B. Franklin

The Franklin Prosperity Report®

'A PENNY SAVED IS A PENNY EARNED'

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How the Wealthy Shield Their Assets From Taxes

Retiring is a personal goal for most of us. Who wouldn't want to end the daily grind and pursue world travel and fun hobbies? Retiring rich, well, that's even better.

Yet the more money you have later in life, the more the taxman will be gunning for you. Once investors get to that point in life where work is a choice, it's less about making more than about keeping more by reducing taxes.

Prudent investing is important. Losing money in poor investment choices can be devastating. Yet the reality is that you are more likely to lose earned wealth to taxes and creditors than to a major investing mistake. Investing errors happen and can be fixed; taxes are forever.

Who needs protection? The median net worth of the top 10 percent of Americans is nearly $1.6 million, according to wealth researchers. The top 1 percent had assets on average of $9 million. Given that the IRS exempts nearly $11 million of a couple's wealth from estate taxes, we're talking about a small sliver of the population.

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That's because every citizen gets an exemption of $5.45 million upon death, meaning they can leave that money to their kids free of estate taxes. If you are married, each individual gets the same exemption, effectively doubling the size of the break.

Nevertheless, advisers say, even people of moderate means can benefit from better planning and commonsense moves to protect hard-earned savings from creditors, the sometimes ill-chosen spouses or their kids, and, yes, even the tax collector.

How do the wealthy shield their assets? And at what level does wealth

protection make sense? Franklin Prosperity Report asked wealth advisers and lawyers across the country to share their perspectives on keeping prying fingers away from your nest egg.

The Power of a Trust

"One of the reasons the rich get richer is because they know how to work within the law to keep their money out of the hands of the IRS," says **Andy Brantner**, a certified financial planner in Houston, Texas. "There are a number of ways they do this."

The most common way is to open a trust, a tax shelter that sets aside money for children but also shields the parents from estate taxes, Brantner says. When you create a trust, you give up your ownership of the assets, usually stocks and bonds. The trust names beneficiaries, typically children, who will benefit from the money but do not control how it is invested or distributed.

Setting up a trust allows heirs to avoid probate, a lengthy and expensive court process after your death. Parents can still use the money in the trust while they are alive and decide how and when to distribute interest earned in the trust. They can choose to disburse assets over time or simply leave it all until they pass. A trust protects the money from creditors in the meantime.

There are a dozen kinds of trusts, some of which can benefit a surviving spouse, then kids or a charity, and even future generations of heirs. "A lot of people think trusts are all about ensuring the children of wealthy are taken care of while also protecting them against burning through their wealth — however, that's not always the full story," Brantner says. "The thing about trusts is they also protect wealthy parents financially. By creating a trust in the name of a child and putting some of their money into it, they can avoid estate and gift taxes. Sure, the money in the trust is no longer the parents', but they're still able to have some control over it."

For mid-market wealth, so-called irrevocable trusts often don't make a lot of sense, unless there is a potential need for asset protection in the future or for a specific asset, say, life insurance, says **Eido Walny**, attorney and owner of Walny Legal Group, Milwaukee, Wis. "If you've got a whole life policy worth at least $1 million, the lower threshold levels of these trusts start to come into play. Above $1 million they come into play for sure," he says. "If you are a doctor or a dentist, these kinds of trusts come into play because of asset protection considerations."

Attorney Eido Walny founded the Walny Legal Group in 2011 in Milwaukee, Wis. He specializes in protecting multi-generational family wealth.

In real estate, people are trying to make sure that if one domino falls, not all of them fall, Walny says. "What you don't want is some outside creditor, someone who you get into a car accident with, for example, coming in and wreaking havoc on your financial footing," Walny says. "If you have

enough assets or highly appreciating assets, you become a target for litigation. Once a case is filed or even the reasons for a case have become known, it's too late to create these kinds of protections."

The key is to act early. "You need to protect that asset while it's small. You have to do asset protection with clean hands. Once litigation is filed, or even the threat of litigation has arisen, you can protect assets except those involved in the threat," he says. "The best option is to do asset protection with the cleanest of hands."

The Generation-Skipping Option

Folks with higher net worths should look instead to a specific trust for the wealthy that allows them to extend giving to future heirs, known as a generation-skipping trust. A generation-skipping trust is most useful for when the adult children of a giver have enough of their own money that receiving more from a late parent might push them above the personal exemption level of $5.45 million per individual.

In effect, the parent can designate the grandchildren as the ultimate beneficiaries, meaning the money left behind has that much longer to compound, says **Larry Chane**, co-chair of the Tax, Benefits, and Private Client Group for Blank Rome LLP in Philadelphia, Pa.

"You don't have to wait until you die to set one of these up. A person with a significant amount of money can set up a trust to begin compounding while they are alive," Chane says. "That's how the really wealthy do it. The name of the game is to do it really early and get the appreciation out of the tax base while you're still alive, if you can afford to do it."

This kind of trust makes the most sense if the couple starting it has well over the combined exemption amount — enough to generate a good income for their kids without necessarily touching the principal. "Children live off the income but it automatically goes to the grandchildren when they die. It will be protected from creditors when the assets are in the trust," Chane says.

In theory, a well-managed generation-skipping trust can run forever, with each succeeding generation pushing assets to the next one down, over and over, Chane says. "Many states have eliminated the rule against perpetuities, where trusts could only last for a certain amount of time. Now many states allow you to avoid the day of reckoning. But a few generations down, you've divided it up into a lot of very small shares, so it may not make sense to continue the trust indefinitely."

A Protective Moat

A key concept for the truly wealthy is creditor protection, says **Howard Rosen**, an asset protection attorney and CPA who practices out of Coral Gables, Fla. Asset protection planning is important, for instance, for anyone selling a business. Sitting on a pile of cash from a business liqui-

dation can invite lawsuits down the road. "On the day you sell a business, everyone is happy," Rosen points out. "A year later, the new owner has run the business into the ground and isn't happy, so we protect the seller from 'post sale price reductions.'"

To avoid this problem, Rosen sets up trusts in the Cook Islands. "No court in the U.S. has the ability to tell that trust or trustee in the Cook Islands what to do," he says. "If you set up in Delaware or one of these states that says it has asset protection, there's always a way for that creditor to get to those assets."

Howard Rosen, CPA, is a partner in the law firm Donlevy-Rosen & Rosen, in Coral Gables, Fla. He has extensive experience in offshore asset protection.

In fact, Rosen says, the only way to access a Cook Island trust is to hire a lawyer in the Cook Islands in a short window of time and attempt to break the trust. However, if your business record is clear the day you create the trust, even that route is difficult and costly for a creditor. "If you're solvent immediately after you set up the trust, the statute is closed and there's no way to bring a lawsuit," Rosen says. "If you aren't solvent, they have two years, but the chance of getting that done in two years is slim to none."

Once you create the trust, your cash can be invested the same as you would here, but there are more investment options than you would have as a U.S. investor, Rosen says.

Protecting real estate is more complicated. You can't move your land or commercial project to the Cook Islands, after all. But you can make it a less interesting target to a creditor by borrowing against it. The only effective way to protect real estate is to reduce its value, and you can do that by having an independent lender making a loan against the property and record a lien on the property as security, Rosen explains. "If you have a $1 million property and we arrange a loan for $950,000, then the property is worth just $50,000," he says. "The loan money is placed in a trust and put into CDs in the Cook Islands, so it's essentially frozen. You're never upside down on the loan."

You can't spend the money, but your real estate is now protected. And you also now have a Cook Islands account for other purposes. "If you put other cash or securities into the trust, you can take income from the account through a trustee and they can pay your bills, say if your wages are garnished," Rosen says.

Staying Stateside

Finally, the wealthy also can look to specific U.S. states to create their trusts in order to avoid state-level taxes on their estates, says **Antony Joffe**, president of Sterling Trustees in Sioux Falls, S.D. "Any time you make a distribution from the trust, that income gets distributed out to you and gets taxed at the federal and perhaps state level, depending on where you live," he says. "In California, for instance, you would pay 39 percent federal tax and 13 percent state tax on ordinary income."

In states such as South Dakota, Delaware, and Alaska, you can avoid state taxes on any accumulated income that builds up in the trust and is not distributed, Joffe says. "The amount of wealth tucked away in those states is staggering. A lot of big banks have their charters there," Joffe says.

It makes the most sense if you have assets over the level of the lifetime gift exemption. At Sterling Trustees, for instance, the average trust is valued $7.5 million. But even smaller trusts can benefit, Joffe says, when it comes to asset protection. "If you are divorced, or if you are a doctor and get sued, it's very hard to access the assets" in a trust, he says. "For wealthy people, asset protection is very important. You don't know who your kids are going to marry. If your kids get divorced, the asset can become community property."

Your federal tax bill never goes away, even if you try to hide it abroad. "Let's say the trust doesn't make any distributions," Joffe says. "Any capital gains and dividend taxes are collected by the federal government. But the state tax is zero."

There are opportunities there, he says. "If you start a business, put the stock in a trust. If it's worth less than the lifetime gift exemption, you pay no gift tax," Joffe says. "If the company goes public, you suddenly can have $45 billion assets in a trust and it's estate tax free. Forty-five percent estate tax savings on a $45 billion trust is enormous."

Importantly, even smaller trusts can benefit from using states such as South Dakota, Joffe says. "You don't have to have huge estates to apply these practices. We as a trust company typically won't take anything less than $1 million, but there are companies that will take $50,000," he says.

"For them it's about asset protection. Setting up a trust gives kids access to income and lets those assets go to work for another generation, rather than giving them $125,000 upon death and it gets blown or split up in a divorce," Joffe says.

Charitable Considerations

The wealthy and even not so wealthy also use trusts to do charitable giving. If your kids are already taken care of and leaving money behind for a charity is your goal, that can be done through a trust, with significant tax advantages.

"Donor-advised funds have been an excellent tool for charitably minded persons to enjoy tax savings," says **John Farren**, director of development for the American Endowment Foundation in Hudson, Ohio. The foundation, a 501(c)(3) public charity holding $1 billion in assets across 3,000 accounts, has donors and advisers in all 50 states, Farren says.

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In short, Farren explains, a donor-advised fund is a type of mini-foundation that gives smaller donors the tax advantages of a family foundation without the costs and upkeep of creating and managing a full-fledged organization. The main foundation creates sub-accounts for donors and puts into those accounts cash, securities, even illiquid assets. The giver gets the tax break now but has the freedom to give money later at their own pace.

The key is to think of a donor-advised fund as a portfolio management tool, say Farren. Say you own $50,000 worth of a blue-chip stock you bought years ago. The cost basis, what you paid for the shares, was just $3,000. That means you will owe long-term capital gains tax on the $47,000 gain in value. If you decide to put money into the donor-advised fund instead, you avoid capital gains taxes.

Donor-advised funds can work with your adviser to come up with the most efficient way of managing the outcomes."If the adviser says it's not an appropriate time to sell, we can hold it," Farren says.

It's an irrevocable, tax-deductible gift, but you don't have to gift it out immediately, Farren says. "(A donor-advised fund) separates the charitable giving from the tax deduction," he says. Donor-advised funds work well for those who have high net worth but aren't necessarily rich. They can finance their own and their children's needs and thus consider giving for charitable reasons.

Unlike a trust, which typically distributes to the next generation and then ceases to operate, a donor-advised fund can carry on for years into the future. You can even call it the "Smith Family Foundation" if you want. "They can create a family legacy for a donor-advised fund — nominate their children or grandchildren to run it as a committee," Farren explains. "It can go on in perpetuity and generate income for charity, like a college endowment, or have instructions to liquidate it on your death for immediate giving. It's a whole spectrum."

For many people, their wealth is not in the form of stocks, bonds, and cash but tied up in a business. They face a significant problem — selling the business can generate a huge amount of income. "Private businesses have almost no cost basis, so they will have a big year," Farren explains. "Prior to selling, they can transfer a percentage of the shares to us and then sell the business and manage the taxes that way."

Another commonly donated asset is life insurance. "Let's say you want to create a legacy but don't have the assets. You can use life insurance to leverage up that gift," Farren says. The fund uses a cash gift to buy life insurance on the giver; upon death, the payout creates a charitable legacy without dipping in their personal spending needs, Farren says. "Using life insurance means that American Endowment is the owner of the policy, yet "the donor pays the premiums as their annual gift to us." ■

— Greg Brown