CHAPTER ONE

Threats in an Uncertain World

by Dan Prisciotta

Today, the wealthy in America are under attack. Recent tax increases and ongoing economic and political crises have caused many, especially the high net worth, to reevaluate the security of their personal, family, and business wealth. The volatility of the global economy, increases in terrorism and global political strife, rising budget deficits, and threats of inflation or deflation create fear and uncertainty.

Potential threats to your wealth can be broken down into several categories, including:

1. A tsunami of changing income, capital gains, estate, and generational transfer taxes converging to confiscate your wealth. A new tax law was recently passed that provides clarity on a number of fronts; however, with the changing political environment in Washington, DC, changes, unfavorable to you, could happen at any moment.

2. An onslaught of potential "creditors and predators" standing ready to strike at any time.

3. Ongoing financial systemic instability, creating a backdrop of volatility that has the potential to strike at the heart of your personal wealth.

These threats combine to assault your

- Personal wealth
- Family wealth
- Business wealth

It is now more urgent than ever before to create a comprehensive plan of action to defend your wealth.

The Tax Man Cometh

On January 1, 2013, President Obama signed the American Taxpayer Relief Act of 2012 (ATRA of 2012). The US government projects that total tax receipts for 2013 will be $2.712 trillion.

Unlike the situation two years ago, ATRA of 2012 doesn't push off decisions about Bush-era tax cuts to a future date. A "permanent" law (or at least as permanent as any legislation can be) is here now. However, a revenue-hungry Congress and administration can and likely will seek to change the status quo at any moment. In fact, President Obama's 2014 budget proposal contains several such zingers that would cap the value of retirement plans, limit the value of itemized deductions for high-net-worth taxpayers, and increase estate taxes.

Although the federal budget deficit is starting to decline again due to growth in revenues, outstanding public debt stands at $16.7 trillion; $52,997 per US citizen. This large and unsustainable public debt burden coupled with rising demands on federal, state, and local governments for benefits and resources is likely to drive governments at all levels to continually seek new sources of revenue, which could result in higher taxes and other types of levies.

Expirations

- Tax cuts that previously lowered marginal income tax rates and provided lower rates on dividends and capital gains on the sale of stocks, bonds, businesses, real estate, etc., expired on December 31, 2012.

Surcharges

- As debate continues on how to fund health-care reform, in 2013, the Patient Protection and Affordable Care Act Net Investment Income surtax of 3.8% is set to be assessed on income from dividends, interest, rents, and capital gains. Couples with adjusted gross incomes over $250,000 (the high net worth) will be especially hard-hit. An additional medicare tax assessed on wages, compensation, and self-employment income, also aimed at high-net-worth individuals, will add 0.9% to your tax bill. Depending on which state you live in, adding in another 5%–10% for state and local income taxes could bring your total income tax rate to 50% or higher.

Estate Tax Redux

- The single largest threat to preserving your family wealth—the estate tax, which disappeared for a time in 2010—is back. Now, the tax will kick in for estates worth more than $5.25 million ($10.5 million for married couples). That's right: add up the value of your home, portfolio, retirement plan and IRA, business, and everything else you own. If the pile is bigger than $5.25 million (or $10.5 million for married couples), Uncle Sam takes upward of 40%. Long-term planning is essential.

This new tax legislation, ATRA of 2012, has a tremendous impact on high-net-worth families and opens up an immediate and unprecedented window of opportunity for planning.

Some highlights of the new law are:

- **A $5.25 million exemption** per person ($10.5 million for a married couple) is granted for estate and generation-skipping taxes (GST), indexed for inflation in 2013 and beyond). Many feared the return of a $1 million exemption and a 55% tax rate at the end of 2012, so passage of this law is excellent news.
- The gift tax exemption also increases to $5.25 million per person ($10.5 million per couple).
- There is a **40%** top tax rate on transfers over the exemption limits.

The new tax law opens up an immediate and unprecedented opportunity for planning.

The relative certainty granted by ATRA presents an unprecedented opportunity for you to defend your wealth. In the recent past, lifetime transfers were limited to $1 million per taxpayer ($2 million per couple) before a gift, estate, or GST tax of up to 45% was triggered. Now it is possible to transfer $10.5 million of private company stock (or any other asset, i.e., marketable securities, real estate, personal-use assets, etc.) completely free of taxes during your lifetime or upon death. Furthermore, the actual amount transferred can be increased exponentially over time once valuation discounts and advanced planning techniques are used, resulting in massive tax savings. Structured properly, these family assets can also be protected from creditors and predators over multiple generations.

Will everyone be in a position to take advantage of the generosity provided by the new tax law? Absolutely not! Careful planning and financial modeling are necessary to determine whether your financial independence is secure *prior* to engaging in gift giving or other lifetime transfer techniques. For those who can afford to transfer significant amounts of assets during their lifetimes, the tax savings are potentially enormous. For those who have already engaged in sophisticated estate preservation planning, there's an opportunity to revisit those plans now to take advantage of the permanence of a number of wealth preservation techniques. Confiscatory taxes are already attacking your family wealth. There are numerous timely strategies to minimize the future tax bite, and many will be shared with you throughout this book.

While the law is technically permanent, it does not mean that it cannot be changed. If President Obama's 2014 budget (the "Greenbook") is passed as proposed, the estate tax exemption amount will be reduced to $3.5 million (with no indexing for inflation), estate tax rates will increase to 45% (from the current 40% rate), and the gift tax exemption amount would be reduced to $1 million. In addition, the president seeks to restrict the use of powerful estate-planning techniques. The budget also contains a proposal to impose a $3 million cap on IRAs and other tax-deferred savings plans, including 401(k)s, 403(b)s, and 457 plans. The rationale behind this plan is to limit retirement account balances to the amount that would be needed by a 62-year-old to purchase an annuity that would generate an annual payment of $205,000. This would not happen until 2018, if at all, but it gives us a sense of where taxes may be heading. The government would also like to close perceived loopholes in the wealth transfer tax world with restrictions on GRATs (grantor retained annuity trusts), IDITs (sales to intentionally defective income trusts), and valuation discounts. If passed, all of these changes will dramatically affect your ability to defend your wealth and pass it on. Consequently, we are clearly in a "use it now or lose it" planning environment even after the passage of ATRA of 2012.

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A Bull's-Eye on Your Back

More and more, high-net-worth families are becoming targets of public-sector passion for wealth redistribution, as well as private-sector predatory behavior such as lawsuits, divorce proceedings, and even extortion. As a result, successful people increasingly feel as though they have a bull's-eye on their backs.

Today, high-net-worth individuals have more liability lawsuit risks than at any other time in history. If your net worth exceeds the liability limits provided by your insurance carrier, all of your wealth can be exposed.

The typical umbrella liability policy won't protect you. Ensuring that you have proper coverage to protect your wealth from lawsuits and legal defense fees can be the simplest and most effective first step toward asset protection. Additional threats include employment practice liability, worker's compensation, or board member or family trustee issues, just to name a few. Asset protection is the process of using legally acceptable methods to ensure that your wealth is not unjustly taken from you. Wealth preservation planning offers an effective way to discourage lawsuits and structure assets to provide legal shelter from potential litigation, as well as taxes.

How Big Are the Storm Signals?

Continuous economic turmoil is unthinkable but has become a reality. The stock and real estate markets have seemingly recovered from the Great Recession, but past crises have shown that these gains could evaporate at any moment due to an internal or external shock. Our great nation is bankrupt, and politicians and economists seem to have little idea of what to do to resolve the situation or any ability to cooperate with each other to craft a sustainable long-term solution to the deficit. While the US economy is on somewhat firmer ground, Europe is still in the grips of a recession, and strife abounds in the Middle East. Although the US employment picture is improving with a national unemployment rate of 7.6% as of June 2013, that statistic is misleading. The fact is that as of this writing, 11.7 million Americans are out of work, with nearly a million of those who have dropped out of the workforce entirely. There are 7.9 million part-time workers who would prefer to be employed on a full-time basis, according to the Department of Labor.

While business activity has rebounded, business confidence and spending are still shaky. Any kind of shock could send the fragile economy back into a recession, potentially triggering more government intervention into the private sector. Could another recession spark massive flight from the US dollar and force the Fed into heavy monetization of unwanted Treasury debt? If this plays out, it could lead to hyperinflation or skyrocketing interest rates. Although the US economy is more than three years removed from the end of the Great Recession, this recovery has been painfully slow and fitful. While the economy seems healthier in terms of the official numbers coming out of Washington, DC, many business owners still express skepticism regarding the ability of the government and the Federal Reserve to create and sustain a growing economy. This attitude constrains business investment, which in turn holds back that very economic growth that entrepreneurs seek, creating a painful Catch-22 situation. Financial markets, industries, and specific businesses are experiencing increasing uncertainty.

Institutional financial mismanagement is widespread. This causes a lack of trust in the financial system of bond dealers, bankers, credit rating agencies, and brokerage houses, who acted without restraint. In addition, recent scandals surrounding the rigging of key interest rates, including the London Interbank Offer Rate (LIBOR), as well as scams perpetrated by con artists such as Bernie Madoff and others, and the "too-big-to-fail" institutions such as J.P. Morgan Chase, which lost $6.2 billion in the "London Whale" credit derivative trade that went awry, further undermine public confidence in the financial system and markets.

The integrity of many financial institutions, stock exchanges, and advisors has been called into question. In May of 2012, Facebook came to market in a highly anticipated initial public offering (IPO). Technical problems on the NASDAQ exchange led to a delay in the first trades by more than 90 minutes; the stock ended the day priced just 23 cents higher than its IPO price, territory the stock hasn't visited in the year since. The NASDAQ ended up paying a $62 million settlement to investors over the botched offering, which cost investors an estimated $500 million. Events such as these don't serve to instill confidence in the markets.

With yields on long-term Treasury bonds below 1%, markets bouncing up and down in patterns that seem to have little to do with economic fundamentals, and consumer and business confidence wavering, investors don't know where to turn. Add to that the fact that so many high-net-worth investors have been burned by poor advice in the stock market and real estate to the point that they don't know whom to listen to anymore and it's no wonder that emotions are taking over, millions in investor dollars sit on the sidelines, and people are searching for answers.

The World around Us

Increasingly, we seem to be experiencing natural disasters such as superstorms, tornados, floods, earthquakes, fires, hurricanes, and shifting climates. In October 2013, Superstorm Sandy caused more than $71 billion in damage in the Greater New York–New Jersey area. The monster tornado that wreaked havoc outside of Oklahoma City, Oklahoma, in May 2013 killed more than 23 people was rated as an EF5, the most powerful type of tornado. It ranked as one of the top five most costly tornados in US history in terms of damage, with estimates ranging from $1.2 to $2 billion. In our man-made world, we have seen an unprecedented wave of financial skulduggery, shaky infrastructure, environmental issues, oil spills, wars, immigration problems, and ongoing displays of humankind's inhumanity to others. The Boston Marathon bombing in April 2013 left four dead and more than 260 people injured, bringing back memories of 9/11 and fears that this was just the first in a renewed string of terrorist attacks. While no country has left the euro despite the recession and the sky-high unemployment experienced in many of those countries, the Cyprus banking crisis in March 2013 was a reminder that the global banking system is still far from stable. For these reasons and many others, people are increasingly worried about a significant "Black Swan"–type event, for example, a disruptive cyber attack, bombs, crippled financial markets, declaration of national bankruptcy by a significant country, political subdivision, class or age warfare issues, and the global effects of shifts in political power throughout the world. Any of these events can increase risk, uncertainty, and financial insecurity.

Public issues do become your business because they threaten your personal, family, and business wealth and well-being, and they impact long-term financial survival. We constantly hear, "Am I OK? Is my family OK? Will the world around me ever be OK again? Do I have enough? What is enough?"

What You Can Control

With the constant threats of increased taxes, a shifting political climate, and terrorism on the forefront again, keeping your guard up is more important than ever. How do you defend yourself while at the same time manage your business and investments, spend time with your family, and have a life?

When so many things out of your control, now is the time to actively defend your wealth. This book will focus on helping you control the things you can while keeping your eyes open to adjust for future contingencies. Clearly, high-net-worth families will always employ methods to use the tax code and legal system to protect their wealth. But with the new threat environment already in place, it's imperative to exert more energy to preserve freedom, independence, security, peace of mind, stability, and the integrity of their financial affairs. Consider the myriad of risks and exposures; identify the minefields and think about how to steer around them or defuse them before they blow up. Unfortunately, many people see the threats and don't act. The goal of this book is to encourage action through a holistic, cross-disciplinary approach.

This book is organized into three sections:

I. Defend Your Personal Wealth

II. Defend Your Family Wealth

III. Defend Your Business Wealth

Defend Your Personal Wealth

"Am I OK?"

"Will all of these threats to my wealth cause me to run out of money, give up my lifestyle, or become dependent on others?"

This is the question we hear day in and day out, at all income and net worth levels. You need to protect your "flanks" from future threats such as:

- Life expectancy—Will my spouse or I live to age 100+? If so, will we have enough?
- What if my net after-tax rate of return in the future is less than it was in the past?

- Standard of living—How much income do I need over the next 20, 30, or 40 years?

- Inflation—It's low . . . really?

We all know that inflation is low in the United States, only 1%–2% or so. How do we know this? The government has told us. But inflation is found everywhere in our economy, except in the government's statistics. Corn, the most important food crop in America, is up 75% since 2008. Gasoline is up from $2.25 a gallon to more than $3.60 a gallon—an increase of more than 60%. The nationwide minimum wage is up by 40%. Rents are up by 25% nationwide and up 40% in most urban markets. The base price of a Ford F-150, the best-selling passenger vehicle in America, has gone from $18,225 to $23,670—a 30% increase.

Meanwhile, the government says there is little inflation . . . and that continuing to print $85 billion a month to buy government and mortgage debt is merely "interest rate policy by other means."

Don't get discouraged or overwhelmed. You can plan and prepare. Personal wealth protection fits into a holistic wealth preservation plan. It starts with an inventory of available resources compared to your expenses or lifestyle needs. It continues with identifying the gap between what has been done and what should be done going forward to defend your wealth.

Defend Your Family Wealth

"Is My Family OK?"

Numerous threats to your family wealth include:

- A neglected, out-of-date wealth preservation plan and estate documents. A plan more than three years old should receive a comprehensive review. Inappropriate or outdated wills, trusts, powers of attorney, and health-care proxies can do more harm than you realize.

- Children who are uninformed, inexperienced, and unprepared to handle large sums of money. Unfortunately, divorce and drug or alcohol problems are on the rise.

- Creditors your children (and grandchildren) may face, including siblings, divorcing and disgruntled spouses, bankruptcy, contract, or tort (malpractice, slips and falls, automobile accidents, etc.).
- Dying too soon or living too long. A shortened or extended life expectancy can jeopardize family wealth distribution.
- The wrong fiduciaries and a lack of proper successors or trust protectors. These unfortunate conditions place assets at risk.
- Not adjusting your plans for births, deaths, adoptions, special health needs, or other family changes.
- Lack of liquidity to pay estate taxes. This can result in the forced sale of your most valuable family assets, such as a business or income-producing real estate. Even if your estate is liquid (has cash or short-term investments on hand), the liquidity you stockpile is itself subject to taxes. The answer is to create a tax-exclusive stash of liquidity.

After the recent death of actor, James Gandolfini, many observers are aghast over his ill-conceived estate plan after it was publically revealed that up to 40% of his estimated $70 million net worth will be owed in taxes. He signed his will just six months before he died of a heart attack at the age of 51. Did he and his estate planning team do all they could to mitigate a nearly $30 million tax bill?

Mr. Gandolfini left 30% of his assets to each of two sisters and 20% to his eight month old daughter, in trust. She will receive her inheritance at age 21, an age many think is too young to handle such a large fortune. His wife is to receive the remaining 20% of the estate. The estate will be forced to liquidate assets to pay the tax within 9 months on 80% of the estate, so the assets will be sold at whatever price the market pays. If values are down, the heirs get hit twice. The eye-popping tax bill in this high-profile situation serves as a reminder that procrastination and poor planning can hurt those left behind.

There are several lessons to be learned:

- Privacy – Mr. Gandolfini's will was admitted to probate so all of this is public knowledge. To ensure privacy, consider a revocable living trust.
- With an estate of this size, numerous lifetime wealth preservation strategies could have been used to dramatically reduce estate taxes (see chapters 3 and 4).
- Consider other ways to make a bequest to siblings or children that do not trigger an immediate estate tax. Optimize use of the unlimited marital deduction to defer estate taxes until the surviving spouse dies.
- Millions of dollars will be distributed outright to a child when she turns age 21. How many 21 year olds have the financial acumen and maturity to manage that much wealth? Also, assets become completely exposed to the child's predators and creditors, including future ex-spouses.
- Mr. Gandolfini did establish an irrevocable life insurance trust (ILIT) with $7 million of life insurance. The proceeds will be received tax-free and provide a ready source of liquidity to help pay estate taxes and preserve assets.

Another often unrealized threat to your wealth is neglect of your existing your life insurance policies. More than $1 trillion of life insurance is now owned in trusts in the United States—and it isn't a static buy-and-hold asset.

> ***Another often unrealized threat to your wealth is the lack of frequent attention to your life insurance policies.***

That's because the industry and policies have changed dramatically over the years. Since the financial markets collapsed, wealthy families have been reexamining their investment portfolios and searching for answers. They expect up-to-date analysis and recommendations for changes. You should expect no less from your life insurance portfolio and the advisors and trustees who manage it. Trustees have a fiduciary duty to make changes to trust-owned life insurance, just as you would expect to make changes to an investment portfolio held in trust. Yet most trustees (whether professionals, such as accountants or lawyers) or your family members often do little more than glance at a statement and pay the premium when it comes due. Such indifference could cost your family millions.

Life insurance policies are complex and are impacted by many of the same external forces that affect your investments, i.e., decreasing interest and dividend rates, volatile stock market performance (if a variable policy), and financial challenges insurance companies themselves face. Add to this:

- Longer life expectancies and declining mortality charges
- Absence of no-lapse guarantees
- Medical underwriting anomalies
- Life settlement and viatical sales
- New regulations for split-dollar insurance taxation and administration
- Vanishing premiums that don't vanish
- Policy repricing

Are you sure that your policies are performing as well as they should be? How would you know? Are they correctly paid for and structured? Are your insurance policies alleviating your estate tax burdens or exacerbating them? With the recent increase in the estate tax exemption, many people are wondering whether they should continue to maintain existing life insurance policies acquired to pay taxes. Now that some estates have fallen below the taxable threshold, should they continue to pay premiums? Should policies be cancelled, reduced, sold, or kept in force in anticipation of future tax increases?

Ordinarily, a thorough policy review should be conducted at least once every three years to protect you, your trustees, and your beneficiaries. With all of the tax turbulence and changes in the insurance marketplace, an immediate thorough review is now a necessity.

Defend Your Business Wealth

"Is My Business OK? It Is the Primary Source of My Wealth!"

Here are other reasons to stay vigilant:

What would happen to your business if your partner or co-shareholder met an untimely death? Do you have a shareholders' agreement (aka a buy-sell agreement)? Is it up to date? Does the price reflect today's valuation? Unless your agreement has been reviewed in the past 12–18 months, it may pose a serious threat to you, your business, and your family. Is the agreement properly funded to give it teeth and make it operative? Without proper funding, the burden of additional debt assumed by you, your partner(s), or the business could be crushing.

Similarly, what will happen if the banks call in loans and mortgages that you have signed for and guaranteed personally? An infusion of cash at a critical point in time (such as the death of the borrower or guarantor) can make the difference between business survival and business failure. How do you attract, retain, and reward key employees? Everyone offers the typical package of 401(k) plans, medical benefits, dental insurance, etc. An employer can make a difference by offering special incentive programs to reward long-term retention. This can be an excellent alternative to giving up equity or cash now. These nonequity performance packages can also be designed creatively to align with corporate growth goals and increased revenues and profitability. The better the employee performs, the bigger the payoff will be in the end. These programs can also serve as a sort of "golden handcuffs," in that if the employee leaves before an agreed-upon time frame, benefits will be reduced or forfeited.

Harvard Business School reports that just 10% of family-owned businesses remain active privately held companies for the third generation to lead.

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Many factors threaten your business wealth, including:

- Not knowing the value of your business for different purposes, i.e., collateral, estate and gift taxes, future sale, etc. Planning is difficult if you don't know what it's worth.

- Lack of a business succession plan. Who will lead your business after your retirement, disability, or death?
- Operational issues. Who will run your company in your absence? Will key employees stay or go? Issues of compensation, governance, dealing with inactive siblings, etc., need to be addressed.
- Lack of a buy-sell agreement, the wrong agreement, or one that is underfunded and can't become operative without potentially disrupting or even bankrupting the business with debt.
- The financial and legal structure of stock transfers to children. Consider the emotional impact on parents, as well as children, throughout the transfer process.
- Tax planning to mitigate income, capital gains, and gift and estate taxes
- Creation of liquidity to pay remaining unavoidable taxes due at death and avoid forced liquidation of the business.
- Corporate taxes, a constant treat that hits businesses especially hard these days. Increasing income taxes directly affect your bottom line and ability to create (or just maintain) jobs, provide employee benefits, satisfy lenders, perform R&D, compete effectively, and maintain your lifestyle.
- Increased regulation, compliance requirements, and bureaucratic red tape
- Insufficient capital
- Lack of an exit strategy to get maximum value and minimize taxes
- Employee benefit packages that fall out of compliance or become prohibitively expensive or ineffective
- Lawsuits

"But I've Had It All Done!"

We caution you not to fall into the proverbial "I've had it all done" mindset. In more than 25 years of practice, I have never met a client whose wealth defense could not be meaningfully improved or updated in some way. Our clients have found that the difference between merely having their planning work done versus having it done as well as possible can literally mean hundreds of thousands or millions of dollars in additional wealth protected or taxes saved. No single advisor has a monopoly on all of the good ideas. Even if he or she does, by the time he or she figures it all out, the rules change again. For example, our real estate clients are experts in the real estate industry, our manufacturing clients know everything there is to know in their niche, etc. They don't know, nor do they want to know, wealth preservation to the depth of detail that we know and live every day. It's truly a team effort. Proper planning requires working in concert with experts and advisors, such as your CPA and attorney, to provide a truly coordinated effort to keep you out of harm's way.

Stay in Bounds

We've found that our clients want solutions that are advanced and cutting edge but not into the gray area that could get them into trouble, i.e., IRS audits, penalties, or worse. Certain red flags such as the requirement for you to sign a "hold harmless" or nondisclosure agreement to learn about a black-box tax strategy are out of bounds. The number of IRS audits has risen. Those with incomes of $10 million or more were audited in 2011 at a rate of nearly 30%, up from an audit rate of 18.38% in 2010. Taxpayers with incomes between $5 and $10 million were audited at a rate of more than 20.75%. The more you make, the bigger the target on your back, which emphasizes the need for proper tax and estate planning that is compliant with all relevant tax laws.

This book does not cover tax avoidance, offshore strategies, or anything bordering on the unethical or immoral. The arcane world of asset protection trusts is full of hazards, as well as opportunities. Choose the wrong foreign asset protection trust and you could wind up in jail. Certain domestic trusts could make you a test case for the US Supreme Court. Certain trusts set up to avoid creditors, after it is too late, may be viewed as a conspiracy to commit fraud. The strategies in this book are clear, legal, and well tested. Pros and cons will be addressed. At the end of the day, implementation decisions are always yours.

My coauthors and I urge you to become educated, using tools such as *Defend Your Wealth*. An informed client is always the best client. This book is not intended to give you an exhaustive technical dissertation but rather a practical familiarity of the issues and concepts, along with a comfort level to ask your advisor the right questions to help you make proactively sound decisions.