SELECTED TOPICS ON ASSET PROTECTION

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Piercing the LLC Veil

Recent court cases have allowed creditors of an LLC to pierce the LLC veil making the LLC members personally liable for the company's obligations. The effect of these cases is to reverse the legal protections which allow investors and business owners to limit their personal liability to the amount invested in a venture. One example of current trends in LLC veil piercing is Martin v. Freeman (2012 COA 21. No. 11CA0145), discussed in the note at the end of this article.

Many physicians use Limited Liability Companies to hold investment assets such as equipment and real estate or to operate a business outside of their practice. LLC's are generally easier to form than corporations, have fewer formal operating requirements and offer a greater variety of tax planning options.

Limiting Personal Liability

Most importantly for some, the basic tenet of LLC law is that members and managers of the LLC are not personally liable for the debts of the company. This is known in legal terms as limited liability and it prevents a creditor of an LLC (or a corporation) from pursuing the personal assets of an owner. The problem is that the purported protection of the LLC law is often and increasingly disregarded by the courts under a variety of legal theories leaving personal assets exposed and unprotected from business risks - exactly the result that the owner was attempting to avoid. In this month's article we'll address the reasons why the courts are reaching these surprising conclusions and what steps can individuals take to protect themselves from unexpected and possibly significant financial losses.

This limitation on liability is a crucial factor in operating or investing in a business venture. An investor wants certainty that personal assets, not invested in the business, are free from any potential claims which might arise. The concept of limited liability permits an individual to calculate the extent of the financial risk which is being assumed in relation to potential profits from the business. If a particular project involves a fixed investment of $100,000 then the risk and potential returns can be estimated and a rational decision about the value of the investment is possible. Limitations

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on personal liability are a foundation of any market economy because no individual or company would knowingly make an investment if the total cost of the investment, including potential liabilities, could not be reasonably calculated in advance.

For example, suppose that the initial $100,000 amount invested in the business was not limited in any manner and instead the total amount of the investors net worth - everything that the investor owned - was subject to a future claim of the business? That proposition is difficult or impossible to evaluate because in this case, the amount of the investment and potential liabilities cannot be accurately measured in advance and the value of the investment is uncertain. Individuals are justifiably reluctant to make investments which place all of their personal assets at risk and the typical solution is to use an LLC or corporation which is intended to limit this exposure.

Piercing the Corporate Veil

Corporate Formalities

The ability of a lawsuit plaintiff to reach the personal assets of the business owner is known as *piercing the corporate veil*. Prior to the widespread adoption of LLC legislation in all states in the early 1990's, corporations were the most widely used form of business entity. But corporations had some glaring defects in accomplishing this essential mission of limiting personal liability. Most notably, over the years, courts tended to weaken the corporate liability shield under a variety of legal theories. Thousands of cases on these issues have been decided and broad rights have developed for those seeking to "pierce the corporate veil" and hold the owners personally liable.

One legal ground for piercing is failure to follow corporate formalities. For example, corporations have certain legal formalities which must be adhered to, such as issuing shares, holding annual meetings, preparing minutes, and creating and maintaining governing bylaws. In cases where these formalities are not properly followed, courts have held that the legal liability protection of the shareholders was effectively waived and the personal assets of the owners could be reached by the plaintiff. This result is most likely to occur in smaller, family owned businesses, which tend to

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be less diligent in maintaining the corporate records than larger companies with the resources and staff necessary to meet filing and compliance requirements.

Alter Ego

A second rational for piercing the corporation veil is based on what is known as alter ego liability. What this means is that when an individual and a company are so closely linked that they should not be viewed as separate entities for legal purposes, the shield against personal liability will not be applied.

Over the years, courts have enumerated dozens of factors that should be considered in making this determination. Some of those examples mentioned frequently in the cases include: (1) commingling of funds and other assets, (2) the treatment by an individual of the assets of the corporation as his own, (3) the failure to maintain minutes or adequate corporate records, (4) the use of the same office or business location, employment of the same employees and/or attorney, (5) the failure to adequately capitalize a corporation, and (6) the use of a corporation for a single venture,

In making the determination under the alter ego test, the law is that no single factor is determinative, and instead a court must examine all the circumstances to determine whether to apply the doctrine. In reality, what this means is that in almost any situation, a finding of alter ego liability can be made depending on the outcome that the court would like to produce. There are very few circumstances under which at least one or more of the dozens of factors have not been violated at some point. Small businesses sometimes treat corporate formalities, written minutes and banking in a more casual manner than larger companies with staff and resources. Since there are so many factors which can be considered and the proper weight to be given to any particular factor is left entirely to the courts discretion, it is too often the case that if a court wishes to find alter ego liability, it is easy enough to do so. A reading of the cases demonstrates that similar fact patterns produce dramatically different results based on the particular conclusion which the court is attempting to shape. The outcome depends less on the conduct of the parties than it does on the courts view of what a just or fair result should be.

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Piercing the LLC Veil

What we have described above about piercing the corporate veil applies as well to Limited Liability Companies. LLC law in the states, as expressed in the legislation and court cases generally, permits piercing of the LLC veil to the same extent as corporate law. Although LLC formalities are sometimes not as strict as those of corporations, when the alter ego doctrine is asserted, a failure to hold annual meetings and maintain adequate company records may influence the court's decision on personal liability protection.

One of the unfortunate byproducts of the uncertainty surrounding the application of the law is an inevitable increase in the number of cases filed against LLCs and their owners. In fact, merely filing these cases, without much regard to merit, may be a profitable business strategy in itself. Lawyers and lawsuit plaintiffs take advantage of the unpredictable outcome of any case by routinely naming the owner as a defendant in litigation against the LLC. This move immediately places the owner's personal assets in jeopardy since he or she is threatened with potentially large legal costs as well as a real loss of personal assets if the plaintiff is successful. Depending on the size of the claim and the amount of the defendant's available wealth, plaintiffs and their lawyers know that there is usually strong motivation for the owner to settle to avoid litigation costs as well as the possibility of an unfavorable outcome in the case, When a legal outcome is uncertain, as it is in most veil piercing cases, plaintiffs lawyers working on a contingent fee have significant bargaining leverage over an LLC owner who must bear the costs of defending the litigation and the possibility of large personal losses.

How to Protect against Personal Liability

The first step to avoiding personal liability in these cases is to comply with the legal requirements concerning company formalities and operations as described in the cases and legislation. This certainly means that the initial organizational filings, IRS compliance and operating documents and procedures for the company are correct and properly maintained. The company should be adequately capitalized for its purpose and commingling of accounts, and undocumented contributions and distributions should be avoided. Following these legal requirements won't guarantee success, but

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depending on the facts of your case, may help tilt the scales toward avoiding personal liability.

As an additional safety measure, many business owners use asset protection planning to insulate and shield personal assets from the risk that their LLC or corporation will be pierced. This legal planning generally involves the use of strategies such as retirement plans, trusts and holding companies to protect assets such as homes, savings and investments. A full description of the asset protection techniques and planning used by physicians can be found at "Legal Guide to Asset Protection Planning."

Taking the proper steps to minimize the risks of business makes sense for those who have accumulated savings and investments. If these assets are intended to be held separately and apart from the liabilities of your business activities then some planning to accomplish this result should be considered. As a note of caution, make sure to discuss the details of your particular matters with your advisors to make sure that the tax and ramifications of your planning strategies are properly evaluated and are appropriate for your specific situation.

Note:

One example of current trends in LLC veil piercing is Martin v. Freeman (2012 COA 21. No. 11CA0145).

To pierce the LLC veil, the general rule is similar to that applied to corporations. The court must find (1) the LLC entity is an alter ego or mere instrumentality; (2) the LLC form was used to perpetrate a fraud or defeat a rightful claim; and (3) an equitable result would be achieved by disregarding the LLC form.

"Courts consider a variety of factors in determining alter ego status, including whether (1) the entity is operated as a distinct business entity; (2) funds and assets are commingled; (3) adequate corporate records are maintained; (4) the nature and form of the entity's ownership and control facilitate insider misuse; (5) the business is thinly capitalized; (6) the entity is used as a mere shell; (7) legal formalities are disregarded; and (8) entity funds or assets are used for non-entity purposes"

In concluding that the LLC was the defendant's alter ego, the court found:

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- *Tradewinds assets were commingled with Freeman's personal assets and the assets of one of his other entities, Aircraft Storage LLC;*
- *Tradewinds maintained negligible corporate records;*
- *The records concerning Tradewinds' substantive transactions were inadequate;*
- *The fact that a single individual served as the entity's sole member and manager facilitated misuse;*
- *The entity was thinly capitalized;*
- *Undocumented infusions of cash were required to pay all of Tradewinds' operating expenses, including its litigation expenses;*
- *Tradewinds was never operated as an active business;*
- *Legal formalities were disregarded;*
- *Freeman paid Tradewinds' debts without characterizing the transactions.*
- *Tradewinds' assets, including the airplane, were used for non-entity purposes in that the plane was used by Aircraft Storage LLC without agreement or compensation.*
- *Tradewinds was operated as a mere assetless shell, and the proceeds of the sale of its only significant asset, the airplane, were diverted from the entity to Freeman's personal account.*

Based on these factors (all fairly common for LLC operations) the court addressed the question of whether the LLC had been used to perpetrate a fraud or defeat a rightful claim. Perhaps, most disturbingly, the court found that since LLC protection would bar the plaintiff from collection, that fact itself satisfied the requirement that the LLC be used to defeat a legitimate claim. No proof of fraudulent intent was necessary.

"We conclude that showing that the corporate form was used to defeat a creditor's rightful claim is sufficient and further proof of wrongful intent

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or bad faith is not required." (Colorado Court of Appeals – LLC Veil Piercing)

As discussed above, LLC's were enacted by all state legislatures specifically to place limitations on personal liability-a crucial factor in all investment and business decisions. Sensible investors evaluate an investment by comparing the maximum loss against the potential rewards. LLC's, as well as corporations, were intended to limit an investor's risk to the amount of capital invested in a project. When the corporate or LLC veil can be pierced based upon court determined standards of "fairness" and "equity" the risk-reward calculation of an investments value is skewed. What if a $100,000 investment in a project can produce a $1 million personal liability if the entity veil is pierced by a court? Is it still a good deal? Strategies to protect accumulated personal assets from corporate or LLC veil piercing are becoming standard practice in business planning.

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Protect Assets From Unexpected Medical Expenses

A growing focus of our practice in recent years is on asset protection planning for individuals to protect against medical expense related liability risks. Medical expenses resulting from an illness or injury to yourself or a family member, represent the single most serious threat to your home, savings and future income.

The potential financial disaster is clear if you're uninsured. Although premium subsidies are provided under the Affordable Care Act (unless the Supreme Court changes this law) many millions remain without insurance. In these cases a trip to the hospital or any extended treatment can cause tens or hundreds of thousands of dollars in medical bills (assuming treatment can be obtained at all). If the physician or the hospital does not arrange a payment plan before the treatment begins, it will, most likely, pursue collection reasonably soon after. Depending on the law of your state, the assets which can be seized include your home and savings and other personal property.

What continues to be less well understood is that even for those covered under private plans, exchange plans or employer sponsored plans, the financial risk remains significant. Copays, large deductibles and uncovered treatment, represent potential liabilities which cannot be controlled. That's not an overstatement. Out of network physicians may be brought in during procedures or surgery *without a patient's knowledge or approval*. Depending on the coverage, insurance may cover none or a small portion of these charges.

A client seriously injured in an automobile accident spent several months in ICU and recovery. She underwent spinal surgery and numerous serious procedures. During spinal surgery her physician brought in an out of network doctor to assist, without the patients consent or knowledge. Total medical bills exceeded $1 million and although her insurance covered most of the charges, it did not cover the $85,000 separate bill from the out of network spinal surgeon. With copays, deductibles and out of network charges, she was left with total uncovered charges of $245,000, accumulating interest and late payment penalties.

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Despite the coverage requirements of the Affordable Care Act, insurer may simply refuses to pay large portions of what should be covered charges. This happened routinely before the ACA .

According to a study by the California Nurses Association California's largest insurers denied 13.1 million claims in just the first three quarters of 2010. That amounted to 26% of all claims submitted. For example, of these insurers, PacifiCare denied 43.9%–Cigna 39.6% and Anthem Blue Cross-27.3%.

"These rejection rates demonstrate one reason medical bills are a prime source of personal bankruptcies as doctors and hospitals will push patients and their families to make up what the insurer denies," said CNA/NNU Co-President DeAnn McEwen. The data, new findings by the Institute of Health and Socio-Economic Policy, the CNA/NNU research arm, is based on data from the California Department of Managed Care.

What happens if you receive medical treatment which runs into the tens or hundreds of thousands and your insurer denies the claim because of an unmet deductible, a copay, an out of network physician, or for a treatment or medicine that is not approved? Who pays the doctor and the hospital? If there is no insurance or the amount is limited, your provider will require that you guarantee full payment of the likely costs incurred, less any amount actually reimbursed by your insurer. Meaning, you're on the hook for whatever your insurance company fails to pay. If your insurer denies a claim that should be covered, you can fight it out and ultimately sue your insurance company but lawsuits take a long time and plenty of money that most people can't afford. That's exactly what the insurer is counting on and why it's more profitable to deny claims and defend the occasional litigation. The strategy of resisting a high proportion of claims is an essential and integral part of the business model of the health insurers even under the ACA.

When Patients Can't Pay

What happens when a large medical bill can't be paid? Usually the outcome is a lawsuit filed by the hospital or collection agency with a judgment and a lien filed against the patient's home and accounts. In most states, a percentage of the debtor's employment earnings can be garnished.

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Generally, before this point is reached, the patient files a personal bankruptcy to stop the wage garnishment and wipe out the medical bills and other accumulated debts. But that requires that he give up all of his assets including savings accounts, real estate and equity in his home. These assets, except those that are specifically exempt, are turned over to the court and divided among the creditors.

According to a study by Harvard University, about half of the 1.5 million annual bankruptcy filings are caused by illness and medical bills. And surprisingly, three fourths of those had health insurance at the start of the illness which triggered the filing. “Unless you’re Bill Gates, you’re just one serious illness away from bankruptcy”, said Dr. David

Himmelstein – the study’s lead author and an associate professor of medicine. “Most of the medically bankrupt were average Americans who happened to get sick.”

How Patients Protect Themselves

The high level of financial risk posed by an unpredictable medical event is now leading patients to take steps to protect their savings from this threat. For instance, I met with a couple in their early 50s. They have about $300,000 of equity in their home and $200,000 in savings. He is self-employed and She works for a small company. Both are covered under her group plan, but, with rising costs, the company might cut back or terminate the plan sometime soon. Individual policies or exchange policies may be available at that point but the cost and extent of the coverage will have the usual limitations. The goal of their planning is to protect current and future savings from large, unexpected bills at any point in the future. They need their savings for retirement and a substantial loss would be a financial and personal disaster for them.

Family Savings Trust

Asset protection with a specially designed Family Savings Trust can often shield savings from these events.

A Family Savings Trust is extremely flexible in form and can incorporate provisions, which combine the features of many domestic arrangements within the language of the plan documents. All of your assets can be held

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within the trust—but be governed by special terms appropriate for that asset.

For those concerned with protection against unexpected medical bills, a trust can be tailored to specifically to address the issue of medical expenses. For example, the trust may be designed to hold your home, and savings and brokerage accounts with the goal of protecting these assets from unexpected medical expenses. It is often designed to preserve the tax benefits associated with the home (including the mortgage interest deduction, property taxes, and avoidance of gain on a future sale), while carrying out appropriate estate planning and asset protection goals for family wealth.

Medical costs are the largest potential source of potential risk and liability that most people face. The actual risk of loss ranks higher than any professional or business activity we have seen. Most likely, you or a close family member will incur substantial medical expenses at some point and all or a portion of those costs will become a personal liability of yours. If you have a home or some savings, bankruptcy will not be a feasible option because those assets, over the exemption amount will be subject to the claims of medical creditors.

All estate planning devoted to preserving family assets should properly consider and appropriately plan for shielding accumulated wealth and future earnings from unexpected liabilities and risks.

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Why Your Living Trust May Be Broken

Living Trusts are the foundation of most estate plans. A properly drafted and funded Living Trust allows property to pass in a seamless transition to a surviving spouse or other family members without a court supervised probate and costly legal fees. Living Trusts can also be designed to provide significant tax savings as well as strong asset protection for surviving family members, shielding family assets from claims of future spouses or potential liabilities.

To preserve these benefits and avoid serious legal and tax consequences, Living Trusts drafted prior to 2013, when The American Taxpayer Relief Act of 2012 (ATRA) became law, should be reviewed and modified if necessary, to comply with these new rules. ATRA significantly impacted all estate planning with ramifications for years to come. Living Trusts which do not conform to the new law may face unfavorable tax results and burdensome administrative costs.

How ATRA Changed Estate Planning

As of December 2012, the US was approaching what was widely known as the fiscal cliff, which included a potential default on government debt and the expiration of the Bush era tax cuts. If allowed to expire, all individual estates in excess of $1 million would be subject to estate tax at a rate as high as 55%. The limitation on the exemption amount of $1 million would have impacted a significant number of individuals with retirement savings, equity in real estate or life insurance policies.

A key goal of estate tax planning has always been to attempt to double the available exemption amount by combining the husband's exemption with that of the wife. This was not a straightforward matter, however, because under the rules, an individual's exemption was lost forever upon the death of that spouse. For example, Michael and Sarah are married and have a total estate of $2 million, with a $1 million individual exemption then in effect. Michael leaves his $1 million share of their property to his wife Sarah. There is no estate tax on Michael's death because property left to a surviving spouse is not subject to tax. However, on Sarah's subsequent death, her estate is then $2 million ($1 million from Michael and $1 million

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of her share). Since Michael's exemption terminated on his death, the tax on Sarah's death is calculated based on her total estate of $2 million less her $1 million exemption. The result is a taxable estate of $1 million and a federal estate tax of approximately $400,000, based upon a rate of 40%.

Most estate planning avoided this result by creating a Bypass Trust. Rather than have Michael's share pass directly to Sarah, provisions in their Living Trust instead directed that amount to a Bypass Trust. Sarah would not have full ownership of the funds from Michael but would instead have the right to all income from the Bypass Trust, plus the use of principal for health, education, maintenance and support. Under IRS regulations, since her use of these funds was limited to these prescribed purposes, on her death, the amount in the Bypass Trust would not be included in her estate and no estate tax would be due. Sarah's estate would consist only of her original $1 million and not the $1 million from Michael, which went into the Bypass Trust. Since Sarah would have her own $1 million exemption, there would be no taxes on her estate and no taxes on the amount in the Bypass Trust. The effect of this planning with the Bypass Trust was to eliminate the estate tax of $$400,000 on the total combined estate of $2 Million.

New Exemption Amount and Portability

ATRA had a significant impact on this planning in two important ways. First, it permanently increased the individual estate tax exemption to $5.25 Million (adjusted for inflation). Far fewer people will have estates which are subject to potential estate taxes.

Secondly, ATRA adopted a concept known as "Portability" which combined the estate tax exemptions of a married couple. Without using a Bypass Trust, the surviving spouse is permitted to combine each spouse's exemption for a total of $10.5 million to apply against the total estate value. Now, for example, if Michael leaves his estate of $5.25 million to Sarah, who has a similar estate value, on the death of Sarah, the estate can combine the total exemptions so that the full $10.5 million is not subject to tax. The use of a Bypass Trust no longer increases the available exemption.

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Eliminating the Bypass Trust

No Basis Step-Up

If the Bypass Trust no longer provides estate tax savings should it be eliminated from your Living Trust? Often the answer will be yes. The Bypass Trust may create additional income taxes because property held in the Trust will not receive a step-up in tax basis on the death of the surviving spouse. That means that property in a Bypass Trust, which appreciates in value prior to the death of the surviving spouse, will be subject to capital gains taxes when sold by surviving family members.

Again, in the case of Michael and Sarah, say their combined estate is now $5 million. On Michael's death, his share is $2.5 million and is allocated to a Bypass Trust. If, by the time of Sarah's death, the original amount has appreciated to $3.5 million, this increase in value is subject to capital gains taxes on Sarah's death. With the effective federal capital gains rate now about 22.8 percent, that is $228,000 in federal taxes. If the couple had not used the Bypass Trust, Sarah's estate would have totaled $6 million and would not have been subject to estate tax. Significantly, the tax basis of all of the property in Sarah's estate would have been increased to the value on her date of death and that step-up would have eliminated all capital gains taxes.

New Rules

- If a couple has an estate that will not exceed the total exemption amount of $10.5 million, the Bypass Trust should be eliminated from their planning. This will avoid capital gains taxes on appreciated property and administrative costs associated with the maintenance of the Bypass Trust.

- If family assets currently exceed, or may in the future exceed, the exemption amount of $10.5 million, the Bypass Trust can be useful to protect future asset appreciation from estate taxes. If the calculation is that estate taxes will exceed the capital gains tax on appreciated assets, the Bypass Trust will provide tax savings and should be considered.

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- Regardless of the size of the family estate, if part of the estate planning goal is to create liability protection and to protect the value of assets within the family, the Living Trust should be designed so that these features are incorporated into the estate plan while minimizing taxes and administrative costs.

These rules are necessarily broad and certainly will vary based on individual circumstances. Determining current and future estate value is subject to a variety of necessarily imprecise forecasts. Our suggestion, as always, is to discuss all aspects of your planning with an experienced attorney who can evaluate each of the relevant factors to carry out your goals in the most efficient and flexible manner.

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Cook Islands Trusts:

Prudent Planning or Tools for Scoundrels?

In addition to the issues with Cook Islands Trusts discussed in this article, several recent developments with foreign trust and bank account reporting should be addressed.

Citizens and residents of the U.S are required to report and pay taxes on their world wide income. While domestic financial institutions provide 1099's to the IRS with customer names and account income each year, offshore banks did not provide this information. Although U.S taxpayers are required to voluntarily report income from foreign earnings, many failed to do so. A vast and virtually impenetrable offshore financial industry developed in these no tax jurisdictions with strict bank secrecy rules. The effect was to allow U.S. taxpayers to avoid payment of U.S. taxes on foreign account income to the estimated tune of $40-$70 billion annually.

After a long history of unsuccessful attempts by the U.S. (and other countries) to persuade or coerce the offshore havens to supply information on the accounts of particular targeted taxpayers the U.S adopted strict legislation in 2010 which effectively requires all foreign banks to provide account information for all U.S . customers. The key provisions of the Foreign Account Tax Compliance Act ("FATCA") became effective in 2014 and 2015 and foreign banks and trust companies are implementing necessary reporting systems as required.

The full impact of FATCA on offshore trusts in countries such as the Cook Islands is not yet fully know. Foreign bank account information, including beneficial ownership and income will be reported by the financial institution to the IRS. Trusts which do not hold foreign bank accounts may be subject to similar reporting requirements. However, many trusts which are intended to be treated as U.S trusts for federal tax purposes, may be exempt from the FATCA filing requirements.

In most cases, individuals who have created foreign trusts for asset protection purposes, rather than attempted tax avoidance, will not be affected by the FATCA rules. As discussed below (Are Secret Accounts and Offshore Havens Gone for Good) foreign banks are sometimes reluctant to accept U.S. customers because of FATCA compliance burdens and costs.

However, offshore trust companies with established banking relationships and compliance procedures in place are likely to continue providing trust services for those seeking particular asset protection benefits.

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The Cook Islands is a popular offshore haven, offering unique asset protection and privacy benefits for wealthy individuals throughout the world. Those with high liability risks, such as physicians, real estate developers and business owners often put assets into Cook Islands Trusts to shield their wealth from potential lawsuits and claims. At the same time, complaints are growing that these trusts are a favorite of corrupt politicians and other lawbreakers, taking advantage of these laws to hide and protect illegal funds. Are Cook Islands Trusts a legitimate planning technique or an international haven for criminals stashing their gains?

First a little background. In 1989 the Cook Islands, a former Protectorate of New Zealand in the South Pacific, began an effort to diversify its tourist economy and attract a robust financial services industry. New laws were enacted which focused heavily in the area of asset protection. These laws clarified a jumble or age old court cases and conflicting laws in other jurisdictions and created a single clear and detailed legislative scheme which permitted the establishment of trusts intended to shield and protect assets from lawsuits and claims. Through these initial efforts and various modifications and court challenges over the years, it is generally acknowledged that the Cook Islands has the strongest asset protection laws in the world. Assets in the trusts are not disclosed to the Cooks Islands authorities and the law makes it a crime to identify who owns the trusts or to provide any information about them. Judgments from foreign countries are not enforced in the Cook Islands against the trusts established there, assets of the trusts cannot be seized by a creditor, and the trustees are required to maintain strict secrecy regarding the owners and beneficiaries of the trusts. The Government of the Cook Islands has no treaties or mutual assistance agreements (as the Swiss do) which would permit disclosure or cooperation with a foreign creditor or even a government agency in a collection action.

Who Uses Cook Trusts?

According to a recent article in the New York Times, the Cook Islands, as an asset protection haven, has perhaps worked out too well- opening the door to a variety of illegal and questionable activities. (Cook Islands, a Paradise of Untouchable Assets). The point of the story is that because these trusts have been difficult or impossible to pierce, they have been a magnet for fraud artists and crooks. Convicted ponzi-schemer R. Allen

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Stanford and various corrupt government officials from around the world ---- used Cook Islands Trusts to protect the proceeds of their activities from defrauded victims and government pursuit. Efforts to recover funds from the Cook Trusts have been largely unsuccessful.

"Even the United States government has had a hard time going up against a Cook trust. In a lawsuit that has dragged on for years, Fannie Mae, a government-sponsored lender, is still waiting to collect on a $10 million judgment against an Oklahoma developer who defaulted on his loans. In legal filings, Fannie Mae says it has collected only $12,000 — and "that is not for lack of trying." The "clear purpose" of the trust, Fannie Mae's complaint said, "is to avoid payment of the judgments obtained by Fannie Mae," efforts that the agency called "brazen."

Recently released documents of leaked files by the International Consortium of Investigative Journalists provide evidence that Cook Trusts have indeed been used to help shield the assets of many politicians and celebrities throughout the world. How and why these supposedly top secret files ended up in the hands of journalists is a story for another day. For now, there is no doubt that some significant portion of the wealth of the rich and famous is parked in Cook Trusts.

Although clearly subject to potential abuse, my own experience in establishing and monitoring hundreds of Cook Trusts over the years, is that generally these trusts are set-up to accomplish legal and prudent asset protection goals. Liability risks from operating a business or a professional practice are well known and understood at this point and many individuals sensibly wish to protect accumulated assets from the particular risks of their business. This can be accomplished in a variety of ways through the use of well known business entities and strategies such as corporations, LLC's, family limited partnerships, retirement plans, domestic and foreign based trusts. Cook Trusts sometimes play a role as a component of these asset protection and estate plans.

No Tax Evasion Opportunities

One of the reasons that the Cook Islands has not drawn much international attention or attack (as Switzerland has recently) is that the Cook Islands has only a minimal banking presence and cannot function as a tax haven or

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a center for money laundering or dubious financial transactions. Unlike the well known and powerful offshore banking centers in Hong Kong, Switzerland, Singapore and the Cayman Islands, Cook Trusts are unlikely to be used by U.S residents for financial crimes, tax evasion or for purposes other than legal asset protection. The trust companies in the Cook Islands are audited and regulated by the Government and impose strict due diligence requirements concerning a prospective client's business and financial background before agreeing to act as trustee. Individuals establishing Cook Trusts must comply with U.S tax reporting and filing requirements and under the provisions of FATCA trustees are subject to similar compliance rules.

States Adopt Cook Trust Laws

Because the opportunities for financial crimes and tax evasion are so greatly limited (as opposed to the tax haven countries), the U.S Government and other nations have not demonstrated an interest in persuading or coercing the Cook Islands to change or modify its strict asset protection laws. In fact, rather than attacking these laws, many U.S. states have adopted similar asset protection rules for their own residents. Noting the popularity, the need and the effectiveness of these laws (and the income potential for financial services), an increasing number of states in the U.S. have enacted their own versions of the Cook Islands trust laws. Fifteen states, including Ohio, Virginia, Delaware and Nevada permit residents to establish trusts which are intended to shield assets from liability and claims.

Laws which permit some measure of financial privacy and substantial asset protection will always be subject to abuse by individuals' intent on corrupt or illegal activities. Government limitations on secret business transactions are justified in the fight against terrorism and corruption to the extent that they are narrowly and accurately targeted. However, given the reality of frivolous litigation, the targeting of "Deep Pocket" defendants and the normal liability risks of most business and professional activities, financial privacy and asset protection with Cook Islands Trusts is often a strategic component of sound business planning.

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Are Secret Accounts and Offshore Havens Gone for Good?

As mentioned previously in our discussion of Cook Islands Trusts, the FATCA regulations have been finalized by the IRS and offshore banks, financial firms and trust companies are attempting to comply with burdensome filing and reporting requirements. Some banks are no longer accepting U.S. customers and others are imposing higher balance requirements and charging additional fees to offset compliance costs. For now, many of the larger banks are focusing their attention on attracting business from increasingly wealthy Asian and South American customers. At some point, when the full extent of FATCA compliance is known and adequate procedures are in place, foreign banks will likely begin competing again for customers from the U.S., the world's largest economy.

Secret accounts in Switzerland or the Cayman Islands, invisible to the prying eyes of tax collectors, creditors and future ex-spouses have long been attractive cash magnets for the super rich and even the merely wealthy. But now, for U.S. residents, these anonymous and private accounts have been closed down and probably shuttered for good as the U.S Government battles budget deficits and tax evasion with a renewed and vigorous attack against the bank secrecy havens.

During the past three years, a concerted and well focused attack by the U.S. Government against the offshore havens has effectively pierced the previously impenetrable shield of bank secrecy which surrounded and protected a sizable portion of worldwide surplus wealth for more than 200 years. Concerns about terrorism, money laundering and the estimated loss of more than $100 billion each year in tax revenue has spurred the drive to shut down the activities enabled by the bank secrecy havens.

Accounts with Benefits

Prior to these recent efforts, opening accounts in the European banking centers -Switzerland, Lichtenstein and Luxembourg - with long traditions of strict bank secrecy laws, was a fairly straightforward process. Most banks adhered to at least a minimal "know your customer" standard. Typical due diligence efforts by the banks required proof of residence and citizenship, bank letters of reference and often an introduction from someone within the bank's referral network of existing customers,

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attorneys and financial advisors. Beyond these relatively minor barriers to entry, most European banks maintained a minimum deposit requirement ranging from several hundred thousand dollars to well over a million. Notably, the source of the funds for the account deposit and whether the new customer was "tax compliant" in his or her home country was rarely a matter of concern or discussion.

Although most of the banks operating in the Caribbean and Central America, in countries such as the Cayman Islands, Bahamas, Bermuda, and Panama adhered to similar standards as their European counterparts, some applied substantially lower minimum deposit requirements. A few were known to be overly welcoming to new customers- with little or no due diligence inquiries to weed out money from a wide variety of illegal activity.

Protecting Bank Secrecy

Common to all the tax haven countries is a low or no tax regime on investment income and income from sources outside the country. This attractive benefit is combined with strict bank secrecy laws which prohibit disclosure by bank employees and government officials of customer names and account details. These secrecy laws are backed by strong criminal penalties. At least until recently, breaches were rare and exceptions to the rules were very narrowly proscribed. Sometimes the funds of a notorious thieving dictator were frozen to avoid a worldwide outcry. Former Egyptian President Hosni Mubarak and Haiti's Baby "Doc" Duvalier reportedly had billions tucked away in accounts frozen by the Swiss government. But with these few exceptions the governments and the banks have stood firm.

To combat the lure of the bank secrecy countries as havens for tax evasion and money laundering, the so called high tax countries, have applied increasing pressure on the bank secrecy countries over the last five years with some limited success. To avoid an international blacklist, most tax haven countries agreed to a set of standards which provided at least limited cooperation with other governments. Although requests for information about the accounts of particular individuals had been previously denied, faced with the possibility of being shut out of the worldwide banking system, the secrecy countries agreed to limited disclosure to assist in

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criminal investigations as well as enhanced due diligence in opening and maintaining customer accounts.

Recent IRS Attacks

Since 2009, the United States has forcefully and aggressively expanded its fight against the tax haven countries with a double barrel attack directed at the offshore banks and their American customers. A string of criminal prosecutions together with tough new legislation may have changed the tax haven game forever.

Naming Names

Although previous efforts by the U.S. to obtain the names of offshore account holders had been largely futile, a potential criminal case against UBS AG, the largest Swiss bank, unveiled a treasure trove of previously inaccessible and detailed customer information.

In brief, the IRS victory was triggered when a UBS wealth manager, an American citizen based in Geneva and in charge of attracting wealthy U.S. customers for UBS, pled guilty to charges of tax evasion for assisting a U.S. billionaire client with avoiding millions in taxes. In exchange for his guilty plea, he testified that UBS routinely encouraged it's bankers to attract U.S clients by promoting the many tax evasion opportunities available from UBS. According to the testimony, the bankers assisted thousands of customers in hiding and disguising transfers to their Swiss accounts, filing fraudulent tax returns and concealing investment gains and income through a variety of offshore companies and structures.

Based primarily on this testimony and mountains of corroborating evidence, UBS narrowly avoided criminal charges with a fine of $780 million and most importantly, an agreement to hand over the names of 250 US clients who had been holding secret accounts at UBS. In addition, as part of the settlement of the case and subsequent cases filed, the Swiss government, agreed to turn over more than 10,000 names of Americans with accounts in at least 11 of the country's largest banks, including UBS, Credit Suisse and Bank Julius Baer.

At the same time as the final settlement was being negotiated, the IRS initiated a voluntary disclosure and amnesty program. Not knowing

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whether their names would be part of the account disclosure agreement and facing potential criminal prosecution for tax evasion, approximately 19,000 taxpayers came forward with undeclared offshore accounts. Under the terms of the deal, taxpayers coming forward were able to avoid prosecution by paying taxes due and penalties, disclosing details of the offshore accounts as well as the names of bankers and advisers, and information about how they moved their money. Information obtained from these taxpayers is fueling ongoing IRS investigations into the offshore banking world with new charges and indictments occurring on a regular basis. In February of 2012 the U.S. filed criminal charges against Wegelin & Co, the oldest Swiss Bank, accusing it of helping Americans commit tax fraud.

Closing the Door

The second prong of the government's attack came in 2010 when Congress passed The Foreign Account Tax Compliance Act (FATCA). The new rules, scheduled to take effect in 2013 require all foreign banks to report details of their U.S. client's accounts directly to the IRS-regardless of whether such reporting would violate existing bank privacy laws in those jurisdictions. Any foreign bank which refuses to comply will have a 30 per cent withholding tax imposed on all payments received from the U.S. The effect of FATCA is that every foreign bank will have to report the names and account information of all U.S customers to the IRS on an annual basis to avoid having their U.S. business effectively shut down.

The combined effect of the bank prosecutions and the FATCA legislation is that the offshore banks have severely limited their dealings with U.S. residents. The expense and administrative burdens involved in reporting names and account details to the IRS, together with the irresolvable tension which compliance would create with local bank secrecy laws, have caused many foreign banks to simply shut the door on all accounts by U.S. residents-even those who can demonstrate that they are fully tax compliant. At many banks, long time depositors have been notified that their existing accounts are being closed and that new customer accounts cannot be opened.

On a positive note, the final rules under FATCA have not yet been issued and their legal impact and costs are still being studied. Negotiations

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between the foreign institutions and the IRS are ongoing and many are hopeful that the rules will ultimately undergo serious modification, easing the most objectionable aspects of the law.

Alternatives to Offshore Planning

Although the offshore world can still be successfully navigated, there is no question that even those individuals who fully report and pay all U.S. taxes will face greater scrutiny and at least some inconvenience in obtaining an offshore account for legitimate asset protection or investment purposes. One question now being raised by a number of legal experts is whether an equal or greater level of asset protection and privacy can be obtained through domestic U.S. accounts in states with favorable laws designed to accomplish these particular goals. In next month's column we'll examine this issue to see what benefits can be offered by state asset protection laws and whether these alternatives can provide reasonable alternatives to traditional offshore planning.

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New State Laws Allow Residents to Shield Assets from Creditors

In 2014 Mississippi became the 16th state to adopt domestic asset protection trust ("DAPT") legislation. In addition, legislators in other states have amended and revised their DAPT laws to increase clarity and certainty for individuals and companies engaged in asset protection planning.

There is no definitive case law at this point as to collection actions against a resident of a non DAPT state who has assets in a trust domiciled in a DAPT state. For example, if a resident of New York (non-DAPT) establishes a trust in Delaware (DAPT) what law will apply in a collection action against the individual in New York? Would a legal judgment in New York be enforced against assets within a Delaware DAPT? Some commentators believe that if the Delaware DAPT violates a strong public policy of New York against asset protection, enforcement may be possible. But with the number of DAPT states increasing and more favorable asset protection laws being adopted throughout the country, public policy concerns may be weakening substantially. Ultimately, the outcome of a particular collection case, and the degree of cooperation which might be available from Delaware courts (or DAPT states) is increasingly in doubt and at a minimum may pose substantial procedural and substantive challenges for a collection plaintiff. Depending greatly on a client's circumstances, in many cases a DAPT can be an effective part of a comprehensive estate and asset protection plan.

A growing number of states have enacted laws permitting residents to legally shield their homes, savings and other assets from potential claims of creditors. As of March 20, 2013, Ohio becomes the 15th state to allow property and savings to be sheltered from lawsuits and creditor collection actions - a relief for many individuals, small businesses owners and professionals, concerned about the threat of personal or business liability risks*

Pushing Back Against Lawsuit Abuse

The new laws, as adopted by Ohio and the other states, represent a significant departure from long standing state laws which strongly favor the interests of financial institutions and trial lawyers attempting to initiate

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or collect a debt or enforce a lawsuit judgment. Typically, state laws have granted wide latitude to plaintiffs in the filing of lawsuits. Expanded theories of liability, broad and intrusive discovery rules and powerful judgment enforcement rules have skewed the litigation process heavily in favor of plaintiffs in the litigation, regardless of whether the underlying claim is with or without legal merit.

At the point that a judgment is entered, almost all assets owned by the defendant, which exceed a minimal threshold amount, can be seized by a creditor to satisfy a claim. Several states, notably Texas and Florida, provide unlimited homestead protection for a personal residence, but in most cases, the allowable state exemptions do not cover a significant amount of personal or business assets. For example, most states permit all savings and investments other than retirement plan assets to be reached by a creditor. As a result, downturns in business, unexpected medical bills or lawsuit liability can quickly erase many years of accumulated savings. As Ohio Representative Christina Hagan put it "the new law" will allow Ohio citizens, business owners and entrepreneurs to better protect their hard-earned assets, homes and businesses."

How the New Laws Work

The creditor protection laws adopted by Ohio and the previous states specify in considerable detail how the law can be used for asset protection results. For example, if you live in Ohio you are now permitted to establish a trust with any individual or trust company located in the state acting as one of the trustees.

Your bank or brokerage accounts, other investments and any properties you own can be transferred into the trust. Under the rules, you are permitted to maintain management authority over the assets while in trust, but the trustee must carry out at least some minimal specified administrative or accounting functions.

Who Can Use the Assets in the Trust?

The law provides that income and principal can sit in the trust earning income or can be distributed to any designated beneficiary, including yourself. If you don't need to touch your savings now because you have sufficient income from your job or business to meet all of your needs, then

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the assets would simply grow inside the trust or would be distributed to children or other family members for whatever purpose. If at some later point you wish to draw on the savings for your retirement or other purposes, you are permitted to do so. Alternatively, if you rely on your savings to pay for your current living expenses, the trust can be designed to provide necessary distributions on a regular basis. You can also put your home into the trust and continue to use it - a valuable benefit for those with some equity to protect.

This ability to receive income and distributions from a trust which you create, and still have the assets protected from a judgment or lawsuit is the key feature of the Ohio law and the other states with similar legislation. (See my article on Delaware Trusts) Trusts set up for the benefit of *other* family members have always been generally protected from most liability claims. But establishing a trust which allows *you* to personally benefit is the unique and distinguishing factor in these laws. Although the details of each of the laws of each state vary, sometimes significantly, the intent of each is to permit distributions for personal benefit while still providing basic asset protection.

Restrictions on the Available Protection

Some key restrictions of the Ohio law are that you can't create the trust and use it, if it will make you unable to meet your obligations or to shield assets from those who already have a claim against you. Also, you are not protected from a liability arising within 18 months of establishing the trust. If you are married, you cannot create a trust during marriage to protect assets against a claim by your spouse. However, if the trust was established prior to the marriage, a current or former spouse is not permitted to collect alimony, support or property from the trust in the event of a legal separation or divorce.

Many issues about the laws in Ohio and the other states still remain and are still too new to have been fully resolved. In particular, there are significant questions about whether the resident of one state can rely on the law of another state to achieve effective asset protection. However, the growing number of states adopting asset protection legislation certainly broadens the scope of options available and makes it more likely that the

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application of the laws and their parameters will be more fully clarified within a reasonable period.

*The following states have adopted legislation permitting the formation of Asset Protection Trusts: Virginia, Colorado, Oklahoma, Utah, Missouri, Delaware, Nevada, Wyoming, Hawaii, New Hampshire, Rhode Island, Tennessee, South Dakota, Alaska.

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California Private Retirement Plans

California allows for the creation of a Private Retirement Plan, which is entirely exempt from judgments and bankruptcy. That is, retirement savings plans which are not IRS Qualified Plans may be protected under state law if certain requirements are satisfied. According to the cases that have been decided, these plans must be carefully drafted and maintained, but they are highly flexible in design, need not cover other employees, and can include annual contributions that can substantially exceed those available under the qualified plans or IRAs. No tax deduction is available for these contributions, but that actually works in favor of asset protection since the plans are not subject to the strict funding and compliance rules of ERISA and the Internal Revenue Code. The complete exemption from judgments for amounts in these plans may be highly valuable in a wide variety of circumstances and should be considered as a stand-alone asset protection plan or in conjunction with a tax deferred account.

This exemption from judgment also applies to distributions from the Private Retirement Plan so the funds are protected while in the plan and later on in retirement, when the proceeds are withdrawn. As long as the funds can be traced to a distribution from the plan, they can be invested in any manner. For example, if you purchase a home or a boat or gold coins or any other asset with the proceeds, those assets are exempt from judgment.

Benefits of a Private Retirement Plan

- California residents are permitted by law to establish Private Retirement Plans which are exempt from creditor claims and judgments.
- All assets in the plan are completely protected from lawsuits and judgments – even in bankruptcy.
- The contributions to the plan are not tax deductible so:
  1. No maximum limit on contributions.
  2. No requirement for covering other employees.

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3. No annual IRS filings.

- A Private Retirement Plan can be used instead of or in addition to an existing qualified plan.

You can maintain plan funds at whatever financial institution you choose, and you can choose to manage all investments.

A Private Retirement Plan we recently set up for a physician client provides an example of how this works. The client is forty-five years old, married with one child, and earns about $500,000 per year as a member of a local ob/gyn group. His goal was to save as much as he could for retirement in a protected vehicle. A Qualified Plan wasn't feasible because of limitations on contributions and the cost of covering other employees. He wasn't sure whether his current income would increase or decrease over time so we established a flexible formula in his plan based on a percentage of his net income over a certain threshold that allowed him to contribute a larger or smaller portion of his surplus cash each year, based on his circumstances at the time. The client hopes to retire at age sixty or earlier, and the plan documents provide that the proceeds can be distributed to him whenever his actual retirement occurs. In these particular circumstances, where the client wanted maximum but flexible contributions in a protected form, without additional employee or administrative costs, the Private Retirement Plan was a good fit with his financial goals. We also considered the fact that for obstetricians, potential malpractice liability continues even after retirement as the statute of limitations is tolled until the patient reaches age eighteen. With continuing liability from an extended term, the ability to withdraw funds at retirement with the proceeds fully protected was an additional benefit of the plan.

A Private Pension Plan must be operated strictly for retirement purposes and misuse of the Plan will disqualify it as exempt under California law.

A growing focus of our practice in recent years is on asset protection planning for individuals to protect against medical expense related liability risks. Medical expenses resulting from an illness or injury to yourself or a family member, represent the single most serious threat to your home, savings and future income.

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When Is It Too Late for Asset Protection?

Often the key issue in asset protection is determining whether the planning is too late. Each state has laws against "Fraudulent Transfers" which are those intended to defraud or defeat a creditor or which effectively leave you unable to meet an existing or anticipated obligation. Transfers which violate these rules can be voided or damages can be recovered. For example, if you have a debt coming due in several years, you cannot transfer money or property to avoid paying that claim. The same is true with any other liabilities including an existing negligence claim or any other amount owed.

Fraudulent Transfer laws do have a statute of limitation which creates a legal time barrier to when a creditor can challenge a transfer. This time period varies by state but is generally between 4 and 7 years. That is any transfer made cannot be challenged by a creditor after the limitations period.

Some states significantly reduce this period for transfers made to asset protection trusts created within the state. See (Domestic trusts article). For transfers to state sanctioned asset protection trusts, the period may be much shorter. Nevada, for example, generally limits fraudulent transfer claims by existing creditors to the later of 2 years or 6 months from discovery. (See note below for Delaware and Nevada statutes of limitations). In Ohio this period is 18 months and the clock can start to run on the filing of a notice. In this manner, assets can be protected from even existing creditors in a period of as little as 18 months.

Ohio, Nevada and other states have also changed the standard of proof required. The normal civil standard for finding liability is known as "a preponderance of the evidence" that essentially means more likely than not. In order to set aside an asset protection trust, many of the asset protection states now require that the grantor's intent must be proved by a much higher stander known as "clear and convincing evidence." This is a much closer to 'beyond a reasonable doubt" standard in criminal cases and is a much more difficult task for a potential creditor. Early planning is essential if preserving family assets is an important planning goal.

The worst time for asset protection planning is when you really feel like you need it the most. Increasingly, the law favors and encourages asset protection in most circumstances, but there comes a point in financial transactions and legal proceedings when it is no longer permitted. In some cases this boundary is clearly defined, but often the question of when the

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remedy of asset protection is still permissible is fuzzy. Experienced planners can follow several guidelines and make some educated guesses about where the line should be drawn in situations that physicians may encounter in their practice.

Fraudulent Transfers: It's All in the Timing

Protecting personal assets from risk of loss and liability is firmly established as an accepted part of sound financial and business planning. The use of trusts, corporations, limited liability companies, family limited partnerships, and other strategies encourage business development and investment by enabling individuals and businesses to effectively limit potential losses from their professional activities. Clearly, business activity would diminish and the range of professional services offered would be substantially curtailed if individuals were unable to protect personal assets from lawsuits and liability exposure. The key consideration in asset protection has to do with *when* and *why* plans are enacted.

Laws in every state prohibit the transfer of property intended to "hinder, delay, or defraud" a creditor in order to avoid paying an imminent legal obligation (a practice known as a "fraudulent transfer"). The law also prohibits transfers that leave you unable to meet your foreseeable obligations.

How does asset protection function within the framework of the fraudulent transfer rules? In some cases the answer is clear: you cannot protect property from an already-incurred debt or judgment. You are obligated to maintain the ability to satisfy existing debts from your available assets or income. It is permissible to create an asset protection plan while you have outstanding obligations, as long as it is not directed at your current debts and you make available sufficient resources, from income or other assets, to repay your outstanding debt on a timely basis. If you fail to repay an existing debt, and it can be proven that the asset protection plan was intended to avoid this payment, fraudulent transfer rules permit your creditors to set aside the plan to reach those assets purposely moved out of harm's way.

Although the law prevents you from creating an asset protection plan to evade current debts, it does allow for asset protection planning to avoid

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liability from future, unanticipated creditors. In these cases we can reasonably distinguish between “existing claims” and those that are still “potential, future, unforeseen claims.” For example, say you set up an asset protection plan and a negligent act involving a patient occurs several months later. Fraudulent transfer is not an issue in this case because the property transfer was unrelated to the claim subsequently developed by this patient. Presumably, at the time you implemented your asset protection plan, you did not know or intend that the patient would be injured. Similarly, loans and contracts entered into after establishing a plan, as long as the creditor is not misled, are also outside the scope of the fraudulent transfer rules.

Some cases, however, are not so cut and dried. Often, lawsuits against physicians are triggered by a negative but unavoidable outcome for a patient, without any wrongdoing or negligence by anyone. How do fraudulent transfer rules apply to a physician involved in a high-risk case, with clear potential for an unfavorable result? The focus in these cases should be the point at which the patient develops a claim - when he or she can establish both negligence and damages. In legal terms, that is when the cause of action arises. If neither of these elements has occurred then the physician is safely in the protected zone. But when one or both happen it is at least arguable that the line has been crossed and asset protection might not be effective if a successful case is later filed by that patient.

Closing Arguments

The law is clear that the fraudulent transfer rules can be used to overturn an asset protection plan when it can be demonstrated that the plan was created with the intent of avoiding paying an existing debt or claim. It is equally clear that planning to protect against unforeseen future risks is both permissible and effective. The gray area in between is where uncertainty creeps in regarding timing, intent, and cause of action—this is where lawyers live and thrive, making this territory you should avoid. As always, consult with your advisors about the propriety of any financial planning, and make sure to address and resolve the timing issue before selecting the appropriate course of action.

Note-Delaware Trusts- Statute of Limitations

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1. *A creditor whose claim arose before the creation of the trust provided the claim is brought within four years after the creation of the trust or, if later, within one year after the creditor discovered (or should have discovered) the trust and the claim is proven, by clear and convincing evidence, that the creation of the trust was a fraudulent transfer. 12 Del. C. § 3572(b)(1).*

2. *A creditor whose claim arose after the creation of the trust provided the claim is brought within four years after the creation of the trust and the creditor proves, by clear and convincing evidence, that the creation of the trust was a fraudulent transfer. 12 Del. C. § 3572(b)(2).*

NRS 166.170 Limitation of actions with respect to transfer of property to trust; certain transfers of property disregarded; limitation of actions against advisers to settlors or trustees and against trustees; transfers to trust.

A person may not bring an action with respect to a transfer of property to a spendthrift trust:

(a) If the person is a creditor when the transfer is made, unless the action is commenced within:

(1) Two years after the transfer is made; or

(2) Six months after the person discovers or reasonably should have discovered the transfer, whichever is later.

(b) If the person becomes a creditor after the transfer is made, unless the action is commenced within 2 years after the transfer is made.

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Do Your Kids Need Asset Protection?

Dynasty Trusts are trusts intended to last for an extended period – sometimes several generations. The primary benefits are that estate tax can be reduced or avoided as amounts are passed from children to grandchildren and to subsequent generations. As of 2013 the federal estate tax is effectively eliminated for the first $5.25 million. A husband and wife can pass up to $10.5 million to children (or others) free of federal estate tax. For estates which are larger than this amount, a Dynasty Trust may be essential to preserving wealth from taxation at each generation. Those with less than this amount would not be gaining estate tax savings but could save on state inheritance taxes in states with a lower taxable threshold.

Asset protection is the second reason for establishing a Dynasty Trust. As discussed below, the assets of a Dynasty Trust are generally not subject to judgement collection or divorce claims. Many of our clients are concerned about leaving hard earned savings to a child – no matter what the amount – and then having the amount lost in a divorce. Unlucky or poorly chosen investments by a family member can also jeopardize an inheritance. Dynasty Trusts can be drawn to protect these amounts from outside claims to make sure that the estate is maintained and preserved for all intended beneficiaries.

As part of the political debate about tax cuts and estate tax, a type of trust known as a Dynasty Trust has received a barrage of criticism from those who claim that the wealthy are not paying their fair share of the taxes. A recent Op-Ed in the New York Times complained that Dynasty Trusts created a powerful new "aristocracy" whose wealth is protected and untaxed for generations into the future. Sounds appealing right? Let's look a little more closely at the available benefits and whether these trusts may have a role to play within your overall estate plan.

How Long Should a Trust Last?

The first point to note about the Dynasty Trust is that it is designed to last for a long time. Many states have recently adopted legislation (abolishing the Rule against Perpetuities) which eliminates legal restrictions on the period of years that a trust may last. Now, in these 23 states, a trust is permitted to exist for whatever term is chosen - even if it reaches far off

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generations many years in the future. In Nevada, a Dynasty Trust is permitted to last for up to 365 years. Who might want a trust lasting generations into the future?

Estate plans are typically designed to include some type of trust to take care of the needs of minor children upon the death of the parents - usually lasting until the ages of 21 or 25 or so. It makes sense to limit the term to this relatively short period of time when the trust fund contains an amount that the child might exhaust for basic living needs or for the expenses of college and higher education. If there is not going to be anything left over after covering the child's basic needs, an extended term trust would not make sense.

It is a different matter when family wealth consists of substantial accumulated savings, a valuable business or a large insurance policy. In these cases, the issue of how long a trust should last assumes much greater significance and specific questions must be addressed. At what age do we want a child to receive a full distribution of substantial trust funds? Should we make large sums of money available to the child when he is young or do we want to control and limit the distributions based on whatever standards we can define for need, responsibility and maturity? These are not easy questions to answer, especially for children who are young when the trust is formed.

The answer to the question of how long the trust should last is often based on two key considerations-the estate tax consequences of the plan and the possible need for asset protection.

Estate Tax Savings

It is true that substantial estate tax savings can be created by the Dynasty Trust. As you probably know, the federal estate tax normally imposed as wealth is transferred from parents to children. Each time the wealth is passed to a younger generation a new estate tax is imposed. At a 50 percent estate tax rate, a dollar in wealth is reduced to 50 cents when it is passed on to your children. The remaining 50 cents is further taxed so that grandchildren would receive only 25 cents of the original dollar and so on until there is nothing much left. For those whose total assets are under the estate tax exemption amount (currently scheduled at $1 million for 2011)

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this is not a problem since amounts under the exemption are not subject to federal estate tax. Those who have accumulated assets in excess of the exemption amount or who have large insurance policies and wish to maximize and preserve these funds for future generations, can significantly reduce estate taxes with a properly structured Dynasty Trust.

The provisions in the tax law which allow these benefits are long standing and well established. Briefly stated, if assets are left to children or any younger generation and the beneficiary's rights to the property are limited by certain defined standards, the trust property is not subject to estate tax as it passes to a younger generation of beneficiaries. For example, if you leave $1 million in a trust for your child, and he or she has the right to the income from the trust and also a right to principal for "health, education, maintenance and support" the trust assets will not be included in your child's estate on death and can then pass to your grandchildren free of estate taxes. The trust can continue, subject to these same provisions and there will never be an estate tax imposed as it passes from children to grandchildren and so on. Depending on the amount of trust assets and whether income is accumulated or distributed, wealth which is not subject to estate tax can be maintained or even increased over time as succeeding generations of family members become beneficiaries. (As with the estate tax itself, the total amount which can be passed through the generations is subject to a generation-skipping tax on amounts in excess of an exemption amount that has yet to be determined by Congress. Stand by for future developments.)

Protecting Your Children from Divorce and Lawsuit Risk

Whether or not you have a need for estate tax savings, the Dynasty Trust is a popular strategy to help protect children from the risks of divorce and creditor's claims that they may face in their personal life and business careers. Possible claims by a child's current or future spouse is always a paramount concern in every estate planning discussion. Facing hard facts, a 50% divorce rate means that there is a substantial financial risk of losing assets to a spouse at some point. Dynasty Trusts are often designed to specifically address this issue to make sure that amounts intended to be the separate and protected property of a child are not available to a future claim by a divorcing spouse at any point in the future.

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The same logic applies to other types of potential creditors that may arise during a child's lifetime. Some common examples of these risks include student loan debt which is almost impossible to discharge, personal guarantees on loans and debts from bad business decisions or just plain bad luck which can cause lasting financial hardship and burdens. The point of the Dynasty Trust is to make sure that a nest-egg is preserved for the child which is not subject to lawsuit and liability claims no matter what happens in the future.

Conclusion

Depending on the outcome of the estate tax legislation proposed in Congress your estate may be subject to significant estate taxes as it is passed to your children or grandchildren. A Dynasty Trust may be useful in reducing or eliminating these taxes as well as preserving family assets from future claims and liabilities. These issues are complicated from a legal and tax perspective however and as always you should discuss your personal situation and the possible benefits and drawbacks of this planning with your professional advisors.

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What Happens if You Don't Pay Your Mortgage?

This article was written at the height of the foreclosure crisis. Many clients were dealing with the impact of a substantial loss of equity in their homes and investment properties. For many, the issue was should they continue to pay the mortgage on an underwater property or simply walk away. The questions concerned the legal and practical consequences of a default. What would a lender do and what was it likely to do under various scenarios.

The worst of the crisis has certainly passed at this point, at least in the residential market. But some clients have been engaged in extended negotiations concerning loan workouts or other modifications which are, only now, reaching their conclusion. For those who have not obtained a satisfactory result in these negotiations or who feel they may still face the possibility of a future default, this article points out some of the key legal issues which should be considered.

It seems like most of our clients were active real estate buyers and investors when times were good. Now, they've been hit hard by the market crash, with property values sinking below the amount of their loans. The real estate website Zillow.com, recently estimated that 28% of all mortgaged homes had a negative equity. And that number is substantially higher in the hardest hit regions of California, Florida and the Southwest.

Many of those with negative equity have and will continue to default on their loans out of economic necessity or as a planned "strategic default." When a comparable property can be purchased or leased at a substantially lower monthly cost, it's reasonable to expect that many or most property owners will choose to default on their loans and "walk away."

The decision to avoid throwing good money after bad, with no end in sight, applies not only to personal residences, but also to investments in commercial property. The toxic combination of falling rents and rising vacancies has caused a collapse of cash flow and value and many investors are faced with the difficult decision of whether to continue to support an "underwater" property with a large monthly negative or whether to throw in the towel and take the consequences. One of the factors making this such a tough decision is that the amount of these commercial loans are often in the millions of dollars and may have been personally guaranteed by a group of partners or members of a limited liability company which

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purchased the property. Since each partner or member who guarantees a loan has legal responsibility for the full amount of the loan -not just a proportionate share- the resulting liability can be far beyond the amount that any single investor anticipated or intended.

For example, a client of ours invested $100,000 for a 10 percent share in a limited liability company formed to construct a medical office building in 2006. The LLC borrowed $8 million with each member signing a personal guarantee to the construction lender. By the time the construction was completed in late 2008, the market had plunged and the estimated value was less than $5 million. Because of low rents and vacancies there is a monthly shortfall of nearly $100,000 and our client has been paying his share, at the rate of $10,000 per month.

The decisions he is facing are those now under consideration by millions of others in similar situations. What are the legal consequences if I default on my loan? Does a default put my other assets at risk? Is there any way to protect my other assets from a possible judgment?

Foreclosure and Deficiency Judgments

The legal consequences of a loan default vary by the terms of the loan agreement as well as applicable federal and state laws. In general, we know by now that if you don't pay your mortgage, at some point, the lender is likely to take back the property through a foreclosure or trustee sale. Although, the number of home foreclosures slowed measurably in the past year, due to litigation over improper foreclosure practices by the banks, the system is now back in high gear with lenders moving aggressively against borrowers who are behind on their payments.

For commercial loans, lenders are usually more hesitant about a foreclosure. Commercial properties are management intensive and the desire to avoid realizing losses on the loan may weigh heavily in the considerations and the negotiations. Alternatives to foreclosure may be explored, but if the negotiations are not successful then the foreclosure route is generally pursued.

The liability problem here is that, in most cases, the amount by which the loan exceeds the value of the property is known as a deficiency and the borrower will generally be legally responsible for the full amount of this

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deficiency together with penalty fees, costs of collection and associated legal fees.

Collection Against Other Assets

In some states, a lender is not permitted to pursue your personal assets to satisfy a deficiency on a property. In those cases, the foreclosure is the end of the process and while your credit report may be impaired, there is no threat to future income of assets.

Unfortunately these protections are usually narrowly limited in their scope and application. For example, in California, the lender's only remedy for loans made to purchase a residence is to foreclose on the property. Whatever it's worth, that's all the lender gets. But if the original loan was replaced in a refinancing or the loan was used to buy an investment property, rather than a home, then the lender has full access to all of the borrowers' available assets to cover any shortfall in the value of the property. These restrictions on collection are known as anti-deficiency statutes and they vary according to the state law which applies.

If you are not protected by an anti-deficiency law, the lender has the right to obtain a court judgment against you and/or any loan guarantors for the amount of the deficiency. Once the judgment is final it acts as a lien against any property or other assets in the name of any defendant. Any property or other assets standing in your name at the time of the judgment or any later time, while it is in force, is subject to collection.

Until recently, the banks rarely pursued collection actions against foreclosed homeowners. To some extent, collection is a time consuming and expensive process and at the end of the day, the foreclosed homeowner rarely had much left to make it worthwhile. However, with the sharp rise in "strategic defaults" from borrowers who may have other assets available, currently or in the future, the number of deficiency judgments and collection actions has risen dramatically.

If collection is pursued, the lenders generally rely on your previous financial statements or a legal procedure known as a Debtor's Examination, to determine the amount and location of your assets. For example, if you live in California and default on a property in Florida, the judgment will initially be entered in Florida and then subsequently in

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California to attach any assets held there.

The decision making process about "strategic defaults" should take into account whether the anti-deficiency protection is available and what other assets or income you may have which is available in a collection action against you.

Can Assets Be Protected From a Judgment?

Certain types of assets are protected by state law from collection and asset protection planning often involves maximizing the use of these exemptions. For example retirement plans are sometimes partially or fully protected depending on the structure of the plan. Also most states protect some or all of the equity in a home from a collection action. Again, depending on the state, life insurance policies and annuities may be exempt, as well as interests in a trust or other specified entities.

The key issue in protecting assets from collection is usually that of timing. All states have laws prohibiting many types of transfers that are intended strictly to avoid paying an obligation. If the goal is to shield or insulate assets from a future potential liability risk, sound planning should be undertaken at the earliest time, to provide the widest range of options and the greatest flexibility.

Anyone making a tough decision about a possible loan default should consider the risks associated with a deficiency judgment and the extent of personal assets which are legally exposed in the event of a claim. Certainly, any planning strategy must be discussed with your attorney who is familiar with your particular situation and after a thorough consideration of state and federal laws pertaining to fraudulent transfer rules and exemption laws applicable to your circumstances.

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S-Corps As Tax Shelters

New Case Highlights Risks and Opportunities

An S-Corp has the potential to produce significant tax savings by converting "wages" into "profits." Distributions from the company which are treated as wages are subject to FICA (social security) taxes and Medicare taxes in addition to ordinary income tax. By treating distributions as profits instead, FICA and Medicare taxes can be substantially reduced. An LLC can elect to be treated as an S-Corp for tax purposes and can achieve the same result. LLC's which elect to be taxed as a partnership or sole proprietorship may also achieve these tax benefits but the rules are not yet clear on this point.

Many business owners and professionals use S-Corporations (S-Corp) to conduct their practice. For a number of reasons this is often a good idea. See "Pros and Cons of Professional Corporations"

An S-Corp can help limit personal liability - generally not from professional malpractice claims - but from other obligations of the corporation. For example if your corporation leases office space or equipment, you have no legal responsibility for payment unless you have personally guaranteed the contract. A Limited Liability Company would achieve the same result but physicians are generally prohibited from practicing medicine in an LLC, so the choices for how to organize your practice are usually restricted to partnerships, sole proprietorships and corporations.

The traditional problem with corporations is that they are treated as separate taxpaying entities, which means that they have the potential to produce two layers of tax, once at the corporate level and again at the shareholder level. The corporate tax can produce some nasty and surprising tax problems, but fortunately, the law allows shareholders to opt out of the corporate tax by filing an S-Corp election if they meet certain qualifications. Under this treatment, all the income of the S-Corp flows through to the shareholder's personal return and is taxed there - only once - similar to a sole-proprietorship or a partnership.

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Profits or Wages?

With this long-standing and simplified tax regime it would seem that S-Corps should be easy to manage and free of significant tax issues. But, in fact, S-Corps have a unique hybrid status, capable of producing savings not available to other business entities. These benefits are created by particular grey areas within the tax law which treat certain types of business income more favorably than others. If income can be characterized to take advantage of the lower available rates, substantial savings can be generated.

More specifically, the income generated through an S-Corp and reported on the shareholder's return can be classified as *wages* or as a *profit distribution* based upon a variety of factors. And the outcome of that determination matters a great deal because amounts treated as wages are subject to payroll taxes while profit distributions are not. Depending on the amount involved, the difference in taxes can be substantial. For example, in years after 2011, the FICA (Social Security) tax is 12.4% of the first $106,800 of salary and the separate Medicare tax is 2.9% of all salary without any upper limitation. If an S-Corp has profits of say $250,000, taking that full amount as salary results in combined payroll taxes of roughly $20,000. If the amount of salary was instead lowered to $50,000 with the balance claimed as a profit distribution, tax savings for the year would be about $11,000.

What is "Reasonable Salary"?

The issue in most cases turns on what is a reasonable salary under the circumstances? What amount of corporate income is properly allocable to invested capital and what amount represents income from the shareholder's services? It's not an easy question.

A recently decided case illustrates the way this issue has been treated. In *David E. Watson P.C. v. U.S.*, Mr. Watson's S-Corp was a partner in an accounting firm. In 2002 and 2003 the partnership distributed $203,854 and $175,470 respectively to Watson's S-Corp. But rather than treating that amount as salary for his services, Watson claimed a salary of only $24,000 in each year with the balance labeled as profit distribution. Based on the

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payroll taxes then in effect, this resulted in a tax savings of nearly $20,000 over the two year period.

The IRS rejected this treatment and asserted that the reported salary of only $24,000 was unrealistically low in relation to the pay for other accountants with similar experience. The point was made that even accountants coming directly out of school make far more than the amount claimed. Ultimately the District Court decided that a reasonable salary amount for Watson should have been about $90.000 per year and full payroll taxes were due on this amount. The balance of the corporate income was treated as profit distribution.

Determining what is a profit distribution and what is salary is the subject of a longstanding game of cat of mouse between the IRS and taxpayers. The IRS's position is that amounts of earnings attributable to corporate capital or assets may be properly classified as a profit distribution but that payments for shareholder services must be treated as wages.

In a medical professional corporation, it is often true that a large percentage of the income is related to services performed by the shareholder, but there are significant exceptions. If profits are generated by the services of non-shareholder employees or from charges for lab work, equipment use, the sale of products or from other investments, then income earned from these activities might not be related to the physician-shareholder's services. In these cases, the allocation between profits and wages is subject to considerable interpretation and the amounts claimed for each can significantly impact the amount of payroll taxes which may be owed. Although Congress may take some steps in the future to clarify these issues, for now the outcome of disputes on this issue depends on the circumstances involved and you should certainly obtain the assistance of an experienced tax advisor when navigating the rocky landscape of tax strategies.

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What is the Best Asset Protection Plan for Physicians?

In our initial discussions with a client these questions always comes up "What's the best asset protection plan?" "Are there any plans which are completely bulletproof?"

Like any well trained professional I usually duck those kinds of direct and unconditional questions. After all, this is the legal system we're talking about and when we compound the mixture of judges, jurors and lawyers, the results can be unexpected, to say the least. Law is probably a lot like medicine in that respect. So while we can't honestly guarantee that the particular plan we design will produce the exact outcome we want, we do know what has happened before in similar situations. If existing case law and legislation is clear and well developed then an asset protection plan that falls within the pre-set boundaries will have favorable and predictable results.

The O.J. Simpson civil case demonstrates this principle in the most dramatic fashion. Despite the fact that the families of the victims have vigorously pursued collection of their $33 million civil judgment for more than 10 years, they have been largely unsuccessful. The reason for this is that a large portion of Simpson's assets are held in retirement plans which are exempt from judgments. The law specifically protects from collection the total amount in such plans as well as any proceeds which are distributed. Published reports are that Simpson had approximately $4.1 million in his retirement plans and draws a benefit of $25,000 per month, completely shielded from the judgment.

Although we've seen many similar results in less notorious cases the asset protection in the Simpson case was well supported by law and withstood persistent and sophisticated attacks from the victim's families. Regardless of the appalling result in this particular case, what is well illustrated here is that legal techniques such as a protected retirement plan can shelter substantial assets from liabilities and judgments even in the most egregious circumstances. If one of your goals is to protect your savings from the risks of your business and medical practice then it is worth considering the pros and cons of the retirement plan strategies.

In order to take advantage of the asset protection features of a protected retirement plan, the plan itself must be developed and designed so that it

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qualifies under the law as an exempt asset - free from potential judgment claims. Since the law often varies from state to state and Federal law may apply in some circumstances, I'll provide some general rules and guidelines and you can discuss the specific details of your case with your local attorney.

Qualified Plans The first group of plans that are exempt are those well known ERISA qualified plans, such as defined benefit, profit sharing and 401(k) plans. Both Federal and state law clearly protect the amounts in these plans and any distributions which are made. There may be exceptions for some court ordered family support obligations and possibly federal or state taxes, but as a general rule the protection of these plans from lawsuits and judgments is very strong.

The drawbacks of these plans are that if you have several employees, in your practice you may have to make contributions for them also - you can't just cover yourself in a qualified plan. As a result, the expenses of covering all employees, preparing the necessary filings and paying for annual administration may exceed the tax and asset protection benefits. A careful evaluation of all aspects of these plans is required to measure the costs and potential advantages.

Self-Employed Plans If you are self-employed and your plan covers only yourself (IRA's and solo 401(k)'s) the amount exempt from a judgment varies significantly based on the law of your particular state. Some states protect the entire amount in these plans while others shield only the amount necessary for reasonable retirement needs, a vague and subjective standard which you probably wouldn't want to rely on. If a big part of your savings is or will be in an IRA, determine with your attorney whether it is exempt from judgments in your state. Also, consider whether the amount of your contribution limits to your IRA is sufficient to shelter a significant portion of your savings.

Private Retirement PlansIn some states (such as California) the law allows for the creation of a Private Retirement Plan which is entirely exempt from judgments. These plans must be carefully drafted and maintained but they are highly flexible in design, need not cover other employees and annual contributions can substantially exceed those available under the qualified plans or IRA's. Although no tax deduction is available for these

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contributions, the complete exemption for amounts in these plans may be highly valuable in a wide variety of circumstances and should be considered as a stand-alone asset protection plan or in conjunction with a tax deferred account.

Make sure to talk with your attorney and tax advisor to see which of these retirement plans provides the best asset protection in your state and that you understand the legal and tax consequences of the strategy which will apply in your particular case.

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How to Make Money in the Litigation Game

> *The biggest obstacle to filing a lawsuit has always been money. Lawsuits cost a lot and most people just can't afford it. When legal fees are added to the costs of consultants and expert witnesses all but the wealthiest few would be hard pressed to cover the ongoing expenses of even the most routine business dispute or injury case.*
>
> *Medical malpractice cases, in particular, are often among the most expensive for a plaintiff. Usually one or more medical experts are required for the initial evaluation of liability and then for ongoing advice and testimony in depositions and possibly a trial. At expert rates of $500-$1,000 per hour and up, it is difficult for any plaintiff to mount a credible case without access to significant resources to finance these costs.*

As we've discussed in previous articles, a partial solution to this affordability issue is the contingent fee agreement which shifts the up-front cost of the litigation from the plaintiff to the lawyer in exchange for a percentage of the recovery. This arrangement often works well for both sides. Many individuals who otherwise cannot afford to hire lawyers are able to achieve some measure of compensation for legitimate injuries.

The contingent fee business model works especially well for attorneys. Because of the inherent advantage of the plaintiff in litigation, the potential profits are limited only by the number of cases, good or bad, which can be effectively financed. Think of the plaintiffs lawyers as the house in a casino game. They have a built-in advantage and like the casino house, all they need to make lots of money is cash for financing and a steady supply of customers.

What happens when attorneys don't have enough money to cover existing cases or to take on new ones? Within the past few years, lawyers, and other profitable business owners have had their bank credit lines tightened or closed so the sources of funds available to finance an inventory of cases has been severely restricted. Without easy access to cash, lawyers have been forced to reduce their case load, limiting the number of cases they can take and leaving lots of potentially profitable cases on the table.

Although the litigation business was once the exclusive province of the lawyers, the potential for large profits is attracting a flock of outside

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entrepreneurs with an appetite for risk, surplus cash and a willingness to supply ample funds in exchange for outsized returns. Historically low interest rates are encouraging individual investors, investment companies, hedge funds and even some specialty banks to enter the business of financing malpractice cases, personal injury claims, business litigation and even divorce cases. In exchange for supplying the attorney with the funds to fully litigate a case, these investors take a big share of the ultimate settlement or award.

For example, one company, Lawsuit Financial Corp., claims on its' website that it is often able to supply funding for a case within an hour of receiving the case material. In addition to providing the cash for the litigation, the company also offers to provide advances to the injured client to relieve financial pressure and enhance "staying power" and settlement leverage. The company invites investor participation in funding specific cases with the prospect of generous returns.

Investors can also participate in cases where contingent fee financing is not practical or permitted. For example, The Model Rules of Professional Conduct 1.5(d) expressly prohibit contingency fees in domestic relations cases where the fee is contingent on the securing of a divorce or obtaining a property settlement. The stated policy behind this rule is that the role of a lawyer in domestic matters should be to encourage reconciliation. As legal commentator Christine Hurt points out ("Financing Divorce Litigation"), if your lawyer only gets paid from a property settlement and the amount of the fee is based on a percentage of the total settlement, the goals of reconciliation and family preservation are even less likely than they are now.

Although the prohibition on contingent fees in divorce cases may make good policy sense, where there is a profitable market to be served, market demands can be counted on to outflank the ethics regulators. A recent front page story in the New York Times ("Taking Sides in a Divorce, Chasing Profit") profiled a start up Beverly Hills firm, Balance Point, which finances divorce litigation in return for a percentage of the ultimate recovery. According to Stacey Napp, company founder, the target market is female spouses seeking the cash to litigate property settlements in the $2 million to $15 million range.

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Litigation has always been a profitable business for lawyers. But now outside investors - flush with cash and an appetite for more risk and profits then they can get from their savings accounts and stocks - are taking advantage of burgeoning opportunities for profits in the litigation business. While this is certainly great news for the plaintiff class, physicians and other potential “deep pocket” defendants may be facing a newly armed and cash rich adversary in the courtroom.

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How to Find a Tax Shelter

Solid tax planning is almost always a worthwhile goal. While other business expenses, such as payroll, advertising and software, are intended to produce greater income and assets, money spent on taxes return zero economic benefit. Every dollar paid in taxes directly reduces, dollar for dollar, the amount you have available for savings and investment in your business. In these times, I have confidence that you can do a better job spending your money than the Government.

So what can you do to save taxes legally, without spending your life and your savings fighting with the IRS? Clearly, maneuvering through the Byzantine tax code is impractical for most and wisely choosing an advisor within the multibillion dollar tax "advice" industry can be equally daunting. In early August, several individuals-near billionaires-testified before a Senate committee about being duped out of tens of millions of dollars in legal and accounting fees by their "blue-chip" advisors who set up fraudulent and worthless tax evasion schemes for them.

Clearly then, having a great CPA or tax lawyer for honest guidance is the most important step. But the role you can play is to understand the language of tax shelters and how to evaluate different strategies which may be presented to you. In this month's column I'll show you one way to make sense of shelters and present an illustration of a popular tax savings technique that can be used in a variety of circumstances.

Classifying Tax Shelters

The most clearly aggressive tax shelters are those specific transactions which the IRS has designated and listed as "Abusive." These activities are those which hold a high potential for non-reporting of income and may involve offshore tax plans in which accounts and true ownership of entities can be easily concealed. Abusive Shelters are required to be fully disclosed on your tax returns and are likely to be subjected to a high degree of scrutiny. Many of the employee "health and welfare benefits" programs are similarly regarded. Unless you are prepared for years of litigation to defend your position, your tax planning should avoid these types of shelters.

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At the other end of the spectrum are “Favored” shelters which are investments or vehicles encouraged by the Government to promote particular economic or social policies. Home ownership, retirement savings, oil and gas exploration and equipment purchases are certainly in this category. Many of these transactions require little or no reporting, the techniques are widely known and approved and it is often sensible to work within these plans to the extent they are available to you.

Somewhere between “Abusive” and “Favored “ is the netherworld known as the “Grey Area” where tax attorneys and CPA’s toil endlessly to squeeze out the greatest advantages and tax savings for their clients. Strategies which reach deeply or too aggressively into the “Grey Area” are sometimes challenged or litigated by the IRS and the taxpayer may win or lose depending on the skill of his attorney and facts of the case.

Tax Benefits with the CRT

One strategy that has worked very well for many of my clients is known as the Charitable Remainder Trust (“CRT”) which has been a part of the tax law since 1969. The intent of the law is to encourage charitable giving but the law is drawn broadly so that even if your charitable wishes are only a minimal part of your overall goals, the CRT can produce highly favored tax treatment in a variety of situations.

In a nutshell, Section 664 of the Internal Revenue Code states that if you create a trust, with a charity as the ultimate beneficiary, the trust will not be subject to taxes on its income. You are permitted to receive payments and distributions from the CRT and contributed property can be sold by the trust without any tax. You also receive a current income tax deduction for the value of the charitable contribution.

Here’s an example of a CRT we recently finished. A physician client with a high income owned a medical office building worth $2 million. He had paid only $300,000 for it about 10 years earlier. Instead of selling it and paying capital gains tax, we formed a CRT and transferred the property to the trust. Based on the way the CRT was structured, he accomplished these results:

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- An income tax deduction of $400,000, producing a tax savings of about $200,000;
- When the CRT sold the property, there was no capital gains tax on the appreciation;
- The $2 million proceeds in the CRT is managed and invested by the client and there are no taxes on the earnings of the investment portfolio;
- Within certain parameters, we have the freedom to designate when and how much of the trust is distributed to the client and/or his spouse (and kids);
- Any remaining amount in the CRT at the time of death is not subject to estate taxes;
- Excellent asset protection is accomplished and property in the CRT is shielded from lawsuit risk.

There are many rules, traps and explanations which apply to any CRT. On this particular plan we stayed squarely within the “Favored” territory but depending upon the size the income tax deduction which is claimed and the timing of the distributions, it’s easy to move into the “Grey Area” and create some possibility for a dispute at a point in the future. As always, we urge you to consult with your tax advisor to determine the impact which any planning may have on your particular circumstances.

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Profit Shifting to Reduce Taxes –

How Businesses and Wealthy Individuals Shelter Their Income

Businesses and wealthy individuals often reduce their overall tax burden by holding assets or conducting business operations in low or no tax jurisdictions. This may be done through overseas transactions or domestically by taking advantage of tax laws in low or no tax states.

Shifting Business Income

To minimize federal income tax companies often attribute a large share of their income to overseas subsidiaries in tax haven countries. Under U.S. tax rules, income earned from activities and sources outside the U.S. are generally not taxed until the income is repatriated. Technology companies have a particular advantage since intellectual property such as patents can be owned, and royalties paid, to an affiliated company in a location that does not tax royalty income or license fees. The result is that U.S. tax is effectively deferred for many years or indefinitely into the future. The current estimate is that approximately $1.5 trillion in profits are sitting on the books of foreign subsidiaries of U.S. based companies. Apple alone holds $74 billion in offshore profits and according to a recent story in the New York Times ("How Apple Sidesteps Billions in Taxes") aggressively routes over 70 percent of its profits through foreign affiliates in no or low tax jurisdictions which provide substantial tax breaks for royalty income, manufacturing and sales activities.

It's not just foreign profits which are sheltered in this manner. Profits generated in the U.S. can be shifted from high tax states to those with a lower corporate tax rate. According to the Times story, although Apples worldwide headquarters are in Cupertino, California, the company is able to move substantial profits to Nevada which has no corporate or personal income tax. By transferring its' investment activities to a minimally staffed office in Reno, Nevada, Apple is able to save billions of dollars in tax on its investment income each year by avoiding the California 8.84% corporate tax rate. Companies which are able to segregate business functions to some degree use similar tax strategies to shift profits from state to state, seeking the most attractive tax treatment.

Trusts for Wealthy Individuals

Wealthy individuals often employ similar income shifting strategies between high and low tax states to shelter investment income and capital gains. These techniques are increasingly popular, as a new wave of IPO's

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create millions and billions in profit for shareholders in successful technology companies, primarily based in California's Silicon Valley.

Here's an example of how this strategy is used. A California resident may own company shares which have appreciated from zero to $10 Million. If those shares were held and then sold by a California Trust, the state capital gains tax would be roughly $930,000.

To avoid recognizing the gain in California, the most popular technique involves transferring the ownership of the shares to a Delaware trust. Delaware law does not tax trust income accumulated for a non-resident beneficiary so a resident of a high tax state such as California or New York can dispose of highly appreciated assets through a Delaware trust without state income tax on the sale proceeds or the subsequent earnings on the funds.

In addition to the tax savings, the trust laws in Delaware are designed to allow a high level of asset protection and flexibility in accomplishing a wide variety of wealth management objectives.

As might be expected, the high tax states attempt to prevent their residents from using low or no tax states to achieve these tax benefits. Just as the U.S. Government attempts to limit revenue loss to the offshore countries, the high tax states fight against these profit shifting strategies with varying degrees of success.

Again, using California to illustrate, the law provides that if a California resident is a beneficiary of an out of state trust, that beneficiary is subject to California tax on the income of the trust. Conversely, if the beneficiary's interest in the trust is "contingent" rather than fully vested than the trust income is not taxed in California. If the goal is to avoid California tax then the Delaware trust must be carefully drafted to make sure that a beneficiary's interest is contingent and subject to various conditions within the trust agreement.

Depending on the specific law of the state and the goals of the trust grantor, Delaware Trusts or trusts formed in other low tax jurisdictions may be a useful income tax planning vehicle for reducing home state taxes on capital gains, investment income and some types of business income. In all cases, knowledge of the tax provisions of relevant state and federal law and proper trust drafting is essential.

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