# CHAPTER 1

# Meltdown



*Muhammad Ali: Superman don't need no seat belt.*
*Flight Attendant: Superman don't need no plane, neither.*

The U.S. financial system meltdown has grimly scythed decades of accumulated business profit, investment, and personal wealth. As we have seen, investors undervalued their own rationality and overvalued chaotic wealth management schemes masquerading as complex asset management in a global economy. Investors dumped business earnings, pension assets, and personal funds into investment portfolios without due diligence as to the logic and structural soundness of those investments and their strategic economic orientation.

Counterintuitively, many wealthy investors and business owners took leaps of faith with hard-won assets into complex investment schemes they didn't understand because returns were bountiful. The hard work processes by which investors grew their businesses or their wealth did not seem to apply to strategically marketed programs devised by Wall Street wizards. "The wizards must be smarter and more inventive" was the mantra. It was an era where not paying attention yielded robust earnings.

## The Party's Over

The charlatans have now been revealed and returning to earth awash in lost assets has been a hard lesson learned for many business and personal investors. Fear of any kind of strategy beyond the most basic principles of accounting math has turned financial markets into rigid, ossified institutions. Credit is tight; doubt is rampant. But fear need not overtake common sense. If one is strategically poised to act, there are methods to reap opportunities even within the constant inhalation of a bad news economy.

There are ways to maximize wealth assets through sound tax strategies aimed at reducing exposure to IRS audits, while freeing liquidity for further investment income growth. Part of the picture is understanding what the U.S. government has and has not done in the financial sector.

The U.S. government failed to regulate its own legislative loosening of the credit and investment markets. The government allowed financial businesses that previously dealt in single issue items, such as credit allocation (banks), insurance (insurance companies), and tax protection (accounting firms) to become full-service investment/banking/insurance hundred-headed hydras. With the ability to manipulate different asset classes, many of these businesses grew astronomically by forging new markets out of fringe niches and clients they previously would not have pursued.

Much of the growth was built on Ponzi-type schemes of trading one asset class for another, rebundling (while claiming it was an asset protection maneuver), and charging transaction and management fees for transferring and translating assets into different holding tanks. Ethical portfolio diversity became a joke.

Forensic auditors will spend years trying to unravel the origination of lost portfolios and their mutation into worthless products that propped up marketing schemes.

## We All Know the Result

Because the government was involved in allowing multipurpose financial institutions to pursue growth by any means necessary, the government now stands confused, dazed, and unable to act under the fallout from the variety and volume of reckless financial transactions it helped perpetuate. In fact, it is throwing more money into the hollow house called Wall Street, assuming that the perpetrators will suddenly ethically encumber themselves and fix the problem.

Meanwhile, the Security and Exchange Commission (SEC), the so-called regulatory agency of the U.S. financial system, is like a lost orphan, its budget miniscule in comparison to the largesse tossed to the big dog bankers and their pals. Shouldn't the budget allocation be the opposite until we have reviewed and identified the malfeasance that brought down the system?

There is another looming storm on the horizon that could swamp any economic lifeboats sent out into the water by the government. There is the potential for a catastrophic failure of retirement funds in the United States, affecting nearly one-third of the pension plans existent. With baby boomers set to retire in massive numbers, such a failure would further erode a weak, destabilized economy.

In 2006 Congress passed the Pension Protection Act, mandating that companies with defined benefit pension programs be fully funded, as measured by the ability to pay out money to all retirees should the latter decide to withdraw their accrued assets. Of the 500 largest U.S. companies, more than 200 do not meet the Pension Protection Act standard in 2009.

Standard & Poor's 1500 Index of corporations reveals how dire the situation has become: The Index corporations moved from a $60 billion pension plan surplus at the end of 2007 to $409 billion deficit before the end of 2008. Defined benefit pensions (usually, where an employee payroll deduction is matched by the company into the employee's retirement fund) at these companies are part of a potential nightmare scenario even in good economic times, and we are entering an undefined period of economic uncertainty and groping in the dark.

When revenues decline in an economic crunch, payroll must be met at salaries that haven't declined. In the worst situation, a company may have to decide between meeting payroll and matching payroll-defined pension requirements. Corporate pension funds are troubled and clearly face the problem of underfunding. Many of the corporate pension funds invest their money conservatively. There are, however, a group of pension fund managers who have not invested conservatively or wisely and they are the first wave of a larger pension fund tsunami that could catapult the U.S. economy into a stunning freefall.

The snowball rolls downhill: jobs are cut, stocks consistently trend downward, reducing a company's investment stream, destabilizing the stock market and the company's ability to remain productive or even solvent.

Public pension funds and federal retirement accounts hold approximately $3.5 trillion in their accounts. There is another $1 trillion in unionized corporate workers who are part of the management team deciding fund investments. Together, these funded retirement vehicles cover approximately 27 million Americans and account for more than 30 percent of the U.S. retirement pension fund system. A failure of 30 percent of the system would be catastrophic to United States and international markets and to the personal retirement benefits of the invested potential pensioners.

## Grim Statistics

The bad news is that 30 percent was at risk before the current financial meltdown. The worse news is some pensions are close to defaulting without cash infusions that would have to come from taxpayers, necessitating higher taxes, less spending, and an unprecedented economic crisis stretching into the foreseeable future. Consider these numbers:

By 2008, just before the stock market began to tank, an estimated 40 percent of union-led pension funds were undercapitalized, meaning there was no guarantee the funds had enough money on hand to pay out member benefits.

California has two of the largest pension funds in the country: CalPERS, which is the biggest U.S. pension fund, covers California public employees, and CalSTRS, the state teacher pension fund. Their combined assets, at their zenith in 2007, weighed in at more than $400 billion, more than the GDP of some nations. By February 2009, the funds had lost 26 percent of their value from July 2008. CalPERS was more than 100 percent funded in summer 2007; it is currently at 70 percent (funding) and declining.

Adding to an already grim picture is CalPERS unaccounted investment in the California real estate market, which has descended faster than most markets nationwide. Things are not looking much better for 2009. In February, LandSource Communities Development, which owns 15,000 acres north of Los Angeles, announced it was filing for bankruptcy protection. The property developer's backer? None other than CalPERS.

The California city of Vallejo filed for bankruptcy in May 2008, in great measure because of an insolvent public pension fund. San Diego's pension fund deficit may cause it to follow Vallejo into the abyss.

Connecticut's state pension fund is estimated to be only 50 percent funded in comparison to its membership base.

Underfunded VEBAs (Voluntary Employee Beneficiary Associations) have been used by corporations to negotiate their way out of seemingly intractable health cost-pension plan obligations. The Big Three automakers recently negotiated VEBA agreements with their union employees, transferring $56.5

billion to a United Auto Workers (UAW)–managed retiree health care VEBA, allowing the parent corporation to erase $88.7 billion in long-term pension obligations.

The math says there is an immediate $30 billion-plus funding shortage. Union VEBA management will be crucial; there is no corporate safety net should the plan fail. UAW president Ron Gettelfinger said the General Motors VEBA would be safe for 80 years, but the recent track record for underfunded VEBAs is not good.

For instance:

Caterpillar transferred $32.3 million to a UAW retiree health plan in 1998. The fund was bankrupt by 2004. Renegotiation and lawsuits ensued. Also in 2004, a UAW-Detroit Diesel health care fund was depleted, resulting in more legal action.

The GM VEBA will probably fail. If UAW projections are wrong, for example, about the rate of increase in health care costs, they will be woefully wrong about how long this fund will remain solvent. The cost of health care escalates each year and the money used to seed the VEBA was not enough to begin with. Health care increases were estimated by the UAW at 5 percent, with invested VEBA funds increasing by 9 percent. The scenario could turn out to be exactly the opposite, or worse.

Prior to 2008's meltdown, comparative studies between public and private employee investment programs indicated a burgeoning problem in the former. A study of 200 state and local pension funds from 1968 to 1986, performed and analyzed by Olivia Mitchell, executive director of the Pension Research Council at the Wharton School, discovered that public pension investments substantially underperformed against other pooled funds, and quite frequently below market indexes.

The evisceration of public pension funds began before recent economic quagmires. Prior to the 1970s the funds were managed conservatively, utilizing fiduciary methods aimed at protecting the future pensioners and tax payers, who end up footing the bill if a fund defaults.

Three things changed in the 1970s and into the 1980s:

1. Politicians began to get involved in the direction of fund management.
2. Pension fund managers began to "play" emerging markets and potential sources of elevated revenue: corporate bonds, stocks, foreign instruments, real estate, private equity companies, and hedge funds.
3. Union and public employee pension funds initiated, sometimes against membership understanding or wishes, a transfer of assets into socially responsible investments. Investment research company Morningstar said that as of November 2008, 76 of 91 socially responsible stock funds were performing at sub-Dow levels. Last December, the Sierra Club's social fund liquidated its assets due to consistent losses.

All three of these developments have accumulated negatively; the union and public pension fund system is in total woefully underfunded. The default costs, combined with recession, deflation, and the stimulus plans guaranteed to raise taxes, would be difficult to recoup except by further tax increases, promoting the vicious depressive economic environment in which we are currently embroiled.

If public pension funds cannot meet their obligations to cover promised member benefits, the only available resource to siphon money from will be taxpayers—the same taxpayers who are watching their personal retirement portfolios fall off a cliff. As a business owner, you need to protect yourself and your assets with a smart tax and investment strategy.

It is crucial that the small business owner understand tax and investment strategies that not predicated on traditional pension planning methods. Business survival may be at stake.

Care must be taken, though, in assessing and choosing the right option.

## Retirement Plans and the IRS

A VEBA, 412(e)(3) plan or a 401(k) plan may be the proper fit for your business and investment strategy, but the IRS will be watching carefully how you form and operate your plan. We discuss the pluses and minuses of these plans further on in the book. A cash-hungry IRS can scrutinize the legitimacy of any of these pension planning methods. It is essential to use the tools, advice, and strategy of competent tax and investment strategists.

The odds are stacked against the average investor, it seems. The opposite is true, however—if the average investor is willing to educate himself and team up with ethical professionals who have weathered this storm, and will weather the next one, too.

One thing is certain, though; when the government is teetering toward insolvency it will seek to make up lost revenues. Over the next 12 months, the Small Business and Self-Employed Division (SB/SE) of the Internal Revenue Service will focus on taxpayer services and increased enforcement. SB/SE owns the majority of the tax gap. Enforcement is a necessary presence when you are talking about tax administration. Let us review a cautionary tale regarding the methods it can utilize.

Bruce Hink, who has given me permission to utilize his name and circumstances, is a perfect example of what the IRS is doing to unsuspecting business owners. What follows is a story about Bruce Hink and how the IRS fined him $200,000 a year for being in what they called “a listed transaction.” In addition, I believe that the accountant who signed the tax return and the insurance agent who sold the retirement plan will each be fined $200,000 as material advisors. We have received a large number of calls for help from accountants, business owners, and insurance agents in similar situations. Don't think this will happen to you. It is happening to a lot of accountants and business owners, because most of these so-called listed, abusive plans, or plans substantially similar to the so-called listed, are currently being sold by most insurance agents.

Bruce was a small business owner facing $400,000 in IRS penalties for 2004 and 2005 for his 412(i) plan (IRC6707A). Here is how the story developed.

In 2002 an insurance agent representing a 100-year-old well-established insurance company suggested he start a pension plan. Bruce was given a portfolio of information from the insurance company, which was given to the company's outside CPA to review and to offer an opinion. The CPA gave the plan the green light and the plan was started for tax year 2002.

Contributions were made in 2003. Then the administrator came out with amendments to the plan, based on new IRS guidelines, in October 2004.

The business owner's agent disappeared in May 2005 before implementing the new guidelines from the administrator with the insurance company. The business owner was left with a refund check from the insurance company, a deduction claim on his 2004 tax return that had not been applied, and without an agent.

It took six months of making calls to the insurance company to get a new insurance agent assigned. By then, the IRS had started an examination of the pension plan. Bruce asked for advice from the CPA and the local attorney (who had no previous experience in such cases), which made matters worse, with a "big name" law firm being recommended and more than $30,000 in additional legal fees being billed in three months.

To make a long story short, the audit stretched on for more than two years to examine a two-year old pension with four participants and $178,000 in contributions.

During the audit, no funds went to the insurance company. The company was awaiting IRS approval on restructuring the plan as a traditional defined benefit plan, which the administrator had suggested and which IRS had indicated would be acceptable. The $90,000 2005 contribution was put into the company's retirement bank account along with the 2004 contribution.

In March 2008, the business owner received an apology from the IRS agent who headed the examination. Even this sympathetic IRS agent thinks there is a problem with the IRS enforcement of these Draconian penalties. Below is one of her e-mails to the business owner who was fined $400,000.

> *From: XXXXXXXX XXXXX <XXXXXXXX.XXXXX@irs.gov>*
> *Date: Tue, Mar 4, 2008 at 7:12 AM*
> *Subject: RE: Urgent*
> *To: Bruce Hink <brucehink@XXXXXXXX.com>*
>
> *Thanks Bruce—yes—please just overnight them to the Grand Rapids address. Once again, I'm sorry about this. Basically, our Counsel told us that we needed language specific to the IRC 6707A penalty in order for that statute to be extended. I will ask the Reviewer to hold off an extra day.*
>
> *I'm also very sorry that this is getting you down. Deeply sorry. It's very difficult for me as well—before I started working this project (412(i)) I was doing audits of 401(k) and profit sharing plans. If there was an error in the plan, the employer would just fix it and the audit was over. There wasn't anything controversial or adversarial about it—and I felt like I was helping people—employers and plan participants. I really liked my job. In two years time, that has completely changed. I know it's not very "professional" to make such confessions—so forgive me. But I guess I just wanted you to know that I really sympathize with your*

> *situation—and have been doing whatever I can to help. I know that having this hanging over your head can't be fun—but as this project goes forward—I think that the IRS is going to have to soften their position somewhat—so these delays may be to your benefit.*
>
> *Also, I'm not really supposed to be sending emails to you—but when I went through the file I couldn't find a good phone number for you. Could you just send me a note or an email with a current phone number?*
>
> *Looking to receive the signed 872s on Thursday. If you have any questions at any time—please call me at XXX-XXX-XXX. I'm usually in the office in the mornings.*

The IRS subsequently denied any appeal and ruled in October 2008 that the $400,000 penalty would stand.

## Could You or One of Your Clients Be Next?

Some of the areas SB/SE will be examining include pass-through entities, high-income filers, and abusive transactions. S corporations are likely to receive particular scrutiny. Further review would not be limited to S corporations, but would extend to pass-through entities like partnerships, which can expect to receive a "significant amount of attention" because SB/SE has found an area of abuse and would like to curb what is called a growing trend of abusive transactions. There also will be a renewed effort to address high-income filers, typically classified as those with an adjusted gross income of more than $200,000.

The IRS has been cracking down on what it considers to be abusive tax shelters. Many of them are being marketed to small business owners by insurance professionals, financial planners, and even accountants and attorneys. I speak at numerous conventions, for both business owners and accountants.

And after I speak, I am always approached by many people who have questions about tax reduction plans that they have heard about.

I have been an expert witness in many of these 419 and 412(i) lawsuits and I have not lost one of them. If you sold one or more of these plans, get someone who really knows what they are doing to help you immediately. Many advisors will take your money and claim to be able to help you. Make sure they have experience helping agents that have sold these types of plans. Make sure they have experience helping accountants who signed the tax returns. IRS calls them material advisors and fines them $200,000 if they are incorporated or $100,000 if not. Do not let them learn on the job, with your career and money at stake.

Fear will not adjust your opponent's motive. Strategic action on your part, though, will make your business adept enough to handle adversarial challenges. You need advocates with tax law knowledge who can strategically allocate your business assets, utilizing legal methods synchronized to an understanding of the most recently updated IRS code provisions. You should meet the IRS challenge as an opportunity to advance your business and wealth-growth goals.

Let us discuss an integrated team approach to protecting your assets, a strategy that should be in place long before the IRS, or other vampirical entities seeking to drain your assets appear at the doorstep. Nothing you do as a business owner is as important as understanding how to minimize your risk.

## Summary

Macroeconomic conditions have resulted in stupefying losses to the investment portfolios of both the public and private sectors. The country is rife with projected pension fund insolvencies totaling literally hundreds of billions of dollars. Our (read: taxpayers) share is staggering. The government is looking for revenue wherever it can find it. Cue the Internal Revenue Service!

## Profound Insight #1

I became confused when I heard these terms with reference to the word "service:"

Internal Revenue Service
U.S. Postal Service
Telephone Service
Cable Service
Civil Service
Customer Service
State, City, and County Public Service

But today, I overheard two farmers talking, and one of them said he had hired a bull to "service" a few cows.

BAM!!! It all came into focus.

Now I understand what all those service agencies are doing to us.

I hope you are as enlightened as I am.