, trained advisers can help their clients equip beneficiaries to understand the purposes of wealth. Before passing on the value of their inheritance to the next generation, wise clients share stories and principles that pass along spiritual and emotional values. These clients heed the wisdom of Solomon by transferring both a relational inheritance and financial inheritance in a manner that establishes a foundation for blessing many future generations. The following chapters explain how.

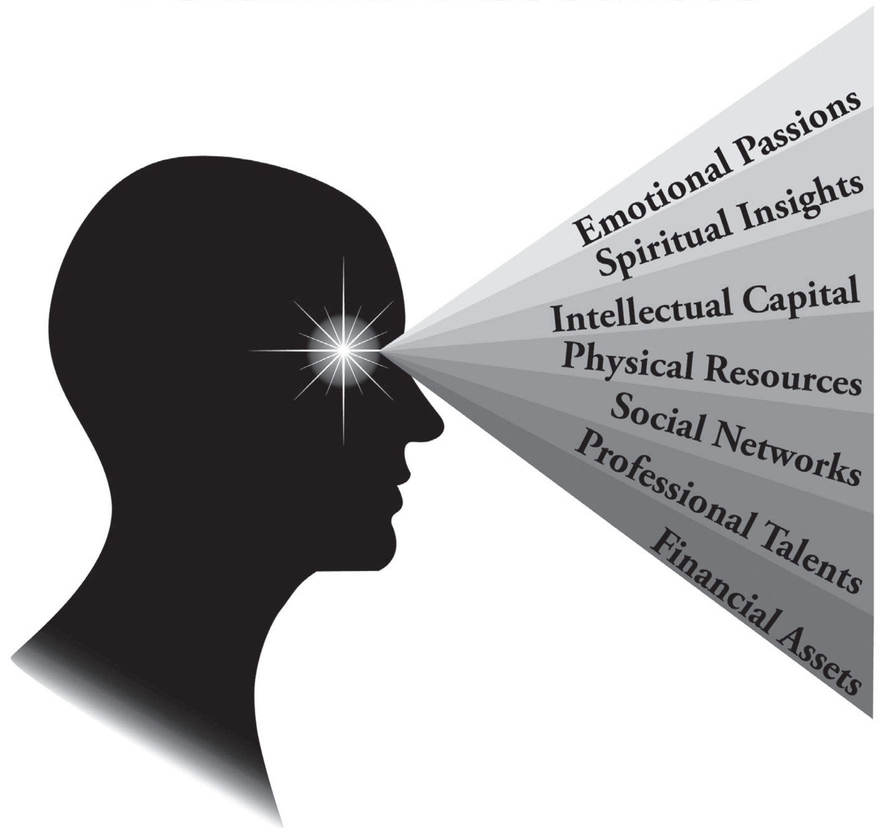
Chapter 1

Zero Tax Planning Helps Clients Control *All* of Their Resources

(Element 1: Present/Potential Resources)

The covenantal planning process begins with identifying available resources. A client must determine the value of his or her current wealth and make reasonable projections about future wealth that might be available for lifestyle expenses, family, charity, or taxes. When anticipating potential wealth, all clients should consider the likely financial assets that can accumulate across the years when there is a commitment to pursuing a calling with passion, questing for spiritual insights, identifying and monetizing intellectual capital, cultivating physical talents, leveraging social networks, and seeking professional training with guidance from a qualified mentor.

Wise use of the seven resources listed in the above paragraph can help anyone accumulate substantial financial assets. While the government cannot easily tax most of our God-given resources, assets on the financial statements will decline significantly unless there is a commitment to disciplined tax planning.



The client's balance sheet should show available financial assets and estimate yields so that planners can determine how the assets will likely grow each year. Next to each asset on the balance sheet, advisers should note how capital gains taxes, estate taxes, or other local, state and federal taxes might reduce the value of the assets.

Zero tax planning can help a client control all of his or her balance sheet assets, including the portion currently allocated for taxes. It is not difficult to zero-out taxes simply by giving wealth to charity. Amazing opportunities arise, however, when the tax benefits of charitable tools are combined with the tax benefits of non-charitable instruments.

To achieve zero tax planning goals, advisers typically integrate well-known philanthropic strategies such as Revocable Bequests, Charitable Remainder Trusts, and Charitable Lead Trusts with common non-charitable techniques such as Limited Liability Corporations, Revocable Living Trusts, and a variety of irrevocable trusts. Advisers can help clients zero-out tax while using widely accepted planning instruments that respect the letter and spirit of the Internal Revenue Code. Such instruments may generate large tax deductions, allow for tax-deferred growth, shelter income from current taxes, and transfer wealth to heirs without estate, gift or generation-skipping taxes.

This chapter will show how Congress and the IRS empower clients and advisers to design planning instruments to minimize taxes, integrate charitable and non-charitable planning tools synergistically, and draft and fund tools to allocate the correct amount of wealth for personal and community goals. The following sections review how clients can decide how much wealth will be consumed, transferred to beneficiaries, gifted to charities, or paid in taxes. Diagrams below suggest how clients can minimize the amount in the tax bucket while maximizing income for lifestyle expenses, transfers to heirs and gifts to favorite charities.

Designing Charitable Planning Instruments to Minimize Taxes

When determining which charitable tools to use in order to minimize taxes, many clients will express concerns about too much money going to charities. To address worries about charitable giving depleting cash available to perpetuate the family legacy, an experienced wealth adviser can discuss a variety of charitable giving techniques that help family members make gifts of illiquid assets (such as closely held business interests, equity in a home, registered stock, etc.). Studies show that most families keep only 7% or less of their assets in liquid accounts used for making donations to charities. If these families see how they can fulfill charitable obligations by giving illiquid equity in businesses or other assets, the philanthropic planning frees up more cash flow for funding vehicles that transfer wealth to family beneficiaries.

In America, a portion of lifetime income and transfers to beneficiaries must be allocated for the good of the community. Every taxpayer is either a voluntary or involuntary philanthropist. Wise tax advisers help clients see that they can choose between voluntary philanthropy and involuntary philanthropy:

- Taxpayers are **involuntary philanthropists** if they do nothing and give to the state and federal treasuries through taxes. As an involuntary philanthropist, an individual must usually sit back and let the government make decisions about spending his or her wealth.
- Alternatively, taxpayers can be **voluntary philanthropists**. Congress allows Americans to use a variety of charitable trusts to direct their would-be tax money to their favorite charities. Taxpayers can send their voluntary tax money to foundations that then redirect those funds to a broad array of causes close to their hearts. Through active involvement in philanthropic planning, individuals can control—and feel good about—the portion of their wealth that must go to the community.

Voluntary philanthropy may involve gift annuities, Charitable Remainder Trusts, Charitable Lead Trusts, donations of company stock, gifts of intellectual property, and numerous other techniques. Skilled wealth advisers can integrate these tools into plans involving clients' existing planning instruments, such as their retirement plans or living trusts. Competent advisers can show their clients how to control not just their personal wealth but their community wealth, as well. For example, a wealth adviser can structure family foundations with boards comprised of family members who gain great influence in the community as they fund favorite charitable causes with money that would have been wasted in taxes.

Integrating Tax Planning Tools Synergistically

It seems to violate the laws of physics to have a plan superior in every important way. Nonetheless, experienced advisers know how to fund retirement income and wealth transfers using cash generated from tax deductions and tax deferral. This cash can be leveraged through the use of trust-funding techniques and low-interest loans. Moreover, the cash can compound very tax efficiently through the right combination of charitable and non-charitable instruments.

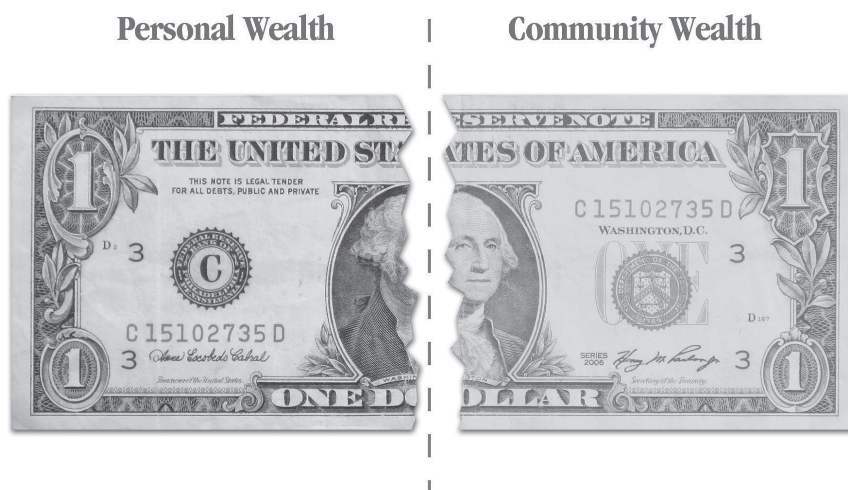
When integrating benefits from multiple tools, individuals must compare current and proposed numbers. Their advisers should examine their current lifetime cash-flow projections to see how much money they will need or expect each year after taxes. Individuals should also conduct current projections of how much wealth each of their beneficiaries will receive after taxes.

Once projections illustrate current after-tax transfers to the client and beneficiaries, advisers can use these baseline numbers as benchmarks when developing proposed numbers. As long as the advisers take the time to calculate reasonable cash flow and wealth transfer amounts from each of the assets and trusts, they will have the granular data to calculate fully-integrated lifetime cash-flow numbers and wealth-transfer projections for each of their client's beneficiaries. If the planning is completed correctly, clients should

be impressed with how the proposed numbers are better than the current numbers. More importantly, they should be delighted to see that they can control all of their wealth by redirecting tax money to trusts for their family members and favorite charities.

Choosing Among the Four Ways to Use Wealth

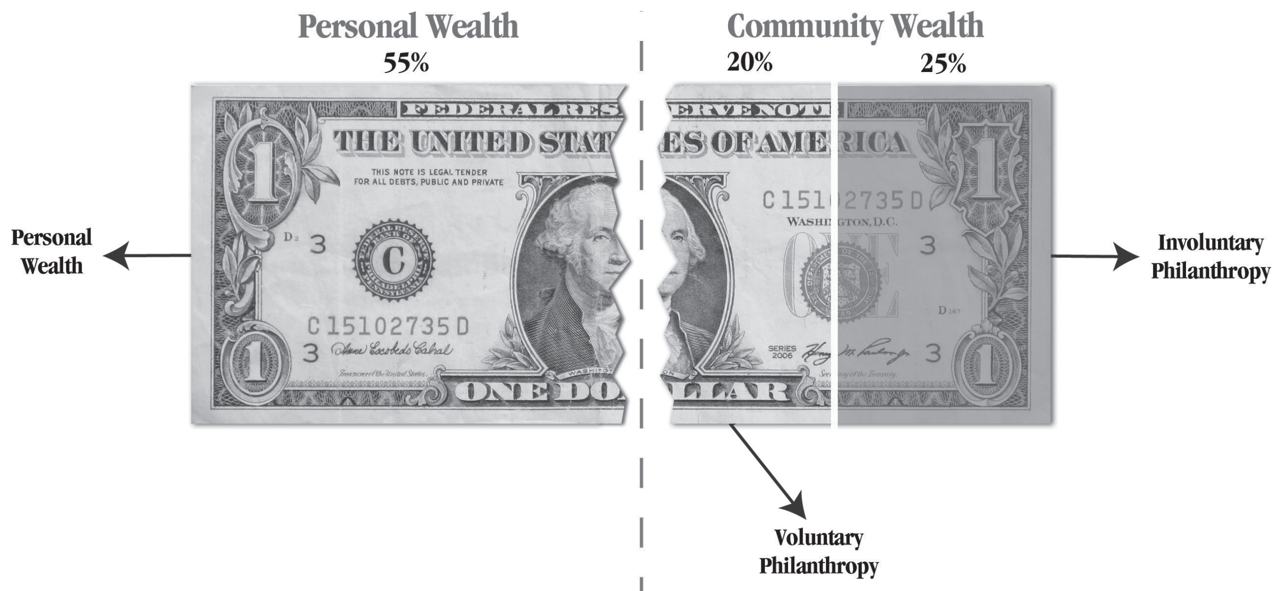
Below is a deeper discussion of the "personal wealth" and "community wealth" resources that need quantification as part of the first element of covenantal planning. Understanding these concepts lays a foundation for powerful "Zero Tax Planning" techniques based on the integration of charitable and non-charitable tools. Throughout the rest of this book, the reader will see how advisers can choose, customize, and integrate twelve of the most common planning instruments to achieve the desired allocations among the four buckets introduced above.



Effective advisers can give their clients much guidance in deciding what portion of their wealth will be consumed by them or transferred to their charitable or non-charitable beneficiaries. Furthermore, advisers can help their clients redirect tax money to foundations that fund a variety of favorite charities. In this way, clients can use all of their personal and community wealth to fund the people and causes who carry on the values that are most important to them. As shown in the following diagram, taxpayers can perpetuate their values by allocating wealth to any of the four "buckets." Personal wealth can be 1) consumed or 2) transferred to beneficiaries. Community wealth can be 3) gifted to charities or 4) directed to the Treasury Department as tax payments.

The average American gives more than 25% of his or her income to taxes. Additional wealth is lost to capital gains, estate, and other taxes. It is not uncommon for 45% or more of a person's assets to go to taxes while less than 5% of his or her assets flow to the community through charity.

As shown on the following pages, individuals can give a large portion of their assets to charity without reducing what is available for their retirement and/or family. Each person can control all of his or her wealth, and effectively "disinherit" the IRS. In addition to directing their personal wealth to worthwhile causes, individuals can redirect wealth from involuntary philanthropy to voluntary philanthropy. Instead of letting the government choose who receives their hard-earned money, donors can direct wealth through their preferred charities and causes that uphold their vision and values.



The above diagram shows a win-win-win outcome with more for family, more for favorite charities (voluntary philanthropy), and less for taxes (involuntary philanthropy). Experienced planners can enhance this outcome to show more for retirement and little or nothing for taxes.

Even simple tax planning tools can direct taxes to charity without reducing what is available for retirement or family. More advanced tools can provide greater benefits and even zero-out taxes. As might be expected, the more sophisticated plans may involve more risk, complexity, or expense. Nonetheless, experienced advisers can normally show how the planning benefits far out-weigh the costs.

As individuals take control of their capital, they should see that they have far more wealth available to fund their vision. They can use wealth in their non-charitable trusts for retirement, transfers to family, or a wide array of investments that build value. They can use wealth in their charitable trusts for investments and/or charitable gifts. They can confidently use all of their charitable and non-charitable wealth to support causes that are probably much more consistent with their values than those the government funds with their tax money.

Combining Legal Tools While Considering Investment Options

Though this book only touches on a dozen of the available tools alluded to in the Introduction, advisers have hundreds of charitable and non-charitable planning tools available to them that go hand-in-hand with the six covenantal elements. Whereas advisers typically used just a handful of planning instruments a quarter century ago, and whereas advisers frequently failed to draft planning instruments that addressed all of the covenantal elements,

experience has shown the need for a more robust process. As explained throughout this book, clients can achieve far greater financial benefits while leaving a more meaningful legacy when they choose from a broader array of tools and then design the tools to uphold all elements of the covenant.

The covenantal planning process can guide the modern adviser as he or she sorts through a complex assortment of trusts, money management instruments, and insurance techniques when integrating the charitable and noncharitable instruments. The adviser must resist the temptation to focus only on financial assets and investment accounts when outlining resources. Instead, advisers should evaluate the use of all seven types of resources listed in the first paragraph of this chapter.

The adviser applying the covenantal plan design process will focus on the client's desired legacy and vision for maximizing tax-efficient lifetime income, transfers to heirs, and gifts to favorite charities. Depending on the client's blend of resources, advisers may design and draft any of hundreds of different trusts. These entities may be funded with any of hundreds of different assets. Evaluating the plethora of drafting and funding options will overwhelm any adviser unless each option can be evaluated in light of desired outcomes. The covenantal planning process defines these outcomes with a methodology that facilitates clear decision-making.

Different types of trusts have widely different parameters for acceptable investments. Generally, clients can use most types of real estate, stocks, and bonds in conjunction with the 10 trusts and two planning methodologies (optimized portfolios and optimized estate plans) summarized in the Introduction. The greatest flexibility usually exists with a Revocable Living Trust because the client is trying to avoid probate costs and not trying to avoid current gift or estate taxes. Once the client seeks to move assets from the taxable estate, several restrictions apply to asset transfers. These restrictions will be greater if the clients want to retain control over assets moved to irrevocable trusts. Generally, the greatest restrictions will apply to charitable trusts because the IRS does not want clients to abuse the potential estate and income tax benefits.

Clients starting with a Revocable Living Trust (RLT) will usually need to decide which assets belong on the schedules of the revocable trust and which belong on the schedules of irrevocable trusts. Normally, the Schedule A of the RLT includes stocks, bonds, and real estate. Schedule B will often include retirement plans and/or life insurance. Schedule C may list community property; Schedule H may document the Husband's separate property, and Schedule W may show the Wife's separate property.

If the client has life insurance that may be subject to estate taxes, the insurance should normally go into an Irrevocable Life Insurance Trust (ILIT). If assets are held for grandchildren, a Generation Skipping Tax Trust (GST) should normally have title to the assets so that no transfer taxes will be due when grandchildren receive the wealth.

When a home (or equity in a home) should pass to children while giving parents the right to live in the home, a Qualified Personal Residence Trust (QPRT) can hold the residence instead of keeping the home in the RLT. Business interests can often pass to successor managers or other beneficiaries by listing the entities on the schedules for a Family Limited Partnership (FLP) or Limited Liability Company (LLC). Advisers will often transfer nonvoting interests in the FLP (or LLC) or an Intentionally Defective Irrevocable Trust (IDIT).

The QPRT, IDIT, and other non-charitable tools can help reduce estate, gift, and other transfer taxes significantly. They do not normally help reduce income taxes unless combined with other tools. The most popular income tax tools with many clients are charitable trusts such as the Charitable Remainder Trusts, Donor Advised Funds, Testamentary Charitable Lead Annuity Trusts, and Inter Vivos Grantor Charitable Lead Annuity Trusts. These vehicles typically own and sell appreciated assets without triggering current income taxes. The Charitable Remainder Trust and Lead Trust are subject to the private foundation rules that put restrictions on how a trustee can manage assets. It is, therefore, very important to work with competent tax counsel before moving assets to charities in order to avoid unnecessary taxes related to investment income (§4940), self-dealing (§4941), failure to distribute income (§4942), excess business holdings (§4944), or other unauthorized transactions involving private foundations.

The strict private foundation rules do not normally apply to assets in public foundations, such as Donor Advised Funds (DAFs). Therefore, DAFs and related public foundations facilitate a variety of advanced planning techniques when clients are trying to move assets from the involuntary philanthropy bucket to trusts that fund voluntary philanthropy.

Ideally, each donor should maintain a balance sheet showing how each asset is owned in the appropriate trust. Qualified wealth advisers should look at the balance sheet to spot unnecessary exposure to taxes. Astute planning team members should quantify the taxes related to how assets are currently owned and then propose a new balance sheet with assets owned in a way that mitigates taxes. The proposed balance sheet should show how the client controls more resources as a result of tax savings. The new or proposed balance sheet should show how ample assets have been identified and allocated to trusts that foster development of all of the client's resources in

harmony with the vision defined during the covenantal planning process (See Chapter 2).

When calculating the potential tax savings, experienced advisers should examine not just current values on the balance sheet but expected future values. Asset value projections should take into account likely inflation and tax law changes. More important, the adviser should consider how a client might invest emotional passions, intellectual capital, professional talents, and other non-financial wealth in building a business that grows tax efficiently. Businesses can usually minimize taxes and maximize growth if using excess taxable income to fund transfers to retirement trusts or trusts that facilitate tax efficient business succession plans.

The following chapters provide a more detailed summary of how the advisers can choose, customize, integrate, and monitor the appropriate instruments when redirecting tax money to trusts designed for retirement, family, or community (charitable) purposes. Clients will see how the many types of resources identified during Element 1 of the covenantal process can be leveraged to fulfill a clear vision (Element 2), with assistance from qualified advisers (Element 3), according to clear priorities and principles (Element 4), with tax-efficient outcomes (Element 5), and in a way that equips future generations to expand the wealth and influence of the Generation 1 client (Element 6).

The Best Zero Tax Planning Tools

How to Maximize Tax-Efficient Lifetime Income,
Transfers to Heirs and Gifts to Favorite Charities

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