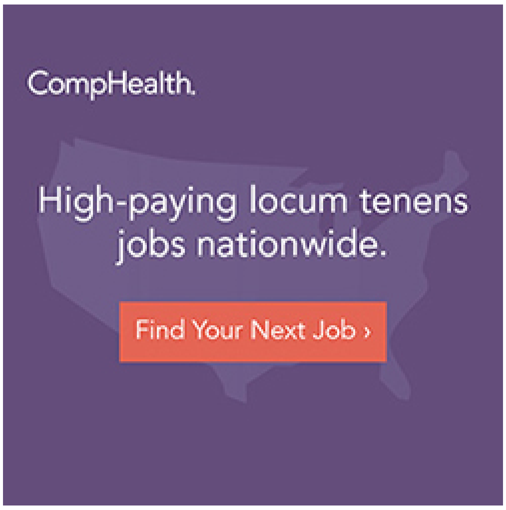
A Visit With a Tax Strategist



I had an interesting experience recently. A tax planner married to a doctor read my book. He had this to say:

> *I am a CPA that specializes in taxes. [My wife] purchased your book and we read it together and I have to say, I was very impressed. I have several physician clients and I will be referring your book to them. Still, when I read the part where you said that you do your own taxes I was skeptical. It is true that many CPA's don't specialize in aggressive tax planning, but I find it hard to believe that your tax bill is as low as it could be if you are doing your own returns. Now that the tax deadline has passed and I have more time, I would like to issue a challenge: give me a copy of your 2015 tax return. Black out the names, address and the Social Security numbers and let me just see the dollar amounts. I am convinced I can show you some ways to save on your taxes. Prove me wrong.*

I'm not sure how he was expecting me to respond, but I like to think my ego isn't all that large and I've always got plenty to learn. I read this email as "here's a CPA willing to give me a free tax strategy session and look over my taxes for errors." All it would cost me is a little time via email and phone and copying and blacking out tax returns. Plus, I was well aware that my 2015 return was significantly more complicated than my previous returns had been. I was particularly concerned about all the tax forms I had to fill out with regard to selling my rental property in 2015, since that was the first time I'd done that and I spent a lot of time on it. I've never actually had a tax professional look at my tax returns, and I haven't yet been audited. So who knew what he would find? I had a little worry that he would find I was underpaying my taxes by tens of thousands.

So a few days after I sent Scott Keithly at Keithly & Glenn Tax Consulting, LLC most of my tax forms (I just couldn't stand to copy, black out, and scan all 150 pages that Turbotax spit out) he got back to me with some great suggestions. Mostly, I was just happy that he confirmed I wasn't dramatically underpaying my taxes and that I'd done the rental property disposition exactly right. He noted a few minor things I could have done better, particularly on the WCI partnership return I did this year for the first time (I guess we'll find out how much the IRS cares about that) but really nothing worthy of filing a 1099X over. Which was good, since I had already done three of those this year! I was also curious about what he would charge to do my taxes and the figure came in around $1500, which was about what I would expect for such a complicated return. This year I definitely spent more than

$1500 of my time doing them, but hopefully that'll get easier in the future.

At any rate, I thought it would be fun to write about some of the suggestions he made to me. These aren't suggestions in ways to fill out my tax forms better. They're suggestions in ways to live my financial life differently that would lower my tax bill.

 # 1 Form a C Corp

I've written before about C corps, years ago. There was this post about the benefits, this one about the downsides, and this one about how lots of doctors mistakenly think incorporating is the key to reducing their liability and taxes. However, when I wrote those posts, my financial life was significantly different- almost all my income was from my practice and WCI wasn't making squat. It was reasonable to reconsider a C Corp for WCI.

The big problem with C Corps is the double taxation issue. Yes, a corporation may have a lower tax rate than you on a limited amount of income, but when you pull that money out, it is taxed again at your qualified dividend rate. Once you've been double taxed, there isn't all that much benefit there. You minimize this double taxation by just paying out all profits every year as wages. By doing that, you get any side benefits of having a corporation and pay about the same amount in income taxes. The other issue with a C Corp is the expense and hassle associated with forming one, maintaining one, and dissolving one. So you're really weighing the side benefits against those costs and hassles. So my discussion with Scott was about the side benefits.

Gold Level Scholarship Sponsor

Here were the benefits that I could personally use if I incorporated. Be aware that most of these work for me because I'm a business owner, not a doctor and your situation will almost surely differ.

Decrease Medicare Taxes

Avoid paying medicare taxes on our employer 401(k) contributions. That's $35K a piece, or $70K a year. 2.9% * $70K = $2,030.

HRA

Set up a Health Reimbursement Account (HRA) and pay for our health expenses using that rather than our HSA (or what we're doing now, a taxable account.) This would allow us to pay for health care with pre-tax money while still allowing our HSA to keep growing. There would be some cost and hassle there for sure, but there's potential to save $1-2,000 a year there given our high deductible. According to this, the maximum that can be put in there is about half your deductible, so $4500 a year given our current plan. If it isn't used, it goes back to the employer, which is also me, so no big deal there. It could become a big deal if I start hiring non-family member employees for WCI though.

LTC

Pay for long term care premiums with pre-tax dollars. I'm not super interested in that option, as I plan to self-insure this expense.

NQDC

Set up Non Qualified Deferred Compensation accounts. Basically, this is a contract between me as an employee and me as a business that my business will retain some of my earnings, pay taxes on it at the lower corporate rates, and then pay it out to me at some later date. It avoids the double taxation issue because what is later paid to me and is fully taxable is a deduction for the corporation. So taking the money out, assuming the corporation is still making good money, is basically a wash from the tax perspective. Since the first $50K a corporation makes is taxed at 15%, the next $25K at 25%, and the next $25K at 35%, if I'm in the top bracket, there is an arbitrage there. If I just pulled that money ($100K) out and paid 39.6% on it, I would owe $39,600 in taxes. But if I did this, I would only pay 15%*$50K= $7,500 + 25% * $25K = $5,000 + 35% *$25K = $8,750 for a total of $21,750, a savings of $17,850 in taxes. (More if you include state taxes, especially if I move to a no-income tax state before withdrawing it.)

Now that gets me pretty excited. What's the downside? Well, I have to incorporate. That means either learning more tax forms or paying someone else to do them. I also would have to pay an attorney to setup and dispose of the corporation. And I'd probably have to pay a company to do my payroll. But all that pales in comparison to $17,850 a year. What could go wrong? Well, WCI isn't exactly GE. Who knows if it will be here and making good money in 20 years when I want to pull this money out. Without that deduction to offset my taxes on the withdrawals, I would end up just getting double taxed (it would end up being about 150% of what I would have otherwise paid.) This strategy would get even better if corporate tax rates are lowered. Clearly this could work great in the right situation, although I'm having trouble seeing where I would need to pull the deferred money out of WCI while WCI was still making lots of money. Maybe if I sold it, but then I'd have to worry about the new owners making good on the promised compensation. First world problems we're dealing with here.

Remember that doctors who form corporations for their practices often have to use a professional service corporation, which doesn't get those lower tax rates on the first $75K of retained earnings. It's all taxed at 35%.

My Thoughts On an S Corp

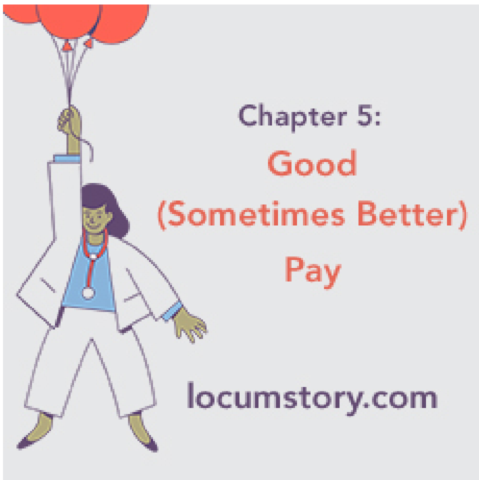
Now, I hadn't really considered doing a C Corp, but I had seriously considered an S Corp for WCI in the next year or two. I really only want enough wages out of it to max out our 401(k)s, which we were barely able to do for 2015. But let's say WCI hypothetically made $600K going forward. Well, we could take $200K each for wages, enough to max out our solo 401(k)s, and call the other $200K distribution and save the Medicare tax on it. That would save us $5800 a year, more as income goes up (if income goes up.) A C Corp couldn't do that. But the potential tax savings from the C Corp could be larger for us, particularly when you include the NQDC.

 # 2 Buying Life Insurance as a Business

Another thought Scott had, although he knew I probably wouldn't go for it and he actually hasn't ever had a client that did (he doesn't sell insurance so has no reason to give the idea a "hard sale"), was the idea of buying cash value life insurance through the business. He knew I'm not big on either lots of leverage or cash value life insurance, but he thought it was worth mentioning. Basically, the way it works is you buy a huge whole life policy using borrowed dollars and use the policy as collateral on the loan. The premiums aren't deductible to the corporation but the interest is. Then hopefully your tax savings is greater than your after-tax interest cost. I've written about a similar scheme before, and it won't surprise any of you to see that I'm not going to be implementing this suggestion. However, he calculated the potential to save up to $43,600 in taxes. A video about this strategy might be worth debunking some time. Let's just say I might save $44K in taxes, but I think I'd be better off skipping this option when all is said and done. It is clearly a great way to sell more insurance!

 # 3 Using a Charitable Lead Annuity Trust

We give a lot of money to charity every year. It helps keep our taxes low as we deduct it on Schedule A. Scott suggested we might like to use a Charitable Lead Annuity Trust (CLAT) instead for our charitable giving. Remember with a CLAT that you put a big lump sum into a trust, get a tax break for it in this year, the charity gets something like 6% annuity payments every year for 18 years or so, and then you get what's left. Meanwhile, the money is invested in something (like real estate) that hopefully earns more than 6% a year. So after 18 years, you get more money back than you put in, plus that big huge deduction 18 years ago. What you lose, however, are the costs associated with setting up the trust, all the taxes you owe on the earnings of the trust over the years, and the deductions you would have gotten from making annual cash donations to the charity from your earnings instead of the CLAT. I can see where this would work well for someone who is charitably inclined and received a big lump sum from the sale of a business or something and needed to lower his taxes in that year and who supports a single charity. For someone like me who expects to have rising income over the years (at least for a while) who supports multiple charities and doesn't want to be locked into one, and needs ongoing tax deductions, I'm not sure it is so useful. There would be some benefit from the time value of money (i.e. getting the deduction up front) but I don't think it works well for my charitable plans-i.e. contributing a percentage of my income each year.



Gold Level Scholarship Sponsor

 # 4 Oil and Gas Partnerships

I've frequently heard the phrase that the only investment that gets more tax breaks than real estate is oil and gas. As near as I can tell, that's true. In fact, Scott suggests it is possible to invest $50K into oil and gas and then write off $45K in intangible drilling costs that same year. He warns it does increase your AMT however. My big beef with this idea is that you never want to buy an investment just for the tax benefits. The investment has to make sense on its own first, and the tax benefits should be gravy. My little beef with this is that I don't know much about oil and gas and would need to find someone I trusted to assist with that investment. It's a nice idea, and maybe I'll delve in there at some point in the future, but not something I'll be implementing any time soon.

It was nice to have Scott take a look at things. Maybe I'll even use him in the future to prepare personal or business tax returns. If you're interested in meeting with a tax strategist, I'm sure he'd be willing to help out. *[Disclosure: Since I wrote this, Scott now advertises here at the WCI and a number of readers have availed themselves of his services.]*

What do you think? Have you ever met with a tax planner or strategist? Does your tax preparer do these sorts of things with you? Do you have a C Corp? Why or why not? Comment below!