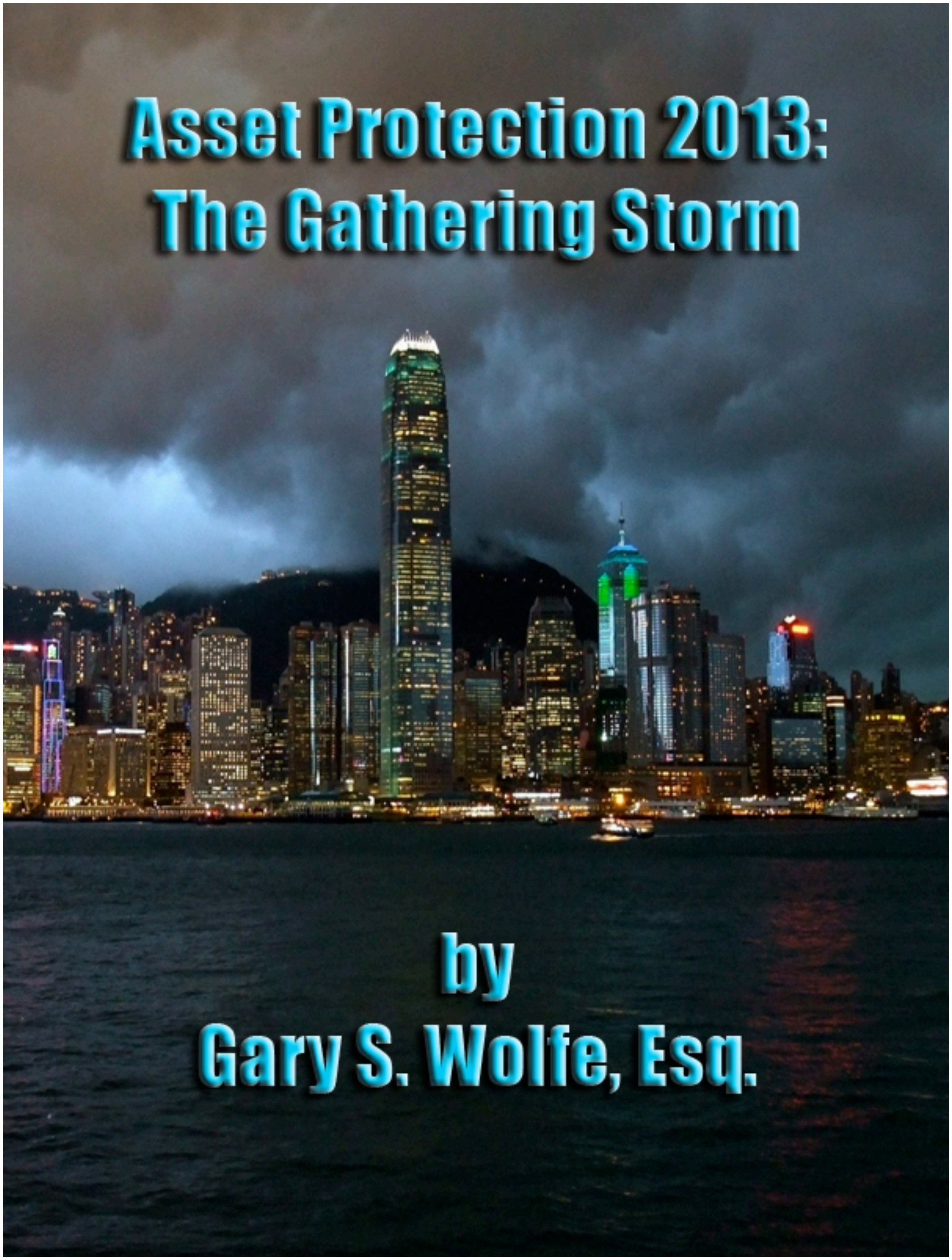
Asset Protection 2013:
The Gathering Storm
by
Gary S. Wolfe, Esq.

Asset Protection 2013: The Gathering Storm

By
Gary S. Wolfe

Special Contributions by:

David Richardson, Mid-Ocean Consulting
and
Ryan L. Losi, CPA, Piascik

Other Books by Gary S. Wolfe
Offshore Tax Evasion: IRS Offshore Voluntary Disclosure Program

For more information please see website:
gswlaw.com

BG Digital Publishing

For Edgar Gross

My friend
My mentor
A lifelong inspiration

Table of Contents

Introduction

For those who wish to keep what they possess, the answer is asset protection.

What is Asset Protection? First, it is NOT tax evasion, fraudulent conveyances, or money laundering. It is the legitimate sequestration of investment assets from the risks of unexpected 3rd party creditor litigation.

In 2013, those who have substantial assets face many risks:

1) "Biblical Disasters" – these include fires, floods, wars, earthquakes, famines ("everything but the locusts")
2) The Middle East engulfed in civil wars.
3) Europe with bankrupt countries, unemployment over 25% in leading EU countries (over 50% for those under age 25).
4) South America/Mexico is a cauldron of political revolution, drug dealing, and class warfare.
5) China, with 7 of the 10 most polluted cities in the world, is the victim of disastrous ecological, industrial policies.
6) Africa is rife with graft, corruption, tax evasion and dictators.
7) The U.S., with the richest Americans hiding $1.6 trillion in undisclosed offshore accounts, is costing $100 billion a year in unpaid taxes on unreported earnings.
8) Rising Interest rates.
9) The Tapering of Quantitative Easing.
10) Projected "bubbles" in U.S. stock market & real estate.

For those investors who wish to keep their investments safe the only issue is whether to spend the money necessary to protect their assets from unexpected litigation (and unforeseen circumstances).

As the saying goes, "By the time you want Asset Protection, it is too late to get it." Like life insurance, you have to plan for it, and purchase it by the time you need it, or you'll be out of luck.

The choice is stark, best expressed, to paraphrase Bob Dylan:
"If your assets to you are worth saving then you better start swimming or you'll sink like a stone, for (in 2013) the times they are a-changing."

Chapter 1
Tax Planning

1) Income, Estate and Gift Tax Planning
An estate which includes multiple assets may entail numerous individual asset transfers. Rather than make numerous transfers (for each of the individual assets), the tax planning transforms individual assets into LLC ownership interests (membership units) which may be distributed to heirs as undivided interests in the underlying assets, for efficient distribution.

2) Estate/Gift Tax Planning
LLC membership interests have reduced marketability (less marketable than the underlying assets) creating a marketability discount (with a corresponding reduction in value of the asset owned, reducing estate and/or gift tax).
Gifts of LLC interests, (which are minority LLC interests), create valuation discounts reducing estate and gift tax (i.e., restrictions on transfer, minority interest discounts).
In 2013, the U.S. Gift Tax/Estate tax exclusion is $5,250,000 (per individual) with a top marginal tax rate of 40%, for transfers over $5,250,000.

3) Income Tax Planning
LLC business operations may reduce taxes by favorable tax deductions (vs. personal tax): Legal fees, accounting fees not disallowed (i.e., subject to the 2% "floor" for itemized deductions), No alternative minimum taxable income (i.e., versus personal tax returns), and No "compressed tax rates" re: non-grantor trusts (i.e. tax year 2013, 39.6% tax on income over $11,200).

4) Tax Year 2013 – Estimated Tax Payments
LLC net income is passed through to the owners (members) and is subject to payment of estimated income taxes (there is no income tax withholding on LLC distributions). The law provides a penalty for underpayment of estimated tax. The Taxpayer can avoid this penalty by paying the minimum installment authorized under one of the exceptions. Estimated income tax payments are due (2013): 4/15, 6/15, 9/15, (1/15/14).

No penalty for failure to pay estimated tax will apply to any individual whose tax liability for the year, after credit for withheld taxes, is less than $1,000. A U.S. Citizen or Resident need not pay estimated tax if he or she has no tax liability for the preceding tax year providing such year is a 12-month period.

Individuals who do not qualify for these exceptions may avoid the penalty for failure to pay estimated tax by:
a. Paying at least 90% of the tax shown on the current year's return.
b. Paying 100% of the tax shown on the prior year's return.
c. Paying installments on a current basis under an annualized income tax installment method.

The required payments may be made either through withholding or payment of annual installments. The annuallization method is suitable for Taxpayers whose income is received or accrued more heavily in one part of the year (IRC §6654(d)). An individual with adjusted gross income in excess of $150,000 can avoid the estimated tax payment by paying 110% of the amount of tax shown on the prior year's tax return, provided the prior year is a full year.

The underpayment of estimated tax by an individual results in imposition of an additional tax equal to the interest that would accrue on the underpayment for the period of underpayment (IRC Code §6654(a)).

Interest on underpayments of tax is imposed at the federal short-term rate plus three percentage points (IRC Code §6621(a)(2)). The interest rates (which are adjusted quarterly) are determined during the first month of a calendar quarter and become effective for the following quarter. Interest accrues from the date the payment is due (determined without regard to any extensions of time, until it is received by the IRS). Interest is to be compounded daily, except for additions to tax for underpayment of estimated tax by individuals and corporations (IRC §6601).

5) Asset Protection – LLCs and Investors Tax Audits
LLCs may reduce IRS tax audit risk and offer third party creditor asset protection.
For individual taxpayers the IRS audit risk:
a. All Taxpayers (2013), 1.0% (1 in 100);
b. Taxpayers earning over $1m (2012), 12.48% (1 in 8);
The audit risk for LLCs is 0.4% (4/10 of 1%; i.e. 1 in 250).
Investment assets, held by an LLC, which generate income have 40%, the audit risk of all taxpayers, 8% of the audit risk of taxpayers who earn over $1m.

6) Asset Protection – S-Corporations, LLC and Tax Planning
Both LLCs and S-Corporations are tax-reporting net income tax-paying entities.
LLCs/S-Corporations pay a $800 minimum California tax, S-Corporations pay a 1.5% California corporate level tax, LLCs pay an annual "gross receipts tax", based on gross income:
Income / Tax
$0-$250,000 / $0
$250,000-$499,000 / $900
$500,000-$999,000 / $2,500
$1m – $4.99m / $6,000
$5m+ / $11,790

<u>S-Corporations</u>
1. May not issue preferred shares. Voting and non-voting common stock may be issued, but in all other respects, S-Corporation's shares must be identical in their rights and privileges.

2. Neither a corporation nor a non-resident alien can be an S-Corporation shareholder.
3. The inside basis of appreciated assets held by the S-Corporation (fair market value in excess of adjusted tax basis) may be adjusted to FMV upon the deceased owner's death for the successor's benefit.
4. Owners of the shares of an S-Corporation obtain no owner level basis adjustments for entry level debt (S-Corporation debt is not allocated as an upward basis adjustment among shareholders), thereby limiting the ability of S-Corporation shareholders to claim entity level losses passed through to them.
5. Distributions in kind of appreciated property from an S-Corporation to its shareholders is subject to a "deemed" sale treatment with gain recognition and taxation.
6. Contributions of appreciated property to an S-Corporation will result in recognition of gain to a shareholder.
7. A U.S. based S-Corporation, with outbound investment objectives may not establish and hold an 80% or more owned subsidiary to conduct operations abroad.

Limited Liability Companies

1. Various classes of interests in a LLC may be created without risk to the income tax classification of the LLC as a pass-through (one level of tax) entity (unlike S-Corporations).
2. The inside basis of appreciated property held by the LLC may be adjusted to FMV upon the death of the deceased owner.
3. LLC owners obtain owner basis adjustments for entity level debt, allowing them to claim entity losses passed through to them (unlike S-Corporations).
4. Distributions in kind of appreciated property from a LLC to its members do not trigger "deemed sale" tax treatment (i.e. gain recognition and taxation) (unlike a S-Corporation).
5. Contribution of appreciated assets to a LLC will not result in gain recognition.
6. Unlike an LLC, a limited partnership must have at least one general partner, subject to unlimited liability. In a LLC, all members will be directly protected against liabilities arising at the entity level under state law.
7. All LLC members can participate in management without losing liability protection (not just general partners in the case of a limited partnership).
8. For cross-border transactions, unlike an S-Corporation, foreign non-resident alien investors may directly join with U.S. co-ventures in a single entity to conduct a U.S. business with pass-through tax treatment for both.
9. U.S. based investors may use a LLC to conduct a foreign business and have limited liability protection and one level of pass-through taxation.

When combined, (i.e. an S-corporation) as the Manager and Owner of the LLC:

1. There is no self-employment tax (Social Security/Medicare) on net earnings distributed ultimately through an S-Corporation. In 2013 the tax savings is $17,396 (15.3% on $113,700, taxable wage base maximum).

2. The LLC may provide a single entity for inbound joint ventures between a U.S. and foreign person.

3. The LLC may hold outbound investment of U.S. based person with limited liability. Asset Protection – LLCs and Tax Planning 2013

In 2013, self-employment tax (i.e. a tax on net earnings from self-employment) which consists of Social Security Tax (FICA) and Medicare taxes are imposed on LLC members, but not on S-Corporation shareholders. As a tax-planning strategy, an LLC may be wholly-owned by an S-Corporation. LLC earnings are distributed to the LLC member, S-Corporation. There is no self-employment tax on the S-Corporation/LLC distribution (a 2013 tax savings of $17,396).

In 2013, high earners face increased FICA/Medicare Taxes (Employer/Employee Share).

1. Social Security (FICA Tax), 12.4% tax on net earnings up to $113,700 ($14,099 annual tax);

2. Medicare Tax (Self-Employment Tax), 2.9% Medicare tax on unlimited net self-employment earnings: $113,700 earnings ($3,298 annual tax), plus 2.9% tax on excess earnings.

In addition, in 2013 high earners face additional increased taxes:
1. Medicare Tax (Net Investment Income), 3.8% tax for taxpayers with income over $200,000 (individual), $250,000 (husband and wife) on lesser of net investment income or modified adjusted gross income;

2. Medicare Tax (Earned Income), 0.9% tax on earned income (wages over $200,000 individual, $250,000 husband and wife). This tax is imposed on employee's share of Medicare tax, and is disclosed on Form 1040.

3. Phase-out in itemized deductions, adds up to 1.19% to marginal tax rates. Itemized deductions are reduced by 3% of adjusted gross income (AGI) over $250,000 for singles, $300,000 for couples, not to exceed 80% of total itemizations (medical expenses, investment interest deductions, casualty losses are all exempt). The phase-out is based on the amount of AGI and net taxable income (i.e. what is left after itemized deductions).

4. Personal Exemption, loss of exemption adds as much as 1.05% per exemption. Personal exemptions are reduced by 2% for each $2,500 of AGI over the $250,000/$300,000 thresholds, and disappear once AGI exceeds $372,500 (singles), $422,500 (couples).

As a tax-planning strategy, investment income may be lessened by “net-income” taxation. Tier #1, the LLC receives investment income, distributes net income (i.e. income less expenses) to the S-Corporation (member/manager), which in turn distributes their net income to the S-Corporation shareholders. The #2 tier distribution to the S-Corporation shareholder is subject to a lesser risk of an IRS tax audit (than an individual taxpayer) and with proper tax planning less additional tax due to the phase-out of the itemized deductions and personal exemptions.

Chapter 2
Creditors Liability

The justification for allowing a person to "protect" assets is to permit a person to control the timing and disposition of property, and to ensure that the use the person wants his or her property to go to, it does.

A person is not obligated to make his or her assets available to creditors. The creditors have no countervailing interest to a person's freedom to freely alienate property.

The settlor's intention will not control if the actions prove to be invalid because it violates public policy, is fraudulent (hinders, defrauds or delays a creditor), or requires the performance of an illegal act.

<u>Present and Future Foreseeable Creditors</u>
A transfer is fraudulent as to both present and future foreseeable creditors if the debtor did not receive reasonably equivalent value for the transfer and either:
The debtor was engaged or was about to engage in a business or transaction for which the remaining assets of the debtor were unreasonably small, or the debtor intended to incur or believed or reasonably should have believed, that he or she would incur debts beyond his or her ability to pay as they became due. (Cal. Civil Code §3439.04(b)).

<u>Asset Protection (California) - Avoidance of Probate</u>
Estate benefits of trusts are avoidance of probate, costs, and time-delay if the trust (i) is properly set up, and (ii) is funded.

1) Revocable Trusts - Power to Revoke
Revocable trusts are not to be considered a safe vehicle for protection of assets. California has enacted a statute which provides that if the settlor retains absolute power to revoke, then his or her creditors can reach the trust corpus. (Cal. Prob. Code §18200).

2) Asset Protection (California Statutes)
The following are key Asset Protection Statutes in California:

California Probate Code §18200
If Settlor retains absolute power to revoke, then creditors can attach trust corpus.

Corporation Code §17302(b)
Court may order a foreclosure on the LLC membership interest, and the purchaser at the foreclosure sale obtains the rights of an assignee.

Corporations Code §17301(a)(2)

An LLC creditor-assignee obtains rights to the economic interest of the member, only, with no right to vote or participate in management.

Corporation Code §17301(a)(3)
An Assignee of an economic interest is entitled only to distributions of property (cash) and allocations of taxable income, gain, loss, deduction and credit.

3) LLC Charging Orders
An LLC offers superior asset protection from creditors, since the creditor's excusive remedy is the charging order.

<u>a. Charging Orders</u> - The charging order rules of Corp C §17302 provide the exclusive remedy for a judgment creditor to satisfy a judgment out of a membership or economic interest in an LLC (Corp C §17302(e)).

<u>b. Creditor-Assignee</u> - The secured creditor obtains rights to the economic interest of the member, only. A creditor assignee who holds only an economic interest will have no right to vote, participate in management, or exercise any other rights of a member unless the articles of organization or operating agreement grants any such rights to holders of economic interest. Corp C §17301(a)(2).

An assignee of an economic interest is entitled only to distributions of property or cash and allocations of taxable income, gain, loss, deduction, and credit. Corp C §17301(a)(3).

An assignee who becomes a member has the rights and powers and is subject to the restrictions and liabilities of a member (to the extent assigned). On becoming a member, the assignee is also liable for the obligations of the assignor to make contributions and return any prohibited distributions. Corp C §§17303(b), 17254.

The assignee is not obligated for liabilities unknown to the assignee at the time the assignee became a member and that could not be ascertained from the articles of organization or operating agreement. Corp C §17303(b).

Certain creditors may have superior rights, e.g., creditors with knowledge of the obligation who extended credit before the assignee's obligation was compromised, or creditors who may assert rights under the fraudulent conveyance laws, bankruptcy laws, or general principles of equity. Corp C §§17201(b)(2), 17201(d).

<u>c. Lien/Foreclosure</u> - A lien by a judgment creditor against a member's interest is created by service of a notice of motion for a charging order on the member and all other members of the LLC and continues unless the order is denied. CCP §708.320. A judgment creditor of a member may charge the "assignable" membership interest of a member without becoming a member. Corp C §17302(b).

To obtain the balance of the benefits of the economic interest, the creditor must establish a right to foreclose on the membership interest. The court may order a foreclosure on the membership interest at any time and the purchaser at the foreclosure sale obtains the rights of an "assignee." Corp C §17302(b).

The judgment debtor and the other members of the LLC retain the right to redeem the membership interest at any time before foreclosure. Corp C §17302(c).

4) Creditors ("Phantom Income")
LLC planning may include "creditor peril" (i.e. unexpected income tax for creditors seeking attachment of membership interests). Attaching creditors may receive income tax liability for LLC/K-1 income (debtor-member) without corresponding LLC distributions ("phantom income").

In an LLC, an attaching creditor is not substituted as an LLC member (i.e. no voting rights, no management rights). The creditor is an "assignee" of the economic interests that the LLC membership units represent (owned by debtor-member (LLC)).

An attaching creditor, of an LLC membership interest, is taxable on the LLC member's pro-rata share of LLC income (re: LLC member's K-1 tax return information).

5) Secured Financing/Asset Protection
An LLC may create asset protection by third-party secured financing. The LLC may own assets (e.g., stocks or bonds) which are pledged, under a senior lien, as collateral for a third-party loan or line of credit.

Asset protection advantages include:
Third party financing (the use of "other people's money" to finance your investment transactions, instead of your own funds). A third-party lender, loans funds to the LLC which loans funds to another company you may own (or designate as loan proceeds recipient).

By interposing a third-party lender you receive creditor protection by virtue of their senior lender lien (which is a priority lien against the assets (i.e., stocks or bonds) held under the LLC).

6) Stocks and Bonds
Bonds. The tax planning/asset protection strategy proposed may include a bond portfolio in which a sum is maintained on account, secured by a credit line which could be used at your election. The bond income would be in two forms:

a. "Discount" bond purchases (includes built-in profit in the event the bond was held to maturity).
b. Net bond interest (excess bond interest over any credit line interest charges).

Stocks. In the event you elect to invest the LLC funds in stocks not bonds, if the stocks appreciate in value, the appreciation may be "borrowed out" tax-free (until the underlying stock is sold) while you receive the income tax benefit of the tax deductions for interest paid.

Chapter 3
Limited Liability Companies: General

LLC Advantages

Asset protection (no creditor seizure of underlying assets).

Reduced tax compliance (no income tax withholding on LLC distributions). When established and owned by a trust offers privacy and confidentiality. Limited liability companies afford members the limited liability enjoyed by corporate shareholders and pass-through tax advantages of a partnership absent the restrictions imposed on limited partnerships and subchapter S corporations.

The limited liability companies are formed by filing articles of organization with the Secretary of State under an operating agreement (not filed) which is between all the members as to the affairs of the limited liability company and the manner in which the business is to be conducted. The limited liability company allows its owners (referred to as members) limited liability, but permits the members to actively participate in the entity's management. If the members do not want to manage the activities of the limited liability company, they can appoint managers.

Neither the owners (i.e., members) nor the managers are personally liable for the company's debts and obligations. For U.S. federal income tax purposes, the limited liability company is treated as a partnership, which makes it a reporting entity, but not a taxpaying entity. All of its items of gross income, deductions, gains, losses and credits are attributable on a current basis to and reportable by its owners (Form 1065/K-1).

For superior asset protection, a Limited Liability Company ("LLC") is a tax-efficient, cost-effective alternative. As of January 1, 2000, amendments to the Beverly-Killea Limited Liability Company Act (Corp. Code §17000-17555) permit the formation of single member LLC's in California (Corp. Code §17001, 17050).

Fees

In addition to the annual tax ($800), every LLC must pay a fee based on total annual income. The LLC fee is due on or before the 15th day of the 4th month after the close of the LLC's taxable year. In addition, California imposes an additional gross receipts tax on LLC's in: Revenue and Tax Code Section 17942(a). See chart below.

Gross Receipts Tax (Additional Fee)	Total Income
$900	$250,000 or more, but less than $500,000
$2,500	$500,000 or more, but less than $1 million
$6,000	$1 million or more, but less than $5 million
$11,790	$5 million or more

Chapter 4
Limited Liability Companies: Advantages

<u>Background</u>

In 1994, the Beverly-Killea Limited Liability Company Act (Corp C §§17000-17655) authorized the formation of California LLCs and recognized the validity of foreign LLCs registered in California. (See Corp C §§17050, 17451)

1) LLC Benefits
An LLC is a hybrid form of business entity that combines the liability shield of a corporation with the benefits of being taxed like a partnership, or, for a single-member LLC, the benefits of being ignored as a disregarded entity.

The shield protects an LLC's members from personal liability for the business's debts, and the tax classification as a partnership provides the advantages of pass-through taxation.

Eligible members of an LLC include individuals, general and limited partnerships, trusts, estates, associations, corporations, other LLCs, or other entities, whether domestic or foreign. (See Corp C §17001)

2) LLC Advantages: No Alter-Ego Liability
Under California law, no member of an LLC, solely by reason of being a member, is personally liable for any judgment of a court, or for any debt, obligation, or liability of the LLC, whether that liability or obligation arises in contract, tort, or otherwise. (Corp C §17101(a))

There are limits to the liability protection afforded by the LLCs. The Act does not protect a member from liability to third parties for the member's tortious conduct (e.g., fraud). (Corp C §17101(c))

Outside the fraud context, a member "shall be personally liable under a judgment of a court or for any debt, obligation, or liability of the LLC under the same or similar circumstances and to the same extent as a shareholder of a corporation may be personally liable for any debt, obligation, or liability of the corporation." (Corp C §17101(b)) Chapter 490 amended Corp C §17101(b) to highlight this point: "A member of a limited liability company shall be subject to liability under the common law governing alter ego liability."

Under California laws, a creditor of a partner or member is only entitled to obtain a charging order with respect to the partner or member's interest. The charging order gives the creditor the right to receive any distributions with respect to the partnership or membership interest. In all respects, the creditor is treated as a mere assignee and is not entitled to exercise any voting rights or other rights that the partner or member possessed.

Creditors have been successful in having a partnership interest subject to a charging order sold in a foreclosure sale when either the other parties consented or the court determined the sale would not unduly interfere with the partnership business. See Hellman v. Anderson, 233 Cal. App.3d 840 (1991); Crocker Nat'l. Bank v. Perroton, 208 Cal. App.3d 1(1989).

However the purchaser only acquired the partner's economic interest re: rights to distributions and not to the partnership's property or management rights in the partnership (which may result in "phantom income" and an income tax liability to the creditor).

3) Protecting Assets From Exposure To Liability
A client may own an operating business engaged in hazardous undertaking or real estate having potential liability under environmental laws. Exposing other business assets to such potential liability could be avoided by placing the hazardous business or real estate in a separate entity.

As a result of the check-the-box regulations that disregard a non-electing single-member LLC for tax purposes, a client-owned parent entity (such as another LLC, a limited partnership, or an S corporation) could own single-member LLCs holding separate parcels of real estate and separate businesses. Treas. Reg. §301.7701-3(a).

Before forming such a holding company, the client owning the hazardous assets would first transfer them to a newly formed LLC and immediately thereafter transfer the LLC interests received in exchange to the client's holding entity for interests in the holding entity. This would ensure that the client's parent entity never owned the hazardous assets outright.

4) Corporate Formalities
LLCs are subject to fewer formality requirements than are corporations, but members should maintain proper records, including copies of the articles or certificate, the operating agreement, a list of members, and copies of contracts and leases. The members generally should also observe the requirements and formalities set out in the company's operating agreement. Since a single-member LLC is especially vulnerable to an alter-ego claim, it is important to bolster the separateness of the owner from the entity.

The failure to observe the formalities of meetings does not establish alter-ego liability or personal liability if such formalities are not required by the LLC's articles of organization or operating agreement. (Corp C §17101(b)) This statutorily recognized ability to conduct LLC operations in an informal manner without exposing the members to alter-ego liability is a principal advantage of LLCs over corporations.

Except in cases of extreme disregard of corporate formalities (e.g., commingling or diversion of assets, manipulation of assets and liabilities, holding oneself as the obligor to creditors), undercapitalization appears to be the most likely ground (other than fraud) for holding members of an LLC liable for the LLC's obligations under the alter-ego doctrine.

5) Undercapitalization
No rule of thumb determines with mathematical certainty what dollar amount adequately capitalizes an LLC. This is determined on a case-by-case basis by considering the size, nature, and reasonably expected hazards and risks of the particularly business. To prevent a creditor from successfully invoking alter-ego liability against an LLC, the LLC's members (or for a single-member LLC, the LLC's member) should respect the LLC as a separate entity by doing the following:
a. Establishing a separate bank account for the LLC;
b. Avoiding the commingling of personal assets with the LLC assets;
c. Documenting loans between members and the LLC;
d. Ensuring that the transactions between the LLC and its member(s) are conducted in an arm's length manner; and
e. Avoiding diversion of LLC funds for non-LLC purposes.

6) Advantages Of Limited Liability Companies
a. Estate Planning
- Members can gift interests in family-owned businesses to children and others without losing control because the recipient does not have free transferability of interest.
- At the death of a member, the remaining members can elect a stepped-up basis of the decedent's share of LLC assets.
- An LLC can provide the estate planning benefits of a family limited partnership without the general partner assuming liability.

b. Compared to C Corporations:
Lower taxes – no double taxation.
No excess compensation problems.
No accumulated earnings tax.
Allows special allocations.
Wide range of management structures available.

c. Compared to Sole Proprietorships:
Limited liability-
Can take in investor(s) without giving up control.
Can give investor(s) tax benefits without liability.

d. Advantages over S Corporations:
Can have an unlimited number of owners (members).
No restrictions on who can be a member.

No built-in gains tax.
No tax on excess net passive investment income.
Can have special allocations.
LLC debt – even nonrecourse debt – is allocated to members, thus increasing basis.
Member's basis is stepped-up at a death of member.

S corporations are subject to certain restrictions on both the number and types of shareholders. There are no restrictions on who may be a member of a LLC or the number of members.

S corporations are not permitted to specially allocate income or loss. LLCs may specially allocate income or loss.

S corporations may not have more than one class of stock outstanding. LLCs can have an almost infinite variety of classes or series of interests.

S corporations are subject to certain penalty taxes for built-in gains and excess passive income. These penalty taxes do not apply to LLCs.

S corporations doing business in California are subject to a one and one-half percent net income tax. LLCs which are classified as partnerships for federal income purposes are not subject to this tax.

On the death of a shareholder or sale of stock, an S corporation does not adjust the basis of its assets. An LLC, since it is taxed as a partnership, can elect to adjust the basis of its assets on the death of a member or on the sale of a membership interest.
A shareholding of an S corporation is not entitled to basis for debts of the S corporation for purposes of using S corporation losses. However, a member of an LLC is entitled to basis for the LLC's debt under IRC section 752 even though that debt will be nonrecourse to the member.

e. Advantages over Limited Partnerships:
LLCs provide advantages over limited partnerships. These advantages include:
A limited partnership must have at least one general partner who is personally liable for the debts of the entity. An LLC does not have or need a general partner.
Limited partners who participate in the management of the limited partnership can be classified as general partners and face unlimited liability. In general, members are not liable for the debts of an LLC.

f. Advantages over General Partnerships:
Limited liability of members can participate without risking liability protection.

7) An LLC's principal advantage over a general partnership is that no member is personally liable for the debts of the partnership. Typically this restriction does not apply to professional LLCs where the members are liable for their own negligence

and the negligence of subordinates. This liability protections may further be limited by judicial doctrines or piercing the corporate veil.

Chapter 5
Limited Liability Companies: Tax Issues

Special Contribution by Ryan L. Losi, CPA, Piascik.com

Federal Tax Law

The “check the box” regulations of the federal tax laws provide that an LLC with two or more members may choose to be taxed as either a partnership or a corporation. The LLC must file an election to be taxed as a corporation or it will automatically be treated as a partnership. (Treas. Reg. §301.7701-3)

A single-member LLC may choose between tax treatment as a corporation or being disregarded for tax purposes (i.e., a disregarded entity). (Treas. Reg. §301.7701-3) A single-member LLC must file an election to be taxed as a corporation or it will be automatically treated as a disregarded entity.

In general, a domestic one-member unincorporated entity does not need to file anything in order to obtain “disregard” treatment, but an incorporated entity formed outside the United States may need to elect “disregard” treatment if it is not listed in the check-the-box regulations as a “per se” corporation. A single-member entity that is disregarded as an entity separate from its owner will be taxed as a sole proprietorship, division, or branch of its owner.

The major differences in treatment between a single-member LLC and an LLC with more than one member is that the latter LLC must file a partnership tax return (IRS Form 1065). As a result, the members of a multi-member LLC must report their share of the LLC’s income or loss on their individual tax return (IRS Form 1040) based on the amounts reflected on the LLC’s Schedule K-1.

For a single-member LLC that is treated as a disregarded entity, there is no Schedule K-1, and therefore its member reports the LLC’s income or loss directly on his or her individual tax return. The IRS permitted the disregarding of a two-member LLC when one of the members had no economic interest. (IRS Letter Ruling 199911033)
For California tax purposes, the distinction is minimized, because, a single-member LLC that is disregarded as an entity separate from its owners must nevertheless file an LLC tax return in California (FTB Form 568), pay the $800 annual franchise tax, and pay the LLC gross receipts fee.

With respect to an LLC owner’s federal tax liability, the IRS Chief Counsel said that the IRS may not levy on the assets of a single-member LLC that is disregarded for federal tax purposes to satisfy the tax liability of the owner. (IRS Chief Counsel Advice 199930013 July 30, 1999) However, the IRS has ruled also that the owner of a single-member LLC that is disregarded for federal tax purposes is the “employer” for tax purposes and is therefore liable for nonpayment of payroll taxes. (IRS Chief Counsel Advice 199922053 June 15, 1999)

California Tax Law

Even though a single-member LLC is disregarded as an entity separate from its owners, however, it must still file an LLC tax return in California (FTB Form 568), pay the $800 annual franchise tax, and pay the LLC gross receipts fee. (Rev & T C §§23038 and 17942; FTB Notice 2000-5 May 12, 2000) (available at the Franchise Tax Board's Web site at www.ftb.ca.gov/legal).

Disregarded treatment applies only for income and franchise tax purposes. It does not apply for purposes of California sales and use, property, and documentary transfer tax laws. Documentary transfer taxes will not be imposed on a transfer between a single-member LLC and its member that changes only the method of holding title to the realty if proportional ownership interests in the realty are not changed by the transfer. (Rev & T C §11925)

Chapter 6
Limited Liability Companies: Tax Compliance

Special Contribution by Ryan L. Losi, CPA, Piascik.com

Tax Filings
For federal tax purposes, the income and deductions of a single-member LLC owned by an individual will be reported on Schedule C of the individual's Form 1040. If the member is a corporation or partnership, the income will be reported on the member's Form 1120, 1120S, or 1065 (and ultimately, for a partnership, on the partner's own Form 1040).

To comply with California's tax reporting requirements, a single-member LLC need only complete FTB Form 568, side 1, and pay the annual LLC tax and LLC gross receipts fee. The single owner would include the various items of income, deductions, credits, and other tax attributes of the LLC on his or her tax return. Single owners should compute Schedule P to determine the LLC's credit limitation.

Avoidance of Consolidated Return Restrictions
Treatment of a one-member LLC as a disregarded entity allows corporate owners of single-member LLC's to treat them as branches or divisions, rather than as subsidiaries, for tax purposes, thus relieving them of the tax and administrative burdens imposed by the consolidated return regulations. Filing a consolidated return may defer the tax consequences of a transaction between a parent and its corporate subsidiaries, but structuring the same transaction between a parent and its single-member LLC subsidiary would avoid altogether any such tax consequences because of the single-member LLC's status as a disregarded entity.

Foreign corporations may not be included as members of an affiliated group in filing a consolidated return. (IRC §1504(b)(3)) Because single-member LLCs treated as flow-through entities are disregarded for tax purposes, however, the income and losses of foreign businesses owned by a single-member LLC may be offset against income of their U.S. parent outside of these consolidated return restrictions.

S Corporation
S corporation stock may be transferred to a single-member LLC without terminating the S Corporation election. (See IRS Letter Ruling 9739014)

Estate Planning
If real estate is held by an LLC and the LLC's operating agreement permits the interest in the LLC to pass to successors in order to prevent an inadvertent termination of the LLC, probate usually can be avoided.

Single-member LLCs have other advantages in estate planning. For example, if two or more executors are required to administer a decedent's estate, practical problems sometimes arise when an executor is unavailable. The executors could cause the estate to form a single-member LLC, with the executors serving as the LLC's officers. This structure provides the executors with some additional degree of protection from liability and (consistent with the LLC's operating agreement) allows one officer to act instead of requiring joint action by all the executors.

<u>Reorganizations</u>
An LLC taxed as a partnership normally may not participate in a tax-free reorganization because Subchapter C (which allows tax-free reorganizations such as mergers, divisions, and recapitalizations) applies only to corporations. (IRS letter Rulings 9409014, 9409016) No analogous set of rules permits LLCs to participate in tax-free reorganizations and mergers. However, an LLC owned solely by a corporation is treated as a branch or division of the corporate parent for tax purposes. Therefore, a single-member LLC owned solely by a corporation should be eligible to participate in tax-free reorganizations under Subchapter C.

<u>IRC §1031 Nonrecognition Exchanges</u>
The IRS has long taken the position that any transfer of property to or from an entity – even a wholly owned entity – simultaneously with or shortly before or after a tax-free exchange under IRC §1031, would disqualify the transaction from nonrecognition treatment. (Rev Rul 77-297, 1977-2, Cum Bull 304; Rev Rul 77-337, 1977-2 Cum Bull 305. See also Magneson v Commissioner (1983) 81 TC, 767 aff'd (9th Cir 1985) 753 F2d 1490)

Both the property surrendered and the property acquired must be held for productive use in a trade or business or for investment. IRC §1031(a). Although this provision does not specify a minimum holding period, the IRS takes the position that if the relinquished property was acquired immediately before the exchange or if the replacement property is disposed of immediately after the exchange, the taxpayer held the property primarily to dispose of it rather than for productive use in a trade or business or for investment.

The courts, particularly the Tax Court and the Ninth Circuit, have been more liberal in allowing transactions involving transfers of property to or from a controlled entity contemporaneously with an exchange to qualify for nonrecognition under IRC §1031, but the IRS has not acquiesced in those decisions. (See Magneson v Commissioner, supra; Bolker v. Commissioner (1983) 81 TC 782), aff'd (9th Cir 1985) 760 F2d 1039) Moreover, Congress amended IRC §1031 immediately after those cases were decided to undermine the foundation of the court decisions. (IRC §1031(a)(2)(D))

In at least two private rulings, the IRS ruled that a taxpayer's transfer of replacement property directly to the taxpayer's wholly owned, single-member LLC in the second leg of a IRC §1031 exchange would not disqualify the taxpayer from receiving nonrecognition treatment. (IRS Letter Rulings 9807013, 9751012) The IRS concluded that, because the single-owner LLC is disregarded as an entity (unless it elects to be taxed as a corporation), the transactions in question would be viewed as if the taxpayer itself had directly received the replacement property, and therefore satisfied the holding requirement of IRC §1031.

Although IRC §6110(k)(3) prevents these rulings from being used or cited as precedent, they do constitute substantial authority for purposes of the accuracy-related penalty rules. (See Treas. Reg. §1.6662-4(d)) The letter rulings also reflect the Service's position with respect to the use of single-member LLCs in connection with IRC §1031 exchanges under the check-the-box regime (it is unlikely that the IRS would adopt an audit or litigating position contrary to these rulings).

In addition to limiting liability, a transfer of the replacement property directly to the taxpayer's wholly owned LLC, rather than transferring the property to the taxpayer and then to the LLC, will avoid duplicative transfer of taxes and fees (e.g., recording fees and escrow fees). Thus, in a multiple-party exchange involving a qualified intermediary, the escrow instructions should direct the escrow officer to transfer title to the taxpayer's wholly owned LLC and bypass both the intermediary and the taxpayer.

A taxpayer could possibly avoid transfer taxes and fees by transferring his or her entire interest in a wholly owned LLC that holds real property to the buyer of the relinquished property in exchange for real property.

For a single-member LLC disregarded as a separate entity, the transaction would be characterized as if the taxpayer transferred the property directly to the buyer. The buyer, who would become the sole owner of the LLC, could choose to continue holding the property in the LLC or liquidate the LLC and distribute the property tax free under IRC §731.

Exchanges of partnership interests do not qualify for nonrecognition treatment (IRC §1031(a)(2)(D)) The check-the-box regulations clearly provide that a single-member LLC is to be disregarded as an entity (unless an election is made to be treated as a corporation). Therefore, the transfer of interests in single-member LLCs should be deemed a transfer of the underlying assets and such transfers should qualify for nonrecognition treatment.

<u>Conversion of Existing LLC to a California Single-Member LLC</u>

The conversion of a disregarded single-member LLC into a multi-member LLC taxed as a partnership, may result in a taxable sale. (See Rev Rul 99-5, 1999-5 Int Rev Bull) If a new member or members contribute cash or property and the original member does not receive any of the contributed cash or property as part of the transaction, generally no gain or loss will result to the members. However, to the extent that cash or property is distributed to the original member as part of the transaction, that portion is treated as a taxable sale of the LLC's assets. The transaction is treated as if the new member buys the assets directly from the original member and then contributes the assets to the new LLC.

Converting a multi-member LLC taxed as a partnership into a single-member LLC (e.g., on the withdrawal of a 1-percent member who is no longer needed for purposes of having a California LLC) may cause a taxable event to occur. See Rev Rul 99-6, 1999-5 Int Rev Bull. If a new member purchases the membership interests of the original members, it is treated as a sale of the original members' membership interests and the LLC terminates.

The new member is deemed to have purchased assets directly from the original members. If an existing member acquires all of the other members' interests, the LLC terminates and the departing members are deemed to have sold their interests to the remaining member. The remaining member is deemed to have received a distribution of his or her share of the LLC's assets immediately before the transaction. Gain may result to the extent that any money distributed exceeds the remaining member's adjusted basis in the LLC interest.

Chapter 7
Limited Liability Companies: California Laws

Effective January 1, 2004, §17001(t) of the California Corporation Code defines a "limited liability company" as an entity having one or more members. The statutory definition does not require an LLC to be organized for a business purpose.

Section 17102 expressly permits members to create different classes of membership, each with its own rights, powers and duties, including rights, powers and duties senior to those of others classes.

Section 17103 gives members the power to vary their respective voting rights in the articles of organization or a written operating agreement. However the statute requires that a majority in interest of the members must approve an amendment to the articles of organization, and all members must be given the right to vote on a dissolution or merger of the LLC.

Section 17151 expressly provides for management of an LLC by on or more managers (who do not have to be members). However, the articles or organization must include a statement to the effect that the LLC is to be managed by managers and not all its members. While it is necessary to include the number or names of managers, it the LLC is to be managed by a sole manager, the articles must also include a statement to that effect. (See also §17051(a)(5))

However, regardless of any management restrictions placed upon members in the operating agreement, §17157 provides that unless a statement regarding management by other than all members is included in the articles of organization, every member will be an agent of the LLC, and the act of any member will bind the company unless the acting member has no authority to so act and the third party involved had an actual notice of the member's lack of authority.

Section 17152 required that where management has been vested in one or more managers pursuant to a statement in the articles of organization, the manager(s) shall be elected by a vote of a majority in interest of the members, and may be removed at any time by a similar vote, with or without cause. Unless a term is specified, managers shall serve until such time as their successors have been elected and qualified.

Pursuant to §17154, managers may appoint officers to serve at the managers' pleasure (subject to any rights under an employment contract).

Section 17202 gives members the right to vary the allocation of profits and losses from the proportion of each member's contribution.

Under the default rule set forth in §17301(a), a membership interest or an economic interest is assignable in whole or in part, provided a majority in interest of non-transferring members consent.

Unless the members have provided otherwise, §17301(a) also states that an assignment of an economic interest entitles the assignee to receive, to the extent assigned, the distributions and allocations to which the assignor would be entitled. The assignor continues to be a member, and to have the right to exercise any rights and powers of a member (including the right to vote in proportion to the interest in current profits that the assignor would have absent the assignment), until such time as the assignee is admitted as a member.

Sections 17100(a) and 17303(a) together provide that a person acquiring a membership interest either directly from the LLC or as an assignee of a current member may become a member only upon the consent of a majority in interest of the members (excluding the vote of the person acquiring membership interest) and the completion of the steps needed to make the acquiring person a party to the operating agreement, unless the members have otherwise provided in the articles or operating agreement.

Section 17303 also states that once admitted as a member of the LLC, an assignee has, to the extent assigned, the rights and powers, and is subject to the restrictions and liabilities, of a member. Upon admittance, the new member also becomes liable for the assignor's obligations to make additional capital contributions and to return any lawful distributions made to the assignee. However, the assignee/member does not become obligated for any liabilities unknown to him or her at the time he or she became a member and that could not be ascertained from the articles or operating agreement. In any event, the assignor's liability continues regardless of whether or not the assignee of his or her membership interest becomes a member.

Section 17301(b) prevents an assignee of an economic interest from having any liability to the LLC for capital contribution or the return of unlawful distributions solely as a result of the assignment, except to the extent assumed by agreement, until such time as he or she becomes a member.

Under §17100 (c), LLC members may provide in the operating agreement for the termination of a member's membership interest or economic interest and the return of such terminating member's contribution, which provision shall be enforceable unless a member establishes that the provision was unreasonable under the circumstances existing at the time the agreement was made. However, the statute also provides that if a member's economic interest in the LLC is terminated pursuant to the operating agreement, such terminating member may demand and shall be entitled to receive a return of his or her contribution. This provision raises a potential valuation problem under IRC §2704(b) if the operating agreement more severely restricts the right to a return of capital contributions.

Section 17252(a) places no limit on member's ability to restrict a member's right to withdraw: the articles or operating agreement may provide either that a member may withdraw from the LLC only at the time or upon the happening of events specified in the operating agreement of that a members may not withdraw at all. However, notwithstanding any restriction placed upon a member's right to withdraw, §17252(a) gives a member the power to withdraw at any time by giving written notice. In the event a member so withdraws in violation of the operating agreement, the LLC may offset any damages it suffers from the breach against any amounts otherwise distributable to the withdrawing member.

Unless otherwise provided, a withdrawing member is not entitled under §17252(a) to any payment for his or her membership interest, and subsequent to his or her withdrawal, a member shall have only the rights of an economic interest holder with respect to distributions. The withdrawn member shall no longer be a member of the LLC.

In 1998, the California legislature amended §17350 to require dissolution of an LLC only upon the happening of the first to occur of the following:

At the time specified in the articles of organization, if any, or upon the happening of the events, if any, specified in the articles of organization or a written operating agreement.

By the vote of a majority in the interest of the members, or a greater percentage of the voting interests of members as may be specified in the articles or organization or a written operating agreement.

Chapter 8
U.S. Taxpayer Federal/State Income Tax Issues

For both United States and California income tax purposes, under a Grantor Trust (i.e., The Trust) the Settlor is treated as if the Settlor owns the Trust corpus (assets). The Trust income, deductions, and credits are reported annually on the Settlor's United States/California income tax returns (Form 1040/540).

In California, if the Trustee and Trustor (Settlor) of a Grantor living Trust are the same person, California follows the federal rule, and does not require a Trustee to file a separate trust tax return (Revenue and Taxation Code Sections 18401, 18405). For any trust, where separate tax returns are required, a fiduciary, acting on behalf of a Trust must file federal/state tax returns if:

Federal tax law requires a Trust tax return be filed if annual Trust gross income exceeds $600.00 or more.

In California, state tax law requires a Trustee to file a tax return if net income exceeds $100.00 or if gross income exceeds $10,000.00.

Under IRC § 6034(a), if the Trust must file a tax return the Trustee must furnish a statement under IRC §6034(a) to each beneficiary or nominee before the filing date if the beneficiaries receive a distribution, or any item was allocated to the beneficiary.

<u>Tax Compliance</u>

Your personal tax returns (Form 1040/540) are due April 15th (unless extended), which includes Trust income and expense. Estates and other Trusts file Form 1041/541 (annually), which is due on the 15th day of the fourth month following the close of the tax year (IRC §6072(a); §6012(a)(3) and (4)).

Other Trusts must use a calendar year, with Form 1041 due on April 15th following the closed of the calendar year.

Exceptions include:

a. Certain tax-exempt Trusts.

b. "Qualified" Revocable Trusts, which may be treated and taxed for income tax purposes as part of an Estate (IRC §645).

c. Estates have the flexibility of using a fiscal year end (unlike Trusts).

d. Real Property Tax (California)

In California (California Constitution, Article XIII(a)), transfer of California real property to a revocable Trust, or from a Trust to a Settlor is not a change of ownership for tax assessment purposes and therefore should trigger no change of ownership or increased tax (see, Revenue and Taxation Code §62(d)).
Real property is reassessed for tax purposes when a Trust becomes irrevocable and the right to possession or enjoyment vests in someone other than the Settlor (see, Revenue and Taxation Code §§ 61(f) and (g)).

Chapter 9
California Community Property/Liability for Judgments

California Statutory Collection Laws

CCP Section 695.010(a) provides that all property owned by the debtor, subject to certain exceptions, is subject to enforcement of a judgment. Community property owned by a debtor's spouse is included within the "all property owned by the debtor." (CCP Section 695.020(b))

Additional costs and interest may be added to the judgment. As money comes in from the debtor to the creditor, it is first applied to satisfy any additional costs and interest, and only then, the principal balance of the judgment. (CCP Sections 695.210 and 695.221) Interest accrues only on the original amount of the judgment unless judgments are periodically re-recorded, in which case interest compounds.

Judgments continue to exist for 10 years from the date of entry of the judgment. (CCP Section 683.020) Judgments may be renewed for additional terms of 10 years. (CCP Section 683.110(a) and 683.120(b)).

Judgments are usually collected through the lien mechanism. The creditor will place a lien on the debtor's real and personal property (by recording the judgment with the county recorder's office or entering it with the Secretary of State), and the lien will be satisfied when the property is sold by the debtor or foreclosed upon by the creditor. Once the underlying judgment is satisfied, the lien must be released. (CCP Section 697.050)

A judgment lien on real property is created when the judgment is recorded in the county where the debtor owns real property. (CCP Section 697.310(a)). The judgment must be recorded in each county where the creditor wishes to create a lien against the debtor. The judgment lien continues to exist for 10 years from the date of the judgment, unless it is renewed. (CCP Section 697.310(b).

A judgment lien on personal property is created when notice is filed with the California Secretary of State and continues for 5 years. (CCP Section 697.510)

In addition to collecting through the lien process, a creditor can collect through the writ of execution. (CCP Sections 699.010 through 699.090) A writ of execution is issued by the clerk of the court where the creditor obtained its judgment. (CCP Section 699.510) The writ of execution directs the county sheriff to secure the debtor's property in that county. Thus, the writ of execution is a levy. A separate writ of execution must be issued for each county where the creditor intends to levy on the debtor’s property. The writ of execution is effective for 180 days.

All property owned by the debtor that is subject to a judgment may be levied upon through the writ of execution process. (CCP Section 699.710) This includes real property, but the levy must first be recorded in the county where the real property is located. (CCP Section 700.015(a)) There are several exceptions, which include the interest of a partner in a partnership or a member in a limited liability company, the loan value of a life insurance contract, and the interest of a beneficiary in a trust. (CCP Section 669.720)

Once the levied property is collected by the sheriff, whether real or personal, the property is sold at a foreclosure sale to the highest bidder, for cash or cashier's check. (CCP Section 701.510) For tax liens, the property cannot be sold until the bid amount exceeds the state tax lien on the property and the exemption amount for the claimed property. Once the property is sold at the foreclosure sale, the lien on such property is extinguished.

Following the foreclosure sale the sheriff remits the amount collected, less certain costs, to the creditor, unless the property was subject to other liens with a priority higher than the judgment creditor. In that case the creditors are paid off in the order of their priority, and any amount left over is remitted to the debtor. (CCP Section 701.810) It is important to note that foreclosures of mortgages are subject to special rules. (See CCP Sections 725a-730.5)

In some circumstances, the creditor may attempt to obtain a turnover order – a court order directing the debtor to turn its assets (usually a specific asset) over to the creditor.

<u>Other Creditor Remedies</u>

At any time while the creditor has a judgment outstanding against the debtor, the creditor may serve upon the debtor written interrogatories demanding information from the debtor which will assist the creditor in satisfying the judgment. Similarly, the creditor may demand documents and records from the debtor which will assist in satisfying the judgment. (CCP Sections 708.020 and 708.030)

The creditor may also require the debtor to appear for a debtor exam before a court or a court appointed referee. (CCP Section 708.110) At a debtor exam, the debtor may be required to produce books and records, tax returns, financial information, witnesses and answer a battery of questions about past employment history, ownership and transfers of assets and any other information that would assist the creditor in locating debtor's assets.

If a creditor has a judgment against a partner in a partnership or a member of a limited liability company, the creditor can apply for a court order charging the interest of the partner/member in the entity. (CCP Section 708.310) Notice of the charging order must be given to all partners or all members of the entity. (CCP Section 708.320)

A creditor may also levy on the debtor's wages through the means of a wage garnishment. (CCP Section 706.020-706.034) The creditor cannot garnish the entire wage of the debtor. Pursuant to federal law, followed in California, the maximum the creditor can garnish is the lesser of: (i) 25% of the debtor's disposable earnings for the week, or, (ii) the difference between disposable earnings for the week, and (b) thirty times the federal minimum wage. (15 U.S.C. 1673(a). The current federal minimum wage is $5.15 per hour. 29 U.S.C. 206(a)(1)) However, if the garnishment is to satisfy a support order, up to 50% of disposable earnings can be garnished. (15 U.S.C. 1673(c))

<u>California Law – Community Property</u>

If assets constitute community property, it is usually irrelevant that the assets are titled in the name of one spouse. The creditor can attach all of the community property, even if only one spouse is the debtor. This may hold true even if the debt arose prior to the marriage. (See CCP Sections 695.020, 703.020 and 703.110.)
In community property states, most property acquired during marriage is treated as community property. Even if property so acquired is titled in the name of one spouse, that merely creates a rebuttable presumption as to the community or separate nature of such property. Because each spouse has a coextensive ownership interest in community property, creditors of either spouse can reach all community property of the two spouses.

However, on divorce, the treatment of the spouses' property is different. All property acquired during marriage, (other than by gift or inheritance) regardless of how it is titled, is treated as marital property, and is subject to a division on divorce. Generally, in a common law state, marital property will be any property owned by a spouse except: (i) property acquired prior to marriage; (ii) property acquired during marriage by gift or inheritance; and (iii) property designated as nonmarital through an agreement between spouses.

During marriage, the creditor can reach only the property titled in the name of the debtor spouse. However, on divorce, all marital property will be divided, regardless of how it is titled and may become reachable by a creditor.

Community Property Jurisdictions – Overview of Community Property
In a community property state there are two types of property: separate and community. (There is actually a third form of property in a community property state: quasi-community property. Quasi-community property is real and personal property, wherever it is located, that would have been community property had the spouse been domiciled (resided) in California when he or she acquired it, or any property acquired in exchange for such property.) Separate property is acquired in

much the same manner as in common law states: (i) property acquired prior to marriage; (ii) property acquired during marriage by gift or inheritance; and (iii) property acquired during marriage but as to which the spouses entered into an agreement treating it as separate property. (California Family Code Sections 770(a) and 850(a))

Separate property in a community property state is afforded similar treatment to separate property in a common law state. During marriage, a creditor of one spouse cannot reach the separate property of the other spouse. However, the one important distinction is that in a community property state, separate property is separate for all purposes, including divorce. In common law states separate property may also be marital property, subject to an equitable division on divorce.

Community property is a form of joint ownership of property by husband and wife. It is defined as real or personal property, wherever situated, acquired by a married person during the marriage while domiciled in this state. Each spouse can manage, direct and control community property.

The distinctive feature of community property (Community property states include: Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin.) is that both spouses own coextensive interests in all of community property. This means that a creditor of one spouse can reach all the community property of the spouses.

California Family Law Code Section 910(a) provides:
Except as otherwise expressly provided by statute, the community estate is liable for a debt incurred by either spouse before or during marriage, regardless of which spouse has the management and control of the property and regardless of whether one or both spouses are parties to the debt or to a judgment for the debt.
The liability of community property extends to contracts entered into by either spouse during marriage, to torts of either spouse during marriage, and to most pre-marriage obligations of either spouse.

Characterization of Community Property – Generally

The five major factors affecting characterization of property as separate or community are the following: (i) time of the property's acquisition; (ii) the source of funds used to acquire the property; (iii) whether spouses entered into a "transmutation agreement" to change the character of property from community to separate, separate to community, and from the separate property of one spouse to the separate property of the other spouse; (iv) actions by parties, including actions that "commingle" or combine separate and purchased or money borrowed is presumed to be community property. The general rule is that property acquired during marriage is community property.

For property acquired during marriage, it is important to establish not only the actual amounts of separate and community contributions, but also their respective proportions. Thus, when the property appreciates in value, it will be still possible to apportion.

Pursuing a Separate Business

When one spouse devotes time during marriage to develop his or her separate business and the business appreciates in value, then a portion of that appreciation is attributable to the community. During marriage the time of each spouse belongs to the community, and the time expanded on a separate business is community's time. California courts have established complicated formulas to apportion the appreciation in value between separate property and community property.

Transmutation

Married persons may, by agreement or transfer, and with or without consideration, change or "transmute" the character of their property in any of the following ways: (i) from community property to separate property of either spouse; (ii) from separate property of either spouse to community property; (iii) from separate property of one spouse to separate property of the other spouse. (California Family Code Section 850)

To be effective, a transmutation agreement must be in writing, the spouses must fully disclose their properties to each other, and a transmutation of real property will be effective as to third-party creditors only if it is recorded. (California Family Code Sections 852(a) and (b). See, also Estate of MacDonald, 51 Cal. 3d 262 (1990).) The law of fraudulent transfers applies to transmutation agreements. (California Family Code Section 851)

The Community Property Presumption

There is a legal inference, called a "presumption," that all property acquired during marriage by either husband or wife or both is community property. (California Family Code Section 760)

The general community property presumption specifically applies to the following types of property: (California Family Code Section 760) (i) all real property, including leased property, that is located in California and is acquired during marriage by a spouse while domiciled (living with intent to remain) in California; (ii) all personal property, wherever located, that is acquired during marriage by a married person while domiciled in California; and (iii) all community property transferred by husband and wife to a trust pursuant to Family Code Section 761. However, the general community property presumption that property acquired during marriage is community property may be overcome by evidence that the disputed property is actually separate property.

Evidence that may be used to overcome the community property presumption includes the following: (i) an agreement between the parties to change the character of (transmute) the property from community to separate property; (ii) tracing property to a separate property source; or (iii) reliance on separate property as collateral when property is purchased on credit.

If the community property presumption cannot be overcome, the party who has made traceable separate property contributions to the acquisition of property may obtain reimbursement in certain circumstances. (California Family Code Section 2640)

There are several statutory exceptions to the general presumption that all property acquired during marriage is community property: (i) property acquired by either husband or wife by gift, will, or inheritance;' (ii) property that either spouse acquires with the rents, issues, or profits from separate property; (iii) property held at death and that a spouse acquired during a previous marriage if that marriage was terminated by dissolution more than four years before death; (iv) any real or personal property interest acquired by the wife by written instrument before January 1, 1975; (v) property acquired by either spouse after separation, unless the property is acquired with community property funds; (vi) property designated as separate by a transmutation agreement; (vii) personal injury damages paid by one spouse to the other spouse if the cause of action arises during marriage; and (viii) personal injury damages received by one spouse from a third party after a court renders a decree of legal separation or a judgment of dissolution of marriage. (See, Family Code Sections 770, 781, 802 and 803)

<u>Effect of Title on Community Property – Joint Tenancy and Tenancy in Common</u>

The general community property presumption applies to all property acquired during marriage, including property titled in joint form, such as joint tenancy or tenancy in common. A spouse intending to rebut the community property presumption for jointly titled property may do so in one of two ways: (i) a clear statement in the deed or other documentary evidence of title by which the property is acquired that the property is separate and not community property; or (ii) proof that the spouses have made a written agreement that the property is separate property.

California community property laws suggests holding assets in a community property form is less desirable than separate property, at least from an asset protection perspective. The reason is that all of community property is liable for the debts of either spouse, whether incurred before or during marriage. Contrast that with separate property, which is only liable for the debts of that spouse who owns the separate property (except for obligations with respect to necessities of life).

In the context of asset protection planning, one may want to convert community property to separate. One way of accomplishing that goal is for spouses to transmute their community property into separate. However, transmutation agreements are subject to the fraudulent transfer laws.

In most community property states, the general rule is that community property can be seized to satisfy community debts even after a divorce. This means that once the community incurred a debt, both spouses are liable for that debt, even following a divorce, and even if the liability has been allocated entirely to only one spouse. (Wilkes v. Smith, 465 F. 2d 1142, 1146 (9th Cir. 1972))

In California, this rule has been changed so that community property awarded to a nondebtor spouse as separate property is protected from the claims of his or her ex-spouse's creditors, even if the debts are community debts. This means that a community debt, which is generally an obligation of both spouses, can be assigned to only one spouse, in California. (California Family Code Section 2551)

With respect to the separate property of spouses following a divorce, the allocation and division of liabilities on divorce in California are as follows: (California Family Code Section 916(a))

Separate property owned by a married person and property received by that person pursuant to the division of property is liable for debts incurred by the person before or during marriage whether the debt is assigned for payment by that person or that person's spouse.

Separate property owned by a Married person at the time of the division and other property received by that person is not liable for debts incurred by the person's spouse before or during marriage and the person is not liable for such debt unless it was assigned to him or her in the division of property.
Separate property and other property received by a married person is liable for debts incurred by the person's spouse before or during marriage and the person is personally liable for the debt if it was assigned for payment by the person pursuant to the division of property.

While a community debt can be assigned to only one spouse (in California), that does not mean that the spouses can assign all of the liabilities to one spouse, and all of the assets to the other spouse. Transfers of property pursuant to a divorce, like any other transfers of property, are subject to the fraudulent transfer laws.

For example, in Britt v. Damson, (Britt v. Damson, 334 F. 2d 896, 902 (9th Cir. 1964), cert. denied, 379 U.S. 966 (1965)) the spouses divorced and the husband filed for bankruptcy. There was a claim that the property transferred to the wife pursuant to the divorce was fraudulent. The court held that although the division of property was not fraudulent under state law, it could be under the Bankruptcy Code's fraudulent conveyance provisions. The court stated:

To the extent that the value of the community property ordered to [the wife] was offset by the value of the community property awarded to husband, the 'transfer' to [the wife] was, as a matter of law, supported by 'fair consideration,' ...

To the extent that the award of community property to [the wife] may have exceeded half of the total value of the community property, there is a question whether, under all the circumstances, [the husband] received fair consideration as a matter of law.

The Ninth Circuit thus made it apparent that even on divorce, transfers of property can be scrutinized and tested under the fraudulent transfer laws.

In a more recent case, the California Supreme Court attempted to harmonize California Family Code Section 2551 and the UFTA. (Mejia v. Reed, 31 Cal. 4th 657 (2003)) Section 2551 provides that the property received by a person on divorce is not liable for debt incurred by the person's spouse before or during marriage, and the person is not personally liable for the debt, unless the debt was assigned pursuant to the divorce to that person. This means that in California divorce overrides the asset protection disadvantages of the community property system.

In contrast to Section 2551 is the UFTA which provides that any transfer of property is subject to the laws of fraudulent conveyances.

The California Supreme Court reasoned that the California Legislature has a general policy of protecting creditors from fraudulent transfers, including transfers between spouses. Just as the fraudulent transfer laws apply to transmutation agreements during marriage, so do those laws apply to transfers of property on divorce.

Despite the court's holding the transfers of property on divorce are subject to the UFTA, challenges under the UFTA are still limited in the context of divorce and leave room for planning opportunities. Under the UFTA, a creditor can allege that the transfer was either actually or constructively fraudulent.

Constructive fraud requires little more than a finding that one of the spouses was left insolvent – a straight forward and objective analysis. However, actual fraud requires a subjective analysis which makes it more difficult for a creditor to prevail in the context of divorce.

Postnuptial and Transmutation Agreements

Postnuptial Agreements

An agreement between spouses after the marriage ceremony and affecting the spouses' property rights is referred to as a postnuptial agreement. A transmutation agreement is a postnuptial agreement that changes the character of the spouses' property from community to separate, or vice versa.

Postnuptial agreements are governed primarily by the California Family Code Sections 721, 1500 and 1620. Section 721 provides that postnuptial agreements (as opposed to premarital) are subject to the general rules governing fiduciary relationships that control the actions of person occupying confidential relations with each other.

Section 1500 provides general authority for spouses to alter their property rights by a marital property agreement. Section 1620 states that, except as otherwise provided by law, a husband and wife cannot, by a contract with each other, alter their legal relations except as to property.

<u>Transmutation Agreements - Generally</u>

Many postnuptial agreements have as their purpose the change, or transmutation, of the character of the parties' property from separate to community, or vice versa. Spouses are free to alter the character of property in this manner, provided that all statutory requirements are met. A transmutation agreement may be used to change the character of property to be acquired in the future, as well as property that the spouses own at the time of the agreement. (California Family Code Sections 850, et. seq.)

The principal limitation on transmutation agreements between spouses is that (i) they must be fair and based on full disclosure of the pertinent facts, and (ii) they must not be a fraudulent transfer of assets.

The following are the major considerations pertaining to transmutation agreements: (i) except for certain interspousal gifts, transmutations of real or personal property are not valid unless made in writing by an express declaration that is made, joined in, consented to, or accepted by the spouse whose interest in the property is adversely affected; (ii) transmutations may be made with or without consideration; (iii) transmutations of real property are not effective with respect to third parties without notice of the transmutation, unless the transmutation is recorded; (iv) transmutations are subject to the laws governing fraudulent transfers; and (v) a statement in a will of the character of property is not admissible as evidence of a transmutation of the property in any proceeding commenced before the death of the person who made the will.

<u>Tax Effects</u>

Transmutation agreements have certain tax implications. For income tax purposes, if spouses file a joint return, then characterization of property as community or separate is irrelevant, as all income is aggregated. However, if spouses file a separate return, then each spouse must report his or her one-half share of community income, and his or her separate income. Because transmutation agreements change the nature of the property (including earnings and other income), they have the greatest income tax impact on separate tax returns.

Transfers of property between spouses are generally nonrecognition events for income tax purposes, as they are always considered to be gifts with basis carryover. There are a couple of exceptions: (i) transfer to a spouse who is a nonresident alien at the time of the transfer; (ii) transfer in trust, to the extent that the sum of the liabilities assumed, plus the liabilities to which the property is subject, exceeds the total adjusted basis of the property; or (iii) transfer in trust, of an installment obligation. (See, IRC Section 1041)

The more important tax aspect of a transmutation agreement is the effect that it has on basis step-up (or step-down) at death.

On a spouses' death, one-half of the community property belongs to the surviving spouse, and the other half belongs to the decedent. (California Probate Code Section 100) If the property has appreciated in value during the time that it was held, the entire property will receive a stepped-up basis equal to its fair market value on the date of the deceased spouse's death, if the decedent's half of the property was included in his or her estate. (IRC Section 1014(b)(6)) The surviving spouse will receive a stepped-up basis in his or her half of the property, and will therefore have a smaller gain on disposition of that property.

By comparison, if the spouses had held the property separately in joint tenancy with a right of survivorship, the surviving spouse would automatically receive his or her half of the property by operation of law through the original joint tenancy title, and not through inheritance or any other type of succession after death. Consequently, his or her basis would not be stepped up if the property has appreciated, but instead would remain at the original cost basis.

While transmutation agreements are generally desirable from an asset protection standpoint, they may have adverse tax consequences, because of the loss of one-half of basis step up. By carefully coordinating the transmutation agreement with the spouses' will or trust, many of the adverse tax consequences can be minimized or eliminated. For example, if the spouses' residence is the separate property of the surviving spouse, then while the residence will not receive a step-up in basis, up to $250,000 of gain will be sheltered on the sale of the residence.

The loss of the basis-step up on one-half of property is important only if it is anticipated that the surviving spouse will be selling his or her separate property. If the surviving spouse retains her separate assets and sells the property inherited from the decedent (which received a basis step up), no adverse tax consequences will result.

Spouses may enter into a transmutation agreement at any time, during marriage. Accordingly, while the spouses are working or practicing their profession (and they are exposed to risks) they can enter into a transmutation agreement and transfer certain assets to the low-risk spouse. When the spouses retire and risks dissipate, the spouses can enter into another transmutation agreement and convert their separate property back to community, regaining the full step up.

While postnuptial agreements are generally subject to the same notice and recording rules as premarital agreements, the rules for transmutation agreements are slightly different.

A transmutation of real property is not effective with respect to third parties who are without notice of the transmutation unless the transmutation instrument is recorded. (California Family Code Section 852(b)) While recording is not a prerequisite to the validity of the transmutation as between the spouses, it is a prerequisite in making the transmutation effective with respect to third parties who are otherwise without notice. This requirement is consistent with the fact that transmutations are subject to the laws governing fraudulent transfers.

Chapter 10
Asset Protection – 2013 Current Issues

Recent statistics (2011) confirm:
1) 1.085m lawsuits filed annually in California. (See 2012 Court Statistics Report, page 96).

2) 284k lawsuits filed annually in U.S. Federal District Court. (See Judicial Business Summary 2011, page 2).

Predatory litigation against defendants (Deep Pocket), legal costs, and Estate Planning (to distribute assets to intended heirs not 3rd party creditors) all mandate asset protection.

In the words of Carl Sagan:
"Knowing a great deal is not the same as being smart; intelligence is not information alone but also judgment, the manner in which information is collected and used."

Chapter 11
Asset Protection – U.S. Case Law

1) Blosam Contractors, Inc. v. Lucyx
(535 So. 352 (Fla. 1st Dist.App 1988)
In Blosam, the lien holder is granted priority before charging order holder. In this case, Blosam obtained a final judgment against debtor and executed a financing statement that covered her interest in a limited partnership (or LLC).

Then Lucyx obtained a final judgment against debtor and filed an application for a charging order, which the lower court granted because the first to get a charging order had priority for the judgment.

The Appeals Court reversed the lower court, holding that a protected security interest (held by Blosam) was superior to the rights of a subsequent lien creditor (i.e. Lucyx).

2) Cadle Co. v. Ginsberg
(2002 WL 725500) CV 9500768115 (Conn. Sup. Ct 2002)
In Cadle, the creditor sought a charging order against the defendant's interest in a LLC, which the defendant opposed because the defendant contended that the LLC must be made a party to the case. The court held:

a. It is not necessary for the LLC to be made a party to the action because the "charging order merely gives the judgment creditor the rights of an assignee" of the LLC's membership interest, but it does not give the assignee the right to manage the LLC.

b. The assignee's right to the LLC membership interest does not equate to the right to manage or participate in the LLC.

3) Koh v. Inno Pacific Holdings, Ltd.
(54 P.3d 1270 (Wash. App. Div. 1, 2002).
In Koh, a creditor was awarded a monetary judgment in California and sought a charging order against the debtor's 50% interest in a LLC formed under Washington law. The LLC's principal place of business was in Malaysia.

The Washington trial court initially quashed a charging order, claiming that the court lacked jurisdiction over the debtor's LLC membership interest in the LLC because the interest as personal property was located outside Washington. The trial court defined the LLC member's interest as personal property and determined that personal property for purposes of levy and attachment is normally adjudicated where it is physically located or where the owner resides.

The Appellate Court reversed, holding that when a LLC organizes under the laws of a state, the entity's interest is located within that state. Therefore, as long as there is a valid foreign judgment (i.e. California's), the creditor can register that judgment (in Washington) and obtain a charging order against the debtor's LLC member interest in Washington.

4) <u>Krauth v. First Continental</u>
("First Come, First Served") (351 So. 2d 1106 (Fla. 4th Dist.App 1977)
In Krauth, the court held that when there are multiple, unsecured judgment creditors against a single debtor, the first creditor that applies for a charging order against the debtor's partnership (or LLC's) interest to a court of proper jurisdiction has priority for the full satisfaction of his judgment. It does not matter when the judgment was entered. Under Krauth, enforcement of charging orders are performed one at a time, with priority given to the order filed first.

Chapter 12
Asset Protection- Creditor Remedies

In a “veil piercing case”, a court is requested to disregard a corporate entity so as to make available the personal assets of its owner to satisfy a liability of the entity.

When the corporate entity acts as a shell for asset protection purposes, has no actual business purpose, and there is a showing of abuse by the debtor, creditors may not be limited solely to a charging order and may instead be able to apply the equitable remedy of “reverse veil piercing” making the entity liable for the debtor’s personal debts (See: C.F. Trust v. First Flight Ltd. Partnership (306 F.3d 126, CCA-4 2002).

Under EPICA v. Swiss Bank Corp., 507 So. 2d 1119 (Fla. 3d Dist. App. 1987), the court test is stated to determine if there is a “reverse piercing action”, based on two criteria:
1. Whether the debtor had ownership and control of the entity;
2. Whether the debtor used the entity to secrete personal assets as a means to deceive, defraud or mislead his personal creditor.

Under the “reverse piercing test”, a creditor does not need to prove that the debtor committed actual fraud. The test requires that the trial court find that the defendants committed an unjust act in contravention of the plaintiff’s rights.

To succeed in a “reverse piercing action”, the creditor:
1. Must name the entity directly as a party, and
2. Show that an unjust act in contravention of the creditor’s legal rights occurred.
Asset Protection – Creditor Remedy: Resulting Trust

As resulting trust is an equitable remedy. The creditor’s position is that an entity (e.g. a corporation) is owned by a “nominee” owner (who has legal title), but is presumed to be holding it for the benefit of a person holding equitable title, since the beneficial interest is not “enjoyed” by the legal title holder.

The nominee owner is presumed to be acting as a “Trustee” for the benefit of the beneficial owner. The entity has no business purpose (other than asset protection) and is a “trust” for the benefit of the beneficial owners (i.e. the equitable owner). If the creditor can prove that the entity “is a trust”, the creditor may overcome the exclusive remedy of a charging order, and obtain an equitable resulting trust entitling the creditor to access those assets held by the nominee (i.e. the entity) for the benefit of the debtor (i.e. the person holding equitable title).

<u>Asset Protection – Creditor Remedy: Alter Ego/Sole Purpose</u>

Under the alter ego/sole purpose remedy, an entity is established to hold title to a debtor’s personal assets, which were transferred to the entity without a business purpose, as a means to shield the assets from creditors (In Re Turner, 335 B.R. 140 (N.D. Cal., 2005), modified 345 B.R. 674 (N.D. Cal. 2006).

The entity is the "alter ego" of the debtor and the creditor is not limited to the charging order, but may be able to disregard the entity to prevent an injustice from occurring. In cases where the courts determined the entity was the debtor's alter ego, the following facts were found to be determinative:
1) The debtor, not the shareholder, was in control of the entity;
2) The debtor paid his expenses (and wife/children's expenses) directly from the entity;
3) There was poor recordkeeping, missing company documents;
4) The entity's assets came from fraudulent transfers; and
5) The entity did not have a business purpose (i.e. fulfilled an economic venture) but was established to "hide" personal assets.

The case law for alter ego/sole purpose creditor remedy focuses on corporate entities but the same legal reasons, i.e., to prevent an injustice from occurring may justify this creditor remedy for an LLC and pre-empt charging order limitations on creditor recovery.

<u>Asset Protection: Creditor Remedy – Constructive Trust</u>

A constructive trust is a remedy that arises against one who holds legal rights to property but, which in "equity and good conscience should belong to another." There does not need to be a showing that the property was acquired by fraud. The creditor does not need to prove an intent to defraud.

The creditor has to prove only that it is unfair for the entity to prevent the creditor from accessing the entity's property.

One case has been cited in which a constructive trust was used to defeat charging order protection (See: Delta Development and Investment Co. v. Hsiyuen, 2002 WL 3174, 8937 (Wash.App. Div. 1, 12/9/2002).

In this case, the facts showed significant fraud by the debtor, including use of company assets to fund personal ventures/opportunities, commingling of personal funds with company funds, use of the company's funds/credit to entice a bank to extend credit, and transforming company funds into a personal account.
The court in Delta determined that the constructive trust could defeat the charging order limitation because it is not a monetary judgment and charging order limitation statutes protect the debtor only against monetary judgments.

Chapter 13
Asset Protection/Special Issues

<u>Asset Protection – LLCs and Real Estate</u>

"FIRPTA Withholding" (Tax Withholding U.S. Real Estate)
The sale (or other disposition) of U.S. real property interest by a foreign person (transferor) is subject to a tax withholding of 10% of the amount realized in the disposition (35% of gain recognized by foreign corporation on distribution to its shareholders), under FIRPTA (Foreign Investment in Real Property Tax Act of 1980). In most cases, the transferee (buyer) is the withholding agent for the "disposition of U.S. real estate" (i.e. sale or exchange, liquidation, redemption, gift or transfer).

A U.S. real property interest is any interest, other than solely as a creditor, in real property (including an interest in a mine, well or other natural deposit) located in the U.S. (or the U.S. Virgin Islands), as well as certain personal property that is associated with the use of the real property (e.g. hotel, furniture, farming machinery).
The transferee must deduct and withhold a tax equal to 10% of the total amount realized by the foreign person on the disposition.

The amount realized is the sum of:
1) The cash paid or to be paid (principal only);
2) The fair market value of the other property transferred, or to be transferred, and
3) The amount of any liability assumed by the transferee or to which the property is subject immediately before and after the transfer.

The amount realized is the amount paid for the property. If the property transferred was owned jointly by U.S. and foreign persons, the amount realized is allocated between the transferors listed on the capital contribution of each transferor.

Regarding real property interests held by corporations:
1) A foreign corporation that distributes a U.S. real property interest must withhold all tax equal to 35% of the gain it recognizes on the distribution to its shareholders;
2) A domestic corporation must withhold a tax equal to 10% of the fair market value of the property distributed to a foreign shareholder if:
a. The shareholder's interest in the corporation is a U.S. real property interest;
b. The property is distributed either in a stock redemption or asset liquidation.

To avert the "FIRPTA tax withholding" on the sale, the investor may establish a U.S. based LLC, which issues a Form W-9 to the buyer so there is no tax withholding on the sale. Subsequently, the LLC will withhold an LLC member's distributions to the foreign person member (verified by the K-1 issued by the LLC).

Chapter 14
Asset Protection Revisited

Special Contribution by David Richardson, Mid-Ocean Consulting Ltd.

U.S. taxpayers with unreported income face asset seizures under jeopardy tax assessments. David Richardson (Mid-Ocean Consulting) has written the following article on planning that could exempt assets from such a seizure.

Absent major tort reform, wealthy Americans (and increasingly, HNW individuals internationally), may actually see an increase in litigation from the current high levels; already far higher than any other country in the world on a per capita basis. The likely increase will result from the recent economic turmoil that has permeated just about every corner of the economy.

Added to which, future increased taxation to pay for and support Congressional stimulus packages is clearly in the offing. Meaning even absent litigation, the client faces asset erosion from increased investment and income taxes.

One of the most effective ways to preserve assets is by effecting international structuring that is at once legitimate and compliant (from a reporting and tax perspective) but distances asset ownership from the client and would-be creditors.

Yet in a non-adversarial way with solid economic rationale. A key element in this structure is international variable life insurance that is offered in a variety of credible financial jurisdictions like Bermuda, Bahamas, The Cayman Islands, The Isle of Man and others.

Such policies are akin to their domestic counterparts by adhering to the same US tax code (7702 et al) but offer distinct advantages. First the similarities:
• Policies may be funded with single or multiple premiums
• Policy assets are invested in client chosen investments- mainly a set menu of mutual funds
• Growth of such assets are income tax exempted during lifetime
• Policy death benefits are income tax exempt at death
• The policy's cash surrender value (CSV) may be accessed during lifetime also income tax exempted

Now the dissimilarities and thus advantages that apply to some, if not all, international carriers:
• Policies may be bought with premium in-kind i.e. assets
• Clients may choose their own investment manager to manage policy investments
• The manager may choose virtually any investment class including stocks, bonds, mutual funds, hedge funds, private equity etc.
• Generally, fees are fractional compared to domestic offerings

In terms of asset protection, some jurisdictions (like some US States) exempt insurance polices from the claims of creditors; most notably Bahamas and the Cayman Islands. In fact Cayman has recently updated their insurance legislation such that it fully protects the premium(s), the growth on the premium and the death benefit from the claim of creditors putting the greatest clarity in this section of the applicable law of any jurisdiction. In addition the Cayman Segregated Account Statute (7 (8) c) legally segregates the assets of one policy from another, while also keeping them legally distinct from the insurance company's general assets and liabilities; yet further protection.

Interestingly, Puerto Rico, as a quasi-US/offshore jurisdiction has recently enacted law (2011) that immediately exempts assets placed into a policy issued by an international P.R. carrier, provided that those assets or monies were not subject to any prior or current claim. This offers very substantial, statutorily provided protection that must be respected by every other U.S. State Court and judge. Also as a U.S jurisdiction for reporting/information purposes, a U.S. taxpayer would also be free from any additional FBAR reporting obligations in owning a PR issued contract. Regardless of the jurisdiction of issuance, such policies are very often held by trusts for estate planning and dispositive reasons. The domicile of the trust can also be an additional layer of protection for the reason that most jurisdictions have a "fraudulent disposition" period to help establish objectively if the assets settled in trust were done so purposely to defraud creditors of the settlor. The Bahamas by example has a 2-year conveyancing Statute. What this means, in the case of the Bahamas, is that if the assets have been in the trust for +2 years, it's presumed that they were not placed there purposely to defraud a creditor.

Can a creditor still come forward and lay claim after 2 years? Yes- but the burden of proof is heavily on that creditor.

What happens if the trust is challenged before the 2-year period? The burden of proof, though somewhat lower, is still on the creditor to establish that those assets (in particular) were placed in trust and are rightly his or hers.

In either case under certain tracing claim actions the trust may be permeated. It can happen. In this situation, the courts could award the trust assets to the creditor. That is, specifically it would order non-exempted assets to the creditor. In the Bahamas, as we have noted earlier, insurance is such an exempted asset and therefore the courts would be unable to assign it to the creditor.

The other relevant point is that in court, the debtor now has a cogent, commercial argument for having established the structure in the first place; to make and hold international investments in the most tax efficient manor that is at once both transparent and compliant. This, as opposed to other structures where the intent is clearly to avoid or even evades liabilities- contingent or otherwise.

In closing, doing asset protection, as most things in life, can be done by degrees. Some structures offering better protection than others. That said it is our opinion that a trust, established in a good Common Law jurisdiction, offering a balanced conveyancing period (neither too long, not too short) and owning an international variable life insurance policy, acquired from a good company (in the better jurisdictions) offers perhaps the best asset protection. The combination also provides significantly effective income and estate tax mitigation; a not insignificant by-product and advantage.

Having said all this, nothing is inviolate. A very determined creditor could challenge such a structure, notwithstanding the significant burden of proof, and substantial cost. At the very least then such structure should offer the client effective means of settling with such a creditor with terms that favor the former over the latter.

Chapter 15
Asset Protection: The Ultimate Strategy

Special Contribution by David Richardson, Mid-Ocean Consulting Ltd.

Investors concerned about third party creditor attachment may seek "ultimate asset protection" for their assets through a Puerto Rico life insurance policy owned by a U.S. Grantor Trust domiciled in the Bahamas.

This ultimate asset protection strategy has three "key ingredients":
1) Under Puerto Rico law, the cash value benefits of a life insurance policy are expressly exempt from seizure by creditors (absent fraudulent conveyance funding of the policy). See: Puerto Rico Act No. 399 of 9/22/04, as amended by Act No. 98 (6/20/11). Under Act. No. 98 (6/20/11), the policy owner and policy beneficiary are statutorily protected from seizure.

2) In the Bahamas under Bahamian law, insurance is exempt from creditor claims, provided that premiums used to fund the policy are not subject to any prior claim at the time of transfer (See: Bahamas Insurance Act, Chapter 347, Section 17, effective 6/1/70).

3) In the Bahamas under the Fraudulent Dispositions Act of 1991 (effective date 4/5/91), Chapter 78, Section 4:
Every disposition of property made with an intent to defraud shall be voidable at the instance of a creditor thereby prejudiced;
The burden of establishing an intent to defraud shall be upon the creditor seeking to set aside the disposition;
No action or proceedings shall be commenced pursuant to this act unless commenced within two years of the date of the relevant disposition.

4) In the Bahamas, under the Banks and Trust Compliance Regulation Act (2000), (effective 12/29/2000), Chapter 316, Section 19(1): no person shall without the customer consent disclose to any person, any such information relating to the identity, assets, liabilities, transactions or accounts of a customer. Any person guilty of an offense shall be liable or summary conviction to a fine not exceeding $25,000, or to a term of imprisonment not exceeding two years, or both.

For those investors with investment portfolios, pre-emptive planning may fully exempt all assets from creditor attachment. The strategy:

1) Transfer all liquid assets (i.e. cash, stock or bonds) to a Nassau Trust (which is a U.S. grantor trust, i.e., IRC Sec. 679), which trust may be amendable or revocable so there is no completed gift (and no gift tax due on Form 709: U.S. gift tax return required);

2) The Nassau Trust capitalizes a Puerto Rico variable life insurance policy, which owns an underlying company (a Nassau International Business Company; i.e. an "IBC");

3) The "IBC" holds title to all investment assets (the IBC is owned by the life insurance policy separate investment account; i.e. "cash value account" which is comprised of premiums paid and earnings on the premiums paid).

Since the investment portfolio is ultimately owned by the Puerto Rico variable life insurance policy, the policy acts as a "tax-free wrapper"; i.e., tax-free gains inside the policy (eg., annual earnings/capital gains are shielded from income taxes). Assets inside the policy grow and compound income tax-free. The death benefit is paid income tax-free (IRC Section 101).

IRS income tax audits may be pre-empted on investment portfolio income since there is neither income tax due, nor any tax reporting due on the investment portfolio income.

Absent a fraudulent conveyance, investment portfolio assets are immediately exempt from creditor seizure once held by the policy. Investment portfolio assets receive the following creditor protection:

1) Under Puerto Rico law (the governing law for the Puerto Rico Variable Life Insurance Policy), the policy owner and beneficiary are statutorily protected from seizure;

2) Under Bahamas law (the governing law for the trust that owns the policy), insurance is exempt from creditor claims and client financial assets may not be disclosed or be subject to a criminal offense of up to two years in jail. In addition, an "attaching creditor" must initiate an action (in the Bahamas) to set aside a "fraudulent conveyance" within two years from the date of transfer or they will be "time-barred". Under the "Ultimate Asset Protection" strategy, IRS tax audits are pre-empted (since no tax is due and there is no tax reporting), both Bahamas and Puerto Rican laws exempt from creditor attachment the "cash value" component of the life insurance policy (which owns the investment portfolio assets), the Bahamas fraudulent conveyance laws "time bar" creditors after two years, and the Bahamas "Bank Secrecy law/criminalize third party disclosures of client "asset information".

If the investments perform in accordance with the S&P 500 historic yields (10.6% over the last 30 years, cumulative with dividends) or hedge fund yields (projected 15% annually), the portfolios will grow "income tax free" but will be subject to U.S. estate (and gift) tax on death (or transfers) for U.S. citizens, estate/gift tax residents; i.e. U.S. domicile). The U.S. estate tax may be satisfied by a U.S. life insurance policy, held in an U.S. irrevocable life insurance trust, so the death benefit proceeds may be paid on a “leveraged basis” (by insurance premiums), and excluded from U.S. estate tax (by the life insurance trust).

About the Author

Gary S. Wolfe received his Juris Doctorate from Loyola Law School in 1982, where he was President of the Tax Law Society.

From 1982 through the present, Gary has been in private practice in Beverly Hills and Los Angeles.

Gary is an international tax attorney representing clients for IRS audits, international tax planning, and asset protection.

Previously, Gary was the managing partner of a tax and business law firm, which represented Fortune 500 companies (IBM, ITT) and financial institutions (Sterling Bank, First Charter Bank.) Gary now provides case management for international litigation.

In 1997, Gary completed the Team Beverly Hills civic leadership training.

From 1997-1999 Gary was Vice-President and Member of the Board of Trustees of The Greystone Foundation, Beverly Hills, California.

From 1995-2001, Gary was the Chief Financial Officer and a Member of the Board of Directors of the Le Faubourg Honore Homeowners Association, Beverly Hills, California.

Since 2004, Gary has been conducting private seminars throughout California on the IRS, International Tax and Asset Protection.

Gary is an international tax expert and a nationally published tax author. In 2013 he published articles in the ABA (ALI-CLE) publication: The Practical Tax Lawyer (Winter, 2013 Edition), "U.S. Tax Planning for Passive Investments," (Spring 2013 Edition), "Why U.S. Tax Evasion is a Bad Idea (UBS/Wegelin Bank)," and in the Summer 2013 Edition he published 2 articles:

1) "International Tax Planning for U.S. Exports (IC-DISC)" (with Ryan Losi, CPA)

2) "International Tax Evasion, Money Laundering, and Other Crimes"

In the Autumn 2013 Edition of the ABA/The Practical Tax Lawyer he will be publishing 2 articles:

1) "EB-5 Visas (Immigrant Investor Visas)" (with Mark Ivener, Esq.)

2) "Offshore Hedge Funds and Reinsurance" (with Allen Walburn, Esq.)