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The Basics of Accumulating Wealth and Keeping It

THE FOUNDATION—THINGS YOU NEED TO KNOW

In this book, I provide a framework that provides you with a better opportunity to master the technicalities of income tax, retirement plans, and estate tax planning for anyone who owns or has ever owned an investment.

I'll mention some tax code sections; however, retention of the specific sections is unimportant. I leave them there only as a reference point. I'm going to lay the groundwork for you and provide you with a set of concepts on how to understand these things in planning your own financial destiny.

An understanding of these concepts and the establishment and implementation of these techniques and strategies are crucial in your determination of how much wealth you would like to have in your lifetime and how much you would like your family to have in the future. The choice is yours as to whether you and your family are getting wealthier over the years or just getting by.

THE BASICS OF TAX PLANNING

In my 20-plus years in this field, one thing with which I've always struggled is how to minimize the effect of taxes for my clients. For the most part, the better they did, the worse my clients' tax positions became. This was because of the ruinous effect of capital gains taxes, income taxes, estate taxes, gift tax, and all the other state and local taxes. In order for them to maintain the same return in any given tax environment, it always seemed that my clients were forced to take many more risks with their capital to offset the impact of taxation.

Most people eventually give back 91 percent of their wealth to the government over their lifetime. (This concept will be explained in detail in subsequent chapters.) This and some of the other things I discuss in these next few sections will be hard to believe. They're going to sound far-fetched and too good to be true. Let me assure you that everything I recommend is clearly defined in the tax code.

RED, GRAY, OR BLACK-AND-WHITE? CHOOSE YOUR TAX STRATEGY

There are several types of strategies that you can implement to avoid taxes and to increase wealth.

1. The first type is strategies that are considered to be in the *red*—strategies that will clearly flag audits and, in fact, may subject the preparer and the filer to tax-motivated transaction (TMT) penalties. None of my strategies will even approach this area.
2. The next type is strategies that fall into the *grey* area of the law—very aggressive strategies that may at some point be challenged because of subjective interpretations of the law. Again, none of my strategies fall into the grey area of the law *unless I specifically qualify* them by stating so. It is then up to you to decide your level of risk.
3. The third type is strategies that are clearly *black-and-white* interpretations of the law, and these are the types of strategies I love to deal with. It is not worth the risk of subjecting my clients or myself, for that matter, to the possibility of penalties, interest, and additional tax. I would much rather sleep well at night than implement a strategy that at some point may be challenged and disallowed by the Internal Revenue Service (IRS) or any other government body.

The strategies that I discuss in this book are strategies that fall into the black-and-white category unless otherwise clearly stated. They are well defined, and they abide with the very letter of the law.

Furthermore, these are *not* hypothetical strategies that were thought up by someone in some back room and never tried and tested. These are strategies that I have used on my own tax returns, in my estate plan, and in those of my clients for many years. They are strategies that you can take home with you today and implement in developing your own tax reduction, retirement plan enhancement, and estate tax elimination plan.

A *Forbes*[1] article dealt with devious tax shelters. In "Tax Shelter Hustlers," Janet Novack and Laura Saunders discussed how the large accounting firms are peddling highly aggressive tax strategies to their clients for a percentage of the tax savings. They stated:

> Recently, *Forbes* obtained copies of two different letters whose first paragraphs contained what you see at left. ["Dear______ , As discussed, set forth below are the details of our proposal to recommend and implement our tax strategy to eliminate Federal and state Income taxes associated with (the company's) income for up to five (5) years ("the Strategy").]
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> Each was sent by the accounting firm Deloitte & Touche this fall to a medium-size corporation.
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> We agreed not to identify the recipients, but we can say that neither is a Deloitte audit client. We can also say that each letter demands a bounty for zeroing out the company's taxes: a contingency fee of 30% of the tax savings, plus out-of-pocket expenses. Deloitte promises to defend its "strategy" in an IRS audit—but not in court—and to refund a piece of the fee if back taxes come due.
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> Pay attention. These letters are prime evidence of a thriving industry . . . that has received scant public notice: the hustling of corporate tax shelters. These shelters are being peddled, sometimes in cold-call pitches, to thousands of companies.
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> Will the shelters hold up in court? Maybe yes, maybe no, but many schemes capitalize on the fact that neither the tax code nor the IRS can keep up with the exotica of modern corporate finance. Hesitant at first to participate, respectable accounting firms, law offices, and public corporations have lately succumbed to competitive pressures and joined the loophole frenzy.
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> This new industry is quite apart from the so-called corporate-welfare tax breaks knowingly granted by legislators, such as for exports or R&D.
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> The new corporate tax shelters have nothing to do with public policy and everything to do with arcane quirks in the tax code. Congress often knows nothing about these breaks and isn't happy when it does hear of them. These unintended tax breaks are saving corporate buyers up to $10 billion in tax a year, estimates Stanford law professor Joseph Bankman. That's still a small part of the $190 billion in corporate tax collections, but business is booming and there's nothing to slow it down: "I'd be astounded if it doesn't grow dramatically next year," says Bankman.
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> Deloitte & Touche and the other Big Five accounting firms have grabbed the lead in this hugely profitable new business. But they aren't alone: Investment banks and tax-product boutiques are also peddling shelters. Law firms such as King & Spaulding and Skadden, Arps are raking in huge fees writing opinions to justify them.
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> Haven't corporations always hired advisers to help minimize their taxes? Yes, but not like this. "This is a totally new phenomenon," says John Chapoton, a former Treasury official now with Vinson & Elkins. Why is it happening now? In part it's related to the growth of derivatives.

> The same minds that figured out how to split a security into a multitude of different cash flows and contingent returns are now engineering products in which the tax benefits are split off from the underlying economics of a deal. It's no coincidence that many of the new crop of shelters use swaps, collars, straddles, and newfangled preferred stock as building blocks.
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> It has taken a while for inhibitions to be shed and the most outlandish gimmicks to propagate.
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> In addition, tax advisers are no longer just devising specific strategies to deal with a client's tax needs as they arise, as in the past. Today's shelter hustlers parse the numerous weaknesses in the tax code and devise schemes . . . that can be pitched as "products" to corporate prospects. Then they sell them methodically and aggressively, using a powerful distribution network not unlike the armies of pitchmen who sold cattle and railcar tax shelters to individuals in the 1970s and 1980s.
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> For tax professionals, the temptation to grab a piece of this profitable business is also intense. Recently the IRS got an anonymous letter blowing the lid off a particularly smelly scheme, and it was signed simply "A Pressured Practitioner." Former IRS Commissioner Lawrence Gibbs likens today's corporate shelters to the abusive individual shelters of 20 years ago: "It's virtually the same thing, with a bit more sophisticated product. Once something like this gears up, it's hard to stop, and the government is far behind the curve." To combat some of these schemes, the IRS can invoke a Supreme Court case from 1935, *Gregory v. Helvering.* It says that if a transaction superficially follows all rules but is devoid of economic substance and produces tax savings Congress didn't intend, it can be considered a sham and disallowed. Unfortunately for the tax cops, this sham doctrine is extremely fuzzy, whereas the rules that define the various components of a transaction are often well defined. This difference is ripe for exploitation, because the IRS is not equipped to find most shelters and even those which are discovered are unlikely to incur penalties.
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> Says one lawyer: "The IRS misses nine out of ten shelters. On the tenth, the company settles and pays back taxes and the government agrees to no penalties. That's a small roll of the dice for the company."

Good news for you, the reader?

None of the strategies I discuss in forthcoming chapters have even come close to being in that article. None of the strategies presented in the pages that follow even border on the aggressiveness that the "Big Four Firms" are actively promoting. These firms are known for their conservatism!

That should give you some degree of confidence in what I will present to you in this book. You should have even more confidence in the fact that I have gone to audit at least once, and in most cases many times, on each and every strategy I discuss—I have won!

THERE IS NO MYSTERY TO SAVING TAXES

There are only two types of income tax strategies: (1) those that involve *income,* and (2) those that involve *deductions.*

The first type we will look at are those strategies that involve doing something with your *income.* You can really only do four things with your income:

1. Transform it—for example, into a lower tax bracket.
2. Avoid it—for example turn taxable income into nontaxable.
3. Decrease it.
4. Defer it—into another year or tax period.

On the other hand, you can really only do four things with your *expenses:*

1. Create them—through the creation of paper losses (expenses you would normally have and now turn into deductions).
2. Accelerate them—into the current year.
3. Transform them—into more favorable deductions (i.e., Schedule C deductions rather than itemized; we will talk more about this concept).
4. Increase them—make expenses that were nondeductible into deductible expenses.

Most people feel that taxes are mandatory, but they are not. My strategy consists of using these eight components to *ELIMINATE* or to significantly reduce your federal and state income tax, tax on your retirement plan, and the burdensome estate tax.

By now you're probably saying to yourself, "That's insane." Well, I'm going to make an even crazier statement:

The federal income tax, the retirement tax, and the estate tax are *voluntary* taxes. You can pay them if you want to, but if you wish to avoid them, you do not have to pay.

I am not talking about tax protestors—those who say the income tax is illegal, that the tax system was never ratified in the law. Take my word for it, income tax is legal, and might makes right. If the government wants to tax you, they will. Fighting them is going to result in some unsavory consequences for you.

Rather than fighting them, I liken my strategies to *tax judo.* In other words, I use the government's own tax laws to help me to limit or eliminate tax.

THE PARADIGM SHIFT TO TAX FREEDOM

In the sixteenth century, people believed the earth was the center of the universe. They thought that all the planets revolved around the earth. To think otherwise would have been heresy. In the late 1500s an Italian scientist named Galileo invented the telescope and with it discovered that the earth was simply one of several planets revolving around the sun.

Up until 1491, everybody knew the earth was surely flat. If you sailed far enough to the world's outer reaches, you would reach the end and fall off into space—until an Italian sailor named Christopher Columbus sailed from Europe to the West Indies and proved that the earth was in fact round.

Up until the middle of the twentieth century, science was convinced that energy and matter were two distinct quantities. Along came a scientist named Albert Einstein who proved, along with his theory of relativity, that energy and matter were, in fact, the same.

What I have just illustrated is a concept called the *paradigm shift.* A *paradigm* is a set of rules or precepts through which the universe is viewed. It is a framework through which people make sense of everything around them. A *paradigm shift,* on the other hand, is what occurs when something comes along to alter that set of rules or framework, and hence an *epiphany,* or major change in consciousness, is attained.

As Dorothy Parker once said, "There are two sure things in life—death and taxes." I say, "There is only one sure thing, and that is death—everything else is negotiable."

And "everything" includes the payment of taxes. The remainder of this book presents many strategies that can help you to achieve this *paradigm shift.*