ADVANCED TAX TACTICS 2.0

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Advanced Tax Tactics
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TOOLS OF $ WEALTH

Introduction

The IRS is your major impediment to financial success and security. The only way you can control them is to know and use their own laws. The number of "tax shelters" has steadily decreased over the past several decades. There are less than a dozen legitimate tax shelters in the IRS Code today.

This course will show you how to use some of the lesser known tax shelters and tax tips. You may not recognize some tax shelters as "shelters." For example, your personal residence is a great tax shelter. And you may not have realized that retirement plans and benefit plans are two of the other few remaining tax shelters.

The problem is that your real estate agent and stock broker are interested in selling you a house and investing your money in a retirement plan. They aren't looking at the tax aspects of what is happening, and they don't look at the house and retirement plan as a special tax shelter. If things you are already doing, such as the simple purchase of a house, can be structured to take maximum advantage of the tax laws, you will end up with a lot more wealth down the road and into the future.

With any investment, the first question you need to ask is, "What is the tax?" Which is better, a 4% return tax free or a 7% return with a hefty tax?

In this *Advanced Tax Tactics* course, I will show you why taxes are so devastating, probably beyond what you imagine. I will show you why most attorneys, CPAs, and financial advisors don't help you with your tax burden.

I can predict where taxes are headed in the future (that's a no brainer), and show you what you can do today to help cut your tax burden in the future.

There are basically two sets of tax laws in the United States—one that rich people use and one that everybody else uses. If you are going to be rich, which set of laws do you have to use? Obviously, the laws designed to protect the rich. You can use those laws, but you have to have somebody show you how to use them.

The tax war is a war you have to fight every day. It isn't something you only think about in the middle or December or at the end of March. You've got to "create" the numbers your tax preparer will plug into the holes on the tax forms. You need to be creating those numbers in your favor throughout the year.

Once you have a broader understanding of the tax theory and basic techniques for lowering your taxes, I will give you some *Advanced Tax Tactics* that I think most folks can use. The ten tax tips you read in the paper or magazine around the end of the year or at tax time are pretty much worthless tips that only one in a thousand people can use. I've tried really hard in this *Advanced Tax Tactics* course to give you the good stuff your accountant probably hasn't told you about.

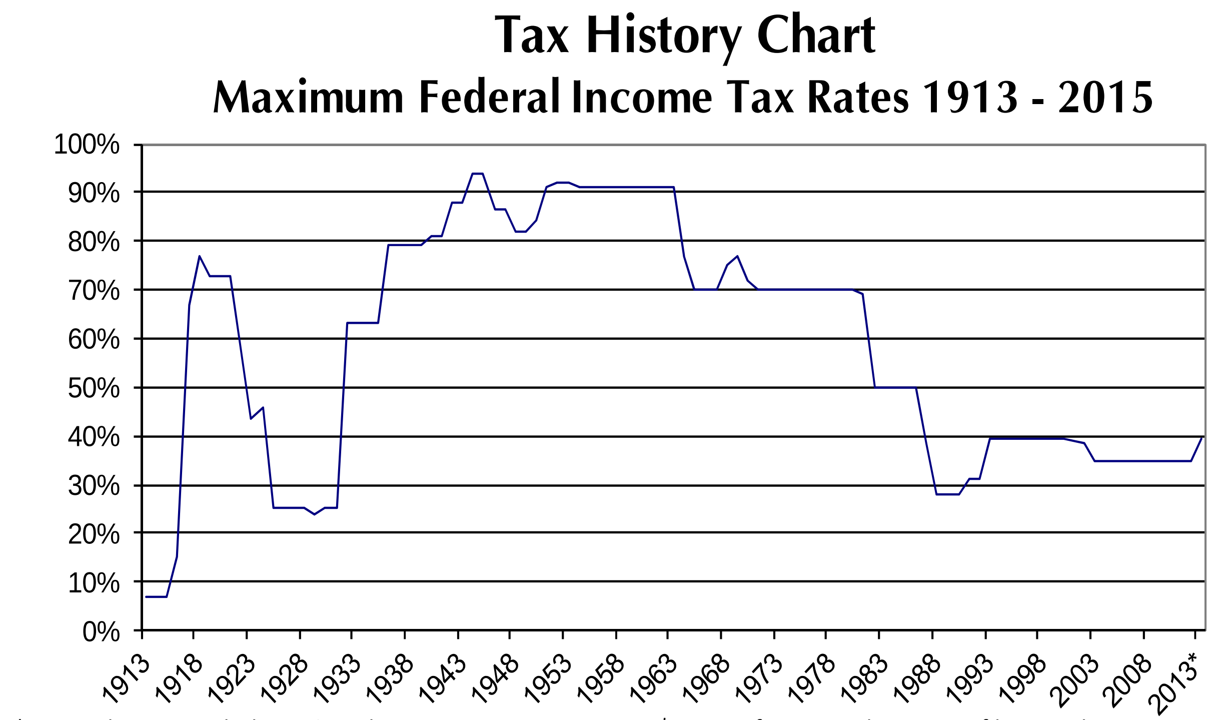
I'd love to hear back from you about any concerns you have that I could address in future updates. Let's work together in the tax war, and spread the word. Feel free to share the link to my Free Ten Tax Tips to get your friends started.

http://www.legalees.com/downloads/Ten_Tax_Tactics.pdf

Keep an eye out for money saving bonuses on other courses I have to help you keep more of your hard earned money and protect your assets.

History and Overview

This manual is a companion to the audio tutorial. The charts in this section are self-explanatory, but are primarily included as a reference to the audio narrative.



* - Rate does not include 3.8% Medicare surtax on income over $250,000 for married taxpayers filing jointly

This is a chart of the highest personal income tax rate each year since the income tax was implemented in 1913. It came in at 8.5% and both Congress and the President promised the rate would never increase. Within a couple of years, it hit 75%. In the 30s, 40s and 50s the tax was very high. Those were the gangster years. People will control their taxes by illegal means when the tax goes over 50%. Note the two periods in history when the tax rates came down. The big step down from 70% to 28% in the 1980s was Ronald Reagan. Both periods when the tax was low (1920s and early 1990s) the economy blossomed. You would think politicians could read the chart, but they don't get it. Taxes are going up. Plan now!

One Dollar Doubled—No Tax

	Beginning of Year	End of Year
1	$1.00	$2.00
2	$2.00	$4.00
3	$4.00	$8.00
4	$8.00	$16.00
5	$16.00	$32.00
6	$32.00	$64.00
7	$64.00	$128.00
8	$128.00	$256.00
9	$256.00	$512.00
10	$512.00	$1,024.00
11	$1,024.00	$2,048.00
12	$2,048.00	$4,096.00
13	$4,096.00	$8,192.00
14	$8,192.00	$16,384.00
15	$16,384.00	$32,768.00
16	$32,768.00	$65,536.00
17	$65,536.00	$131,072.00
18	$131,072.00	$262,144.00
19	$262,144.00	$524,288.00
20	$524,288.00	**$1,048,576.00**

Take a dollar and double it 20 times, you'll get a million dollars plus. BUT, there is no tax on this math sequence. What happens if you tax the dollar at a 40% tax rate (federal and state)? How much do you end up with? A 40% tax should leave you with about 60% of the million dollars. You'll only have $600,000 left. Right?

One Dollar Doubled—TAXED

	Beginning of Year	Gain	Tax	End of Year
1	$1.00	$1.00	$.40	$1.60
2	$1.60	$1.60	$.64	$2.56
3	$2.56	$2.56	$1.02	$4.10
4	$4.10	$4.10	$1.64	$6.55
5	$6.55	$6.55	$2.62	$10.49
6	$10.49	$10.49	$4.19	$16.78
7	$16.78	$16.78	$6.71	$26.84
8	$26.84	$26.84	$10.74	$42.95
9	$42.95	$42.95	$17.18	$68.72
10	$68.72	$68.72	$27.49	$109.95
11	$109.95	$109.95	$43.98	$175.92
12	$175.92	$175.92	$70.37	$281.47
13	$281.47	$281.47	$112.59	$450.36
14	$450.36	$450.36	$180.14	$720.58
15	$720.58	$720.58	$288.23	$1,152.92
16	$1,152.92	$1,152.92	$461.17	$1,844.67
17	$1,844.67	$1,844.67	$737.87	$2,951.48
18	$2,951.48	$2,951.48	$1,180.59	$4,722.37
19	$4,722.37	$4,722.37	$1,888.95	$7,555.79
20	$7,555.79	$7,555.79	$3,022.31	**$12,089.26**

Surprised? You only have $12,089 not $600,000. Are you getting a feel for how important it is to cut your taxes? A simple 10% or 20% tax cut today could mean millions of extra spendable dollars over your lifetime.

AGI

The best way to control your tax liability is to put your AGI (Adjusted Gross Income) on a diet. Your AGI number is found at the bottom of Page 1 on your 1040 tax return (see the tax forms which follow) and is carried over to the top of Page 2. It determines whether or not you can take many of the deductions on Page 2. It also has a huge influence on what tax bracket you will fall in. It is by far the biggest factor in determining your tax bracket.

If your AGI is high enough, certain deductions will "phase out." Basically, your deductions can be reduced. The affected deductions listed on Schedule A include:

- Taxes paid - line 9
- Interest paid - lines 10, 11, 12, and 13
- Gifts to charity - line 19
- Job expenses and certain miscellaneous deductions - line 27
- Other miscellaneous deductions - line 28, excluding gambling and casualty or theft losses

The IRS sets limits based on how high your AGI number is. The limits determine when a deduction will or won't be allowed. The following deductions are also subject to different limits based on your AGI:

- Medical and dental expenses - line 4
- Investment interest expense - line 14
- Casualty and theft losses of personal use property - line 20
- Casualty and theft losses of income-producing property - line 28
- Gambling losses - line 28

For example, health expenses can only be taken as a deduction if the expenses exceed 10% of your AGI. If the expenses are less than 10% of your AGI, you cannot deduct any of your medical expenses. (There is a way that you can pay 100% of your medical expenses using pre-tax dollars. We will discuss that later.)

- If your expenses were $20,000 and your AGI was $200,000, 10% of AGI is $20,000 and you would get no deduction.
- *But,* if your expenses were $20,000 and your AGI was $100,000, 10% of AGI is $10,000 and you would get to deduct $10,000 ($20,000 - $10,000 = $10,000) in medical expenses.

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return **2014** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2014, or other tax year beginning , 2014, ending , 20 See separate instructions.

Your first name and initial	Last name	**Your social security number**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).		**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/state/county	Foreign postal code

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**

Boxes checked on 6a and 6b

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here ▶ ☐

No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see instructions)

Dependents on 6c not entered above

d Total number of exemptions claimed

Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7
8a	**Taxable** interest. Attach Schedule B if required		8a
b	**Tax-exempt** interest. **Do not** include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required		9a
b	Qualified dividends	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes		10
11	Alimony received		11
12	Business income or (loss). Attach Schedule C or C-EZ		12
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13
14	Other gains or (losses). Attach Form 4797		14
15a	IRA distributions 15a	b Taxable amount	15b
16a	Pensions and annuities 16a	b Taxable amount	16b
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17
18	Farm income or (loss). Attach Schedule F		18
19	Unemployment compensation		19
20a	Social security benefits 20a	b Taxable amount	20b
21	Other income. List type and amount		21
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22

Adjusted Gross Income

23	Educator expenses	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	Deductible part of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid **b** Recipient's SSN ▶	31a	
32	IRA deduction	32	
33	Student loan interest deduction	33	
34	Tuition and fees. Attach Form 8917	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 35		36
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2014)

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Tax and Credits

38 Amount from line 37 (adjusted gross income) . . . 38

39a Check if: ☐ **You** were born before January 2, 1950, ☐ Blind. ☐ **Spouse** was born before January 2, 1950, ☐ Blind. } **Total boxes checked** ▶ 39a

b If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b ☐

Standard Deduction for—
• People who check any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions.
• All others:
Single or Married filing separately, $6,200
Married filing jointly or Qualifying widow(er), $12,400
Head of household, $9,100

40 **Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin) . . 40

41 Subtract line 40 from line 38 . . . 41

42 **Exemptions.** If line 38 is $152,525 or less, multiply $3,950 by the number on line 6d. Otherwise, see instructions 42

43 **Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0- . . 43

44 **Tax** (see instructions). Check if any from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ 44

45 **Alternative minimum tax** (see instructions). Attach Form 6251 . . . 45

46 Excess advance premium tax credit repayment. Attach Form 8962 . . . 46

47 Add lines 44, 45, and 46 . . . ▶ 47

48 Foreign tax credit. Attach Form 1116 if required . . . 48

49 Credit for child and dependent care expenses. Attach Form 2441 49

50 Education credits from Form 8863, line 19 . . . 50

51 Retirement savings contributions credit. Attach Form 8880 51

52 Child tax credit. Attach Schedule 8812, if required. . . 52

53 Residential energy credits. Attach Form 5695 . . . 53

54 Other credits from Form: **a** ☐ 3800 **b** ☐ 8801 **c** ☐ 54

55 Add lines 48 through 54. These are your **total credits** . . . 55

56 Subtract line 55 from line 47. If line 55 is more than line 47, enter -0- . . . ▶ 56

Other Taxes

57 Self-employment tax. Attach Schedule SE . . . 57

58 Unreported social security and Medicare tax from Form: **a** ☐ 4137 **b** ☐ 8919 . . 58

59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required . . 59

60a Household employment taxes from Schedule H . . . 60a

b First-time homebuyer credit repayment. Attach Form 5405 if required . . . 60b

61 Health care: individual responsibility (see instructions) Full-year coverage ☐ . . . 61

62 Taxes from: **a** ☐ Form 8959 **b** ☐ Form 8960 **c** ☐ Instructions; enter code(s) 62

63 Add lines 56 through 62. This is your **total tax** . . . ▶ 63

Payments

If you have a qualifying child, attach Schedule EIC.

64 Federal income tax withheld from Forms W-2 and 1099 . . 64

65 2014 estimated tax payments and amount applied from 2013 return 65

66a **Earned income credit (EIC)** 66a

b Nontaxable combat pay election 66b

67 Additional child tax credit. Attach Schedule 8812 . . . 67

68 American opportunity credit from Form 8863, line 8 . . 68

69 Net premium tax credit. Attach Form 8962 . . . 69

70 Amount paid with request for extension to file . . . 70

71 Excess social security and tier 1 RRTA tax withheld . . . 71

72 Credit for federal tax on fuels. Attach Form 4136 . . . 72

73 Credits from Form: **a** ☐ 2439 **b** ☐ Reserved **c** ☐ Reserved **d** ☐ 73

74 Add lines 64, 65, 66a, and 67 through 73. These are your **total payments** . . . ▶ 74

Refund

75 If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you **overpaid** 75

76a Amount of line 75 you want **refunded to you.** If Form 8888 is attached, check here . ▶ ☐ 76a

Direct deposit? See instructions.

▶ b Routing number ▶ c Type: ☐ Checking ☐ Savings

▶ d Account number

77 Amount of line 75 you want **applied to your 2015 estimated tax** ▶ 77

Amount You Owe

78 **Amount you owe.** Subtract line 74 from line 63. For details on how to pay, see instructions ▶ 78

79 Estimated tax penalty (see instructions) . . . 79

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete below. ☐ **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here

Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature | Date | Your occupation | Daytime phone number

Spouse's signature. If a joint return, **both** must sign. | Date | Spouse's occupation | If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Print/Type preparer's name | Preparer's signature | Date | Check ☐ if self-employed | PTIN

Firm's name ▶ Firm's EIN ▶

Firm's address ▶ Phone no.

www.irs.gov/form1040 Form **1040** (2014)

BUSINESS MATRIX

There are a number of entities that you can use to "do business." Each entity has both an asset protection aspect and a tax aspect. Some of the entities have more moving parts and require more "maintenance" or work associated with keeping them in order. Some require little or no work to maintain them. So the decision as to which entity should be used can actually be complex. For most small business structures today, an LLC is usually recommended, because it has a superior asset protection when compared to a corporation or limited partnership, and it has the flexibility of being able to choose its tax structure.

The asset protection of the LLC is the same no matter how it is taxed. Legal issues and tax issues are totally separate, which is a difficult concept for many people to grasp. The legal aspects of "maintaining the corporate shield" have to be followed to obtain the desired asset protection even while all the tax laws associated with the tax structure that you choose must of course also be followed.

In the accompanying audio instructions, the four ways that an LLC can be taxed are examined, and a business matrix is created to help you decide on your LLC's tax structure. The matrix is pictured below. The left side of each box gives the positive aspects of the tax structure and the right side gives the negative aspects of the tax structure.

Sole Proprietorship		**General Partnership**	
+ Simple	- Self Employment Tax - Higher Audit Risk	+ Debt Basis	- Self Employment Tax
S Corporation		**C Corporation**	
+ No Corporate Tax + No Social Tax on Distribution	- No Debt Basis - Owner Restrictions	+ ERISA, HRA, HSA + Funding + Listing	- Double Taxation - Tax Traps - High Audit Adjustment

The advantages and disadvantages of each choice are spelled out in more detail in the following pages and on the audio instructions.

Hobbies

Is Your Business Just a Hobby?

However you choose to have your LLC taxed, or however you set up your business, there is a small chance that the IRS could classify the business as a hobby. If the business makes money, there isn't any issue. However, if the business loses money, a hobby designation could be issued by the IRS. The IRS is looking to see if the business activity shows a profit for three out of the last five years. Of course businesses lose money, and there are lots of factors to consider rather than just profit. Some of the big internet companies are worth billions of dollars, but they have never shown a profit.

What do I file?

Income Tax: List expenses on Line 28 of Schedule A, which enters into your 1040 on Line 40.

If an activity is determined to be a hobby, expenses attributable to the activity are generally NOT deductible to the extent they exceed income generated by the hobby. You cannot deduct more than you made in profit from that hobby. And any deductions that you can take come in BELOW the line as part of your Schedule A Itemized Deductions, subject to 2% of your AGI. *There is NO AGI reduction with a hobby.*

As a side note, remember that any hobby expenses that would be deductible regardless of the type of activity (taxes, interest, casualty losses, etc.) continue to be deductible even if they exceed hobby income.

Sole Proprietorship

Advantages

- Business losses are deductible
- Easy to set up and maintain

  In most cases, no separate EIN (Employer Identification Number) is required—your Social Security Number acts as the tax number for the business. This type of setup is referred to as "disregarded" in the tax world because there is no separate return.
- You own it all and have full control. There are no partners.

What do I file?

Income Tax: Proceeds and expenses) for a Sole Proprietorship are listed on Schedule C and entered into your 1040 on Line 12.

Disadvantages

- Very low or no asset protection
- Higher audit risks
- Self-employment taxes on all income
- No liability protection

If you are conducting a business with a very low liability, like growing vegetables in your yard to sell at a Farmer's Market, it may not be worth the extra paperwork and expense of setting up a business structure.

So set up your little business, keep track of all your expenses, and document what you do to try to make the business profitable. Every time you make a decision relating to the business, ask yourself, "What's the tax?" The tax issues need to be planned. For example, sometimes you can time your bigger expenses to come in a year when the deduction of the expenses can be used to offset a higher AGI for that year.

But if you are expecting high active income and/or you are doing business in a high liability field, you really should consider using a business structure with better asset protection than a sole proprietorship offers.

General Partnership

Advantages

- Lower audit risk than Sole Proprietorship
- Can take debt basis on rentals
- Rental income is passive, not subject to self-employment taxes

Disadvantages

- Any active income generated by the business is subject to self-employment taxes

  Including gains from flipping real estate

- Maximum liability exposure (no asset protection plus the liability of having partners and their acts)

What do I file?
Income Tax: Proceeds (and expenses) for a General Partnership are listed on Schedule E and entered into your 1040 on Line 17.

A partnership is created when two or more persons join together to carry on a trade or business. Each partner contributes money, property, labor or skill, and expects to share in the profits and losses of the business. Income, gains, losses, deductions, and credits of a partnership are passed through to the partners based on each partner's distributive share of these items. The distributive share is based on the partnership agreement, hopefully written out in detail in the partnership agreement. The taxpayer must report his or her distributive share of these items on the tax return whether or not they actually are distributed.

Self-Employment Tax

The self-employment tax is often a significant portion of a self-employed individual's total tax liability, currently 15.3%. For some, it will be more than their income tax. Just like a W-2 employee, it consists of two parts:

- Social Security, also called "OASDI" for "Old Age, Survivor's, and Disability Insurance"
- Medicare, or "MHI" for "Medicare Hospital Insurance"

The self-employment tax is all borne by the individual. For W-2 employees, the employer pays half the tax and the individual pays the other half.

Net earnings subject to self-employment taxes include:

- A general partner's distributive share of income from a partnership that carries on a trade or business
- The general partner's guarantee payments for services and for the use of capital

Gains and losses in income resulting from the sale of land and from depreciable property are considered "active" income, and included in income calculations subject to self-employment taxes. Rental income from real estate and from any personal property leased with the real estate is usually considered "passive" and excluded from net earnings for self-employment tax calculations. But remember, whether it is passive or active, all income must be reported somewhere on the return.

Rental income would also be included as active IF the landlord provides significant services for the tenant, to the point that it looks more like a motel service than a rental. While the cost of utilities, cleaning public areas, and trash collection are not considered services for the tenant, providing maid service would be a significant service for the tenant. So, if you are operating a hotel, tourist camp, or boarding house, the "rental" income would be considered active, and included in your net earnings subject to the self-employment tax.

Net operating losses can be carried back two years and forward for up to 20 years. However, the taxpayer receives no deduction for net operating losses in calculating net earnings from self-employment taxes. The taxpayer's distributive share of the partnership losses is limited to the adjusted basis of the partnership interest at the end of the partnership year when the losses took place.

S Corporation

What do I file?

Pass through: File an 1120S for the S corporation. The S Corporation will issue a K-1 for each shareholder.

Income Tax: Use the K-1 to list profits and losses on Schedule E, which enters into your 1040 on Line 17.

Advantages

- Assuming the corporate shield is fully in place: your personal assets are not at risk because of the activities or liabilities of the S corporation, unless you pledge assets or personally guarantee the corporation's debt.
- No double taxation from a corporate level income tax: gains, losses, deductions, and credits pass through to you and other shareholders to be claimed on your individual tax returns.
- Self-employment taxes are only owed on salaries paid to you and employees, rather than on all regular business earnings, as is the case with sole proprietorships and partnerships.

Disadvantages/Restrictions

- Owners with greater than 2% interest are not entitled to most fringe benefits available to employees.
- Losses are limited to the shareholder's basis, which does not include any of the corporation's debt, even if the shareholder has personally guaranteed it.
    - * Real estate losses from a rental business are thus at a disadvantage compared to losses occurring in partnerships or sole proprietorships.
- A shareholder must comply with several IRS sections before losses are deductible:
    - * Sec. 183 Hobby Loss
    - * Sec. 1366 Adjusted Basis
        - The total S corporation loss claimed by a shareholder cannot exceed the adjusted basis in his stock plus the adjusted basis in any indebtedness owed by the corporation to the shareholder.
    - * Sec. 465 At-Risk
    - * Sec. 469 Passive Activity Loss
- Cannot have more than 100 shareholders
- Can only have certain kinds of shareholders
    - Must be an individual, estate, or certain type of trust
    - * All shareholders must be citizens or resident aliens of the US
    - * Can only have one class of stock
- May only own qualifying subsidiaries and can only have one type of stock
- Cannot list on the stock exchange or receive venture capital

An S corporation does not accumulate earnings and profits from year to year, because all current earnings and profits are taxed to the shareholders annually. In most cases, the corporation itself will not pay tax on its income. Income, losses, deductions, and credits are passed through to the owner and reported on his or her return. If there is more than one owner, their share is passed through.

S Corporations Have a Big Tax Advantage

S corporations were created to help the small business owner survive. They have liability shielding aspects and tax aspects that make them the "work horse" of today's small business. An LLC can be taxed as an S corporation, so with an LLC you can have both the tax advantages of an S corporation and have an LLC, which offers greater asset protection than a corporate legal structure.

Legal Aspects

A lot of people think that you get better asset protection or "liability shielding" from a C corporation than you do from an S corporation. That's false, and yet, it is often true. The problem comes with "maintaining" the corporation, not the legal structure of the corporation.

The legal structure and asset protection aspects of a corporation are the same for the C corporation and S corporation. The "corporate shield" is exactly the same in both corporations. C corporations are usually the bigger companies, and the "big boys" are often more meticulous at maintaining their corporate structure than the little one-man-band S corporations. Therefore, it is true that more C corporations survive legal challenges, but it's not because of a difference in the legal structures.

The only difference in a C corporation and an S corporation is the choice of tax laws. A C corporation is taxed under Chapter C of the IRS Code. An S corporation is taxed under Subchapter S of the IRS Code. There is no legal difference in the two types of corporations.

As a small business owner, real estate investor, or professional in a practice, there really aren't many reasons you should be operating as a C corporation. If someone (any one of your advisors) suggests that you form a C corporation, there had better be a compelling reason – and it had better be really compelling!

If both corporations have the same legal structure and the same asset protection shielding, then the choice of which corporation to use has to be based on the tax structure. The Subchapter S corporation has a tax structure that is a lot better for small businesses in most cases.

Tax Aspects

The main tax difference in a C corporation and an S corporation is the way an owner can get money out of the company.

In a C corporation, there are two ways the owner can get money out of his company. First, you can get money out as a W-2 wage, and all of the W-2 income you receive will also be subject to self-employment taxes. Second, you can receive a dividend. The tax on a dividend brings up a double tax situation. The C corporation is a taxpayer. It pays taxes on all of its profit. When a dividend is paid, the C corporation doesn't get a deduction for money it pays out as dividends. The dividend payment is made with an after tax dollar. When you receive the dividend, it is considered income to you, and you have to pay income taxes. Thus, the money is taxed at the corporation's level and then at your level.

In an S corporation, the owner can take a W-2 wage and the rest can be paid as a "distribution." Note that it is not called a dividend, rather a distribution. The tax aspects of a distribution are very different than a dividend.

An S corporation is generally not taxed because all the income flows through to the owner(s). Thus, no double tax like a C corporation. When the owner gets the distribution, it comes out without any of the self-employment aka payroll taxes. That can save the owner more than 15% in taxes on the amounts taken as a distribution rather than a wage. That can be a lot of money.

The S corporation owner is required to take a "reasonable wage" out of the company before any distributions are made. Taking the reasonable wage and then paying the rest out as a distribution can save a lot of taxes.

The Edwards Loophole

Payment of a reasonable salary and then distributing the rest of the corporation's profits as a distribution to the shareholder(s) has helped small business owners for decades. In what is now ancient history, the strategy of taking a reasonable wage and then making distributions from an S corporation was dubbed the "John Edwards Loophole." When Edwards was in the presidential campaign, it came out that he had paid himself a million dollars as "reasonable wage" from his S corporation. Then he took an additional $26 million as distribution. The IRS has a hard time arguing that a million dollars isn't a reasonable wage.

Of course, he paid income tax on the $26 million. (This is pre Geithner. Geithner established the precedence that politicians don't pay income taxes, and a number of Obama administration appointees followed suit.) Edwards may have paid income tax on his $26 million, but he didn't pay any employment taxes. That saved him over $500,000. It's all perfectly legal.

This is all fully sanctioned by the IRS, although they aren't happy about it. Paying a reasonable wage and making distributions on the rest of the company's profits has been the common practice of most S corporation owners for many years. If you aren't doing this, you need to be doing it.

Edwards brought the issue front and center into the public's view. Of course, the press made it out to be totally outrageous that a rich person didn't pay a half million dollars in payroll tax. The press just forgot to mention that he paid over $10 million in income taxes. Because of all the press the issue got, the IRS decided to TRY and close the "loophole." Congress tried twice after that to change the law.

In the last attempt, language in the law that would make the S corporation owner pay self-employment taxes on any distribution received from the S corporation, made it into the final House and Senate version of the Unemployment Compensation Extension Act of 2010. The law was actually passed by both the House and Senate with the language in it that killed small businesses.

Somehow, between the time the law was passed by both the House and Senate and it was sent to the President for signature, the language was removed. The S corporation tax advantage offered for distributions remains safe for now.

Reasonable Salary Standards

The IRS says that the S corporation owner has to take a “reasonable wage” or “reasonable salary” before a distribution can be made. Unfortunately, there isn’t any standard for what “reasonable” means.

The IRS audit manual lists the following factors to determine whether a reasonable salary has been paid before the distribution is made.

No one factor is controlling. They all go to the weight of the evidence in order to determine what constitutes a reasonable wage:

- Employee’s duties
- Experience and background of the employee
- Unique knowledge the employee has of the business
- How big the business is
- How much the employee contributes to the business’ profitability
- How much time the employee spends at the business
- General economic conditions in the locality of the business
- Amount of responsibility given to the employee
- Seasonal adjustments in salary
- How much stock the employee has in the business corporation
- What other businesses similar in size, location, and nature pay

The Anatomy of a Distribution

1. Make sure you make a corporate minute entry authorizing the distribution.
2. State the distribution in the minutes as a number of dollars per share. (That means you have to know how many shares you have and how many are on the books being held by someone else.)
3. Don’t make distributions more often than once a month.
4. Distributions should be made to all shareholders on the same day in proportion to their

ownership interests.

5. Do not pay personal bills directly and then call the payment a distribution. Make the distribution to yourself first and then pay your bills.
6. Make sure you are paying a "reasonable wage."

Conclusion

If you follow the rules and are conservative, distributions from your S corporation, or your LLC taxed as an S corporation, can mean a lot of extra cash in your pocket. In fact, if you link the tax benefits of the S corporation with the asset protection of an LLC, you can get all of the tax benefits and double the asset protection.

There's no reason you shouldn't take advantage of every law you can in order to reduce your taxes. We are in for a firestorm of taxes, and your ability to take advantage of the black and white laws may mean the difference between your success and failure.

What Saving on Social Taxes Can Do to Your Bottom Line

	Without Distribution	With Distribution
Business Owner's Income	$120,000	$50,000
Distributions from Business		$70,000
Adjustments to Income: 1/2 Self-employment Tax	(8,478)	$(3,533)
Adjusted Gross Income	$111,522	$116,467
Less: Itemized Deductions	$20,000	$20,000
Exemptions (family of four)	$15,800	$15,800
Taxable Income	$75,722	$80,667
Less Child Tax Credits	$(1,900)	$(1,650)
Self-Employment Taxes	$16,956	$7,065
Income Taxes (after Tax Credits)	$8,744	$10,231
Total Taxes	$25,700	$17,296
Tax Savings by Taking Business Distributions		**$8,404**

C Corporation

Advantages

- Benefit plans available to owners
- Can make use of venture capital
- Can list on the New York Stock Exchange

Disadvantages

- DOUBLE TAXATION
- Lots of tax traps
- Very complicated series of rules and regulations that must be followed to the letter

What do I file?

Corporate Tax: Form 1120

Income Tax: Wages and dividends go on your 1040.

Double Taxation

A C Corporation files its own tax return and is taxed on all income. The only way money can be taken out of a C corporation is through W-2 wages or dividends. Dividends are subject to double taxation in that they are an after tax dollar paid out of the company and they are income for the individual receiving the dividend.

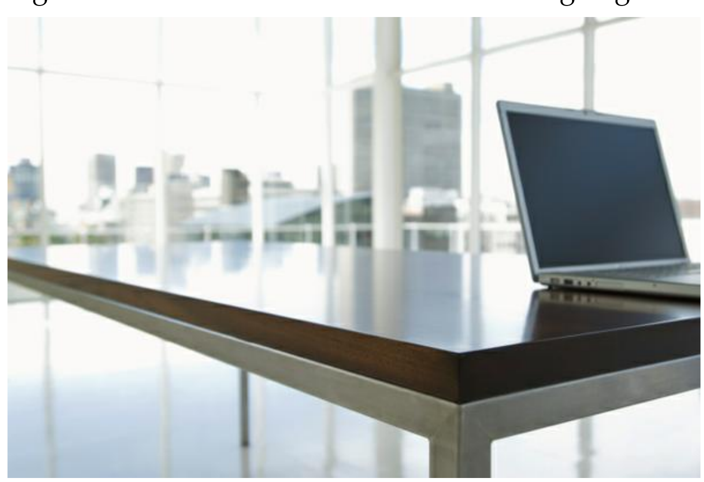
Benefit Plans

About the only reason I can readily see for a small business to use a C corporation is if the owner wants to establish a benefit plan, like a health reimbursement account (HRA).

The rules changed recently to make it so the only way a small business owner can participate in an HRA is to use a C corporation.

Health Reimbursement Accounts or Health Reimbursement Arrangements (HRAs) are Internal Revenue Service sanctioned programs that allow an employer to reimburse medical expenses paid by participating employees, thus yielding "tax advantages to offset health care costs." They really are neat and can save a significant amount of taxes.

However, C corporations have tax disadvantages for a small business owner making a good profit. If you want the benefit plans, which will give a good tax advantage, it is possible to establish both a C corporation and an S corporation. The business activities are done in the S corporation, which contracts with the C corporation for all of the labor. All of the employees and benefit plans are in the C corporation, and the S corporation "feeds" enough money into the C corporation to pay for the employees and benefits. The S corporation keeps the profit from the business activities to be taxed under the S corporation laws.



Using an LLC

Congress created corporate protection to encourage people to fund and run companies. The "corporate shield" protects the personal assets of people willing to take the risk of starting a small business.

In order to have the protection of the corporate shield, specific actions have to be taken when you start your business. This is different than a sole proprietorship or partnership which can be started without any formal action. Please note that an S corporation, C corporation, and ***LLC*** (Limited Liability Company) all have the same corporate shield.

What do I file?
There is no LLC tax form
See IRS Publication 3402

File as a:

- **Sole Proprietorship**
- **Partnership**
- **S Corporation**
- **C Corporation**

The LLC is much more flexible than a corporation, primarily because it can choose the type of tax structure it will be taxed under. It can be taxed as a sole proprietorship, general partnership, a C corporation or an S corporation.

When you establish an LLC, you get to choose what tax structure the company will be taxed under by simply telling the IRS how you want the company to be taxed. There is no such thing as an LLC in the tax code. You choose how the IRS looks at your LLC, and they ignore the fact that your company has the legal structure of an LLC. The IRS simply sees your company as a sole proprietorship (one owner), a partnership (two or more owners), an S corporation (one or more owners), or a C corporation (one or more owners).

The asset protection aspects of your LLC are completely separate from the tax aspects of your LLC. The asset protection offered to you by your LLC is dependent upon the legal structure of the LLC. Asset protection has nothing to do with how your LLC is taxed. The LLC offers you not only the corporate shield protection, it has a secondary asset protection advantage that the corporation doesn't have. The second form of asset protection is called "charging order protection."

With basically twice the asset protection power and the flexibility of choosing how the company will be taxed, the LLC is fast becoming the business structure of choice in the majority of situations.

Unlike a corporation or limited partnership, an LLC can choose how to be taxed based on what will be best for the company's bottom line. This choice needs to be made shortly (immediately) after you set up your LLC. Otherwise, the IRS will make the choice for you, which may or may not be to your advantage.

Single Member LLCs

Single member *LLCs* that neglect to make a selection will default to the taxing structure of a sole proprietorship. You

simply file a schedule C with your personal 1040 tax form. No EIN is needed; your Social Security number will function as the tax ID for your LLC. In essence, as far as the IRS is concerned, your LLC does not exist and you are the one making all of the money. The IRS refers to this as a "DisRegarded Entity" (DRE).

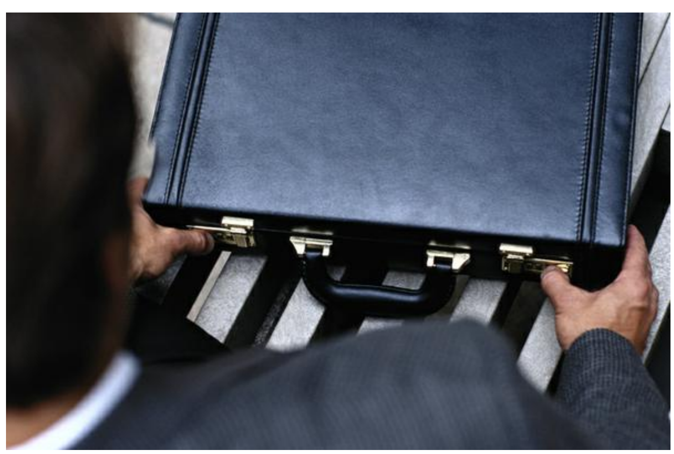
Multi-Member LLCs

Multi-member LLCs that do not choose a tax structure will default to being taxed as a partnership. This format requires an EIN (Employer Identification Number). Previously, this was obtained by filling out an SS-4 form, available on the IRS.gov website. It is now done by an online application at: http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Apply-for-an-Employer-Identification-Number-%28EIN%29-Online. Or you can go to www.IRS.gov and enter EIN in the Search field. "Apply for an Employer Identification Number (EIN) Online" will be the first link in the search results. After all validations are done you will get your EIN immediately upon completion. You can then download, save, and print your EIN confirmation notice.

If you decide to have an LLC taxed as a corporation, you must file an election with the IRS. If you want to have the LLC taxed as a C corporation you will file Form 8832. If you want to elect to have your LLC taxed as an S corporation, file Form 2553 with the IRS. The SS-4 form says the LLC must timely file Form 2553, and this is a requirement the IRS enforces.

Once you file the 8832 or 2553, make sure to file a tax return each year, even if your LLC does not make any money. This may seem silly, but it is the law and there can be trouble with the IRS if you don't file. I have been called by folks who have neglected to file because they did not make any money in the LLC or corporation. Imagine their surprise when the IRS came against them for money they never made. They were charged a penalty of $195 per month per member/shareholder for each month the tax return was late. You can end up owing a fortune to the IRS, even though your company never made a dime. Just don't take the chance. If you don't make any money in the LLC, still file a zero tax return.

If you want to change your LLC tax election, you can do it at the beginning of the tax year. You can change your LLC tax election once with basically no questions asked. You generally cannot retroactively change your election. Once you change your LLC tax election, you cannot change it again for 60 months (see Publication 3402). Note that for certain changes, like that from a C corporation to an S corporation, the form may look simple, but the IRS can get VERY picky about every detail, so it is a good idea to get professional help in making the change.



The Corporate Shield

If you'll take the risk of setting up a corporation and starting your little business, or if you'll invest in a company, Congress has agreed to protect your personal assets even when some disaster takes all the company assets away.

You certainly wouldn't want to be liable for the stupid things Enron did, just because you had purchased stock in Enron. (Actually, you were liable, but only up to the amount of money you invested in the stock.) Because of the corporate shield, you're safe from the creditors and liabilities of Enron and all the big companies you invest in. But what about your own little company? Are you safe from the little company's creditors and liabilities?

In many respects, the corporations and LLCs you are dealing with when you set up your small company are different than the Wall Street companies. When you set up a corporation or LLC, you own it alone or maybe with a couple of other people. That means it is "closely held" and the courts will look at it very carefully to make sure you treat it as a real entity rather than just your "alter ego." Technically, the legal structure and asset protection is the same as the big corporations, but the care and feeding of your closely held company feels very different.

It doesn't matter whether you have a C corporation (a corporation taxed under chapter C of the IRS Code), an S corporation (a corporation taxed under chapter S of the IRS Code), or an LLC, the asset protection shielding for each individual owner (shareholder or member) will be the same. It's all the same corporate shield or limited liability protection, and the formalities are all the same. (Note: corporations have "stockholders" while LLCs have "members.") The corporation is only designed to put up a corporate shield and protect the people (officers, directors, and stockholders) behind the shield from liabilities that occur as a result of the corporation doing business out in front of the shield.

Stated another way, in a corporation or LLC, if the attack comes from the company side of the shield, then the people behind the shield are protected. However, if the attack comes from the personal side of the shield, the corporate shield doesn't protect the individual under attack. It also doesn't protect the company or any of the other co-owners of the company from your personal disasters. In IBM that's not a big deal, because there are hundreds of thousands of shareholders. But in your closely held corporation with two shareholders, it's serious if one of the shareholders loses their corporate shares.

If you have a successful business, your business is probably your most valuable asset. Your business needs to be protected from you.

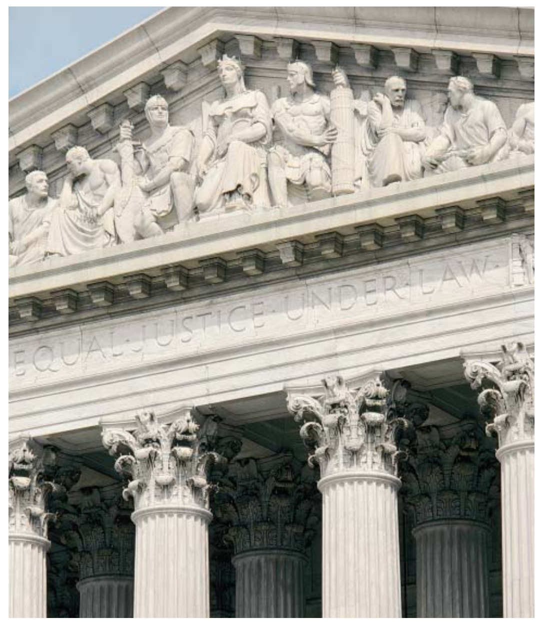
The Corporate vs. LLC Difference: The Charging Order

Let's assume that you own two apartment buildings. One apartment building is held in an LLC taxed as a partnership (sole proprietorship if you are the only member) and the second apartment building is held in an S corporation.

In either case, if a tenant slips and falls, the tenant will have to sue the entity that owns the building. The attack is coming from the front (company) side of the shield. Assuming the corporate/LLC shield holds, the most the tenant can get is the assets of the entity that owns the building. Your other assets, including your ownership of the entity that owns the other apartment building, will be safe.

What happens if the attack comes from the back (personal) side of the shield? Let's assume you are the sole owner of the corporation and the sole owner of the LLC. Let's also assume the attack is successful. The spoils of the suit will include your stock in the corporation that owns one apartment building, and your membership interest in the LLC that owns the other apartment building. When the lawsuit winner (creditor) takes over your assets, he gets your stock in the S corporation.

Effectively, the creditor now owns the apartment building. The creditor has all the stock. He will throw you out as officer and director, elect new officers and directors (himself), and he now runs the show. The creditor now has a new apartment building.



The creditor will also get your membership interests (stock) in the LLC—sort of. What does "sort of" mean? When the creditor gets a membership interest in an LLC or a limited partnership interest in a limited partnership, including a family limited partnership (FLP), the creditor has to get what is called a "charging order" to come against the entity. The charging order limits the creditor to only being able to receive the financial benefit of the owner's interest in the LLC or limited partnership.

When the creditor gets a membership interest, he can't just take over the LLC. Once he wins the lawsuit, he has to then ask the court for a charging order to come against your interests in the LLC. Under the charging order laws, a charging order *does not* give the creditor any voting or management rights.

This is very different from being able to seize the stock in a corporation and have all the voting rights and management rights. If the LLC document is written properly, the management of the LLC is intact and free from the creditor's influence. In fact, the managers of the LLC can basically make life miserable for the new member.

The bottom line is, you are still in control of your LLC. You can continue to pay yourself and other people wages for working in the LLC. The creditor gets any profit that is distributed out of the LLC which would have gone to the member (you). In some cases, the LLC can shift tax burdens to the creditor without ever giving the creditor any money.

Basically, you still have the apartment building held in the LLC as an asset.

Using the corporate structure, you lost the building. Using the LLC structure, you still have all the benefits of the second building. That's a very different outcome. You need to plan for the personal attacks from behind the shield, as well as the business related attacks that come from the front of the shield.

In order to put charging orders in perspective, a little history lesson is appropriate. Centuries ago, partnerships were the only business structure. When a creditor took a partner's interest, the creditor replaced the partner as the *new* partner. As a partner, the creditor could bind the partnership, sell assets of the partnership, conduct business in the partnership, and do anything he wanted without any approval or consideration of any other partners. That's simply the law of partnerships.

Take the case where three partners spent 20 years building a business. One of the partners got in trouble (divorce, bankrupt, lawsuit, whatever) and ended up with a judgment against him. The creditor would simply take the partner's interest in the partnership, and the creditor had free rein of all the partnership assets and activities. The other two partners just lost everything, because the third partner got in trouble personally.

That's not fair to the other partners. Several hundred years ago, British laws changed to protect the other two partners. The charging order concept was born.

Instead of having the creditor come in as a new partner, the laws have evolved to where the creditor only gets the benefit of the debtor partner's "economic interest" in the partnership. The creditor will get a judgment against the partner, and then the creditor is forced to get a court order "charging" the debtor partner's interest in the partnership for the debt owed. The charging order allows the creditor to collect the debt owed by the debtor partner by standing in the shoes of the debtor partner and getting any distributions made from the partnership which would have gone to the debtor partner. (Corporations pay dividends to shareholders. Partnerships and LLCs pay distributions to members.)

The charging order basically gives the creditor a lien against the debtor partner's interest in the partnership. The creditor doesn't have direct access to the partnership assets, can't bind the partnership or participate in the partnership management, and is unable to control the partnership in anyway. There is simply a lien against the partner's interest, and when money intended to go to the partners is distributed, the creditor gets his share standing in the shoes of the debtor partner.

Note that charging order protection was intended to protect the position of the "other partners" in a partnership. It wasn't intended to protect the debtor partner. The debtor partner will lose his economic interest in the partnership.

Uniform Laws

Charging order protection applies to general partnerships, limited partnerships and LLCs. It does not apply to corporations. LLCs can be thought of as a cross between partnerships and corporations. They have some elements of both entities.

The charging order laws in the United States have evolved to the point where uniform laws have been passed which influence the laws in every state and give a consistent foundation for each state on which they can draft their laws. There are variations in state laws concerning LLCs and partnerships, but the state laws are all very similar.

The national Uniform Limited Partnership Act was updated in 2001. The Uniform Limited Liability Company Act was enacted in 1996 and then updated in 2006. The act clearly makes the creditor's only remedy a charging order. There isn't any transfer of rights other than the economic interest, i.e., the expectation of a distribution of profits. That protects the company from the attacks that come against the individual partners and members.

Erosion of Charging Order Protection

There have been cases where the courts have flat out denied the charging order protection for an LLC. In the two highest profile cases, the LLCs were single member LLCs. (All the membership interests were owned by one individual—a single member.) In both cases, the single member was a despicable dude that really deserved to be nailed.

In a Colorado court case (*Albright*, 291 B.R. 538, 540 [D. *Colo*. 2003]), the judge addressed a bankruptcy of the owner of a single member LLC. The judge gave the bankruptcy creditor the right to take both the economic interest and the management interest of the member. Basically, the court ignored the charging order protection the LLC was supposed to give its member. The *Albright* court reasoned that charging orders were developed to protect the other members/partners in the business activity. Since there was only one member, there wasn't any need to protect anyone else, so the court gave the creditor everything.

In a Florida Supreme Court case (*No. SC08-1009 Shaun Olmstead vs. FEDERAL TRADE COMMISSION, [June 24, 2010]*), the court "set aside" a single member LLC and let the personal creditors of the LLC owner come directly against the LLC assets. The creditor (FTC) in the *Olmstead* case was simply given the assets of the LLC to satisfy the LLC owner's debt. Olmstead was a bad dude. So the good guy won, even though it was the government. This means Florida has come out against the charging order protection that the Revised Uniform LLC Act says single member LLCs should enjoy.

Denial of charging order protection for single member LLCs is definitely the trend for the courts and state legislatures. For example, the Ninth Circuit bankruptcy courts (Western States) have said they will not apply charging order protection to single member LLCs. Utah and Idaho have legislatively stripped single member LLC charging order protection. The bottom line is, single member LLC charging order protection is under attack today. Note, this does not mean an LLC doesn't offer the corporate shield protection for its single member owner from activities of the LLC. It simply means the personal creditors of the single member owner can use assets of the LLC to satisfy the debts of the sole owner of the LLC.

Therefore, if you want to ensure that you get charging order protection, you need to seriously consider having someone else own some of your LLC. I would say at least 5%, because that is the threshold the IRS uses for "significant" ownership of an LLC.

You could use less than the 5% for a second member, because there is no set amount, but to be safe, I think 5% is a good number. Just be reasonable and treat the second member with all the respect of a full partner. However, remember in a community property state, you should use a child or someone other than the spouse, because spouses in community property states are considered to be a single ownership unit.

Give the Creditor the Income Tax, but NO Income

When a creditor gets a charging order, it is possible to shift income tax burdens to the creditor without ever making an actual distribution of cash to the creditor. Having said that, you need to know that the income tax trick won't work in most situations.

It is quite clear that when the creditor gets a charging order, he simply gets the hope of an economic benefit. He doesn't really stand in the shoes of the member. He basically just has a

lien against the membership interest. If however, the creditor "forecloses" on his charging order, then he does stand in the shoes of the member, and he does have to recognize the tax consequences of being in the member's shoes.

At the end of the year, each member gets a K-1 tax form showing the member's profit or loss in the LLC. If the LLC has a profit, but doesn't distribute any income to the member, the member will show income for tax purposes even though he never got any money. Thus, it is entirely possible that the LLC could force a tax burden on the creditor and never transfer any cash to the creditor.

Most creditors who get charging orders do not foreclose on the charging order. If the creditor does not foreclose, his lien can be satisfied by having the LLC pay out enough money to get rid of the lien. Once the charging order is satisfied, the charging order is rescinded.

If the creditor forecloses on the charging order, the lien becomes permanent. The creditor doesn't get any more rights to management of the LLC, but the lien is good forever. The creditor gets the economic benefit forever.

If the creditor forecloses, he can be in an unpleasant situation. With no right to ever force a distribution, no right to manage or vote, and the possibility of getting phantom income that creates a tax liability, most creditors simply don't try to foreclose on a charging order. In fact, most creditors don't try to collect through a charging order.

If you can get rid of your creditor at a deep discount, the LLC and charging order have done their job. The LLC has given you the opportunity to settle with your creditor for pennies on the dollar and have the situation go away. That's great asset protection. Unfortunately, many advisors don't concentrate on charging order protection and don't write the LLC or limited partnership documents to provide good charging order protection.

When you set up an LLC, the articles of organization are forms you have to file with the state. Just filing papers with the state isn't going to give you the benefits of an LLC you are hoping for. You have to do more than just file. You have to create an operating agreement (the bylaws) for your LLC. The operating agreement is something some people forget about or they get the attorney's latest generic "boilerplate" version. However, the operating agreement is critical. You basically get to define what charging order protection you'll get out of your LLC, and that's done in the operating agreement, not the articles of organization.

If you write your operating agreement with the nuggets that beef up charging order protection, the courts will honor those documents in almost every situation. If the operating agreement says that no distributions will be made to an "assignee" or "transferee" of a member's interest, many of the state courts will honor that.

You also need to make sure that you actually follow everything that you set up in the operating agreements. Corporations and LLCs will often mess this up by doing only half the needed paperwork. They are seldom managed correctly, in accordance with that operating agreement (if they even have one). There are a bunch of things you have to do routinely in order to insure that your corporation or LLC will actually protect you when there is a problem. Not only do bad records hurt you if you are audited, but they can sink you if you get sued.

They will always sue you and your corporation or LLC. When you get to court, you will ask the judge to dismiss the suit against you personally. That part of the suit against you can be dismissed if you can prove that the company is a real company and not just an extension of yourself or your "alter ego." If you haven't done what the law requires you to do to have a corporation and get its protection, the judge can't use the law to protect you. He will have no choice but to "pierce the corporate veil" of your corporation or LLC. If no formalities have been observed, then the company (corporation or LLC) will simply be considered your alter ego—you.

As a side note, whenever you establish a legal tool, such as a limited partnership, corporation, or LLC, the tool or entity has to be integrated with your living revocable trust. Very few corporations or LLCs are ever integrated with the owner's estate plan. It isn't hard to integrate your company into your estate plan. All you have to do is remember to take ownership of the stock or membership interests in the name of your living revocable trust and not your own name. Stock in corporations and membership interests in limited partnerships or LLCs are assets that you have to sign your name for in order to transfer them. To avoid probate they have to be owned by your living revocable trust. And if you are electing to file as an S corporation, they need to be held in a special Subchapter S qualified trust.

BUSINESS DEDUCTIONS

Ordinary and Necessary

Business expenses must be ordinary and necessary. This is determined by an "all-events" test under which all facts and circumstances are considered, including the degree of effort that the taxpayer has expended in the pursuit of the income.

"Ordinary" means that the expense is considered normal for a taxpayer in a similar trade or business.

"Necessary" means the expense must be appropriate or helpful to the business. Whether or not an expense is necessary will be determined by looking at the situation **at the time** the expense was incurred.

It is advisable to record your expenses within a reasonable period of time—at least quarterly. The longer the time between when you incurred the expense and the time it was recorded, the fuzzier your memory will be and the weaker your case will be for including it as a deduction in your business.

Continuing Education

Education required to maintain a license or a profession is deductible as a necessary business expense. Education which is not used to maintain or improve your current profession is not deductible.

Membership Dues

Membership dues paid to professional organizations are deductible, provided the membership is used as a means of advancing the business interests of the taxpayer (business) and the principal purpose of the organization is something other than conducting entertainment activities for members or their guests.

Licenses and Fees

Obviously, licenses and fees paid to regulatory agencies or government bodies in order for your business to legally conduct business are deductible.

Insurance Premiums (other than Health)

Liability, Worker's Compensation, and malpractice insurance premiums are deductible as a business expense. Fire, flood, and theft insurance premiums for the business are deductible as well. However, premiums for insurance to cover loss of earnings, secure a loan, or self-insure reserve funds are not.

Employee Expenses

When employee business expenses are reimbursed to the employee by the company, the amount reimbursed is not included as wages on the W-2 and is excluded from the employee's gross income. There needs to be proper evidence of the expenses reimbursed, and the expenses need to have been made on behalf of the company as ordinary and necessary expenditures.

Legal and Professional Services

You can deduct fees charged by attorneys and accountants that relate directly to operating your business. Fees for tax advice for your business are also deductible.

Section 179

Section 179 is a very useful tool that can help you manage your net earnings and thus minimize taxes in a specific year. Before we get into the section's use in detail, you will want to make sure you understand a few related expensing strategies.

Depreciation

Depreciation is a reasonable allowance for exhaustion, wear and tear, and obsolescence on certain types of property used in a trade or business for the production of income. To qualify for depreciation, the property must:

1. Be used for the business or held to produce income
2. Have a useful life of over one year. Assets with an expected useful life of one year or less (like some tools) are deducted as *current* expenses in the year their costs are incurred.
3. Wear out, decay, become obsolete, or lose value from natural causes

Depreciation of a property begins in the tax year it is placed in service and ends in the tax year it is retired from service. Other notes to keep in mind include:

- Land is not depreciable, but buildings are.
- Property used exclusively for personal purposes is not depreciable.
- Inventory held for sale to customers is not depreciable.
- Repairs/improvements that increase value of a property, make it more useful, or extend its useful life are capitalized and depreciated.
    - Repairs merely maintaining property are deductible.

Timing

If you are being taxed as a sole proprietorship or general partnership and want to save on self-employment taxes over multiple years, the name of the game is to get your net earnings as close to zero as possible without going under into a full loss.

Self-employed individuals who incur losses in some years and realize profits in others will pay more self-employment taxes than a taxpayer who earns the same total income but incurs no losses. Losses that put you below zero may lower your AGI when combined with other income, but give you no advantage in self-employment taxes. If you are able to move some of the loss that takes you below zero into another year that otherwise would show a net profit for that same business, reducing the profit amount will mean you pay less self-employment taxes in that other year. Instead of paying no self-employment taxes one year and high self-employment taxes the other, you pay a lower combined amount for the two years together.

For example, in order to keep my son's garden business from being classified as a hobby, I told him not to deduct all the fertilizer expenses every year in order to show a profit every so many years. Showing even a small profit is sufficient. Suppose he bought enough fertilizer to last for several years all at once. Using the fertilizer the next year meant he didn't have to buy it again and made a tidy profit, which he paid self-employment taxes on.

Suppose he realized he also needed to replace some worn gardening tools. He might be able to use the old ones until spring, but if he buys just enough tools before the end of the year to offset nearly—but not all—of his profit, the self-employment taxes he will be liable for in the current year will be nearly non-existent.

Because the amount you expense is limited to the amount of taxable income from all your trades and businesses, if you have a huge loss confined to a single year, you may not get the entire potential benefit of that loss. Because you can't pay less than $0 in self-employment taxes, it makes sense to accelerate or defer some expenses so that they count for the year that you need to offset income. Spreading out your expenses or losses in this way brings multiple years' income closer to the $0 level for you to pay self-employment taxes on. You save on self-employment taxes over a multiple year spread.

So plan your timing of revenues and expenses to prevent net operating losses. Some ways you can do this include:

- Elect the straight-line optional method for computing depreciation on assets purchased during the year.
- Delay discretionary expenses such as advertising.
- Accelerate income and/or defer expenses to avoid a business loss that would otherwise never be deductible for self-employment tax purposes.

Section 179 Deduction

Section 179 gives you a way to accelerate depreciation, within certain limits so you can "time" your deductions on depreciable property. It's an incentive created by the U.S. government to encourage businesses to buy equipment and invest in themselves. Essentially, Section 179 allows businesses to deduct the full purchase price of qualifying equipment and/or software purchased or financed during the tax year, in which the purchase is made. Only a specific amount of equipment can get an accelerated depreciation under Section 179. The amount depreciable has traditionally been about $200,000 of equipment purchased in a specific year.

You can elect to depreciate all or just part of certain qualifying property under Section 179.

Equipment that qualifies for an 179 deduction includes:

- Tangible personal property
    - Machinery and equipment
    - Property contained in or attached to a building, such as a refrigerator, counters, office equipment, testing equipment, signs
    - Livestock
- Other tangible property
    - *NOT buildings or their structural components*
- Single purpose agricultural or horticultural structures
- Off-the-shelf computer software
- Qualified real property
    - Qualified leasehold improvement, restaurant, or retail improvement property
- Property NOT acquired only to produce income
    - *Investment property, rental property when rentals are not your trade, or property that produces royalties will not qualify*
- Property used at least over 50% for the business if used both for business and non-business

  * Multiply the cost of the equipment, vehicle(s), and/or software by the percentage of business use to arrive at the monetary amount eligible for Section 179

- Must have been acquired by purchase
  * NOT bought from one member by another member of a controlled group
  * NOT under stepped-up basis rules when acquired from decedent
  * NOT from a relative—*If the seller is related to you, only 10% is usable*

Detailed information on Section 179 can be found at:

http://www.section179.org/section_179_deduction.html

Be sure to check on the latest numbers. Congress has been known to increase the limit temporarily at the last minute, year after year.

The Section 179 deduction itself is all about using the time value of money through accelerating deductions. You should remember that an immediate deduction is not as useful:

- If the business has overall losses
- If the business will be in a higher tax rate in future years
- If a cashout through a sale of the business is anticipated

You will be taking the same depreciation amount in your business whether you count it all in one year or spread it out over the use life of the property. Use 179 only if it makes sense to accelerate depreciation and write off the full amount of your purchase in a single year.

Use section 179 if you need to depreciate the full value of the qualifying item and the depreciation can be used to offset current income in your business. If your business will have a loss in a tax year, then don't use section 179 and depreciate the item using the normal depreciations schedules. This will help you move most of the depreciation to future years when you will have income that can be offset by the depreciation recognized.

Section 179 does come with limits. There are caps to the total amount you can write off under the Section. Only the first $200,000 in qualifying items can be depreciated under section 179 in the year of purchase. Section 179 was passed to help small businesses by allowing them to deduct the full value of purchased qualifying assets in the year the assets are purchased.

And there is an important catch. In order to use Section 179, the equipment you purchase must also be placed into service in the year it is purchased. More or less, the equipment must be paid for and actually placed into use during the tax year in order to use Section 179 and accelerate the depreciation. Actually, in order to depreciate property in any specific tax year, the equipment must be paid for and used during the tax year. If the equipment is not used during the year, then depreciation must be postponed until the tax year in which the equipment is actually used.

280A(g)

If you rent a residence to your business for up to 14 days per year, that rental income for no more than 14 days per year, is tax free to the landlord. If you are renting the residence to your business for business purposes, the business gets a deduction for the rent paid and you don't have to report the income you get from the rental of the residence. Thus, you can remove income from the business tax free. This is a small loophole, but it can certainly help a small business that has good profits get some of those profits out to the owner(s) tax free. The applicable law reads as follows:

IRS Code Section 280A(g)

26 USC § 280A - Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.

(g) Special rule for certain rental use

Notwithstanding any other provision of this section or section 183, if a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the tax able year, then—

(1) no deduction otherwise allowable under this chapter because of the rental use of such dwelling unit shall be allowed, and

(2) the income derived from such use for the taxable year shall not be included in the gross income of such taxpayer under section 61.

Make sure you 1) have a legitimate business use and 2) that you take a reasonable rent. If you follow both rules and have less than 15 days rental a year, you should be in the clear. A residence doesn't have to be your principal residence. Also, make sure that you have your company actually pay the rent!

Basically, it is where someone can sleep and fix meals. You can have more than one residence in a year that you apply 280A(g) to. For example, a personal residence and a second home or even a boat or motor home will often qualify. The IRS defines it in 280A(f) as a "house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to such dwelling unit."

Travel and Vehicles

Travel Per Diem

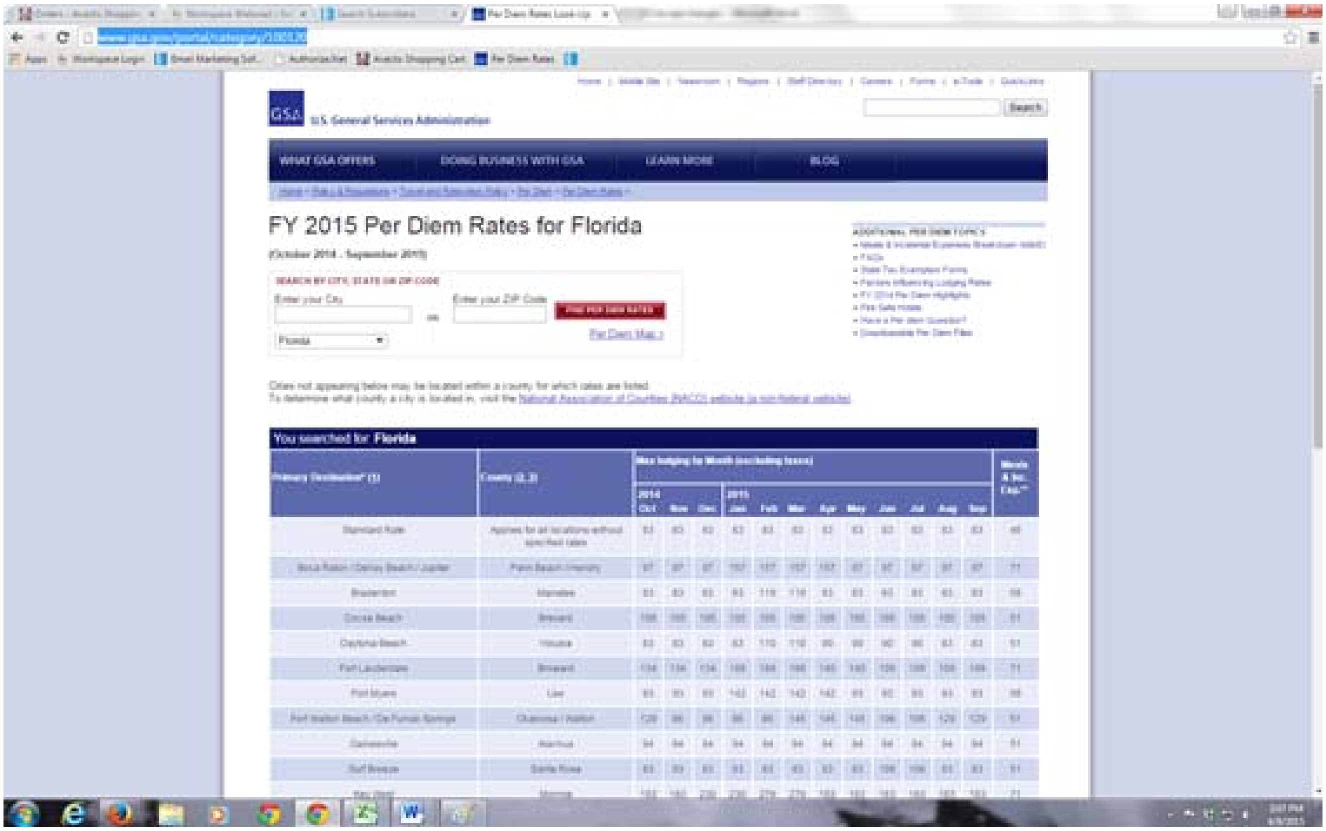
You can reduce your taxes by documenting your expenses when you travel for business reasons. In order to obtain a deduction for travel and entertainment expenses, you need to document the following:

- Amount
- Time and place
- Business purposes
- Business relationship to persons entertained

Documentary evidence is generally required for any expense incurred for lodging while traveling away from home and for any other expense of at least $75.

In general, if you are self-employed, you can deduct 50% of the meals you eat while you are away from home overnight for business reasons. [Code Sec. 274(n)1)]. However, you could instead choose to use the per diem rates. If you happen to eat less than the actual per diem amount allotted for food in a day, you can still take the full per diem amount, and that ends up being tax-free money in your pocket.

http://www.gsa.gov/portal/content/104877



http://www.gsa.gov/portal/category/100120

Vehicles

Vehicle deductions are a highly targeted item by the IRS because they are often over-exaggerated and incorrectly applied. It's probably not a good idea to put a vehicle in the business' name for tax purposes. Audit risk aside, there are a number of reasons for this:

- A taxpayer usually receives no benefit from Code 179 for the purchase of a business automobile. The code severely limits the total amount that you can deduct for depreciation and for the purchase.
- Liability insurance is much higher for a commercial vehicle than it is for a personal vehicle, so insuring a business vehicle generally costs THREE TIMES as much as insuring the same vehicle in your own name.
- State registration costs are much higher for commercial vehicles than for personal vehicles—a difference of hundreds, if not thousands of dollars.

According to the tax laws, non-corporate business owners are allowed to deduct actual expenses incurred for their vehicle (gas, depreciation, repairs, etc.), or alternatively calculate their deduction by using the standard mileage rate for business mileage incurred.

Most vehicles being depreciated are titled and insured under the business owner's name rather than the corporation. A corporation cannot depreciate an asset it does not own. The corporation does not own your vehicle; it's owned by you. You certainly understand that you couldn't depreciate your neighbor's vehicle. Thus, vehicle deductions are often disallowed because the vehicle is deemed a personal asset of the shareholder, not an asset of the corporation.

However, as an employee of the corporation, you are entitled to reimbursements from the corporation. Under an accountable reimbursement plan, you can be reimbursed for business miles you travel.

Consider using your personal vehicle for business use, keeping track of your mileage and submitting the mileage for reimbursement from your company. The reimbursement payment does not need to be reported as income by you and it counts as a deduction for your business.

Commuting to and from your office is considered personal and is not an allowable business deduction. However, if you accomplish a business function during the trip from home to work, the entire trip is deductible. For example, you could drop off or pick up the mail at the post office on your commute to or from work. Deductible business mileage also includes trips to meet with clients, business trips, errands, etc. The standard mileage rate is set by the IRS and is adjusted annually.

The business standard mileage rate is adjusted each year to reflect inflation. For 2015 it is set at 57.5 cents per business mile. (Yes, it does cost you that much to operate your vehicle.) If you take the mileage deduction, you don't need gas/maintenance receipts. You do need a mileage log detailing the date of the trip, business purpose, miles driven and starting/ending locations. You then multiply the amount of business miles driven by the standard mileage rate in order to figure out your tax deduction.

You can always switch from using the standard mileage rate to actual expenses, but once you switch to using actual expenses, you cannot revert to using a detailed mileage log.

Mileage reimbursements are TAX FREE to you and deductible by the business. Make sure to document your business miles (but remember that commuting miles from home to work usually do not count). Without good records, you may lose the mileage deduction. Adequate records for business miles include the following:

1. Account books, diaries, logs
2. Documentary evidence
3. Trip sheets
4. Expense reports
5. Written statements of witnesses

For most business owners, it works best to keep a mileage log. The log should include the date of travel, where they went to and from, the business purpose of the trip, and the mileage driven.

You need to establish a practice of recording the relevant information when it is fresh in your mind. Submit your requests for mileage reimbursements to your company at least quarterly.

Have your business reimburse you based on the current standard mileage rate. It is important that you actually reimburse yourself and label the payment "mileage reimbursement." The business will deduct these reimbursements as "auto expense."

SHIFTING INCOME

Shifting income to someone else is a long established tax planning technique of the wealthy. Income is moved away from family members in a higher tax bracket to family members in a lower tax bracket. Earned income cannot be shifted. Only passive income can be shifted.

Professionals can shift income by holding their business equipment in a separate company that they have set up. Their main business rents the equipment from the company that owns the equipment. The company that holds the equipment is "owned" by the children or older members in the family. This is not only a good asset protection move, it can also save the family on taxes. The business gets a tax deduction for paying the rent and the kids or older family members get the rental money as their income. More money ends up in the family's pocket, because the family members who get the rental income are usually in a lower tax bracket than the professional. Thus, less money is paid in taxes by the family as a whole.

When income is shifted in this way, the professional can end up with a lower adjusted gross income (AGI), which is a major goal.

Shifting income is still a great tool in the tax fight, but it has had its wings clipped. Some time ago, Congress passed the "Kiddie Tax" to make shifting income less effective. The Kiddie Tax applies to passive or "unearned income." It does not apply to earned income. Unearned income is income produced by assets, like rental equipment, real estate, or stocks. Earned income is the income an individual earns through selling goods or services.

The Kiddie Tax says that for kids up to 18 years of age, unearned income above a minimal level can be taxed at Daddy's rate. The age is extended to 24 if the child is a student who is claimed as a dependent by Mom and Dad on their tax return. If the tax applies, the income is taxed at the parent's highest rate instead of the child's, completely negating the strategy. However, parents can still transfer income-generating assets to children, and if the income for the tax year is under $2,000 in 2014, the child's lower rate applies. As children reach the age of majority and continue earning substantially less than their parents, the opportunities to shift passive income increases.

There is no question that this is a discriminatory tax. Let's say your child bought some stocks, bonds, real estate, or some other income producing assets on their own, with money they had earned. The income earned by the child's assets will be subject to the Kiddie Tax. The child will pay tax at Dad's rate, even if Dad had nothing to do with obtaining the asset.

Fortunately, every "child" is allowed around $2,000 in unearned income. $1,000 of that is counted as the child's Standard Deduction and the next $1,000 is taxed at the child's rate. All of that first $2,000 in unearned income will not be subject to the Kiddie Tax. Until the $2,000 limit is reached by each child, the Kiddie Tax doesn't kick in.

There are a few other ways to get money to your family without messing with the Kiddie Tax. One is to hire your kids to work for you, which gives them earned income that is not subject to the Kiddie Tax. If you hire your children to work in your company, make sure to document when the work was performed and the amount of time the child worked. The wages can be deducted as a business expense, but remember that it needs to be a reasonable wage for the work performed. And, just like any other worker in your business, you need to give them a W-2 form by January 31 of the following year, if they make enough money to qualify (about $600). A parent can also match the child's wages up to $5,500 with a Roth IRA contribution in the child's name. This will reduce the parents' future tax on investment income by the amount of the return on the contribution, which would grow tax-free.

Another alternative is to shift income to other family members who do not fall in the age bracket covered by the Kiddie Tax. Older family members who need help are usually in a lower tax bracket than the family members actually earning the money. If you shift the income to these older family members, the family as a whole saves taxes and more money is available to take care of aging parents. It is a little more complicated, because Social Security payments and other senior government assistance programs have to be figured into the mix.

AUDITS

What triggers an IRS tax audit is something we all want to know. Let's face it, nobody wants to get a letter from the IRS announcing that they will be auditing your return. Even if everything is in order, it is a time consuming nightmare.

So what can you do to avoid IRS tax audit triggers?

DIF Score

The first thing to do to avoid IRS tax audit triggers is to make certain your tax deductions and credits are in line with what others in your line of business tend to claim. This is tracked using a computer scoring algorithm called Discriminant Information Function or DIF.

The DIF evaluates tax returns based on certain IRS formulas. The IRS categorizes businesses by their NAICS code. Information on basic deductions, credits, and exemptions from businesses with the same code are combined, and some random audits are performed to confirm the numbers for that line of business.

If your return is radically different than others with the same code, that could trigger an IRS tax audit. The IRS will examine your return to spot inconsistencies and look for reasons to audit, such as a high mortgage interest deduction with inconsistent income to support the payment.

Ways to lower your audit risk:

- Have the correct NAICS code
- Minimize LUQ (large unexplained or questionable) amounts
- Set up taxation as any entity EXCEPT sole proprietorship
    - Only field agents can audit general partnerships, S corporations, and C corporations. Because they are paid higher, there are far fewer of those agents, often in short supply due to tight IRS budgets.
    - Any type of agent can audit a sole proprietorship, so your chances in the audit lottery are higher.
- Don't have too many years of losses in a row
    - The IRS may decide they need to au dit you to decide if your business is actually a hobby

Ways to come out ahead even if you are audited:

- Don't commingle money between your business and personal accounts.
- DO keep good records, easily found and explained.

The bottom line is that you should be careful when filing your return and keeping records to back up your deductions. But you shouldn't let fear of an audit keep you from filing for tax credits or deductions that you honestly qualify for. The IRS generally is held to a 3 year statute of limitations on auditing a filed return, but there is no limit on how long they have to audit you if you didn't file.

So do your best. If you are audited and some expenses are disallowed, they will adjust your totals and you will pay the difference. Generally, the only way you get in jail-time type trouble is by not fully reporting your income.

According to US Code 7201:

> Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.

IRAs

Individual Retirement Accounts (IRAs) are one of the eleven tax shelters left in the IRS Code. There are ways to get money into an IRA in addition to annual contributions, but directly or indirectly they all involve a "return on investment." Any tax strategies that involve putting money into an IRA need to qualify the money going into the IRA as a return on investment made by the IRA.

IRAs are technically not qualified retirement accounts. They do not fall under the Employee Retirement Income Security Accounts (ERISA), like your 401(k) does. They are a special type of trust.

IRAs have been around since 1974. Through the years the IRA act has been modified. The last modification was the Taxpayer Relief Act of 1997. It substantially raised the income limits applying to taxpayers, so even more folks could participate in IRAs. The act also introduced "Roth" IRAs. Roth IRAs allow contributions that are not deductible at the time you make them, but later can be withdrawn tax-exempt.

Unlike the 401(k), IRAs are not run by employers. Because of how the IRA act is structured, self-employed folks without pensions are able to get the same kind of tax advantages given to pensioned workers, plus one additional benefit: it is possible to stretch an IRA past your death.

Section 408 of the IRS Code is the law of IRAs. An IRA is a 408 Trust. It has a trustee: someone or a company approved by the IRS. The IRA trust has beneficiaries. While you are alive, the IRA can only have one beneficiary—you. But your IRA should list successor beneficiaries. If the beneficiary is a living breathing person, then that person can "stretch" the IRA over their lifetime.

IRAs protect the growth from income taxes. The Supreme Court has upheld the protection of IRAs from bankruptcy in Rousey v. Jacoway. In most states they are protected to at least some degree from all creditors. For example, Nevada has a $500,000 exemption for IRA funds in all circumstances.

Choose Your Custodian Wisely

The whole concept of an IRA is an account that is controlled by a custodian (trustee) that the IRS has qualified and approved.

Self-directed IRA custodians are not all created equally. When the self-directed IRA industry caught on in a big way about fifteen years ago, there were a limited number of custodians and t hey seemed to be a lot more interested in following the law. Today, it's more of a free for all. Sometimes it seems that the philosophy of the industry in general is, "Tell the dumb IRA owner whatever they want to be told, and sign up their account."

One of the big self-directed IRA custodians started franchising offices about 15 years ago. They recruited quite a few franchisees and had a big operation going within a couple years. Everything went along fine until the IRS figured out that each of the franchisees was managing their accounts independent of the franchisor.

The franchisor was an IRS qualified self-directed IRA custodian, but since they didn't actually manage the IRA accounts of each franchisee's clients, the accounts were not being managed properly. The individual franchisees weren't considered a qualified self-directed IRA custodian.

The IRS came in and shut all of the operation down. Most of the IRA "owners" didn't really know what happened. They just knew that things changed. Some of the franchisees went through the steps of getting individually approved by the IRS as custodians, and some just collapsed. The IRS was nice and didn't go directly after the IRA owners.

The penalty for placing an IRA in the hands of a non-qualified person is the loss of the IRA, if the IRS decides to come after the individual accounts. So do some homework when you choose a self-directed IRA custodian. Don't be afraid to ask questions and get exact answers.

Traditional IRA Versus Roth IRA

A Roth IRA or Roth 401(k) are great vehicles that let money grow tax free. When you retire, you can then take the money out tax free. You are not required to take required minimum distributions, so you can leave the money in or take it out as you wish. Of course, any time money is put into a Roth it is "after tax" money. You pay the tax at the beginning. Everybody says the **Roth** is the way to go, but you may or may not want to do a Roth.

In contrast, a traditional IRA is funded with a pre-tax dollar. The dollar then grows in the IRA without a tax, and when the dollar and growth are taken out of the IRA they are considered ordinary income, and income tax is due. The standard statement is, "don't use a traditional IRA, use a Roth."

There are a number of reasons why you would or wouldn't want to invest in a Roth. Understanding those reasons and then looking at the long term tax trends will help you plan your retirement. The reality is that understanding these trends could help you make more money in every aspect of your financial life. The following table shows you the difference between investing in a Roth IRA vs. a Traditional IRA.

As the table demonstrates, *if there is no difference in tax rates*, the after tax dollars spent out of the IRA for the Roth are the same as with the traditional IRA. The take-home message? Use the Roth if you think tax rates will go up in the future and use the traditional IRA if you think tax rates will be lower in the future when you need the money.

You can now also have a traditional 401(k) or a Roth 401(k), which are similar to IRAs. There's a little PS here. 401(k)s are almost bullet proof asset-protected tools. IRAs are subject to state laws, so whether or not you can lose them depends on the state. In contrast, 401(k) plans are ERISA (Employee Retirement Income Security Act) plans and federal law applies. IRAs are protected in federal bankruptcy cases (Supreme Court ruling), but for common lawsuits, the protection isn't absolute in some states. Someday the Supreme Court may extend absolute protection to all IRAs in all states, but not yet. Bottom line: not only do the IRAs, 401k)s, and other retirement vehicles give you a great tax advantage, they are some of the best asset protection you can get.

Traditional IRA versus Roth

Assumed Tax Rate (Combined Federal & State) 25%		
Assumed Same Growth Rate on Investments (10%)		
Year	**Traditional IRA**	**Roth IRA**
1	$5,000	$3,750
2	$5,500	$4,125
3	$6,050	$4,538
4	$6,655	$4,991
5	$7,321	$5,490
6	$8,053	$6,039
7	$8,858	$6,643
8	$9,744	$7,308
9	$10,718	$8,038
10	$11,790	$8,842
11	$12,969	$9,727
12	$14,266	$10,699
13	$15,692	$11,769
14	$17,261	$12,946
15	$18,987	$14,241
16	$20,886	$15,665
17	$22,975	$17,231
18	$25,275	$18,954
19	$27,800	$20,850
20	$30,580	$22,935
Tax Due at Withdrawal	$7,645	$0
After Tax Total	**$22,935**	**$22,935**

Stretching an IRA

The "taxed advantaged" investments you have may be your most valuable asset, and they are almost certainly the most valuable thing you can leave to your loved ones.

One of the most powerful financial and estate planning vehicles today is hidden in the IRA act. It allows a younger beneficiary to inherit and then "s-t-r-e-t-c-h" an IRA for their lifetime. By using a younger beneficiary's life to stretch the tax-deferral benefits associated with a Roth IRA, the IRA can grow tax free for years after your death.

While you are alive, you are the only beneficiary of your IRA. However, you should make sure that successor beneficiaries are listed as well. The first successor beneficiary should be your spouse, if you are married. The secondary beneficiaries should be the kids (if you have children and that's who you want to receive the IRA money). Name each kid.

Do not put your living trust as the beneficiary. If the beneficiary is a living breathing person, then that person can "stretch" the IRA over their lifetime in addition to yours.

Tax-free income growth is one of the most powerful ways you can grow money. The good news is that even if you have a qualified plan, such as a 401(k) or profit sharing pension plan, you can now take advantage of stretching this asset. You simply have to roll your qualified retirement account over into an IRA, according to the rules. You don't have to miss out on the opportunity to stretch the tax benefits of your retirement plan dollars into the next generation. Just be careful to ensure that you don't end up taking a tax hit instead.

Stretch Inherited Retirement Accounts

So how do you transfer a qualified plan into an IRA? By law, the rollover must be accomplished through a trustee-to-trustee transfer whereby the 401(k) plan administrator transfers the funds directly into a new IRA account that only holds the transferred 401(k) funds. In other words, have a broker help you.

One of the most important things you can do is make sure your beneficiary designations are up to date. This is critical to a successful transfer of the account to the next generation. It is important to note that the account's beneficiary designation trumps even the will in determining who will inherit the account.

You should not make your living trust the beneficiary of your life insurance, 401(k), or IRA. In each case make your spouse the primary beneficiary. ALWAYS name a secondary beneficiary. Your spouse may die 10 minutes before you at the scene of the automobile accident, and if you haven't named secondary beneficiaries, your IRA will end up going to your estate.

You do not want your IRA going to your estate. BIG MISTAKE!

If the estate is the eventual beneficiary of an inherited qualified plan (401(k)) or IRA, the heirs will lose the option of rolling the funds into an inherited IRA. This will cost them a fortune, because the IRA money growing in the tax-free or tax-deferred environment is a big deal.

If you fail to name a beneficiary, the IRA will likely be paid out to the heirs of your estate according to state laws. This will cause a loss of the tax-deferral benefits that can otherwise be realized with an inherited IRA.

You may be thinking, "I don't really care if my 401(k) is stretched. Why does it matter? I am not that wealthy, and the kids will probably need the money right away." If this is the way you think, you probably won't do anything. Then your qualified retirement plans, such as your 401(k) and profit sharing plans, will become subject to a different set of rules that won't allow your funds to be distributed over time. More or less, your retirement funds will be distributed in a single lump sum payment to your beneficiaries and they will have to pay income taxes on the entire amount they get. This can be particularly painful since the distribution will undoubtedly put them in a high tax bracket.

In contrast, the rules governing your inherited IRAs allow your beneficiaries to "stretch" the tax-deferral associated with your accounts, providing for a distribution of the accounts' value over a period of years following your death. Typically, an account beneficiary must either take distributions over his or her lifetime or exhaust the account funds within five years of the original owner's death. In both options, the account value continues to grow and also stretches out the tax liability that accompanies the distributions. Your beneficiaries will be able to have a lot more control over the tax bite.

While you may or may not be able to control the type of retirement accounts you have, you can maximize the tax-deferral benefits associated with your accounts. Stretching an IRA is a huge deal, because the money could stay in the IRA growing tax free for decades. In this way, a modest IRA can turn into millions of dollars for your family.

For example, a $500,000 IRA growing at 6% left to a 40 year old son or daughter can deliver over $2.5 million to the child during their lifetime. If the money is in a Roth IRA, it is even more valuable. After tax, the child can have millions of extra dollars to spend during their life.

Of course, there are rules that have to be followed. First, the money has to be in an IRA. Therefore, it might be a good idea to "roll" your money from your retirement account into an IRA. If you've retired, you have the right to do that.

However, never roll retirement money into an IRA that you already have established and have been making your annual contributions to. If you commingle the retirement money with existing IRA money, you lose options, such as being able to roll the money back into another retirement plan.

Multiple IRAs

You can have multiple IRAs. It is sometimes a good idea to break up your IRA into a number of IRAs and designate just one person as the primary beneficiary on each account. If there is a large age difference (more than about 10 years difference) in the beneficiaries, you definitely want to divide up your IRA now and create multiple IRAs. Then name each child or intended recipient as the primary beneficiary of one of the pieces of your IRA.

The reason you want to create different IRAs for each recipient is because when the beneficiary gets the IRA, they have to start withdrawing minimum required distributions from the IRA based on their life expectancy. However, if there is a group of beneficiaries, the required minimum distribution calculations have to be made on the life expectancy of the oldest member of the group. The younger members of the group won't get the benefit of having their IRA share grow during their entire lifetime.

If you want your children and grandchildren to benefit from your IRA, you'll need to create at least two IRAs—one for the kids and one for the grandchildren. And remember to always name secondary beneficiaries.

Because the IRA money is so valuable in your heirs' hands, make sure that you use your other money to live on and spend your IRA money as a last resort in your retirement. Yes, you'll have to take required minimum distributions, but don't take out any more than you have to.

Teach Your Children NOT to Touch the IRAs

Educate your children on the IRA stretch theories. IRAs are easy money for the beneficiaries. Most children immediately withdraw any money they inherit in an IRA and blow the money on a trip. You've got to tell them not to take any money out of the IRA. If you think one child will take it out, don't leave IRA money to them. Give them other assets.

It's a disaster when the kids take the IRA money to pay taxes (or for any other reason). In a traditional IRA, when the money is taken out, it is subject to income tax. Your heirs may have to get "cash" to pay estate taxes. IRAs are part of your taxable estate. Educate your kids not to take the money out for any reason. The temptation is to take the "cash" out of the IRA to pay the estate tax, because the IRA may be the most liquid asset in your estate.

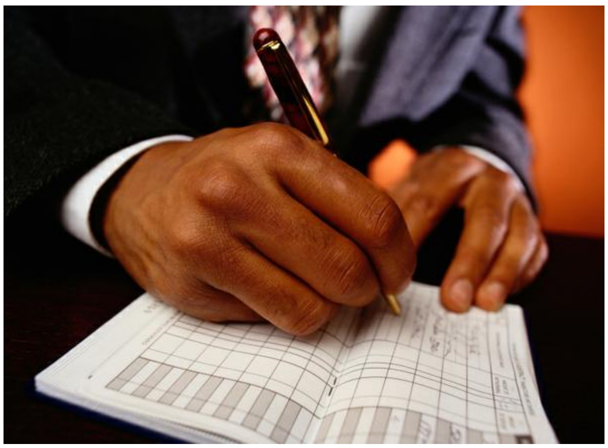
When the child takes the money out to pay your estate tax, that generates an income tax—on the order of a 50% tax, because the amount he takes out goes right on top of all other income and boosts him into the highest federal and state tax brackets. With a huge income tax, the only place he can get the money to pay the huge income tax is to take more money out of the IRA, but that generates more income tax. This can go on until there is nothing left in the IRA. If this scenario starts to unfold, the child will actually lose 105% of the IRA in some states when the estate taxes and income taxes are stacked on top of each other.

If there will be an estate tax liquidity issue, buy life insurance on yourself to give the family money to pay the estate tax. (Use the *Accumulation and Preservation of Wealth* course and do some estate planning to eliminate the tax, and use an irrevocable life insurance trust to make sure the life insurance goes estate tax free.)

I can't overstate how important it is to train yourself and your family on the IRA stretch. Because of the tax treatment, your IRA in the hands of your family can do incredible things, and your Roth IRA can be stunning. And even better, the IRAs are fully asset protected in addition to being tax advantaged.

Checkbook IRA and Other IRA Traps

Because of the IRS's crackdown in tax shelters, many taxpayers—innocent or not—now face additional scrutiny. As the government cracked down on the high-end shelters, promoters turned to Middle America to market tax avoidance schemes. In reaction, the IRS turned its attention to Middle America, too.



Checkbook IRAs

A recent "fad" in real estate investing is using IRA money to buy real estate. There's no question that if you have cash today, you can get some great real estate investments. The place people have cash is in their IRAs and retirement accounts.

Buying real estate in an IRA becomes thorny over two issues. First, the trustee has to "do the deal," and second, if there isn't enough money in the IRA to buy the property outright and then maintain it once the IRA owns it, there are lots of issues.

The nice thing is, if you get real estate in your IRA, any profit from rents or appreciation goes into your IRA's tax preferred environment. It is a return on investment.

As you know, you need to have a "self-directed IRA trustee" to buy real estate or do anything more than invest in traded securities. The trustee has to take title to the property. Technically, you can't enter into the picture. The trustee has to sign the offer, do the counter offer, close on the purchase and do everything in between. Of course, you are standing in the wings telling the trustee what to do. It's just a matter of filing another paper with the trustee and paying the associated fee.

If you get too close to the deal, you will cause the whole thing to be disallowed by the IRS when they look at it. You can't sell your IRA a property you already have under contract or own. That's called "self-dealing," and it's a big no-no in the IRS world.

You can't take the check to the closing, sign any papers, or have anything to do with the whole deal. Man, that's a pain.

To cut the pain, many self-directed IRA trustees have come up with a technique called a "Checkbook IRA" that will solve the problem. It's a trap. DON'T DO IT!

It sure sounds good though. Look at what one of the websites says:

> *"With your self-directed IRA, you can invest in real estate, tax liens, personal loans, private businesses and more with the ease of writing a check and without transaction, holding or asset-based fees. Tap the purchasing power of your IRA before retirement age without incurring early distribution taxes or penalties!"*

Use a little logic with me for a minute. Do you really think the IRS is going to let you tap the purchasing power of your IRA before you are 59½ and not incur any taxes or penalties? The whole IRA game is set up so you can't get your IRA money before you are old enough. That's why you have a trustee managing the assets for you. Do you smell something wrong?

There are a few variations in checkbook IRAs, but the deal basically goes down like this:

1. You establish your IRA with an opportunistic self-directed IRA trustee. Often you get a trustee that doesn't care what you do. The trustee probably doesn't care if you lose your IRA to the IRS. The trustee is insulated, because all he has to do is say he was following your directions. That will get the trustee off of most "hooks" the IRS and others might put out.
2. The trustee gets a percentage of your IRA's "net worth" each year. So if you're a trustee, the name of the game is to get as many funds under management as possible. As a result, most trustees will tell you whatever you want to hear. Just because the trustee will let you do it, doesn't mean the IRS will let you do it.
3. You establish an LLC and have the trustee move all of the IRA money into the LLC. Basically, the IRA is buying the stock or "membership interests" in the LLC, just like it would buy stock in Exxon.
4. Now the LLC will have all of the IRA money. Oh, by the way, you are the manager of the LLC. Now as manager of the LLC, you have "checkbook" control over the IRA funds, and can do whatever you want with those funds.

You don't need the self-directed trustee guy to do anything else. Of course, he still gets his management fee each year based on the worth of your IRA (the value of the stock in the LLC). Most IRA owners that fall for the checkbook IRA scams really are out to use the money in the LLC to buy real estate or do something else that will make more money in the LLC. However, you could take the money and go to an LLC manager's meeting in Hawaii.

All of the laws associated with IRAs are put into place to prevent you from getting at your funds until you are "of age" and then you pay the tax when you take them out. (Yes, Roth IRAs don't pay the tax when you take the money out, but the IRA game was created before the Roth, and the Roth still has to follow the rules.)

The checkbook IRA sites will all cite the Swanson case where Mr. Swanson created a second corporation to "sell" the tools Swanson Tools manufactured. He had his IRA buy all the stock in the sales company that sold Swanson Tools. There were no employees, no additional infusions of capital and the corporation paid all of its income taxes before any dividend was paid to the IRA shareholder. Swanson was president of the corporation. Swanson was paying all of the sales commissions for selling tools to the sales company, and all of the commissions were going straight to the IRA.

The case doesn't say what all of these folks say it says. I have read the case a number of times and discussed it with many attorneys. The short story is, there is no way you can extrapolate the case and justify checkbook IRAs. All of the folks arguing for checkbook IRAs cite the case as justification for checkbook IRAs, and then create a bunch of dust around their justification to fuzzy things up.

The IRS is well aware of checkbook IRAs and the use of IRAs coupled with LLCs. If they follow the usual pattern, it is only a matter of time before the IRS will shut down these plans. The folks will lose their IRA money and face penalties in addition to the loss of their IRA money. It will not be happy.

The Dirty Dozen

I have mentioned the list of the top dozen tax shams the IRS puts out each year. Go to the www.IRS.gov and search for "dirty dozen."

A few years ago, they singled out LLCs and IRAs under Abusive Retirement Plans:

> *"The IRS continues to uncover abuses in retirement plan arrangements, including Roth Individual Retirement Arrangements (IRAs). The IRS is looking for transactions that taxpayers use to avoid the limits on contributions to IRAs, as well as transactions that are not properly reported as early distributions. . . . Other variations have included the use of limited liability companies to engage in activity which are considered prohibited."*

If you have control over the money as the manager of the LLC, does a checkbook IRA sound like an early distribution? Isn't "Tap the purchasing power of your IRA before retirement age" an early distribution?

What about "transactions that taxpayers use to avoid the limits on contributions to IRAs"? Once the house is purchased in the name of the IRA, any repairs, services or expenses associated with the house are either going to be paid by the IRA, or whatever is paid on behalf of the IRA will be considered a contribution to the IRA. If you pay the expenses, you are adding value to the IRA. If you pull the weeds at the property, you are adding value to the IRA.

The IRS is specifically gunning for IRA and LLC combinations. Several years ago, the IRS tried to get Congress to prohibit ownership of an LLC membership interest by an IRA. The law didn't pass, but President Obama has, by executive order, given much broader powers to the IRS and nearly doubled the number of IRS agents.

IRA—LLC Keys to Abuse

When an IRA owns an LLC, there is too much chance for abuse—intentional or through ignorance. (Ignorance is no excuse under the law.) There are two specific areas of abuse that are going to ruin the whole IRA/LLC thing for everyone.

First, the LLC has to pay taxes. LLCs are often set up as "pass-through" entities. That means the tax responsibility passes through to the membership interest holders and they pay the income taxes when they get a K1. If an LLC collects rent, the responsibility for paying taxes on the rental income passes through to the IRA. The LLC is a pass-through entity and doesn't pay taxes on its own. The owners pay the tax. Since the IRA is a non-tax entity and the income "passes through" to the IRA, people just assume no income tax is due. This is wrong.

To make certain non-tax entities paid taxes on earnings received through business activities in the 1980's, Congress passed the Unrelated Business Income Tax (UBIT). UBIT laws require a tax exempt entity, like an IRA, to pay income tax on revenue it receives from activities unrelated to its tax exempt status. So the LLC needs to pay tax on the rents it collects, profits it makes on the sale of the property, and all of the other "sources of income" a non-exempt taxpayer (you) would have to pay if you owned the membership interest in the LLC instead of owning it through your IRA. After the taxes have been paid, then any after-tax profit can be claimed by the IRA.

Another favorite use of an LLC linked to an IRA is to buy properties using funds borrowed by the LLC. Encumbering an IRA in any way is a prohibited transaction. Therefore, people set up an IRA and then have it "own" an LLC which borrows the money and purchases the house. Provided a ton of rules are followed, there isn't anything wrong with that per se.

However, there are laws associated with the purchase of property with debt. IRS Code Section 514 expands "unrelated business income tax" (UBIT) to include "unrelated debt-financed income" (UDFI) from investment property in proportion to the debt acquired in purchasing it. Property purchased with borrowed money ("acquisition indebtedness") and held to produce investment income is called "debt financed property." An exempt entity (an IRA) has to pay the UDFI tax and the UBIT.

The Bottom Line

The bottom line, if it sounds too good to be true, it probably is. The IRS is out to get any "arrangement" where an entity is set up specifically to avoid application of certain tests, such as fiduciary responsibility or any scheme to avoid a prohibited transaction. Specific regulations have been passed to deal with these invalid arrangements (C.F.R. § 2509.75-2(c)). This includes circumvention of the custodian requirement set forth in IRS Code Section 408.

IRAs are great tools, but don't push the envelope. It will take the IRS 10 years to shut down the LLC loopholes, but they will do it, and there will be a lot of unhappy people. Please avoid the traps, and pass this information along to those who are looking at the trap. The gurus with all the tax tips will point out that they have clients that have been using their scheme for several years. Don't let that fool you. There is no statute of limitations for prohibited transactions involving an IRA. The IRS simply isn't exercising their rights to go after the abusers—yet.

Insurance Plans Acting as IRAs

Tax advantaged investments come in a number of different forms. Obviously, your retirement accounts and IRAs are the ones you would think of first. But you should make sure you also look at life insurance.

Life insurance is the sweetheart of the IRS, not to mention one of the best asset protection vehicles in existence. Not only does the industry have huge lobbies to protect insurance interests, but the government wants to make sure your beneficiaries will reap their financial rewards rather than going on the government dole after your death.

Your cash value life insurance is tax advantaged to you while you are alive, but not to your family after your death. In planning for your retirement, you can make a life insurance policy act almost exactly like a Roth IRA. In some ways the life insurance acting as a "nonqualified retirement plan" is better than a Roth IRA. For example, there are no contribution limits, required withdrawals, discrimination rules, adjusted gross income regulations, or other regulations that restrict your use of a Roth IRA.

Be very, very careful though. The insurance companies can burn you in a New York minute. We have read hundreds of life insurance policies and only seen one or two good ones. Those are bad odds, so call me if you try to play the life insurance cash value game and actually try and use your cash value as a source of retirement funds.

IRAs, 401(k)s, and life insurance policies are all contracts. In each one of them, you will name a beneficiary. They are not subject to probate, because the terms of the contract determine where the asset will go after your death. They actually supersede your will and living trust.

Charities

Most charitable deductions come out below the line, but there is a way to maximize your contribution and affect your numbers above the line as well.

If you tend to give large amounts to a specific charity, and you own any properties or investments that have done very well, it is possible to donate the property or stock directly to the charity. If you sell the property, there will be a gain on the sale, and you will be taxed on the gain. It may be short term capital gains or long term capital gains, but there will be a tax if you have made money when the property is sold. If you sell the property, get the money for the sale, pay tax and then donate the cash to your favorite charity, that's probably not the best way to handle the transaction. You can avoid the capital gain taxes from the sale of the property if you contribute the property directly to the charity. You can still take the current value off of your taxes as a charitable contribution, but you skip paying the capital gains tax.

For example, most charities will take a donation of stock. If you make your contribution in this way, you get to write off the value of stock rather than what you paid for it. The net result is that the charity will get more than if you sold the stock, paid the tax and then donated what money you had left after tax to the charity.

Say you bought some stock for $10 and it is now worth $100:

- If you sell the stock, you now have a capital gain tax on the $90 you made in profit—the difference between its initial cost and current value.
- But if you donate the stock directly to the charity, the charity gets $100 and you can claim a full $100 as your charitable contribution *and* avoid paying the taxes on any capital gains from it.

Additionally, if you sold the stock, that $90 in profit will go as an increase to your Adjusted Gross Income. It is possible that the additional income could move you into a higher tax bracket or trigger other tax considerations, such as the Alternative Minimum Tax, exemptions phaseouts, the new Obamacare tax, etc.

Making donations directly to a charity also works well for required distributions from your IRA. If you are old enough that you have to take distributions AND you regularly give substantial amounts to charity, there are multiple benefits to making the charitable donation directly from the IRA to the charity. Direct contributions mean that you do not have to take the distribution as income, which would increase your AGI and could both put you into a higher tax bracket and affect any Social Security distributions you may qualify for.

For eligible tax years, individuals age 70½ or over can exclude up to $100,000 from gross income for donations paid directly to a qualified charity from their IRA. Key points about qualified charitable contributions include:

- The donation satisfies any IRA required minimum distributions for the year
- The amount excluded from gross income isn't deductible.
- Donations from an inherited IRA are eligible if the beneficiary is at least age 70 ½.
- Donations from an SEP or SIMPLE IRA aren't eligible.
- Donations from a Roth IRA are eligible.
- Married individuals filing a joint return may exclude up to $100,000 donated from each spouse's own IRA ($200,000 total).

http://www.irs.gov/Retirement-Plans/Charitable-Donations-from-IRAs

With the Tax Increase Prevention Act, the provision that allowed certain IRA owners to make tax-free distributions to charity was extended through the end of 2014. Note that while this type of extension is common, there is no guarantee of what Congress may decide to do in the future.

In summary, making contributions to a charity after selling stock or property, or taking a distribution from an IRA, means that you have to recognize the charitable contribution as a deduction below the line. Contributing the asset directly to a charity means that any gains from the asset are kept off your AGI, which gives you a tax break above the line.

One more note: charitable donations must be made by a year's end to qualify for a deduction. The donation has to be made—not merely pledged—in order to count.

If you are going to be making charitable donations anyway, how you handle them can make a big difference on your taxes.

SUMMARY

Making a lot more money is what this is all about. There isn't a lot you can do by yourself as yourself to control your taxes—you have to have an entity to do it for you.

The tax aspects and legal structure have to go hand in hand if you are going to create wealth. Entities give asset protection. Keeping it is often more important than making it, and the IRS is a major impediment both to keeping or growing what you have been able to make. Use the correct structure to minimize the IRS tax effects and you'll have a lot more to work with and grow one year to another well into the future.

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