# WEALTHFORTRESS

## *Comprehensive Guide to Asset Protection*

PREPARED BY


# GERBER & Co.

CPAs - Financial Advisors

# Legal Methods of Asset Protection From Legal Predators

How to Insulate Yourself from the Lawsuit Epidemic

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# How to Insulate Yourself from the Lawsuit Epidemic

U.S. citizens and residents with assets or insurance are becoming targets for entrepreneurial plaintiffs and lawyers who are looking for a big payoff. It's no longer just a case of suing someone after they injure another party. Now the **lawyers are engaging in proactive "marketing" to find people they can sue**. Finding a "victim" is no longer very difficult.

The United States is one of a few countries in the world where lawyers are permitted to receive contingent fees based on the amount of a judgment for their client. Lawyers working for a contingent fee have far better odds of making a million dollars or more on a single case than any lottery contestant.

A widely quoted statistic is that there are more than 700,000 lawyers in the U.S.. However, all of these lawyers aren't involved in suing people. There are about 66,000 lawyers who are members of the ABA Litigation Section but only about 1/3 of the lawyers belong to the ABA. If litigation lawyers are typical, there are about 198,000 lawyers who are in the business of suing people. That means that for every 400 families in the U.S. there is one lawyer who is looking for someone to sue. If those layers only concentrate on the top ten percent of the market, that means they will be looking for just forty people to sue out that group of 400 families. If you in are that top 10%, **there is a lawyer somewhere who is just waiting for you to make a mistake** - any kind of mistake.

**Does that help to put the problem in perspective?**

If you have money (or insurance), you are at risk. In 1989, 1.2% of all families with an income over $50,000 were sued in a U.S. District Court. And that's the tip of the iceberg. Here are a few of the excuses that can be used by legal predators to confiscate your assets.

Personal injury claims or divorce
Civil rights violations
Environmental cleanup liability
Malpractice and product liability
Employee injuries
Occupational Safety & Health Administration violations
Federal and state tax liens

And ... you can also be held liable for the acts of your spouse, your children, your employees, your partners, and anyone who uses any of your property or is acting on your behalf. **Fault or negligence is no longer necessary to be held liable** for someone else's injuries or damages. The courts and the juries are far more concerned about finding some way to help an injured plaintiff than about whether the defendant (you) is really at fault.

## What Can You Do To Protect Yourself?

Here are two paradoxes for you. The safest way to legally avoid paying income taxes is to avoid having any income. And ... the best way to avoid losing your assets if you are sued is to be devoid of any assets. While each of these two statements might seem to be contradictory, they accurately describe how the wealthy are able to minimize their taxes and protect their wealth.

For example, "income" for tax purposes is defined by the law. You may have economic income without having taxable income. Interest on tax exempt bonds isn't considered income for federal tax purposes. The gain on assets that grow in value isn't currently taxed.

**"It's not what I own, it's what I control that really counts."**

This is a quote from a wealthy individual who understands money. This person had given control of his business to his adult children and his retired parents. But he is confident that his children are unable to use the business to make money without his participation. He is the real source of the money. The legal ownership of his corporation is of far less importance than his ability to control the business. For the same reason, **politicians have power without ownership because they can control other people's assets**.

There are a mind boggling variety of ways that people use to retain a substantial element of control without retaining unrestricted ownership. Here are a few of the more popular methods. (Please note that these are not all legal methods of asset protection.)

1. Transferring assets to safe family members
2. Securing assets with loans from other family members
3. Hiding non income producing assets in obscure places
4. Using a corporation for business activities
5. Putting assets into a limited partnership
6. Putting assets into an irrevocable trust
7. Putting money into life insurance owned by others
8. Giving money to a charitable trust or family foundation
9. Moving money into offshore trusts or corporations

Some people seem to think that the last strategy is the only strategy used to protect assets. A reporter from the L.A. Times called to inquire about my newsletter and made the following comment regarding the concept of asset protection.

**"I thought that only drug dealers and swindlers used offshore trusts."**

Offshore trusts are only one of the many devices used by the wealthy to protect their assets from predatory plaintiffs and lawyers. There is little doubt that those who operate outside of the law will use the law to their advantage whenever they can. However, **David Tedder**, an asset protection attorney and seminar speaker, tells his audience that **the offshore asset protection trust is "The Final Step"** for the law abiding citizen. It's the last resort for those with a lot of money. Asset protection is not just about offshore trusts. It's about a variety of legal strategies and techniques to use the protection of the law to avoid unnecessary losses. It's about finding ways to change the legal form of ownership of your assets without losing effective control of the assets.

Most people with modest estates are at great risk simply because of the common practice of putting property in joint ownership. **Creditors of either owner can take jointly held property in most states**. Of 18 million businesses in the U.S., over **70% are unincorporated** proprietorships. While a corporation isn't a perfect legal protection, it's a very economical way to reduce your exposure to some types of losses. These are simple lawsuit protection strategies that are not expensive or even complicated.

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## Beware of Defrauding Your Creditors

If you wait to do something until someone brings a lawsuit against you, it's really too late.

**Anything you do to remove your assets from the reach of your creditors after a lawsuit is filed is likely to be a "fraudulent conveyance."** That means the courts can and will seek to obtain repossession from the transferee. One specialist in the field says that if you are in a high risk profession or occupation, you must keep some assets (or insurance) available to your creditors or the courts can recover the assets.

**You must take steps to protect your assets before there are any potential claims against you.**

Like estate planning if you wait until you have a problem, it's too late to solve it. Like insurance, l**awsuit protection planning must be done when you don't think you need it**.

The various state courts have indicated that there must not be any reasonable prospect of a specific claim against you at the time that you put your assets beyond the reach of your

creditors. In most states, that seems to be a period of one to three years before any claim is filed against you.

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# A Checklist of 14 Lawsuit Protection Strategies

The practical solution to the "lawsuit epidemic" in the U.S. is to **spend a little bit of time to stop being an easy target**. When you take the time to lock your doors, a thief is likely to go on to an easier target. Lawsuit protection is like locking your doors.

While there are at least 198,000 trial lawyers who are working hard to find opportunities to separate you from your money, there are only a few hundred lawyers who specialize in helping you to protect your assets from all of those other lawyers. There is no single, safe and simple device that will totally thwart a determined creditor when there is a lot of money at stake.

Here are some of the practical things you can do to protect yourself from losing everything if you should lose a future lawsuit.

1. Warning: **Joint ownership may be hazardous to your wealth**. Don't put assets in joint ownership without having a good reason and without the advice of competent legal counsel. The general rule is to avoid joint ownership, because those assets are subjected to a double risk. The creditors of both owners can attach any jointly held assets. Spend some time with an attorney to learn about "joint ownership with right of survivorship", "tenants in common" and "tenancies by the entirety".
2. **Don't put anyone else on your personal bank account.** If someone else is treated as a co-signer of your bank account, your assets could be exposed to their creditors. Avoid giving a family member the power to be an co-owner on a bank account. Your creditors can take the assets from an account where you can withdraw funds on your own signature. If there is a need to sign checks on someone's account, check with an attorney about being authorized to do so with a power of attorney, as an agent of the account owner or as a trustee. Some banks offer an arrangement whereby you are treated as an agent of the owner of a personal account so that you can sign checks on the account, but you don't have the legal right to take money in the account for your own use. If the bank won't accept that type of arrangement, consider having the account owned by a trust, in which you can be a trustee - or the only trustee. Another option is to find another bank.
3. **Don't rely on a domestic, revocable living trust for lawsuit protection.** It may help to avoid some state probate expenses, but it does not remove your assets from your future creditors.
4. **Use a corporation or LLC to operate a business** . If there are tax reasons to operate as a proprietor, make an election to be taxed as an S corporation or establish a LLC to own the business. Observe the legal formalities of the

corporation or LLC and don't treat the corporate checkbook like a personal account.

5. **Have a detailed review of the form of title to your assets**. A common problem is to set up a limited partnership or irrevocable trust or corporation and to fail to change the title to your property. Jointly held assets pass outside of your will or your trust. Assets with a named beneficiary are not subject to the general provisions of your will or your trust.
6. **If you have more than US$1,500,000, you need an estate plan.** The current U.S. estate tax law exempts up to $1,500,000 of an estate from the estate tax. Any assets in excess of that amount may be subject to some estate taxes without some estate planning. Do it right and co-ordinate it with your asset protection plan.
7. **Risk management is an organized system of dealing with risk**. You compile a list of potential risks. Then you decide how much you can afford to self insure. Then you decide whether there are some risks you can get rid of - like an apartment building where the tenants might be injured. The last step is to look for insurance.
8. **Avoid being on any board of directors** unless they can assure you that they have ample insurance coverage. Be particularly careful about serving on the board of a closely held corporation.
9. **You shouldn't do lawsuit protection in a vacuum.** Your asset and lawsuit protection strategies need to be integrated with your other financial planning concerns like your personal insurance, your investment allocation plan, your income tax strategies, your estate plan and your business plans.
10. **Be careful about acquiring title to any land.** Require a qualified environmental waste examination. If any land is contaminated by hazardous wastes, you could become fully liable for the entire clean up costs if you are an owner or co-owner, operator or transporter of the waste at any time. You could even have legal exposure as a trustee, executor of an estate or as a partner of a firm that owns contaminated land.
11. **Don't rely entirely on one advisor.** Get competent advisors who are willing to work with you to develop a practical asset protection strategy. Get referrals from other professionals in the field. Interview at least three or four prospects in each field. Don't be frustrated by disagreements between your advisors. It's healthy. Listen and learn. Always be willing to get a second opinion before making a major commitment. Get second opinions on any advice from those who work purely on a commission basis. Don't let your advisors have discretionary control of your assets unless you can afford to lose those assets.
12. **Don't ignore legal protocols.** Respect the separation of ownership when you create limited partnerships, corporations, irrevocable trusts or charitable entities. These are all creatures of the law. If you ignore the legal protocols, the courts can ignore the existence of these entities.
13. **Separate the ownership and control of your assets**. To avoid losing your assets to a claimant in a lawsuit, you must divest yourself of the ownership of the assets long before any claim occurs. That means making valid restricted gifts to your spouse, parents or children, but not to the point of becoming insolvent.

14. **Don't be a pig.** Leave some fat on the bones so that potential creditors will be willing to walk away from some of your assets and give you a chance to start over.

# Why You Need Asset Protection

The Dangers of Joint and Several Liability
Political Lawsuits
Judge Holds Online Service Liable for Libel
Are You At Risk For Pension Errors?
Looking For A lawyer Before Surgery ?
Your Money Or Your Freedom
If Your Opponent Is The Government
Company is Sued For Not Paying Off A Regulator
Who Needs Asset Protection ?
More Cause For Concern ?
Open Ended Liability For Medical Care Providers
Failure To File A Report May Cost $357,144
ADA Has Become A Bonanza For Lawyers
Re-Classification Of Independent Contractors May Entail Pension Costs
Sexual Harassment Opportunity Lawsuits
Tax Exempt Directors & Officers Face New IRS Penalties
Domestic Spendthrift Trust Doesn’t Stop The IRS
New Penalties For Medicaid Planning

## The Dangers of Joint and Several Liability

The cover story for the April 24, 1995 issue of Medical Economics is about a doctor who was held liable by the trial court for a $15 million judgment where he attempted to help two people who were the victims of another doctor's negligence. The trial court in Texas refused to separate the second doctor from the first, and the jury found that the second doctor was 25% at "fault" even though the plaintiffs presented no experts who would argue that the second doctor was negligent in any way and even though ten experts testified that the second doctor did everything medically possible to help the two patients. The total judgment was for $15 million. The Texas State Board of Medical Examiners had revoked the license of the negligent doctor who had declared bankruptcy - so the second doctor was held liable for the entire judgment. On appeal, the second doctor was exonerated on the basis that his treatment had not been a proximate cause of the plaintiff's injuries. The appellate court did not address the issue of joint and several liability in this case.

Regardless of whether you are a doctor, this could happen to you in many of the fifty states, if you are a partner, a participant in a joint venture, one of many persons involved in an accident, as one of many people indirectly involved in a sex discrimination case, an ADA case or a toxic site case. It's nearly impossible to list all of the many ways that one

person can become jointly and severally liable for an injury to someone without having been personally negligent with respect to those specific injuries. In many cases, it's enough that you are or were connected in some way. If you are one of a number of people who are brought together as defendants, and if the other defendants are without assets or insurance, you could end up with the "short straw".

How can you protect yourself? By segregating your assets in the many ways that have been described in past issues of these reports. By using a combination of methods like a family foundation or charitable trust, one or more family limited partnerships, corporations in which you are not the controlling shareholder, foreign trusts, bankruptcy exemptions permitted in your state and by making gifts of assets to parents, children and your spouse long before a claim is filed against you.

## Political Lawsuits

The June 26, 1995 issue of *Medical Economics* (page 53) reports that the pro-life advocates are using lawsuits as another way to push their campaign against doctors who do abortions. Even when the lawsuits are lost in the courts, the plaintiffs have won on a political level. Of course, some of the pro-choice advocates could soon begin to pursue the same strategy against their opponents.

If you are involved in a highly controversial political issue, you may find your opponents resorting to the courts as a weapon in their cause. By targeting you for civil lawsuits, they can get adverse publicity against you, consume your financial resources, and sully your business reputation. They could also put you in a position of being unable to get insurance coverage. This is just one more of the many reasons why anyone with significant assets is in need of some premeditated asset protection.

## Judge Holds Online Service Liable for Libel

The Wall Street Journal (5/26/95) reports that the Prodigy on line service was responsible for the libelous statements of a subscriber because it advertised that it monitored such messages. The issue was whether Prodigy was merely a conduit, like a telephone company, or whether it was acting as a "publisher", with some control over the content.

While you might not be as big as Prodigy and you might not be providing a computer service, this case may apply to you if you sponsor or support any kind of moderated discussion group on the internet. It seems to me (from my perspective as an electronic publisher) that you either have to make it very clear that the discussion group you sponsor is completely open and unmoderated or you have to maintain some significant control over the content of the messages that are sent to the entire group. If you allow a participant to make a derogatory statement about any individual or company, that person

or company can sue you for libel. That's why I enforce the rule for my discussion group that if you can't say something nice, don't say anything at all.

While a truthful statement is generally a defense against a libel suit, it won't protect you from the legal expenses and the time involved in defending yourself.

## Are You At Risk for Pension Errors?

Errors in computing pension benefits are apparently so widespread that a couple of entrepreneurial pension consultants are soliciting work on a contingent fee basis. According to the National Center for Retirement Benefits (NCRB), if you leave your job, "*there is a 50% chance that your lump sum distribution was incorrectly calculated and that you are entitled to substantially greater money*." Paul Holzman, A CPA and former IRS pension agent claims that 95% to 98% of the errors they find are in the favor of the employer. Thus, they expect to find extra money for nearly half of their clients.

Holzman has teamed up with attorney Allen Engerman to found the NCRB, which reviews benefit computations on a contingent fee basis. They will review, analyze and/or audit the computations of an employee's retirement benefit for 50% of any increased money that accrues to the employee as a result of their services.

If you are an employee who is going to receive a significant distribution from an employer, you might want to contact them to make sure you are getting everything you are entitled to receive under the plan. (You can call them at 800-666-1000)

But ... **if you are an employer**, Holzman and Engerman are confident that you have probably understated the benefits due your employees. Assuming that isn't intentional, you might want to check with your own pension advisors to explore ways to review the accuracy of your benefit computations. (Holzman and Engerman are so busy examining benefit computations for employees that they don't seem to be interested in doing the same thing for employers.)

I found out about them because they contacted me as the editor of a financial publication. Judging from the press kit they sent me, they are getting a lot of publicity. That means your employees, (current and former) are likely to find out about them before long.

## Looking For A lawyer Before Surgery ?

Here is a flagrant example of the need for asset protection planning. A lawyer on the internet was looking for a medical malpractice litigation specialist to be available **in advance of surgery** for a friend of his. (It brings to mind images of vultures circling the potential prey.) I've edited some of his message to eliminate any chance that this guy might sue me for describing him as a flagrant example of predatory lawyers. This is the essence of the message he posted to a legal discussion group on the internet.

*I'm located in New York, but have a friend who needs a good medical malpractice lawyer in the Houston area. Is anyone interested? Or do any of you know a medical malpractice lawyer with a good reputation? Please contact me ASAP, as my friend is going in for surgery very soon.*

I sent a copy of this to my asset protection advisors discussion group on the internet with the following comment.

"Isn't it interesting that this lawyer .. needs a good medical malpractice attorney before the friend has surgery?"

Richard Duke, an author, professor of law and international tax specialist, sent me the following observation.

*Vern: As a follow up. A good trial lawyer will file a conspiracy charge against this lawyer if in fact a lawsuit is later filed by this person going into surgery. If it is a real good trial lawyer suing the lawyer looking for a malpractice lawyer, the trial lawyer will "sting him good."*

It's nice to know there is a way to deal with such legal vultures, but it won't help unless you know the lawyer was waiting in the wings - and that wouldn't often be known. I suggest you treat this an example of the thinking of many lawyers and an indication of what you are up against - whatever business you are in.

## Your Money Or Your Freedom

Apparently F. Lee Bailey felt that $20 + million might be worth six months in jail. But some folks can get a lot more than six months. A recent story in the *Money Laundering Alert* tells of a drug dealer who agreed to turn over $150 million to the government to avoid jail time. It seems this person was told she would stay in jail as long as it took to give up the money. Bailey was lucky or had some connections. If the government really wanted the money, it could have been a lot more than six months for Bailey.

## Domestic Asset Protection May Not Work If Your Opponent Is The Government

It seems to me that there are two very distinct sources of concern about asset protection. One is the litigation epidemic, where everyone with any money is like a sitting duck for a civil lawsuit from anyone who is willing to allege that they have been injured in some manner by the defendant. The second source of concern is the growing area of civil forfeiture and related ways in which the government can take our property.

Some commentators on the subject have been critical of the use of domestic structures such as limited partnerships, limited liability companies, corporations, charitable trusts, irrevocable life insurance trusts and outright gifts on the grounds that these structures are subject to the vagaries of U.S. j udges and juries.

Frankly, if any of us get on the wrong side of some government agency, I agree that domestic partnerships, corporations, charitable trusts and even outright gifts to others may have little value in protecting our assets from forfeiture or some other means of appropriation. Even offshore trusts may not work because a U.S. court could threaten to put you in jail if you refuse to return the property to the U.S. Never mind that you may not have the power to comply. The judge makes the law until you can appeal.

If your greatest fear is about losing your assets to your own government, it seems to me the safest course of action is to move abroad and to take your assets with you. For those who worry about an outlaw government, there is no legal safeguard I can think of to protect your assets within the jurisdiction of the government.

Hopefully, some of the political pressures for change will greatly reduce the risk of increasing the powers of the government to violate the intent of the Constitution by permitting government employees to conduct witch hunts to secure property without due process or just cause. Meanwhile, we each have to decide whether we prefer to stay here or to leave. For those who decide to stay, the most effective method of asset protection appears to be a foreign trust, perhaps combined with a foreign limited liability company..

## Company is Sued For Not Paying Off A Regulator

If this case is decided for the plaintiff, it will have to be right up there with the scalding coffee suit against McDonalds as one of the most "Absurd Awards". The February 27, 1997 issue of The Wall Street Journal reported that an environmental regulator is suing a nuclear waste disposal company because the disposal company allegedly refused to pay the regulator for certain favors the regulator conferred on the waste disposal company. What a strange world we live in.

And - even if the plaintiff doesn't win the suit, it will cost the defendant or his insurance company some substantial legal fees. If the defendant has liability insurance that is broad enough to cover this kind of claim, the insurance company will probably pressure the defendant to settle. But it's much more likely that the insurance company will have some clause in their contract that will excuse them from liability in this case.

## Who Needs Asset Protection ?

Here are three examples of the need for asset protection from our editorial advisor, Bill Comer.

> *A movie theater was required to pay legal fees and to settle with a woman who sued the theater chain because their seats were too small for her. She weighed 360 pounds.*

*The owner of an apartment building was found negligent in providing adequate security when a woman tenant was raped in her apartment*. (This is just one of many examples of why owners of residential or commercial real estate are at high risk for damages arising from their properties.)

> *A company that provides electronic home monitoring security was found liable for the death of a man who was murdered by a convicted felon who escaped from house arrest when the monitoring system broke down.*

Bill Comer is the author of Freedom, Asset Protection and You, which is an encyclopedia of asset protection information - and available from Research Press, Inc.

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## More Cause For Concern ?

In his book, the Professional Asset Protection Manual, Mark Warda, one of our editorial advisors, gives some additional examples of some absurd awards that juries "have been handing out". For example,

*** $41 million for a misdiagnosis of abdominal pain**

*** $49 million for a stillborn baby**
*** $84.5 million for children drowned and brain damaged in a swimming pool**
*** $986,000 to a woman who lost her "psychic powers" after a CAT scan**
*** $300,000 for slapping a daughter twice on the face**
*** $60,000 for cursing, which caused "emotional distress"**
*** $75,000 for spraying perfume on a person without permission**
*** $5.87 million for sponsoring a party where a guest later caused an auto accident**

Mark recently sent me some clippings of more recent awards, such as;

*** $12.7 million for a mistake in medication administered by a nurse**

*** $7 million to a laborer who lost a limb at work on a construction job**
*** $12 million to a doctor for failing to take a blood test for a rare disorder**
*** $160,000 to an employee who was "goosed" by fellow employees**

And, it seems the widely publicized $2.7 million award to Stella Liebeck (for her injuries from spilling some hot McDonalds coffee between her legs while driving) has encouraged a number of copycats. The same company is now being sued again, by another customer, and two claims for scalding coffee have been filed against other food chains.

## Open Ended Liability For Medical Care Providers

I've recently heard from a subscriber that Medicare can apparently go back as long as they wish to impose claims regarding alleged overcharges for patient services. This puts doctors in the position of having a financial sword hanging over their head for the gross billings to all of their Medicare/Medicaid patients for as long as the doctor has been in practice. Not only does this put a huge recordkeeping burden on the doctors, but it also appears to sidestep normal statutes of limitations in commercial transactions. I'd welcome any details to confirm or refute this contention.

## Failure To File A Report May Cost $357,144

If you try to take cash out of the country without filing the required reports with the customs service, the government will try to take it all. A recent case in which the government took possession of $357, 144 in cash under this rule, as reported by the New York Times, will be reviewed by the Supreme Court. The Circuit Court of Appeals in California held that the fine was unconstitutional because it was in violation of the Eighth Amendment, which says,

> *Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted.*

## ADA Has Become A Bonanza For Lawyers

A new ruling from the EEOC says that the Americans With Disabilities Act gives employees the right to sue their employer for being fired if the employee is rude to his or her boss or co-workers, is chronically late or is hostile to his or her boss. In a press release by the Libertarian Party,

> *"The ADA has become a multi-million dollar bonanza for lawyers. The ADA has been cited in lawsuits against a company that fired a dentist for fondling his patients, against a company for firing an employee caught falsifying records, against an employer for not banning perfume and against the New York City Transit Authority because a subway driver couldn't fit into the driver's seat."*

## Re-Classification Of Independent Contractors May Entail Pension Costs

If an employer treats someone as an independent contractor and the IRS later finds the 'contractor' was an employee, the costs may be greater than just paying some back taxes and interest. In a recent comment posed in a legal discussion group on the internet, it seems that some independent contractors who are re-classified are demanding full employee benefits, including back pension plan benefits.

## Sexual Harassment Opportunity Lawsuits

*Lawyers Weekly USA* regularly reports on an assortment of sexual harassment cases in addition to many other civil lawsuits. Their 9/22/97 issue included a summary of a case in which a company lost a suit in which an employee who claimed to have been harassed informed her immediate superior, but the superior didn't bring the complaint to the attention of any higher level superiors. The moral of this case seems to be that employees and front line supervisors or managers need to have some very clear method for bypassing normal communication channels about such matters. (The citation is U.S. Court of Appeals, 7th Circuit, Young v. Bayer Corp., No 96-3700, Sept. 5, 1997)

In another case reported by LW USA, "*a worker at a group home for the mentally retarded was sexually harassed by a resident*". The Eighth Circuit said she could sue her employer. The moral of that case seems to be that the employer didn't make a sufficient effort to protect their workers from their residents. (The citation is U.S. Court of Appeals,, 8th Circuit, Crist v. Focus Homes, Inc., No. 96-406, 8/15/97.)

The same issue of LW USA reported on a third case in which a male worker sued his employer because of being sexually harassed by a male heterosexual boss. I guess the moral of this case is that sexual harassment isn't limited to males who are bothering females at work. (The citation is Cunningham v. Koehnen, MN S. Ct., No. C6-96-1118, 8/28/97.)

Meanwhile, LW USA also reported on a case where an employee, who was fired after he admitted (in a deposition) that he may have harassed a co-worker, successfully sued his employer for "retaliation". According to LW USA, "*the plaintiff claimed that he wasn't fired for engaging in harassment; he was fired because he got the company in trouble by telling the truth.*" The moral of this case seems to be "Damned if you do. Damned if you don't". (The citation for this case is Merritt v. Dillard Paper Co., U.S. CA, 11 Circuit, No. 96-6247, August 29, 1997.)

To order reprints of these cases call Lawyers Weekly USA at 800-933-5594.

Meanwhile, *Research Recommendations*, (8/25/97) reported on a bizarre case where seven white police officers sued their city because their supervisor made sexist, racist remarks to female and black officers. The white officers sued on the grounds that the supervisor's comments created a hostile work environment. (Childress v. City of Richmond, No. 96-1585)

Unless you work by yourself, your business could be at risk from a sexual harassment lawsuit. To protect your company, I suggest that you get a copy of the *Employers' Guide to Preventing Sexual Harassment*, for $33.45 (shipping included) from National Institute of Business Management, PO Box 9070, MacLean, VA 22102-0070.

Without denying that many employees are seriously threatened by other workers, the law is encouraging employees to look for opportunities to "hit the jackpot" with a large lawsuit judgment. No matter how hard you might try to create a non-threatening work environment, there will always be some employees who are overly aggressive with sexual advances and other employees who may be looking for the slightest provocation as an excuse to sue their employer.

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## Tax Exempt Directors & Officers Face New IRS Penalties

If you are involved in the management of any tax exempt organization, you need to get informed about some new rules in the Taxpayer Bill of Rights 2 that became law last July 30th. As part of the revenue raising section of the law, this law created a new set of problems for the people who volunteer to serve on the board or who work part time in a management capacity. Scott Blakesley, our editorial advisor on charitable matters, pointed out that "These new rules will also impact those who work full time for the charities and who have any management authority with respect to the charities."

For many years, the people who administer private foundations have been subject to a variety of penalties and excise taxes on prohibited transactions. These rules did not previously apply to public charities. Instead, when a publicly supported charity was found to engage in similar self dealing transactions, the only option available to the IRS was to remove the entity's exempt status. To cure that problem, the IRS convinced the Congress to apply similar penalty rules on any self dealing transactions between any "disqualified person" and the charity.

The Commerce Clearing House explanation of this law states, "*Penalty excise taxes may now be imposed as an intermediate sanction when a Code Section 501(c)(3) or 501(c)(4) organization engages in an 'excess benefit transaction'. These excise taxes are imposed on 'disqualified persons' who improperly benefit from the transactions and on organization managers who knowingly participate in the transactions.*" [Taxpayer Bill of Rights 2; Law and Explanation, Commerce Clearing House, 1-800-835-5224]

A “disqualified person” includes any person who is in a position to exercise substantial authority over an organization’s affairs, regardless of their official title. Generally, that would include directors, officers or trustees, members of their families and any entities in which they own a 35% or greater interest - for up to five years after the alleged excess benefit transaction occurs.

For this purpose, an “excess benefit transaction” is any transaction in which the value of the economic benefits (consideration) received by the charity are not equal to the value of the benefits given. According to an article in the January, 1997 Journal of Accountancy by Arthur Cassill and Susan Anderson, “*If a charity gives its directors (or other person with substantial authority) a compensation package greater than that of directors of charities of comparable size, the director will be subject to a penalty tax ...(and) any of the charity’s managers who agreed to the package knowing it was excessive will also be subject to penalty taxes*.”

Scott also suggested that I mention that “*..an excess benefit transaction includes any situation where the disqualified person is receiving a benefit which is based on amounts the charity if receiving for certain activities. For example, the person was being paid an amount equal to 5% of the charity’s net receipts for the year. I’m not yet sure exactly how this provision will be applied, but it is probably worth noting in your newsletter.*”

If your charity hasn’t looked into this yet, this would probably be a good time to start. You should begin with IRC Section 4958. Some background on this matter would be in the 1996 Taxpayer Bill of Rights 2. Your exempt organization tax advisor should be able to get you the details. If you need help from a specialist, you might want to contact Scott Blakesley, our Editorial Advisor on exempt organizations and planned giving.

## Domestic Spendthrift Trust Doesn’t Stop The IRS

Bill Comer recently sent me a copy of a 1996 case in which the Sixth Circuit Court of Appeals overruled a district court in a case involving the state law relating to a spendthrift trust and the federal law relating to a tax lien. [Bank One Ohio Trust Company vs. U.S., CA-6, 94-3974, 4/4/96] For me this case is a reminder that when the “Feds” want your money, there’s hardly any protection available in any form of U.S. entity.

Frank Reitelbach’s father established a trust for Frank with a spendthrift trust provision that prohibits any trust income from being used to satisfy any debts of the beneficiary and from being assigned by the beneficiary to any other party. The IRS levied Bank One (as trustee) for the income that was otherwise payable to Frank. Bank One appealed and the Circuit Court held in their favor. The IRS appealed that decision and the Sixth Circuit Court of Appeals held for the IRS. Basically, the Appeals court found that state law was not binding on federal tax liens. So, in the US, a spendthrift irrevocable trust might protect the income and assets in the trust from any legal predators other than the Federal

folks. So, if you are more concerned about losing your money to your government than to some future judgment creditor, your best bet is to get the money offshore in a jurisdiction that won't cave in when the feds come calling.

## New Penalties For Medicaid Planning

One of the more obscure provisions of the Health Insurance Portability and Accountability Act of 1996 was the establishment of penalties to be imposed on anyone who aids in structuring the financial affairs of a Medicaid recipient so that they are eligible for Medicaid. The subject came up in a discussion group of planned giving consultants on the internet and Stephen Gill, Esq. contributed a copy of the exact statute for the edification of the email forum. With his permission, here is a copy of what he posted to the internet about this new law.

"*I've had a number of requests for the full, unedited text of the statute, so here it is (below). One person wrote privately that "the penalty provision of the statute does not address the added provision -- in other words, there is no fine or imprisonment specified for a person who transfers assets impermissibly. However, the 'catchall' penalty for anyone who violates any provision of section 1320a-7b is that DSS may deem an individual ineligible for assistance for up to one year." In reading the statute, however, I do not see the distinction, since it seems to me the statute is rather clear on the penalties."* Here is the full text:

*"Section 1320-7b - Criminal penalties for acts involving Medicare or state health care programs (a) MAKING OR CAUSING TO BE MADE FALSE STATEMENTS OR REPRESENTATIONS*

*"Whoever - (6) Knowingly and willfully disposes of assets (including by any transfer in trust) in order for an individual to become eligible for medical assistance under a state plan under Title XIX, if disposing of the assets results in the imposition of a period of ineligibility for such assistance under section 1917(c) shall (i) in the case of a statement, representation, concealment, failure or conversion by any person in connection with the furnishing (by that person) of items or services for which payment is or may be made under the program, be guilty of a felony and upon conviction thereof fined not more than $25,000 or imprisoned not more than five years or both, or (ii) in the case of such a statement, representation, concealment, failure or conversion by any other person, be guilty of a misdemeanor and upon conviction thereof fined not more than $10,000 or imprisoned for not more than one year, or both. In addition, in any case where an individual who is otherwise eligible for assistance under a state plan approved under subchapter XIX of this chapter is convicted of an offense under the preceding provisions of this subsection, the state may at its option (notwithstanding any other provision of that subchapter or of such plan) limit, restrict, or suspend the eligibility of that individual for such period (but not exceeding one year) as it deems appropriate; but the imposition of a limitation, restriction, or suspension with respect to eligibility of any individual under*

*this sentence shall not affect the eligibility of any other person for assistance under the plan, regardless of the relationship between that individual and such other person.*"
[Statute contributed by Stephen C. Nill, Esq. Rancho Santa Margarita, CA SCNisHere@aol.com)]

As I read and re-read that statute, I came up with a host of questions as to it's meaning. It makes many of the more obscure sections of the tax code seem simple by comparison. However, an article in the Nov./Dec. issue of the Ernst & Young *Financial Planning Reporter* states that "*Beginning January 1, 1997, offenders could be subject to five years in prison and/or a $25,000 fine for knowingly and willingly disposing of their assets to gain Medicaid benefits.*" E & Y also states that *"Loopholes by which seniors may 'reposition' assets do exist, however and some will be unaffected by the new law"*. If I encounter any better explanation, I'll pass on whatever I find out in a future issue of APS. At the least, I would urge some caution before getting involved in helping a relative (or a client) to become eligible for Medicaid by disposing of their assets.

Update: Although this law has not been recinded, it is not being enforced at this time.

# The Moral Basis for Asset Protection

Any discussion of asset protection among most lawyers, accountants, lenders or even the general public seems to engender some false assumptions that the purpose is to run up a lot of bills or to borrow a lot of money and then stiff your legitimate creditors.
**First of all, no legitimate asset protection attorney will aid a client in doing anything remotely similar to that because it's an out and out felony for the attorney as well the client.**
Secondly, anyone from whom you borrow a substantial amount of money is likely to have a secured claim against assets that are worth more than their claim. Those creditors will get paid.

Third, any unsecured creditors from whom you buy goods or services can be repaid by you after bankruptcy so that you can retain your credibility and reputation with them.

Fourth, you should have a reasonable amount of liability insuance with which to adequately compensate anyone who suffers an injury that is caused by you, members of your family or any employees.

Fifrth, if you establish a sound asset protection plan, you most likely won't have to take bankruptcy at all and your legitimate unsecured creditors won't have to suffer any loss. If some ambulance chasing lawyer sues you on behalf of an angry former employee who is willing to commit perjury to get even with you, is it moral for your other creditors to lose the chance of getting repaid because of a preposterous award by a sympathetic jury?

If you form a partnership with someone else, you are not morally obligated to expose all of your personal wealth to their business related errors or omissions by doing business as general partners. It's not immoral to do business as a LLC or corporation so that you aren't liable personally for the acts of your partners or co-owners.

**The basic purpose of asset protection is to balance the scales of justice in connection with lawsuits that would not only wipe you out but would also wipe out your family. There is no moral basis for leaving your spouses's or parents assets exposed to the claims of your unknown future judgment creditors because of joint ownership.**

If you are concerned about providing for your children's or grandchildren's college education, there is nothing wrong with taking steps to secure that money by making transfers now in the form of a trust, limited partnership or similar entity.

To the extent that you do not seek to defraud your present known creditors, there is nothing immoral in placing some of your assets beyond the easy reach of the legal predators in the U.S... who are taking advantage of a dysfunctional legal system where fault is seldom an issue in determining liability. If our legal system regains a moral basis of fairness between the plaintiffs and defendants, then there might be some small grounds

to question the morality of asset protection. Until then, self preservation is moral and asset preservation planning is as well.

There are two kinds of people in this world.

(1) There are those who argue strenuously that you and everyone else are somehow obligated to sacrifice yourself to the needs of others. They would have you believe you should own all of your property in your own name, with no legal protection, because someday, you might cause some injury to someone. If that were literally true, then the question is whether they are doing the same. And for whom is this great sacrifice being made? Is it for your spouse, your parents, your children or even for someone you actually know? No. The implication is that you are somehow obligated to sacrifice yourself, your family and your employees for the un-specified need of some future unknown person. Of course, there will also be a needy lawyer helping this unknown future person and taking from 1/3 to 40% of the total award.

(2) The other kind of people believe that self preservation is a moral right. They don't feel any obligation or any guilt if they have provided for their spouse, their children, their parents and indirectly for themselves, leaving some unknown future person to find another lamb for the sacrificial meal.

Can unscrupulous people use legal methods of asset protection to deprive others of a just claim? Certainly.

Automobiles have provided a great many people with a lot of benefits, but they also kill a lot of people every year. Nuclear energy can be used to produce electricity or bombs. Weapons can be used for self defense or to wage war on women and children. Virtually anything can be abused by those who seek to harm others. The morality of asset protection is based on the purpose to which it's put. Like a gun, it can be used for self defense - only when needed. Or it can be used to harm others. It's not the weapon that's immoral. It's the person who is using it.

## Benefits of Asset Protection

When most people first approach the subject of asset protection, their concern is usually the result of some immediate judgment, lien or lawsuit.

**The law provides generous protection for the rights of creditors.** Any efforts to delay, hinder or defraud creditors of their just claims can be overturned by the courts. Asset protection can be accomplished with respect to a general (not specific) concern for potential **future** lawsuits, so long as the process is not *solely* for the purpose of asset protection.

Thus, to be effective, any asset protection plan must also provide other benefits, as described in this article.

In a like manner, the tax law gives the IRS the legal power to disregard some arrangements if the IRS contends that the only purpose of the arrangement is to avoid or to evade taxes. However, the tax benefits are far more likely to survive a challenge if the financial arrangements can be shown to have some purpose other than tax avoidance. Lawsuit protection is usually an effective justification.

Here is a brief checklist, with comments, of the six primary benefits of asset protection planning.

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**Avoid future lawsuits**
**Greater Financial Privacy**
**Negotiate very favorable settlements With Future Creditors**
**Save on liability insurance costs**
**A nest egg to start over**
**Save on income and estate taxes**

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### 1. Avoid future lawsuits

When you make an effort to arrange your financial affairs so that predatory lawyers and entrepreneurial plaintiffs will have a hard time getting any liquid assets, you will greatly reduce the chances of being sued in the first place. The most effective way to avoid a civil lawsuit is to be "judgment proof". Those who are devoid of assets or insurance are not an attractive target for a lawsuit. Lawful methods of asset protection don't make you judgment proof, but they can make you much less attractive as a potential defendant.

Essentially, the lawful methods of asset protection convert your attractive, liquid assets into what some people call "ugly assets". However, just a child may be ugly to others, it's often a sight of great beauty to its parents. In a like manner, the form in which your assets

are owned may present a future creditor with an ugly asset, but those assets may be even more attractive to you because of the added tax benefits or other advantages of owning assets in legal entities that are unattractive to future judgment creditors.

## 2. Greater Financial Privacy

Asset protection generally results in the transfer of your assets into legal forms that are not as highly visible to those who might want to pry. If you have less personal assets in your own name, you will usually have less income in your own name.

The credit reporting agencies are building huge databases with an extremely detailed history of everyone's financial activities - what they own, what they owe, what they buy, how much taxes they pay, etc., etc., etc. For those who know how, the information in these databases is accessible for a modest fee.

By reducing your financial profile, you become less interesting to the IRS and other predatory regulators. Mind you, I'm not suggesting that asset protection involves illegal tax evasion. It just divides your assets and income into more pockets, making you less of a target.

In addition, some of these asset protection entities are not a matter of public record - such as a trust. And, if you have a foreign trust that owns a foreign corporation that owns your assets, there is simply no record of your assets in any public database. However, there are reporting obligations with respect to foreign trusts, corporations or financial accounts that are onwed or controlled by U.S. persons. Greater privacy may be available with a foreign life insurance policy.

## 3. Negotiate very favorable settlements With Future Creditors

Even if you can't prevent someone from suing you, if you lose a future lawsuit, the plaintiff will soon discover that it will be very time consuming and expensive to get a full settlement of his or her judgment. You will often be able to negotiate a settlement for 10% to 25% of the judgment.

Consider the plight of a future judgment creditor who has won a lawsuit against you because of an accident caused by an employee or by one of your children - or even a grandchild. If you have your assets properly owned by a family limited partnership, the only remedy available to the creditor would be to get what's called a "charging order". That order requires the general partner to give your creditor any distributions otherwise payable to you. But if the general partner is your wife, or a corporation owned by your family, the general partner might decide not to make any distributions for a few years. Meanwhile, the creditor may be liable for any income tax due on the share of the income that has been awarded to the creditor. Thus, the creditor has a "double ugly" asset. He has to pay income taxes on an asset that doesn't generate any cash flow. Don't you think that creditor would be willing to negotiate a settlement of his claim for about 10% of the amount of the judgment?

## 4. Save on liability insurance costs

Asset protection is a form of risk management, and is partly an alternative to buying costly insurance. When the cost of liability insurance is totally prohibitive, asset protection may be the only option. With a sound asset protection plan, you can gradually reduce the upper limits of your insurance coverage and offset the cost of asset protection with substantial reductions in insurance premiums.

Some advisors strongly recommend that you retain at least enough liability insurance to get the help of an insurance company's legal staff - but not enough to be attractive to a creditor after the legal fees are paid. And, it's not advisable to cut back on your insurance coverage right away. Reduce your coverage gradually or increase your deductibles in order to reduce your premiums.

## 5. A nest egg to start over

It isn't reasonable to expect an asset protection plan to protect every dime you have from every possible legal contingency. The most practical approach is to use an asset protection plan to safeguard enough assets so that you can start over if you ever become the victim of a ruinous lawsuit.

Asset protection is much like investment diversification. It doesn't make sense to put all of your investments into one mutual fund in order to get diversification. In a like manner, it makes better sense to utilize an assortment of asset protection devices, with some of your assets being in a trust outside the U.S. and beyond the reach of anyone.

## 6. Save on income and estate taxes

One of the most effective forms of asset protection involves the transfer of legal ownership of property to your children and grandchildren, even though you may retain control of a limited partnership or limited liability company that owns the assets. This will usually result in substantial income tax and estate tax savings as well as creditor protection

# Checklist of Asset Protection Methods

The following is a check list of asset protection tactics and concepts, categorized but not described. Explanations of many of these tactics are included in other articles in this web site or in back issues of *Global Asset Protection.*

**Some of the tactics listed in this checklist are subject to dispute by different asset protection advisors. This checkist is not intended to serve as a list of recommended asset protection devices for any specific person, but as a reminder of different tactics and devices that are used by different people at different times. It would be extremely unlikely that any one person or family would utilize all of these tactics.**


**Segregate Ownership and Control of Assets**
**Insure Against Losses When Practical**
**Avoid Unnecessary Exposure**
**Avoid Fraudulent Transfers**
**Make Gifts to "Safe" Family Members**
**Transfer assets to protected entities**
**Checklist for Using Family Limited Partnerships**
**Checklist for Using A Controlled Corporation**
**Checklist for Offshore Asset Protection Trusts**


## Segregate Ownership and Control of Assets

**Review legal title for all assets**
**Avoid joint ownership whenever possible**
**Avoid authorized signatures on personal accounts**
**Avoid joint liability on loans when possible**

## Insure Against Losses When Practical

**Self insurance (deductible & co-insurance)**
**Errors & omissions insurance**
**Product liability**
**Personal liability umbrella**
**Foreign captive insurance**

**Diversify coverage among insurance companies**
**Make sure companies are among highest rated**
**Use variable annuity/life insurance contracts when feasible**

## Avoid Unnecessary Exposure

**Avoid serving as an inactive corporate officer**
**Avoid serving as director of a corporation**
**Avoid general partnership and proprietorship**
**Check environmental liability on land purchases**
**Don't rely entirely on one advisor**
**Don't ignore legal protocols of various entities.**
**Use multiple entities for maximum protection**
**Segregate safe assets from high risk assets**
**Provide mechanism to change trustees of trusts**
**Dispose of unneeded high risk assets**
**Avoid loaning property to others who might misuse the property**
**Don't agree to serve as an executor or trustee except for your closest family members**

## Avoid Fraudulent Transfers

**Measure solvency under state and federal law before making transfers**
**Exclude all protected assets**
**Base asset values on fair market value**
**Include contingent liabilities**
**Include future income that is available to pay creditors**
**Avoid gifts when insolvent under applicable law**

**Avoid gifts after exposure to potential claims unless there are enough assets or future income to satisfy those claims**

## Make Gifts to "Safe" Family Members

**To spouse if not subject to litigation risk and if there is no concern over a divorce.**
**To parents in trust or via FLP**
**To Children in trust or via FLP**
**To an Irrevocable trust**
**To a Qualified Residential Retained Interest trust**
**Get qualified appraisals for assets not listed on an exchange**

## Transfer assets to protected entities

**Limited partnership with transferor as L.P.**
**Closely held corporation (minority interest)**
**Irrevocable life insurance trust**
**Offshore asset protection trust**
**Charitable remainder trust**
**Family foundation**

## Checklist for Using Family Limited Partnerships

**Don't use FLP to hold only idle or personal assets**
**Don't combine low risk and high risk assets in the same FLP**
**Maximum protection is obtained if highest risk family member is not the general partner**
**Greater protection is likely if the FLP has multiple partners**
**Consider having L.P. interest owned by a foreign trust**
**Avoid personal use of FLP assets without compensation to the FLP**
**Maintain separate bank accounts for the partnership**

## Checklist for Using A Controlled Corporation

**Avoid more than 49% ownership by one family member**
**Controlling shareholders, officers & directors should be covered by adequate liability insurance**
**Use a FLP or LLC to own and lease critical assets to the corporation**
**Avoid personal use of corporate assets without compensation to the corporation**
**Maintain separate bank accounts for the corporation**
**Maintain corporate minute book, stock ledger and by-laws**
**Minimize the use of employees when possible or isolate employees from assets in separate legal entity**
**Segregate unpaid payroll taxes from all other bank accounts**
**Avoid personal loan guarantees whenever possible**
**Withdraw any idle (unneeded) cash or other assets if possible**
**Don't use the corporation to accumulate passive investments**

## Checklist for Offshore Asset Protection Trusts

**Don't put all of your assets into an OAPT**
**Don't structure the trust to achieve tax benefits**
**Avoid putting appreciated assets or growth assets into the offshore trust**
**The grantor/settlor should not be a trustee**
**Make the OAPT irrevocable with the grantor as a discretionary beneficiary rather than a primary beneficiary**

**The OAPT can be structured as a temporary (reversionary) trust with a fixed term of years**

**The settlor/grantor should not be the primary or sole beneficiary**

**If the settlor/grantor is a trust protector, his or her powers should be suspended during periods of duress**

# The Secrecy Myth

[Secrecy versus Privacy]
[Tax Avoidance or Tax Evasion?]
[Secret Bank Accounts]
[The High Cost of Secret Accounts]
[Why Can't You Just Hide Your Assets?]
[Asset Protection By Giving Your Assets Away]
[The Secret Foreign Bank Account Scheme]
[Bearer Share Domestic Corporation Schemes]
[Bearer Share Foreign Corporations]
[Secret Accounts Through IBC/Nominee Ownership]
[The Secret Foreign Trust]
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[Multi-National Pressure to Eliminate Banking Secrecy]
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[IRS Targets 132 Offshore Promoters]
[Why Secrecy Isn't The Best Strategy]
[Is It Time To "Come Clean?"]
[If You Want Help In "Coming Clean"]

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## Secrecy versus Privacy

Some subscribers who have talked to me by phone have asked why I don't devote much space to the subject of privacy. That's gotten us into a discussion of the difference between financial privacy strategies and asset protection strategies. Sometimes the two goals can be achieved with the same device, but most of the time, the use of some asset protection entities will reduce your privacy and create more exposure of your financial affairs. Most of the lawyers who actually do a lot of asset protection work advocate full disclosure to the various tax agencies and any other regulatory agencies. (I believe the other lawyers are living on borrowed time.)

Partnerships, limited liability companies, corporations and private foundations are entities authorized by law. Individuals have certain rights and powers without the consent of the state. A corporation or partnership only exists as a creature of the law. Without virtually full disclosure of the financial affairs of the partnership or corporation, the state won't grant the entity the benefits of a separate entity with it's own rights under the law. Trusts do not require registration with any

government agency because they are simply agreements between the grantor/creator of the trust and the trustee. While revocable trusts don't provide any asset protection, an irrevocable trust might provide some protection.

Certain aspects of the concern for privacy make a lot of sense. You just never know whether some innocent remark might be misconstrued. If you brag about saving taxes, someone might think you are doing something illegal and turn you into the IRS. If everyone knows you are out of the country for three weeks, will one of those people be a burglar? If you have a lot of money and make sure everyone knows it, aren't you inviting a lawsuit?

Although the use of asset protection devices may be entirely legal, why tell everyone about it? It's one thing to make the necessary disclosures to the regulators, but why let everyone else know what you are doing? Those who set up family partnerships or offshore trusts sometimes seem to feel that using these devices is a mark of success and they have to brag about it at every party or social gathering. It's like the person who is "complaining" about his high tax bracket. It sure sounds a lot like bragging to me.

But there are some forms of asset protection that rely on secrecy and evasion rather than on openly making use of the law. When that happens, the desire for privacy can overlap into a potential felony. If secrecy, subterfuge or fraud are essential to the success of an asset protection device, the odds are that it's illegal. A concern for privacy is reasonable, so long as it's also legal.

Keeping a low profile and keeping your financial affairs private is the first and most important step in avoiding potential lawsuits or even some opportunistic civil forfeitures.

There are many legitimate reasons for wanting to keep your financial affairs to yourself and to not have those affairs easily accessible to any potential plaintiff, private investigator or lawyer who may be curious as to your net worth. In the U.S., such privacy is extremely difficult to secure. The ownership of real estate, corporations, partnerships and limited liability companies is a matter of public record. With nothing more than your name and address or phone number, an experienced investigator can quickly discover your social security number and can then get access to your credit history and even some of your insurance records. Extensive details about your bank transactions and credit card transactions can also be obtained. Getting a copy of your tax return is usually more difficult, but if the price is right, I'm told that it can be done. In some cases, I'm told that a potential plaintiff can get a court to order you to disclose this information even prior to a lawsuit.

None of this kind of transparency has been available through offshore financial institutions. By having an offshore bank account, securities custodian, corporation, LLC or trust, you can shield a lot of your financial affairs from prying

eyes. But some people are wondering if the recent assault on financial secrecy by the U.S. and other high tax countries against the tax havens means that offshore financial privacy will also be a thing of the past. If you are looking for secrecy to keep your income hidden from the government, it seems to me that your days are numbered. But if you merely want financial privacy, I don't think you have anything to fear at this time. Right now, it seems to me that the main focus of the U.S. and the OECD is to be able to pursue their own tax evaders without getting stone-walled by bank secrecy laws.

Tax evaders need a lot more than privacy.They need secrecy to hide their unreported gains. I may be mis-reading what is happening right now, but I sense no effort by the big governments to force the financial havens to become as financially transparent as we are in the U.S. Those of you who are reporting your foreign accounts on Treasury Form TD F 90-22.1 and checking the box on Schedule B-III of your 1040 tax return and filing other required tax forms should not have anything to fear from the changes that are going on in the financial havens. If you are contacted by an IRS agent because you have an offshore account or even an offshore credit card, you should be able to avoid a full scale audit by showing the agent that you have been filing these documents.

As I indicated above, I've been told that if someone has enough money and the right connections, then it is possible to get tax return information. But in most cases, that information is very difficult to secure and it's not readily available to potential litigants. There are no meaningful laws in the U.S. to prevent commercial establishments from sharing customer information as there are in many foreign countries. Disclosing information to the IRS is not the same as disclosing it to a local loan broker or credit card company.

Maximum privacy from potential plaintiffs can derail or deter a lot of predatory lawsuits. But when a concern for privacy turns into a paranoid need for secrecy, it begins to look like you are a criminal. If you act and look like a criminal, the authorities will conclude that you are one. Then you have to work much harder to convince them you are not engaging in any crime.

If the IRS believes you are not reporting all your income they will perform a "life style" audit in which they try to measure how much you are spending each year. Then they compute how much income you would need before taxes in order to have that much available to spend after taxes. If your reported income and taxes are substantially less than their computed amount, they will assess you for back taxes, penalties and interest and may even pursue criminal charges. You then have to prove you are innocent. The most effective way to do that is with an annual balance sheet that is tied to your total income and by having an "audit trail" to connect your total income to your bank deposits and then to your tax return and your personal balance sheet. You also need to be able to explain any unusual spending by showing the receipt of non taxable gifts, inheritances or loans that were used to pay for those expenses.

The dividing line between privacy and secrecy is simple. File the required government reports for your offshore financial accounts, trusts and companies. Leave an "Audit trail" to show that you have reported all your income. You may even want to be prepared for a life style type of audit by having an annual personal balance sheet that is connected to your personal income the same way a business balance sheet is connected to the income of the business.

But I really see no reason at this time to close out your private foreign accounts, companies and any trusts if you have been reporting the income from your offshore assets to the tax authorities.

I can't count how many people call me or send me email messages wanting to know if some "plan" they have concocted to hide their assets in some bizarre manner will work. Often, they want to use a foreign corporation that is "managed" by a nominee and their ownership is evidenced by bearer shares. My answer is always the same. Even if it were legal, secrecy is not a solution because there are too many ways that a plaintiff's lawyers can uncover assets that have been hidden.

By itself, secrecy isn't enough to protect your assets from future lawsuits.

As a practical matter, secrecy is useful in making it difficult for a lawyer to easily find out how much you are worth before the lawyer decides whether to sue you. But if you are sued, the lawyer is then able to use discovery proceedings to require you to disclose some information under oath even before there is a trial. And if you lose a lawsuit, the courts will require you to disclose the extent of your holdings.

You can't make a transfer of real estate without leaving tracks. The same is true for an interest in a corporation, limited partnership or limited liability company. If you make gifts of more than $10,000 to any one person in any year, you are required to file a gift tax return. If you have listed securities, you have to convert them to cash to avoid leaving tracks. When you convert to cash, you leave a record. If you have a gain from selling securities, you have to report that on your tax return.

Whenever there is an inheritance, there are usually some probate records or a federal estate tax return. Any tax return information can be obtained by a creditor/plaintiff unless you claim the 5th and that's almost certain to be passed on to the IRS. I'm told that a bankruptcy trustee has nearly unlimited access to tax information. Any half competent auditor can look at a tax return for two years in a row and quickly identify any assets that haven't been accounted for in the second year.

And, there is always the requirement to report any cash or currency that you take offshore in excess of $10,000. If you use a foreign trust, there are extensive

reporting requirements with heavy penalties for not reporting. Ditto for a foreign corporation or foreign partnership. Using a non-profit entity isn't a solution because their records are seldom protected. The list goes on and on.

For those who are greatly frustrated by the growing lack of privacy in the U.S. and most other major countries, the only "solution" I can think of is to expatriate if you have the resources to live elsewhere. If you are self employed and can work anywhere in the world, then you have an ideal situation. Or, if you have ample assets and can live off your investments, you are also in an ideal position to change your country. Of course, you will most likely have to leave some family and friends behind, which is what makes it a difficult choice for most people. As for the prospect of ever regaining any significant personal privacy in the U.S., I'm extremely pessimistic. And, the lack of financial privacy is growing in most other major countries.

Even so, it's foolish to make your financial affairs public any more than is required to avoid problems with the law. If you have assets in an offshore trust, it won't show up on a routine financial investigation by a lawyer who is considering taking on a suit against you on a contingent fee. Assets in the name of a family partnership won't disclose the extent of your financial resources if a trust is the limited partner. (Global Asset Protection, 7/99)

This report is a compilation and update of various articles and correspondence I have written or received in the past few years on the subject of privacy and secrecy. Portions of this report are articles by contributors to previous issues of Global Asset Protection or from Offshore Tax Strategies.

## Tax Avoidance or Tax Evasion?

What's the difference between tax avoidance and tax evasion?

The short answer is five years and $10,000. (For a corporation, the penalty is $100,000.)

The serious answer is that the real difference is secrecy and deception.

Legal methods of tax avoidance do not require the use of bearer shares, unregistered trusts or secret bank accounts. Legal methods of saving taxes offshore do not require a U.S. taxpayer to commit perjury on his tax return.

There are a proliferation of phony tax schemes, scams and myths that involve some aspect of "going offshore". Although both of us (Richard Duke and Vernon Jacobs) are eager to find ways to help our clients to minimize their tax burden, we sense that a great many people simply don't how really difficult it is to evade

taxes with illegal schemes without being caught. We also sense that many people (including some of the promoters of these schemes) just don't understand the various ways in which the tax law gives the IRS the power to penetrate and ignore many intermediate entities in a complex web of offshore structures. We also suspect that a lot of the people who think they can avoid taxes with a secret bank account, secret trust or secret corporation don't have a clue as to how difficult it is to avoid getting caught.

Most likely, those who are tempted to evade taxes aren't even aware that there is no statute of limitations on back taxes, penalties and interest for an intentional failure to report and pay any taxes.
For example, few of the promoters of offshore tax structures ever mention U.S. tax code section 318 and 958, which gives the IRS the power to attribute the ownership of corporate stock to certain related parties. Examples of related parties include a spouse, children, parents and grandchildren. Stock owned by a partnership, corporation, estate or trust is deemed to be constructively owned by the partners, shareholders or beneficiaries - and vice versa. Thus, if a U.S. person forms a foreign trust, which then forms a foreign corporation, the stock of the foreign corporation is deemed to be constructively owned by (attributed to) the grantor of the trust and the beneficiaries of the trust. This is just one of many rules that are like "booby traps" for the uninformed.

This is just one of many complicated traps in the tax laws that make it difficult to avoid U.S. taxes with offshore entities. Promoters and hustlers can easily persuade an eager prospect that he has found the "holy grail" of tax avoidance with some scheme by merely failing to disclose the obstacles and pitfalls that await the unwary and uninformed.

Vernon Jacobs & Richard Duke

## Secret Bank Accounts

As far as the U.S. tax law is concerned, U.S. citizens and permanent residents are required to report any income from foreign bank accounts. The fact that the income is not reported to the IRS on an information return does not alter the legal duty of the U.S. citizen/resident. The existence of a foreign bank account is required to be disclosed on Form 1040, Schedule B, Part III and a Form TD F 90-22.1 must be filed by June 30th of each year to disclose the location and other information about any foreign "financial accounts" with an aggregate value of more than $10,000 at any time during the prior calendar year. There are substantial penalties for failing to report income from foreign accounts and for failing to file the form TD F 90-22.1.

The IRS has been trying to convince the U.S. Congress that a lot of people are evading taxes in the underground economy. It's their bureaucratic assumption that they can and should somehow uncover every dime of unreported income - regardless of what it costs.

It's also widely known that there are a lot of U.S. citizens and residents who are evading taxes by not reporting the income from their secret foreign bank accounts, trusts or corporations. We're not about to try to tell you that tax evasion isn't widespread. Frankly, the IRS may be correct in saying that almost everyone cheats on their taxes sometime or other.

Of course, we also know a lot of people who will stoutly deny that claim. The ones we've met always tell us that their tax return is "squeaky clean". But we really doubt if there are a lot of people from the U.S. with foreign bank accounts who are reporting it all to the IRS. After all, if the Swiss banker or the Austrian banker won't send an information return to the IRS, why should the taxpayer volunteer? "Who wants to be a sucker anyway?" At least that's the argument of many people for not reporting income from foreign accounts.

Let's not get derailed at this point into a discussion of the moral issues of whether it's right or wrong to evade taxes or even to avoid taxes. Our focus here is on the practical issue of what's legal and what isn't.

First, you need to know that when you fail to report income, there is no U.S. statute of limitations on your tax return for that income. If the IRS finds out about some foreign bank account twenty years from now, it's all subject to penalties and interest plus the taxes that should have been paid.

It only takes one audit out of a lifetime to get caught.

Second, you should also know that there is no dollar threshold for tax evasion. As a practical matter, the IRS rarely tries to pursue a criminal conviction for small amounts, but that's not because there is any legal reason to ignore the small fry. They just don't have the staff or the budget to pursue more than a few tax evaders.

Now then, how can they catch you if you fail to report a few dollars of interest in a foreign bank account? For one thing, it's nearly impossible to move more than a few dollars offshore without leaving a paper trail. For now, you can move as much as $10,000 in currency offshore without leaving tracks. But that only works if the withdrawal of $10,000 is from such a large account that it won't be noticed if you are audited. If you don't have a habit of carrying around that much cash, some bank employee is likely to file a suspicious activity report on you. Basically, you would have to engage in a lot of very small transfers of money, spread out over many years, in order to avoid leaving a trail. The travel costs would far exceed the tax savings.

Transfers of large amounts (in relation to what you have) leave a trail. They even leave a trail when there is something missing. For example, you had $1 million of net assets last year, you made $150,000, you spent $100,000 (including the taxes you paid) and this year you have $900,000 of assets instead of $1,050,000. What happened to the other $150,000? Most auditors spend four or five years in college learning their craft. Then they often spend another four years with one of the big CPA firms as an auditor. Or they go to work for the IRS and get a crash course on how to find hidden money. An auditors job is to find things that don't fit a pattern. Ratios are out of whack. Financial trends change for no apparent reason. Most IRS agents are auditors. Only a few are lawyers.

Like the detectives in the movies, the books and t.v., the IRS auditors acquire a sixth sense of when something isn't in sync with everything else. They soon learn to sense when someone is lying or is nervous. They even learn to observe body language to get a feel for whether the taxpayer might be trying to hide something. The more of these clues they get, the more they want to get to the bottom of it. They ask leading questions of the taxpayer in different ways. If they are auditing a business, they ask seemingly innocent questions of the employees. They look for large deposits or withdrawals of cash from bank accounts or other financial accounts.

Frequent foreign travel without an obvious business reason tends to make the auditors suspicious. They will want to know the reason for the trips. Are you going to the same place each time? Who did you visit? What did you discuss with them? Where did you stay? When did you see them? Where did you meet? Was it a profitable trip? Did you establish new business relationships? What are you buying or selling to this new foreign contact?

If they have sufficient reason to doubt the information they are getting from a taxpayer, they can begin a lifestyle type of audit. Instead of just looking at your tax returns and supporting records, they look into every nook and cranny of your personal life for clues to unreported income. They then try to reconstruct how much income you would need to support a particular lifestyle. If you haven't reported that much income, they dig deeper.

But maybe you will win the audit lottery and not get selected for one of the random audits that occur just because yours was one of the random numbers they pulled for that year. <u>There's a really huge problem of being reported to the IRS by someone you know</u>. You have to resist the great temptation to tell someone about your exciting and ingenious scheme to hide some income from the IRS. A lot of people can't resist telling someone. But then they get divorced, or they have to fire the employee who knows what they did, or the business goes broke, a former partner is angry over the breakup, a lover gets mad at them and someone blows the whistle with the IRS. Did you know that most IRS informants don't want the money the IRS is willing to pay for information leading to collecting more taxes?

What about all the communications you have with your foreign banker? Will you be making monthly phone calls to Zurich? Or will you have to travel frequently in order to take care of such matters in person? How much taxes would you have to save in order to pay for the plane fare and other travel costs? Of course, you could use the internet with encrypted email messages. But first, the foreign banker has to get well enough acquainted with you to do business by email, phone or other impersonal means. With the pressure of the U.S. and other major countries to require bankers to "know their customers", it will be much more difficult to establish a new banking relationship outside the U.S.

And - if you decide to do business through someone who is willing to lie for you, to commit a felony with their own government, to sign documents that are false, how can you be sure this person will be honest with you? Secret bank accounts may sound easy in the movies and the novels, but they actually require a lot of hard work and expense.

## The High Cost of Secret Accounts

(The following comments were written in October of 2000.)

I've just received an email from a party who wanted me to visit their new www.sparbucks.com web site which promises a 100% anonymous offshore debit card from Austria. (As of December 11, 2001, this web site is not longer online.)

A quick look at their web site disclosed the high price of secrecy -- which they actually claim are "low costs and fees".

> The cost per Baltic Sparbuck is "only" $595 plus $60 shipping plus $40 opening deposit.
> Annual renewal fee is "only" $295.
> ATM cash withdrawal charges are a "low" 1.5% of the amount withdrawn.
> There is a 5% charge for wire transfers and a 10% charge for e-gold transfers.

It does not appear that you get any credit for funds on deposit.

Is this a bargain or what? Frankly, if you don't have funds earning any interest, there is no problem with tax evasion because there is no income and hence no tax to evade.

So why does anyone want to pay these fees to have an anonymous (secret) offshore debit card?  Maybe they want to use it to hide some transactions from a spouse?

Well, I do understand that if you are a drug dealer or engaged in some other kind of illegal activity, this might be an appealing way to launder money out of your illegal activity.

Can anyone think of any legal reason why it would make sense to forgo all income from interest for any funds on deposit and to also pay almost $700 to sign up and $300 a year, plus up to 11.5% of the funds put into the account and later withdrawn?

Perhaps the fees would not be a problem if you had a large amount on deposit, but then your lost income and transfer fees would be pretty costly -- it seems to me.

Is secrecy really worth this price?

Perhaps not, since their web site is not longer online.

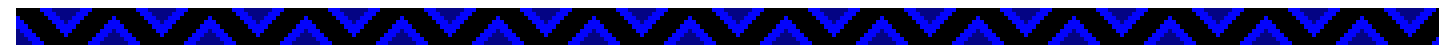
## Why Can't You Just Hide Your Assets?

A common assumption about protecting your assets from judgment creditors is that you can somehow just hide your assets somewhere. First of all, that clearly won't work for immovable assets such as your home, your business, your pension plan and any investment real estate. Secondly, if you attempt to hide movable assets such as cash, stocks, bonds or other securities, you will have to commit perjury under oath. The judgment creditor will be able to engage in a fact finding process (which includes taking a deposition, reviewing any financial statements and even looking at your tax returns) to identify and locate your assets. If you have reported the interest, dividends, rent or related tax deductions for any movable assets on your tax return, it will show up and you will be asked what happened to the assets. The creditor will also ask for any financial statements you have used to secure credit - and those statements may disclose the existence of the assets you are trying to hide. Basically, you have to be prepared to convincingly lie under oath, and to be able to cover your tracks through all of the various paperwork that may identify any assets you have ever owned. You also have to able to resist the temptation to tell someone about your "secret" stash.

## Asset Protection By Giving Your Assets Away

Another common attempt to hide assets from judgment creditors at the last moment is to make gifts of the assets to a spouse, children or other relatives. Sometimes, you might attempt to put the assets into a family corporation or even into an irrevocable trust.

Assuming that these transfers are disclosed during the discovery process, the creditor can ask the court to have the assets transferred back to the control of the court for the benefit of the creditor. To do this, the creditor only needs to show that the debtor transferred the assets in order to "delay, hinder or defraud" any of their creditors. All of the states have some form of fraudulent transfer or fraudulent conveyance law to protect the rights of creditors. Property transferred without sufficient consideration (payment) can be recovered by the creditor from the person or entity to whom the property was transferred if the creditor can convince the court that the transfer was intended to hinder, delay or defraud any creditors. It's possible to rebut this claim by showing that you were technically solvent at the time of the transfer. An in-depth discussion of solvency in connection with asset protection is available on our subscriber's restricted web site.



## The Secret Foreign Bank Account Scheme

Some "advisors" will tell you that money in a foreign bank account is protected from any creditors, but they often fail to point out that this only works if you are able to keep the existence of that foreign account a secret and are willing to commit perjury on your tax return. These advisors allude to the well publicized "numbered accounts" of Swiss banks and Austrian banks, whereby there is no record in the U.S. of the ownership of these accounts.

But first, you have to find some way to get the money out of the country without leaving a paper trail of any kind - and that's extremely difficult. You can take up to $10,000 out of the country with you on a trip. If your spouse travels with you, he or she can take another $10,000. As I understand it, each child could take $10,000 out of the country - if it's their money. But if you use this exemption too often or just use your kids as a conduit, you will be guilty of a crime called "structuring". This crime was created to prevent drug dealers from laundering money through multiple smaller transactions, but it's a crime without regard to whether you are a drug dealer and without regard to whether you are even engaged in money laundering. As a practical matter, if you, your spouse and each of your five children are searched (or questioned) when you depart from the U.S. or when you enter another country, the fact that each of you are carrying $10,000 in cash is likely to be viewed as a crime by the customs official and you will then have to spend a lot of time to try to prove you haven't committed any

kind of crime. It's also highly likely that the cash will be confiscated (forfeited) by the customs personnel.

Of course, you can transfer funds to a foreign bank account with a check or a wire transfer, but that leaves a trail that could be found by a determined creditor. And you are still faced with the decision of whether to lie on the part of your tax return that asks if you have a foreign account. It may be possible to hide some of your assets in a numbered foreign bank account, but it "ain't easy". It will require a great deal of careful subterfuge - which most people are not capable of accomplishing.

In the past year or two, it's become even more difficult because of pressure by the major countries (like the U.S., England, Canada, France, Germany, Japan and others) on other countries to adopt rules to ostensibly deter money laundering. More international banks are refusing to take funds from new customers without first engaging in an extensive review of their credit and financial records. There are fewer and fewer banks in the world that will accept deposits that are secret.

Some commentators have argued that if you have funds in a foreign bank account, a creditor will have to pursue a court action in the foreign country in order to get a lien or attachment on the funds in the foreign account. However, if you have the legal right to draw checks or to make withdrawals from that foreign account, a creditor will merely ask the court to order you to withdraw the funds in those foreign accounts. If you refuse, the judge will hold you in contempt of court and will let you spend some time in jail to think about it.

## Bearer Share Domestic Corporation Schemes

Some promoters are selling packages consisting of a Nevada corporation or an international business company (IBC) as a way to protect your assets from creditors and even to "save taxes". The key to these schemes is that the ownership of the entity is evidenced by bearer shares. There is no public record of who owns the shares of the corporation and the shares can be quickly transferred to someone else without the time and delay of registering the change in ownership with the corporation.

Basically, the protection -- and the tax savings -- rely on secrecy.

This is a legitimate way to prevent potential plaintiffs (or their lawyers) from discovering all of your assets with a quick computer search. That may deter a

predatory plaintiff from suing you and it's almost certain to deter a lawyer working for a contingent fee from taking the case. If the potential plaintiff has to pay cash to hire the lawyer, that is usually the end of the matter. Thus, when properly used, the Nevada Corporation or foreign IBC can make it a lot more difficult for legal predators to find out if you are worth suing.

But most of the promoters of these arrangements claim a lot more in the way of benefits. Many of the promoters claim that a bearer share corporation provides asset protection and some even claim that it provides tax savings.

But -- while a bearer share corporation might prevent someone from deciding to sue you, it won't protect your assets very much after you are sued. The claims of tax savings are often based on very limited circumstances that seldom apply to most people.

If you lose a lawsuit, the plaintiff can require you to disclose all of your assets under penalty of perjury. If you have substantial assets that have been moved into a bearer share corporation, any half witted investigator can easily discover that there is an unexplained loss of assets. You will be grilled. If you refuse to disclose where the assets are, the plaintiff will then hire a really good auditor who is a specialist in forensic accounting. They will demand your tax returns and complete details of your credit files and applications for credit for the past few years. They will demand an explanation of any discrepancy in your assets from year to year. If you still refuse to explain a sudden and substantial loss of assets, they can get a judge to put you in jail for contempt of court.

The promoters of the Nevada Corporation often claim that you can save income taxes because Nevada does not have a state income tax. This is true if you are doing business in Nevada and have an office in Nevada and if your corporation is making a profit. But if you don't read the fine print, you might not realize that the tax savings only apply to state income taxes -- and not to federal income taxes.

Some promoters go a step further and claim that you can use your nevada corporation to move profits from a separate corporation in a high tax state like California into your state tax free nevada corporation. The scheme involves billing your California or other corporation for services alleged to be performed by your nevada corporation -- and at a very high markup.

If you live in a high tax state with a corporate income tax, you need to be sure that they don't have some laws that limit the extent to which you can transfer profits from their state to another. Merely having a paper entity in Nevada that bills your operating corporation for some phony service will not stand up to a challenge by your state tax collector unless there is some substantial substance to the work that is being done in Nevada.

But when you incur extra expenses to establish and maintain an office in Nevada, the tax savings become less attractive. For example, if you have a corporation that is making $100,000 a year in profits, and if your state imposes a corporate income tax of $5,000 on that profit, you clearly need to spend a lot less than $5,000 a year to operate your Nevada corporation. If you really like this idea, at least take the time to run the numbers before you spend your money to set up a Nevada corporation. And also check with some local tax professionals to find out if your state has some tax laws that allow them to challenge this kind of profit stripping activity.

The Nevada corporation doesn't do anything to reduce your federal income taxes. In fact, if you are able to reduce your state income taxes, you will incur some added federal income taxes.

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## Bearer Share Foreign Corporations

If you object to the sales pitch for a secret Nevada corporation with bearer shares, the promoter may respond by telling you about how you can set up a secret foreign corporation with bearer shares. According to the promoter, there is no way anyone can find out about your foreign corporation unless you tell them.

You have to have some help to do this, and the help is usually provided by a promoter who is merely a more devious thief than a burglar.

A non-resident alien (including a non-resident foreign corporation) can invest in U.S. stocks and any gains (or losses) are not subject to U.S. taxes. Investments in U.S. government securities or certain kinds of U.S. bank or S&L obligations do not result in any tax to the foreign investor. In addition, any income or gains from investing in any non-U.S. investments would be tax free if the corporation were domiciled in a tax haven. A great many U.S. taxpayers would like to be the owner of a foreign corporation that can generate tax free investments - but they clearly aren't aware of the complicated obstacles the U. S. Congress has put in their path.

Usually, the U.S. person who forms such an entity will fund it with cash. As with the secret bank accounts or other secret investment accounts, transfers of large amounts will leave a trail for a nosy auditor but transfers of small amounts are not adequate to offset the fees to create and to maintain this entity. All of the earlier comments about how secret bank accounts or investments can be found out apply to the secret foreign corporation. It's something that's very hard to keep secret because of the phone calls, mail and travel to visit with the managers of the foreign corporation.

One of the more popular foreign tax schemes is to create a foreign corporation (usually called an International Business Company or IBC) with bearer shares or with some kind of unsigned agreement with the person who is acting on your behalf. You can purchase an "off-the-shelf" IBC in most foreign jurisdictions that has been formed by a local attorney (or other professional person) who merely hands you the shares to this standby corporation for a fee. Then, if you wish, the promoter/lawyer will offer to act as your agent for the company.

The problem with that approach is that the U.S. tax law includes provisions that give the IRS and the courts the power to disregard the legal formalities of an ownership arrangement that is inconsistent with the facts and to look at the substance of the arrangement. If someone else is acting as your agent, as a nominee or an intermediary, you will still be treated as the owner of that entity for tax purposes.

Certain U.S. shareholders of a foreign corporation are required to pay taxes on the current investment income of the corporation, plus certain other kinds of "sub-part F income" if more than 50% of the corporation is owned by five or fewer U.S. persons.

The U.S. tax system requires that if a foreign corporation is a passive foreign investment company (PFIC), all U.S. shareholders are required to file an annual information return (on form 8621). And, the U.S. shareholders are required to pay taxes on the income of the corporation as it is earned - somewhat like a partnership or S corporation.

In addition, if the foreign corporation is deemed to be a foreign personal holding company (FPHC) or a controlled foreign corporation (CFC), the shareholders who own 10% of more of the company must file form 5471 each year to disclose substantial details about the financial operations and financial condition of the company.

If the foreign corporation is engaged in an active trade or business outside the U.S., then there might be a reason to operate a foreign corporation - which would be able to accumulate profits tax free until they are returned to the U.S. But even then, it is sometimes more profitable to operate a foreign business as a U.S. corporation.

The U.S. tax law imposes severe penalties for not filing various reports for this kind of arrangement. Because the corporation is more visible than the secret bank account, it will be more likely to be noticed at some point by an inquisitive auditor. Or, it will be reported to the IRS by an angry former partner, former spouse, former lover or anyone else who has a reason to be mad at you and also knows about your foreign corporation.

Worse yet, the foreign managers can take the money from your accounts and then defy you to sue them. If you do, they will threaten to notify the IRS that you have a foreign corporation. And even if you settle up with the IRS, you still have to sue in a foreign country, with foreign lawyers, under foreign laws and subject to foreign judges. How much are you willing to trust the foreign managers who will help you to break the law in the U.S.?

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## Secret Accounts Through IBC/Nominee Ownership

(The Following is by Richard Duke, from the October, 1999 Offshore Tax Strategies report.)

Practitioners in the international arena are aware that promoters in the U. S., and especially those in tax haven financial centers, have promoted and continue to promote "bearer share" corporations. The implementation of this structure involving a nominee entity is accomplished as follows:

A U. S. person transfers cash or other assets to an IBC that is established by a foreign person. The IBC is a "bearer share" corporation with the certificates placed in the hands of the foreign person or entity. This corporation belongs to the person who physically possesses the stock certificates with no official record of ownership. Generally, the person or entity establishing the IBC names himself and others as officers and directors of this IBC.

The U. S. person, however, is the "beneficial owner" of the account in the name of the IBC. The U. S. person is the sole signatory on the account and generally fills out a form at a bank identifying himself as the beneficial owner of this IBC. Also, the foreign persons who are acting as directors will follow the advice of the U. S. person with respect to where to invest the money and when to make distributions.

Generally, a debit card is also issued on the account in the U. S. person's name. In such a structure, there is no question that the U. S. person is subject to tax reporting requirements and income taxation on all subpart F earnings of the IBC. Those who make claims to the contrary are either seriously uninformed or are outright charlatans.

As beneficial owner, the U. S. person is required to indicate his "financial interest in, or signatory or other authority over, a bank, securities, or other financial account in the foreign country" by checking "yes" to Schedule B, Part III of his Form 1040. In addition, the Bank Secrecy Act of 1970 requires his filing a Form TD F 90-22.1 (for the transfer of more than $10,000 in cash or assets outside the U. S.). This form requires checking a "yes" as to the transfer of assets outside

the U. S. and further requires the U. S. person to "enter the name of the foreign country" to which he has transferred assets.

The Form 1040 instructions also require a "yes" to the foreign bank account questions (Schedule B, Part III) if the U. S. person: (1) at any time during the year had "an interest in or signatory or other authority over a financial account in a foreign country;" or (2) the U. S. person owns more than 50% of the stock in any corporation that owns one or more of such accounts.

Two things can occur here. First, the promoter, whether inside or outside the U. S., can be a target of the IRS. If the target is being watched, the IRS can learn about the clients who have established such a structure who are not disclosing the foreign account and not reporting income. The targeted promoter can also be indicted followed by the IRS subpoenaing the promoter's records (his clients). Secondly, a simple random audit of the U. S. person can cause extreme problems for both the U. S. person and his professional advisor or advisors.

In a random audit, the U. S. person may disclose to the professional advisor that he has a "secret" foreign account. The professional advisor, after learning the facts, then becomes aware of the fact that a false return (Form 1040) has been filed since Schedule B, Part III has not been checked "yes" (indicating an interest in a foreign account). The professional advisor is faced with a dilemma. If this fact is disclosed to the IRS, it will place the IRS on notice that a foreign account has been established and the taxes have not been paid. This can result in criminal as well as civil fraud charges by the IRS. On the other hand, if the professional advisor fails to advise the IRS of the failure of the client to appropriately answer the question on the Form 1040, the professional advisor may be subjecting himself to criminal (tax) conspiracy. If the professional advisor is not a practicing attorney, the attorney-client privilege may be lost, since there are generally legal issues outside the strict tax privilege available to accountants.

It appears that the only solution for the lawyer representing the client is to advise the client to take the Fifth Amendment privilege against self-incrimination. The client may then decline to answer the foreign bank account question by claiming the Fifth Amendment privilege. The client also has to deal with the failure to file the Form TD F 90-22.1. However, there are several courts that have rejected the Fifth Amendment privilege as a basis for the non-filing of bank secrecy act forms.

As the above indicates, there is no "good" scenario with respect to someone who has been "caught" with an IBC/bearer share structure where income is not being reported and tax return and Bank Secrecy Act forms are not being properly completed and filed. For those who are in such a scenario and now wish they could get out, they must seek legal counsel from a tax attorney.

Generally, a tax attorney who is a planning and structuring attorney (transactional attorney) must engage a criminal tax attorney or refer the client to such an attorney. A criminal tax attorney is one who spends most of his time handling criminal and civil fraud litigation rather than planning and structuring. It is possible that working through a criminal tax attorney, the U. S. person desiring to "come clean" can work out an arrangement with the IRS to file the appropriate tax returns, pay the taxes, penalties and interest and avoid criminal charges by the IRS. Planning and structuring attorneys do not usually understand the nuances of the Fifth Amendment privilege against self-incrimination, as do criminal tax attorneys.

There is one additional serious legal problem with respect to the IBC/bearer share arrangement (as a nominee). Financial centers have two corporate laws: (a) corporate law for residents and (b) corporate law for non-residents (IBCs). A resident cannot own an IBC. If the resident who is in possession of the stock certificate is considered the owner, a non-resident did not form and does not own the IBC. This is a legal issue, however. This legal issue is raised simply to show the "pitiful" planning of many offshore promoters.

An excellent article regarding the seriousness of this structure and of a random audit is: Scott D. Michel, "Advising a Client With Secret Offshore Accounts-Current Filing and Reporting Problems," 91 Journal of Taxation 158 (Warren, Gorham and Lamont), September 1999. Scott Michel specializes in criminal tax matters.

Richard Duke

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## The Secret Foreign Trust

If the promoter can't sell you a secret foreign corporation with bearer shares, he may then tell you there is something a whole lot better -- a secret foreign trust. A corporation is a creature of the law and there are records that must be kept somewhere for every corporation. A trust is essentially a relationship and can be formed without being registered in any database of any kind. Hence, the trust is more secret than a corporation. The promoter may also inform you that a foreign trust is a foreign entity that can invest on a tax free basis until some of the trust assets are distributed to a U.S. person.

Here's another arrangement that requires the help of a scoundrel to make it happen - and that puts it into the category of a scam.

A foreign trust that does not have any U.S. beneficiaries or that is not funded (settled) by a U.S. person is treated as a non-resident alien for U.S. tax purposes. Like a foreign corporation, it can invest in U.S. government securities

and certain U.S. bank and S&L accounts on a tax free basis. Any gains on buying or selling U.S. securities are also tax free to the non-resident alien. In addition, any income or gains from investing in any non-U.S. investments would be tax free if the trust were domiciled in a tax haven. Even if some U.S. persons are beneficiaries of the income in the foreign trust, the assets in the trust are not subject to any estate taxes when a beneficiary dies - unless the beneficiary has some kind of measurable interest in the trust. If it's a discretionary income interest, the assets are not subject to U.S. estate taxes.

Obviously, a lot of U.S. taxpayers would like to have one of those foreign trusts. On the surface, it's fairly easy to create a foreign trust. Before 1976, it was becoming a very popular thing to do. Since 1976, it seems a lot of U.S. taxpayers have created foreign trusts but have not complied with the tax laws. So the Congress changed the reporting obligations in 1996 for U.S. grantors and U.S. beneficiaries of a foreign trust.

Since 1977, the U.S. tax law has included a section (IRC 679) that treats a foreign trust with a U.S. grantor and any U.S. beneficiary as a "grantor" trust. What that means is that the settlor who creates and funds the trust is treated as the owner of the assets in the trust and is taxed on any income earned by those assets - as if the trust did not exist. In most respects, it's the same tax treatment as a revocable living trust. With a domestic trust, this tax treatment occurs if the grantor retains some power over the trust assets or retains a right to recover some of the income or principal in the trust. But with a foreign trust, you could create an irrevocable trust in which you retain absolutely no powers of any kind and you are still subject to income tax on the income of the trust. We're not saying that's fair. It's just part of the law that makes it difficult for U.S. investors to save taxes with a foreign trust. The U.S. congress does not want you to quit paying taxes on your investment income just because you put the assets into a foreign trust.

Because of the rule that the foreign grantor trust must have a U.S. grantor and a U.S. beneficiary, many seemingly clever people have tried to find ways to create a foreign trust through nominees, agents, foreign corporations or other deceptive arrangements. Most of these arrangements fail because the tax law looks through these intermediate parties to the person who has the real influence. In the case of a foreign trust, if you are the person with the money, the IRS will treat you as the trust grantor no matter how many intermediate entities you interject in the arrangement.

For exempla, one popular arrangement is to have a foreign person (usually a promoter) create a foreign corporation (IBC) and to then have the corporation form a foreign trust. Since the corporation is a non-resident alien, the promoter argues that the trust does not have a U.S. grantor. That won't fly with the IRS or the U.S. tax courts.

In the first place, the foreign person (promoter) is a mere agent, alter ego or nominee for the U.S. taxpayer. The corporation formed by that foreign person on your behalf will be treated as if it were formed by you. Thus, it is a controlled foreign corporation. The trust formed by the CFC will be deemed to be a foreign grantor trust, funded (indirectly) by you.

Or, the trust may be treated by the IRS as an agent of the foreign corporation and the U.S. grantor would be treated as the sole shareholder of a controlled foreign corporation that is a Passive Foreign Investment Company and a Foreign Personal Holding Company. No matter how you cut it, the income belongs on the tax return of the U.S. person who put up the cash or whatever assets were used to fund the trust.

There are many variations on the ways in which promoters or "consultants" try to help you to bypass the rules relating to a foreign trust. One such arrangement that strikes us as rather ghoulish is to pretend that the taxpayer's parents are the grantor's of the trust. Assuming the parents aren't well to do, they are given the funds to create the trust, but not enough to create any gift tax problems. Then, the taxpayer basically waits until the parent dies, at which time there is an ostensible foreign trust without a U.S. grantor. At that point, the taxpayer engages in a variety of financial transactions with the trust that is intended to transfer profits or equity into the trust and out of the U.S. tax system. In the event that the IRS were to investigate such an arrangement, it's very likely that they would argue that the real grantors were the taxpayers who provided the funds to the parents.

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## Is It Really Worth the Hassle?

Whether the IRS is really able to find out about a secret corporation being operated out of the Bahamas, Cayman Islands or Switzerland is not the critical issue for Americans unless they are prepared to drop out of the system and try to work in the underground economy. (As a practical matter, the only people who can do that are those who have converted all of their assets into liquid savings and can easily move to another country.) Most people of some financial substance have ties to their community and can't (or won't) just carry assets with them and become a legal vagabond. The vast majority of Americans own businesses or real estate or have retirement plans from U.S. companies, etc. Even if they changed their citizenship, they couldn't avoid taxes on much of their income.

The critical issues (apart from whether you are willing to ignore the law) is the time and the cost and hassle of trying to avoid being discovered.

First and foremost, you have take steps to ensure that your foreign bank account, foreign corporation or other secret stash is kept secret. That means you really can't tell anyone -- including your spouse, your children, your mistress, your business partner, your faithful bookkeeper, your golf buddies or even your tax accountant. But if you do manage to keep this foreign stash a secret, it will be lost after you die. That's the equivalent of a 100% estate tax on those assets. (If you leave a note to one of your children or to your spouse to be opened after your death, you are creating a huge and costly problem for them. They will curse you for it. You will be remembered with more fondness if you don't tell them about your secret stash.)

Second, everything connected with the hidden money must be "off the books". The money has to come from sources that won't leave a trail when you move it offshore. To do that, you have to commit tax evasion. You have to keep two sets of books. You have to hide this activity from everyone in your business and from your family. To move the money offshore, you need to move it in small amounts over a period of time. That will require a lot of trips to your offshore bank and you will need some plausible reason for making so many trips offshore. You soon find yourself lying to friends, family and business associates about your activities. When some of your lies don't make sense and you are questioned, you have to cover up with another lie, and soon you are having trouble remembering what you said to whom.

Third, hiding money and evading taxes are serious crimes in the U.S. I'm not arguing that it should be a crime to have hidden assets or to not pay taxes. In many countries of the world, tax evasion is not a crime. It's a mere misdemeamor. Having secret bank accounts is not a crime in many countries. However, that is rapidly changing. More and more countries are adopting the approach of the U.S. Even those that are not copying us are willing to pass laws to prevent money laundering. It's virtually impossible to hide any money anywhere without engaging in some form of money laundering.

Thus, when you embark on the seemingly simple procedure to have some assets that are hidden from prying eyes or to have some income that is not being consumed by taxes, you are beginning a journey that will eventually lead you to a lifestyle that is hard to distinguish from a professional crook, a drug dealer or even a terrorist.

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## Multi-National Pressure to Eliminate Banking Secrecy

(From our Special Report on Harmful Tax Competition.)

In October, 1997, the European Commission adopted a proposal from their Taxation Commissioner to curb "harmful tax competition" -- within the European

Union (EU). The proposal calls for (1) a code of conduct for business taxation, (2) an EU system for the taxation of income from savings and (3) measures to eliminate withholding taxes on cross-border interest and royalty payments between companies. At the time the phrase "harmful tax competition" referred to the kind of competition that was inconsistent with the goal of free trade within member states of the EU.

However, it seems that this catchy sound-bite was picked up by others in various international groups and has taken on an expanded definition. As we like to say in the U.S., "It grew legs."

The Organization for Economic Cooperation and Development (OECD) is an international organization of 29 of the world's most industrialized (and generally most highly taxed) countries. The OECD includes most of the members of the Economic Union (EU), the U.S., Canada, the U.K., Japan and many other major countries. The OECD is like a "think tank" that studies various issues and develops recommendations. A recommendation made about two years ago advocated the elimination of "harmful tax competition" (HTC). Without reading their report, many people jumped to the conclusion that HTC was synonymous with low tax rates. However, as defined in the report, HTC really aimed to eliminate banking secrecy and to encourage a greater exchange of information between countries regarding financial matters. The goal of their recommendations is to make it easier for the country where a person or company is resident to find out if the person or company is evading taxes. According to the OECD,

*Harmful tax practices may exist when regimes are tailored to erode the tax base of other countries. This can occur when tax regimes attract investment or savings originating elsewhere and when they facilitate the avoidance of other countries' taxes.*

On June 26, 2000 the OECD released a report called *Towards Global Tax Cooperation* which identified 35 tax haven countries and 47 preferential tax regimes (policies) being used by various members of the OECD. The 35 tax havens identified by the report include,

Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, British Virgin Islands, Cook Islands, Dominica, Gibraltar, Grenada, Guernsey, Isle of Man, Jersey, Liberia, Liechtenstein, Maldives, Marshall Islands, Monaco, Montserrat, Nauru, Netherland Antilles, Niue, Panama, Samoa, Seychelles, St. Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, Tonga, Turks and Caicos, US Virgin Islands and Vanuatu.

In case you missed it, the U.S. Virgin Islands is on the above list. Missing from the list are Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino. These six countries agreed with the OECD (in advance of the issuance of their report) to implement the OECD recommendations for fiscal transparency. For all practical purposes, there will be no financial privacy in these countries with respect to any government based inquiries involving stipulated crimes.

(However, this does not mean that private financial investigators will have the same easy access to financial data in these countries as in the U.S.) Bermuda in particular does not want to be identified as a "tax haven" or a rogue nation. They are one of the three largest insurance centers in the world and are committed to establish a strong e-commerce base on their island.

The U.S. is conspicuously absent from the list of tax havens despite the fact that the U.S. is the major tax haven of choice for non-resident investors from other countries. The U.S. offers substantial tax exempt interest and tax free capital gains to non-resident alien investors who invest in certain U.S. debt securities or U.S. based stocks. (The specific rules are actually quite complicated and have been discussed in our Offshore Tax Strategies newsletter.)

In addition to identifying the 35 countries that are tax havens, the OECD report identified 47 preferential tax regimes (statutory exemptions, exclusions, deductions or credits) that are deemed to be "harmful tax competition" among member countries. The U.S. foreign sales corporation (FSC) tax exemption is on the list and the World Trade Organization has already demanded that the U.S. end the FSC tax break by October, 2000. (Which the U.S. did repeal, but immediately replaced it with a new law that provides tax benefits fro exporters.)

Close behind the release of the OECD report on Global Tax Cooperation, the G7 nations (the seven most powerful countries in the world) announced an initiative to tackle harmful tax competition. The focus of the agreement was on the exchange of tax information to curb international tax evasion and avoidance through tax havens and preferential tax regimes. This is the first reference I have seen where tax "avoidance" is included within the concept of harmful tax competition. As indicated above, the meaning of HTC is being expanded with each new report.

However, As Christopher Riser pointed out to me after seeing a draft of this report,

"… the US and European countries (particularly Germany and France) look at tax "avoidance" (as opposed to outright tax evasion) from very different perspectives. Basically, tax avoidance has a long history as being acceptable in the US, whereas tax avoidance and tax evasion are basically considered the same thing in Europe. I think this is a MAJOR driving factor behind all of these initiatives. When clever U.S. tax advisors come up with a legal tax avoidance maneuver, Congress either accepts it or changes the tax law. When European tax advisors come up with a tax avoidance maneuver, they and their clients are likely to face jail time. I think this is what is behind the reference to tax avoidance through tax havens that shows up in the G7 initiative."

The somewhat obvious trend of these efforts of the major high tax countries is to eliminate banking secrecy whereby citizens of one country can avoid taxes in their own country by establishing secret accounts in other countries. In the

aftermath of the terrorist attack on the World Trade Center and the Pentagon, the U.S. and many other countries have rushed to adopt and implement greatly expansive forms of investigative procedures which further eliminate the rights of the citizens of these countries to keep their affairs private.

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## IRS Probe for Offshore Credit Card Records

(This is from the November, 2000 issue of Global Asset Protection.)

Last month, I reported that the IRS was seeking a summons to secure certain records of American Express and Master Card account holders with cards that are tied to certain offshore banks. In case you missed the news, the IRS has received approval by the U.S. District Court (Miami) for a John Doe Summons to secure the records of American Express and Master Card regarding their customers who have …

*"… credit, charge or debit cards issued by or through, or for which payment was received from banks in Antigua and Barbuda, the Bahamas or the Cayman islands or issued to persons or entities in Antigua and Barbuda, the Bahamas or the Cayman Islands."*

If you have been tempted by the promise of tax free income in a foreign bank account that you can access secretly with an offshore credit card, you may soon find yourself being visited by an IRS agent. (If two IRS agents show up at your door you should call a lawyer immediately because when they come in pairs they are pursuing a possible criminal conviction.)

You have three choices if you have an offshore credit/debit card issued by AMEX or MC through a bank in one of these countries - and if you have not reported the income on those bank accounts. (1) You can wait to see if you are lucky and don't get picked for a visit by an IRS agent or agents. (2) You can try to beat the IRS to the punch by coming clean on your own with respect to any unreported income. (3) You can leave the country and look for permanent residence in a country that does not extradite on the basis of a tax/fiscal crime. You should not attempt to move the assets and income into the U.S. so they can be reported in future years. That does not cleanse you of any unreported income in past years. More importantly, doing that will be deemed to be money laundering and will subject you to much worse penalties than mere tax evasion. Any one who helps you to do that is also guilty of money laundering and conspiracy.

If you do decide to "fess up" (confess) before you are found, be sure to get the help of a criminal tax attorney. An experienced criminal defense lawyer can often approach the IRS on a confidential basis and inquire as to reduced penalties for

voluntary disclosure. A criminal defense lawyer who does not do any tax work is not what you need. A tax lawyer who does not do any criminal defense work is not what you need. You need a tax lawyer who does criminal defense representation for taxpayers and who has been doing that for many years. A lawyer with experience in this kind of work has developed critically important working contacts with representatives of the IRS and is familiar with the appeals process. This is a very specialized area of tax law and you don't want an inexperienced lawyer to learn the ropes with your freedom at stake. Nor do you want to take this matter to your local CPA. Find a lawyer first and then have the lawyer hire your CPA for any preparation or accounting work that may be needed.

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## Locating Hidden Assets
**By Bruce M. Peele, Esq.**

Individuals often believe they can defeat creditors, spouses and bankruptcy trustees through the use of secret accounts, forming secret corporations or secret trusts. While such an approach may work on occasion, the results can be disastrous if the assets are located. This article will briefly describe how a professional fraud investigator goes about locating hidden assets.

It should come as no surprise that people have often hidden their assets from creditors, governments, neighbors, thieves and even from their own families and spouses. Loose bricks in basement walls, mattresses, caves, hollow tree trunks and holes in the ground have provided places of secrecy for centuries. In recent years, hiding assets has become a much more sophisticated endeavor, often involving investments, banks and overseas financial transactions. As methods for hiding assets have grown in sophistication, the sophistication of investigators has also grown - primarily as a result of governmental agencies having to deal with the ever-growing power and wealth of the drug cartels..

### Beginning the Investigation

An asset investigation may begin simply because someone is owed money and the debtor indicates that he or she doesn't have the money to pay. That claim might indeed be true - or an investigator might discover that the debtor continues to live well beyond his or her apparent means and his spending habits haven't been changed. Locating hidden assets can also be the result of the dissolution of a business or a marriage relationship where the assets are required to be divided evenly-except that one of the parties might not be truthful in listing all of their assets. So how do you know if everything is listed as it should be?

Usually there are indicators that a person has more than they claim. The two most common indicators are lifestyle and financial analysis. Not only are lifestyle

and financial analysis the two major indicators that assets are not being declared, they could be the only indicators that something is amiss.

**Lifestyle Indicators**

A person's lifestyle can be a symptom of hiding wealth. Knowing that, the fraud examiner uses these indicators to prove that the subject's income cannot possibly pay for the lifestyle and spending habits he or she is leading. The fraud examiner should strive to identify the subject's lifestyle and compare it to his or her sources of income. Although the following factors may not individually be an indicator of hidden assets, a combination of several of these factors, with the subjects income (or lack thereof), should lead the astute fraud examiner to look further into a person's financial affairs.

Personal characteristics an investigator would be interested in could include: whether the subject is known to (1) carry large amounts of cash , (2) wear designer clothes or expensive jewelry, (3) have club memberships, (4) belong to fitness clubs and spas, (5) live in an expensive house or (6) purchase expensive furnishings, artwork and vacation homes. Consideration should also be given to the type of car the subject drives; that is, is it a luxury or exotic or does the a subject own numerous cars and are they late model vehicles? The investigator should also pay attention to be subject's leisure activities. Do they take expensive vacations, cruises or trips to exotic locations?

**Financial Analysis**

Another good way to determine if assets might be hidden is to analyze financial information (either personal or business) to identify inappropriate activity. The numbers are a good indication of where the money is coming from (income) and where the money is going (expenses). Financial statement analysis further points out changes in financial status. An unexplained change can mean that fraud is occurring. The three most common analysis methods performed for fraud in financial statements is: (1) vertical analysis, (2) horizontal analysis, and (3) ratio analysis.

<u>Vertical analysis</u> is a technique for analyzing the relationship between the items on an income statement, balance sheet, or statement of cash flows by expressing components as percentages. In a vertical analysis of an income statement, net sales are assigned 100 percent. In the vertical analysis of a balance sheet, total assets or liabilities and equity is assigned 100 percent. All other items are expressed as a percentage of these numbers. This method is of little value in detecting small amounts of fraud in relation to the totals.

<u>Horizontal analysis</u> is a technique for analyzing the percentage change in individual financial statement items, from one year to the next. The first year in the analysis is considered the base year, and the changes to subsequent years

are computed as a percentage of the base year. Like vertical analysis, this technique will not work for small, immaterial frauds.

Ratios can be helpful in detecting potential errors and other irregularities with respect to various balance sheet and income statement items. The quick ratio and current ratio assesses the liquidity of the suspect's financial resources. Accounts receivable and inventory turnover ratios assess the operational efficiency of a business. Other ratios such as debt-to-equity indicates the solvency of the enterprise. The profit margin, return on assets, return on equity, and earnings per share ratios assess the profitability. Unexplained changes in the ratios should be a signal to the fraud examiner that fraud might exist in the records. In a typical financial statement fraud, assets and revenues are overstated and expenses and liabilities are overstated. However, in the case were assets might be hidden, just the opposite can be true.

**Profiles**

The fraud examiner begins by profiling the subject. Two types of profiles may be developed: a personal profile and a business profile. The personal profile consists of two parts: the financial profile and the behavioral profile.

**---**The Financial Profile

The financial profile is essentially a financial statement with some modifications and additions. It shows what the subject earns, owns, owes and spends. The behavioral profile reveals habits-what is important to the subject in life - which would cause the fraudster to accumulate illicit funds. The first act in developing the personal profile is to prepare a financial profile of the suspect. The profile may yield either direct evidence of hidden assets, or circumstantial evidence that shows the suspect cannot possibly pay for the lifestyle he or she is leading. The financial profile is best at revealing transactions of significant amounts, such as large deposits or expenditures. It will not catch small currency transactions, particularly if they are used for concealed activities, consumables or unusual onetime expenses.

In preparing the financial profile, an investigator would normally take the following steps: identify the assets, identify significant liabilities, identify income sources, identify expenses, and analyze the information developed. An examiner can identify the subject's assets, liabilities, income and expenses from: (1) interviews, (2) public records, and (3) non-public records. Interviews can be one of the most important steps in developing the personal profile. The information obtained can lead the fraud examiner to areas previously unknown or confirm information already known. The interview can lead to documents and to more people that could be important to the case. Interviews will normally be conducted with the subject's personal associates (spouses, friends, relatives) and business associates. Public records is another avenue to search for information regarding

the subject's holdings. The information is widely available from several sources. Non-public records can also be used to develop the financial profile of the subject. These records include bank records, credit card records and credit reports. While these records are more difficult to obtain, obtaining them in United States is not impossible.

---The Behavioral Profile

The behavioral profile complements the financial profile. While the financial profile works best for large transactions, the behavioral profile is best at identifying small activities. Information gathered for the behavioral profile might provide the possible motive for fraud and it can indicate to the existence of hidden assets. Information for the behavioral profile is obtained primarily from interviews with the subject and observation.

As with the personal profile, the fraud examiner begins with the business. The business profile lists prospective witnesses, relevant documents and suspicious transactions. The business profile should contain information about the subject's organization, personnel, money flow patterns, location of bank accounts, the subject's financial condition and record keeping systems. The subject's business banker may be able to supply the investigator with credit applications, financial statements and loan files as well as bank account information.

Financial statements and tax returns are good sources of information for the fraud examiner. The financial data will show the overall financial condition of the subject and its financial statements can be useful to show any lawsuits or significant events. Business reporting companies such as Dun and Bradstreet or other commercial reporting companies disseminate basic information about individuals and businesses.

Business public filings also contain useful information regarding information on mortgages and leases.

Other business filing such as corporate records will give an examiner the name of the registered agent and the members of the board of directors.

**On-Book And Off-Book Schemes**

In on-book schemes, illicit funds are drawn from the subject's regular, known bank accounts and recorded on its books and records, in a disguised manner so as to reflect some sort of legitimate trade payable, consulting fee, brokerage fee or commission. Payments can also be made to fictitious employees. Payments are generally made by regular business checks. Cash payments are relatively small amounts that might be generated by fictitious charges to travel, entertainment, or miscellaneous amounts. Three common schemes are fictitious

payables, fictitious employees and payroll kickbacks, and overall billing schemes.

Off -book currency schemes (as used here) refer to arrangements in which funds to make illegal payments or transfers are not drawn to regular, known bank accounts of the payor. The payments do not appear anywhere on the payor's books or records. Off-book funds are usually generated by some sort of unrecorded sales or by failing to record legitimate rebates from suppliers. Off-book schemes are often employed by businesses that have significant cash sales, such as bars and restaurants. Additionally, an owner might accumulate an untraceable currency hoard by reporting only part of his cash receipts.

Identifying and tracing off-book payments is usually more difficult than locating on-book schemes. Success in detecting the off-book schemes generally depends upon identifying sources of funds, using an inside witness, or focusing on the point of receipt.

Bank records are perhaps the single most important financial source of information available to fraud examiners to identify assets. In addition to their use as evidence to prove a violation, bank records provide leads on sources of funds, expenditures, other accounts and other personal items. In order to obtain bank records, substantial legal requirements must usually be met and banks will customarily demand a subpoena or a search warrant as a condition for disclosure.

**Locating Assets Using Indirect Methods**

Analysis of the suspect's financial condition can reveal much about the suspect and where assets might be hidden. In both criminal and civil investigations, indirect methods of proof reveal that the suspect has more money available than can be accounted for from legitimate sources. This method analyzes the relationship between the suspect's receipts and the subsequent disposition of funds. In addition, evidence that the suspect lives beyond his means, and therefore must have had unexplained income, is admissible in court. It can be used to corroborate the testimony of co-conspirators, provide circumstantial evidence of the underlying offense or as evidence to impeach testimony of a subject who denies the offense.

There are three indirect methods of proof: (1) net worth analysis, (2) sources and application of funds (expenditures method) and (3) bank deposit analysis. The net worth analysis method is used when the subject has accumulated wealth and acquired assets from illicit proceeds which cause the subject's net worth to increase from one year to the next. The expenditures method works best when the subject's  illicit income is used for consumables such as travel and entertainment. If the subject spends illicit income, it will not cause an increase in

net worth. The bank deposits method is a variation of the source and application of funds method - which works best when there is heavy use of bank accounts.

**Sources of Information**

A vast array of information is available to the fraud examiner. The primary sources of information are the workplace, public records and other sources. Other sources of public information include:

Voter registration records
Marriage license records
Permits
Workers compensation information
Property tax records
Medical records
Sheriff and county prosecutor records
County fire marshal
Utility company
Real estate property records
Litigation history
Divorce records
Fictitious business name records
Personal injury suits
State tax cases
Professional licensing boards
Financial suits
Bankruptcy records
Corporate registration records
Probate records
Telephone bills

In addition to the foregoing sources of information, other sources of information can be obtained through subpoenas, search warrants, trash covers, the mail covers, informants and others.

Subpoenas/financial search warrants: Some investigators are granted subpoena power which allow investigators to obtain many non-public records by using subpoena duces tecum (bring with you). The subpoena duces tecum requires the production of books and documents pertinent to the investigation.

A trash cover is defined as legally obtaining the suspect's trash and researching it for evidence in an investigation. As odd as it might sound, analyzing the subject's household refuge is often a sound investigative technique. Trash contents can provide the investigator with solid clues regarding the subject's finances and lifestyles. Valuable information that may be found in the subject's trash include bank statements, credit card bills, correspondence from

accountants, lawyers, business associates and telephone bills. The courts have ruled that an investigator may shift through personal trash without a search warrant when the trash has left the subject's possession. Once it leaves the subject's possession there's no longer an expectation of privacy with the contents of the trash.

Mail covers also offer a good source of information - although its use is limited to law enforcement investigators. The outside of a letter or package can reveal much about the suspect's spending habits. For example, letters from collection agencies might indicate financial troubles, packages from mail-order companies might reveal purchasing additional assets. Mail from a travel agency might indicate an upcoming trip. Whereas the letter or package cannot be opened, the U.S. Postal Service can make a record of the addressee and the return address.

Informants can be a good source of information for fraud examiners. An informant is a person who has specific knowledge of an event or an interest in the investigation. The informant might be directly involved in the activity, motivated by revenge, or has been a position to hear about information of interest to the investigator.

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## IRS Targets 132 Offshore Promoters

By Richard Duke

The IRS (along with the FBI, CIA and Secret Service) has been watching offshore promoters, beginning some time after January, 1996. In January, 1996, Congress required the IRS to begin training the FBI, CIA and Secret Service on "offshore" matters--trust, corporations, banking, etc. The IRS (and each time I say IRS, this includes the FBI, CIA and the Secret Service) is now focused primarily on 132 offshore promoters. These promoters have many U.S. clients who have evaded the tax laws and are guilty of tax fraud and evasion. And, don't tell me that most of the clients of these promoters are innocent. I know better. I've been in this business too long to believe this.

From the focus on these 132 promoters, this has taken the IRS into the professional network in which these promoters work. The network consists of those who are connected with the promoters: persons who establish structures (trusts, corporations, etc.), establish bank accounts with bearer shares and the banks and other investment managers. With 132 targeted promoters, the network is very, very large. And the amount of taxes to be collected is mind boggling. The IRS will indict the promoters, subpoena the records of the promoters (in other words, their client lists) and then collect huge sums of taxes, penalties and interest from these clients. So, the IRS is aware of "bad" banks and investment managers, the bad professionals, etc. who are in the network of these 132 promoters. No tax returns are being filed by these clients.

The IRS is not interested in U.S. persons who establish a foreign trust or structure and file the required tax returns. The strategy then is to set up a trust or structure that avoids the U. S. litigation system and permits investing in the global arena of investments (otherwise closed to Americans). The focus is on using competent professionals. If you required serious surgery, you would focus on finding a serious and legitimate professional, not some "cute" practitioner who tells everyone that he has found the holy grail of surgery. Serious surgery requires a serious surgeon and those working with him such as the anesthesiologist. The same is true with respect to international planning: the focus is on the professionals: the attorney, the trustee, the investment manager or managers and the trust protector.

The IRS attack on shady promoters and the breakdown of banking privacy (secrecy) offshore has no impact on those who desire to go offshore for legitimate reasons, such as asset protection or access to global investments. The reason that bank privacy is falling apart is due to the lack of tax returns being filed by so many Americans and Europeans. This has nothing to do with Americans who aren't trying to launder money or evade taxes. Banks generally will not divulge your name to anyone so long as you are not a target of the IRS or appear to be engaged in some unlawful activity. The fall of so-called bank secrecy is due to the targeting of money laundering and to a greater extent, tax evasion.

The fact that you dislike and can point out many improper actions of the government is irrelevant if the government catches you in an illegal offshore scheme. Unless you are seriously wealthy, the government is more powerful than you, irrespective of whether their actions are proper or improper. So, comply with the law and avail yourself of the services of serious professionals. As professionals, we agree that the government is often guilty of questionable actions, but we must comply with black and white laws (the gray areas are the areas of planning). If a U. S. person, directly or indirectly, transfers assets out of this country, very black and white laws require the transfer(s) to be reported. No one can legally avoid these very black and white laws.

Richard Duke

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## Why Secrecy Isn't The Best Strategy

By Vernon Jacobs

Meanwhile, perhaps those who have secret accounts in tax havens should begin to look for ways to either "come clean" with their own tax authorities or they should begin the process of expatriation to a more hospitable country.

Although unreported income in secret foreign bank accounts has been a popular way to evade U.S. taxes, I have not been an advocate of that method of tax "savings". Because I'm a CPA and was an auditor (many years ago), I know how hard it is to keep substantial assets or income hidden for a long time. Any competent financial auditor can quickly identify missing assets by comparing two balance sheets or even two detailed income statements -- if the amounts are substantial. Where the amounts are not substantial in relation to the amounts that are disclosed, the cost of maintaining a secret foreign stash is usually more than the taxes that are being "saved". The recent efforts of the EU and the OECD will further raise the cost of the secrecy game.

Many U.S. taxpayers do get away with hiding assets and income offshore for many years because the IRS only audits a small fraction of the tax returns that are filed each year. But they are very effective at selecting those tax returns that are most likely to generate some additional revenue due to an audit. They have also become a lot more pro-active in looking for people who are likely to have unreported income offshore. They have a program to look at more of the tax returns of people who frequently travel outside the U.S.. I also hear they have full time agents working and living in the popular tax haven countries who look for clues as to U.S. travelers who may have illicit income in that country. I've also heard that they have agents who regularly travel to the various offshore seminars that are likely to discuss foreign investments and related subjects. They strike up discussions with attendees and collect business cards from the speakers.

I've heard the IRS also has a program with the U.S. Postal Service for checking the return mail addresses from tax haven countries. If they have any reason to suspect that you might have a secret foreign account, they could easily check your phone records to see if you are making phone calls outside the U.S. Actually, it would not be a major hurdle for them to require the phone companies to disclose international phone call information to them.

Richard Duke tells me that the IRS, the Customs service, the DEA and the FBI have been working together on a task force that has been gathering information about various lawyers and promoters who are selling tax avoidance trusts,

foreign trusts, foreign corporations and such dubious deals as the "pure trust". According to Richard, we should begin to see news items any day now about sting operations where the task force has nailed one or more of the promoters and has "persuaded" the promoter to disclose the identity of his or her clients. When they have the list of clients, they will give the clients a choice between paying the back taxes, exorbitant penalties and interest or spending some time in "Club Fed".

Last year, the U.S. government stumbled onto a situation where a banker in the Cayman Islands was nabbed for money laundering when he was traveling in the U.S. To get a lesser sentence, the banker (Mathewson) "copped a plea" and agreed to disclose the identity of his more than 1,500 U.S. customers. He went back to the Cayman's, got the bank computer tapes of his customers and turned them over the U.S. government. A few months ago, one of those customers was put in jail as part of the IRS annual propaganda program to remind the rest of us about what can happen to those who don't pay their taxes.

Some of their audits are triggered by a "whistle blower" who is a former friend, former business partner, former spouse or former lover of the taxpayer. While the IRS does offer a meager reward for turning people in who have evaded taxes, I've heard that very few people ask for the reward. Most informants apparently do it to get even with someone. If you are going to keep some assets and income offshore without paying taxes on the income, you really need to keep it to yourself. You can't brag about your clever plan at the country club or the neighborhood bar, let alone the church social. Other people tend to have the belief that if you don't pay your "fair share", then they must somehow be forced to make up the shortfall. (It’s not really true, but it's a very widespread belief.)

Even if you get away with it, you will have a very hard time getting that money into the hands of your spouse or your children after you are gone from this earth. You might as well instruct the offshore banker to write a check to a foreign charity because if the money comes back to the U.S., your heirs will have numerous reasons to burn you in effigy for the aggravation you will cause them. And if you let your spouse or children in on your little "secret", you had better hope that your marriage is very solid and that your kids and their spouses really, really love you.

For these and other reasons, I do not believe secret foreign accounts or corporations are a safe or cost effective way to reduce your taxes, or even to protect your assets from lawsuits.

Those who really want to reduce their taxes can often do better with various tax saving methods available in the U.S. or by simply expatriating to a more hospitable country. For example, with some creativity, you could probably operate a revenue producing "charity" that complies with the U.S. tax laws. Take a look at Internal Revenue Code Section 501(c). It includes 27 different kinds of entities that are tax exempt on their investment income and any accumulated

income that is not paid out as salaries or benefits to the managers of the activity. A few years ago, I compiled a check list of more than 200 legal ways to defer or avoid taxes of various kinds. Most of those methods are still available. ( http://www.offshorepress.com/vkjcpa/checklist.htm )

And there are some legal ways to avoid or to defer taxes offshore that do not rely on secrecy to work. Richard Duke and I discuss these in our Offshore Tax Strategies newsletter each month.

Unless you are planning to give up your U.S. citizenship in the near future, trying to save taxes with secret bank accounts, secret trusts, bearer share corporations and similar deals are likely to cause you a lot more grief than they are worth.

For those who have been using secret foreign bank accounts and bearer share foreign corporations to evade taxes in their home country, the stakes have been raised by the recent attack on the secrecy policies of the many tax and financial havens of the world. I believe it is very likely that most of the financial havens will concede to exchange financial information with the high tax countries of the world. I also believe they will eventually concede to give up the practice of granting tax concessions to non-resident investors and corporations that are not available to their own residents. For many countries, including the U.S. and the U.K., this will require some politically difficult changes in their tax laws. But there will continue to be some rogue nations that will cater to those who are willing to pay the price for financial secrecy.

(The Cayman Islands has very recently agreed to an information sharing arrangement with the IRS.)

## Is It Time To "Come Clean?"

For those who have waited until now to decide what to do with old-time offshore secret accounts, is the "handwriting on the wall?" Is it time to declare the previously secret income and pay the taxes, plus interest and penalties? Or will that merely result in spending some time in "Club Fed?"

Jay Adkisson (www.falc.com) made an interesting observation in an email message to the ABA Asset Protection Planning Committee. He basically reminded the lawyers on that list that:

> *" … if you assist a U.S. person with 'remediation' of an offshore account - including repatriating the money into the U.S. so that it is taxable on a 'go forward' basis - you can be held criminally liable for money laundering. … In one of the cases, a CPA tried to convince a client to go back and file returns for unreported offshore accounts.*

> *The client wouldn't do this because of the heavy penalties, so the CPA compromised and formed a new company in the U.S. into which the foreign moneys came in as capital. Although the company started paying taxes on the money from that time forward, the CPA was successfully prosecuted for money laundering on the basis that he had helped 'disguise' the clients past tax evasion by 'cleaning' the money on a go-forward basis."* *(emphasis added.)*

Jay urged the other lawyers on the list to refuse to discuss the matter with anyone who approaches them and to refer them to a criminal defense tax lawyer. This is a very specialized field of law that requires a lot of experience and someone who does a lot of this kind of work.

So what does that imply for the taxpayer who is wondering what to do with a secret offshore account? At a minimum, the taxpayer can expect to have to pay the back taxes, plus interest and maximum penalties. It's possible that the IRS might attempt to pursue some criminal charges, but they seldom do that when a taxpayer comes forward on his or her own account without having yet been audited or otherwise "found out." The best approach is to contact a criminal tax defense lawyer and discuss your options with the lawyer. The conversation with the lawyer will be protected by the attorney-client privilege and you will not be compelled to settle up. The lawyer can advise you of the consequences of not settling and even of leaving the country but he or she will not be able to advise you how to circumvent the law.

The consequences will be much less severe if you do settle with the IRS without having been caught or found out. If you take your chances and wait to see if they find you in one of their fishing expeditions (like their subpoena of the credit card company records or the disclosure of client information by a foreign banker or promoter who is accused of money laundering), they may elect to pursue criminal charges and you will have less bargaining room.

If the cost was more than you could bring yourself to pay, could you just leave the country? Perhaps, but that would not relieve you of the tax liability and you would need to be sure you locate in a country that does not permit extradition of criminals to the U.S. With the recent international concern about terrorism, there are few countries left in the world where real secrecy is still available.

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## If You Need Help In "Coming Clean"

If you have only been thinking about trying to open a secret foreign bank account, or setting up a secret foreign corporation or secret foreign trust, I hope

this article will save you some grief by helping you to appreciate that you are trying to "swim up a waterfall" .

But if you have already opened one or more unreported foreign accounts, a foreign corporation or a foreign trust, you basically have three choices.

1. 1. You can move permanently to a country that does not have an extradition treaty with the U.S.
2. 2. You can spend a lot of your time looking over your shoulder for the long arm of the IRS and spend many sleepless nights worrying about who is going to tell on you.
3. 3. You can "come clean" by filing the required back returns and amended returns, with the payment of any back taxes and interest. You should also be prepared to pay whatever penalties the IRS may impose. If you won't or can't do that, then you should reconsider option # 1, above.

Your choice may depend on the amount of potential back taxes, penalties and interest in relation to the liquidation value of your net worth. If you spent the taxes that you didn't pay, you will need the help of a good criminal tax attorney -- assuming you are at least able to pay his or her fee. If you are fully prepared and able to make restitution for all the back taxes, penalties and interest, you will also need a tax accountant who can prepare the special tax returns that are likely to be required.

If you have a controlled foreign corporation, you will need to file Form 5471 and 926 for each year that the corporation was in existence.

If you put money into a foreign partnership, you will need to file Form 8865 for the years the partnership was active.

If you had money in a foreign trust, you will need to file Form 3520-A for each year and you will have to file Form 3520 for each year in which there were any transactions with the trust.

If you had money in a foreign investment corporation (mutual fund) that was not also a controlled foreign corporation, then you will need to file Form 8621 for each fund, for each year in which there were any distributions or the disposistion of any shares of the fund.

No matter which form of entity you had, if you or any of these entities had more than $10,000 (in the aggregate) in any combination of foreign financial accounts, you will need to file Treasury Department Form 90-22.1 to disclose the existence and location of the accounts.

If you had any combination of these foreign entities, you might have to file all of these forms or whichever ones apply for each prior year.

You will also need to prepare accounting statements and income statements for each entity for each year so that the required returns can be prepared. In most cases, the accounting work is the most time consuming and the most expensive.

Whoever you hire as your accountant will have to prepare amended personal income tax returns for each back year. Amended state income tax returns will also be required if you had any unreported income.

The forms described above are not the kind of forms that most tax preparers work with on a regular basis. They are dramatically different from the kind of forms that most tax accountant's prepare and will require a lot of time for the accountant to read and understand the instructions. In my opinion, if a tax accountant has not prepared a number of these forms previously and does not do this kind of work on a continuing basis, either the accountant will not be able to charge enough for the time that will be required, or the forms will be prepared inadequately or incorrectly. By way of example, hardly any of the professional tax preparation software programs include these forms. Your accountant will have to do them by hand.

# Asset Protection Scams & Schemes

## Why Can't You Just Hide Your Assets?

A common assumption about protecting your assets from judgment creditors is that you can somehow just hide your assets somewhere. First of all, that clearly won't work for immovable assets such as your home, your business, your pension plan and any investment real estate. Secondly, if you attempt to hide movable assets such as cash, stocks, bonds or other securities, you will have to commit perjury under oath. The judgment creditor will be able to engage in a fact finding process (which includes taking a deposition, reviewing any financial statements and even looking at your tax returns) to identify and locate your assets. If you have reported the interest, dividends, royalties or related tax deductions for any movable assets on your tax return, it will show up and you will be asked what happened to the assets. The creditor will also ask for any financial statements you have used to secure credit - and those statements may disclose the existence of the assets you are trying to hide. Basically, you have to be prepared to convincingly lie under oath, and to be able to cover your tracks through all of the various paperwork that may identify any assets you have ever owned.

## Asset Protection With a Living Trust

There are some uninformed individuals who will suggest to you that a revocable living trust can be used to protect your assets from your creditors. Don't believe it. A living trust is an alternative to probate and serves to transfer assets to others via the trust - upon your death. Until then, you are the owner of everything in the trust, even though the property is titled in the name of the trust. If you are sued, your judgment creditor can get the court to require you to transfer any assets in your living trust to your judgment creditor. A revocable living trust will not protect your assets from your creditors.

## The Pure Trust or Contractual Trust and Others

The are a number of promoters of trust packages who are claiming that you can set up a special type of trust that will protect your assets from all creditors (including the IRS), virtually eliminate all income taxes and eliminate all estate or gift taxes. In addition, the promoter promises that if you establish one of these trust arrangements, you will have complete control over the investment of the funds and the use of the funds. These trust arrangements go by a mind-boggling variety of names as the inventive promoters attempt to make their trust packages appear to be unique. A common sales pitch for these trust arrangements is that the promoter has somehow uncovered the "secrets" of the trusts used by the Rockefellers, Mellons, Kennedy's and other wealthy families who have ostensibly been able to avoid income and estate taxes with their "secret" trusts.

In late 1997, the IRS, CIA and FBI formed a special task force to track down and eliminate these trusts, which they described as "abusive" trusts in their publicity release on the subject. The difference between these "abusive" trusts and legitimate trusts is that when you put money into a trust, you may alter who pays the tax on the income of the trust, but you don't eliminate the tax. With a trust, the tax may be paid by (1) the creator/grantor/settlor, (2) the beneficiary, or (3) the trust. With the "abusive" trusts the IRS is attempting to close down, the promoters claim that no one pays any taxes - ever.

As for asset protection, if the grantor of a trust retains the power to make distributions to himself or herself, the courts will simply order the grantor to do so if they are subject to the claim of a judgment creditor.

## Last Minute Homestead Protection

In Florida, Texas, Kansas, Iowa, Minnesota, Oklahoma or South Dakota, the state creditor protection laws offer nearly total protection for the equity in a home from creditors who are seeking to attach assets to satisfy their claims. These states do not permit creditors to attach the equity in a primary residence. From time to time, someone will attempt to buy a home in one of these states when they are "under the gun" of judgment creditors (or when a business has failed). Sometimes this tactic works and sometimes it won't. Some Florida judges have denied the benefits of the state homestead laws for new residents who clearly moved to Florida for that purpose. In Kansas, a wealthy real estate operator who lived in Missouri went broke and attempted to buy an expensive home in Kansas at the same time he changed his domicile from Missouri to Kansas. But a Kansas judge said that the homestead exemption was not intended to be a magnet to attract those who were attempting to deprive creditors of their rights. To make effective use of the homestead exemption, you need to change residency before you lose a lawsuit.

## Asset Protection By Giving Your Assets Away

Another common attempt to protect assets from judgment creditors at the last moment is to make gifts of the assets to a spouse, children or other relatives. Sometimes, you might attempt to put the assets into a family corporation or even into an irrevocable trust. Assuming that these transfers are disclosed during the discovery process, the creditor can ask the court to have the assets transferred back to the control of the court for the benefit of the creditor. To do this, the creditor only needs to show that the debtor transferred the assets in order to "delay, hinder or defraud" any of their creditors. All of the states have some form of fraudulent transfer or fraudulent conveyance law to protect the rights of creditors. Property transferred without sufficient consideration (payment) can be recovered by the creditor from the person or entity to whom the property was transferred if the creditor can convince the court that the transfer was intended to hinder, delay or defraud any creditors. It's possible to rebut this claim by showing that you were technically solvent at the time of the transfer. An in-depth discussion of solvency in connection with asset protection is available on our subscriber's restricted web site.

## The Domestic "Financial Fortress"

The family limited partnership (FLP) is being promoted as the cure-all for asset protection in the U.S. by some attorneys. However, there are circumstances where the courts are likely to deny the partners the protection generally available to limited partners. Thus far, there have been only a few cases where any courts have done this, but this author believes it is just a matter of time.

The reason limited partners are afforded protection from the claims of a creditor is because the partnership is presumed by the law to consist of a personal relationship between the partners. By contrast, the shareholders of a corporation have an impersonal relationship to each other. Absent any special prohibitions in the by-laws of a corporation, any shareholder can freely transfer his shares to anyone else. Thus, a creditor can simply take ownership of any shares of stock you may own. If you own more than 50% of the voting stock, the creditor can then force a liquidation of the corporation to get at the assets.

But if you are a partner, the law presumes it would be a burden on the other partners to permit a creditor to become a partner by "stepping into the shoes" of a previous partner. A creditor is not allowed to take the place of a partner as a co-owner of the partnership because it would cause an injury to the other partners. In addition, a partnership is presumed by the law to be operating a business or managing investments. To permit a creditor to become a partner and force a dissolution of the partnership would cause an injury to the partners who are not subject to the claims of the creditor. Instead, the creditor of a partner is usually granted a "charging order" that requires the general partner to divert the payment of any distributions of a partner to his or her creditor. However, the general partner is not required to make distributions to any partners. Thus, if all the partners are members of a family, the general partner is not likely to make any distributions.

The problem arises when a person forms a limited partnership in which he is both the general partner and the only limited partner. There are probably thousands of these partnerships in existence at this time. Why should the courts deny a creditor of this partner access to the assets? Certainly not because any other partners will be harmed by such an action. In the opinion of this observer (who is not a lawyer), it's only a matter of time before the courts begin to break up this type of asset protection device.

Closely related to the one-owner partnership is the family limited partnership in which the only partners are a husband and wife and where there is no active business being conducted by the partnership. The assets of the partnership consist only of passive investments that require little or no management. While this type of partnership may survive the attacks of creditors for a while longer than the partnerships with only one owner, some judges are likely to conclude that breaking up the partnership is not causing an injury to any innocent parties - particularly where all the assets of the partnership were provided by one of the spouses and then a partnership interest was gifted to the other spouse.

Bankruptcy courts are courts of "equity" - meaning that the judge is empowered to secure an equitable result for the parties in dispute. The judges are not as bound by legal precedent and some of them are "loose canons" with respect to the nuances of the law. They will make rulings that totally contradict a long line of precedent in order to obtain what they regard as an equitable result. Thus, it won't be long before some bankruptcy judges begin to ignore the legal nuances of the family limited partnership and order a partner to deliver the assets in the partnership to his or her creditors.

Does this mean that the family limited partnership itself is a scam or a scheme that should be avoided? Not al all. It just means that some common sense should be applied. The partnership is far more likely to withstand a challenge if it includes partners other than the two spouses and their minor children. It's far more likely to withstand an attack if it is operating an active business or owns investment real estate or at the least is actively managing its investments.

## The Foreign Bank Account Scheme

Some "advisors" will tell you that money in a foreign bank account is protected from any creditors, but they often fail to point out that this only works if you are able to keep the existence of that foreign account a secret and are willing to commit perjury on your tax return. These advisors allude to the well publicized "numbered accounts" of Swiss banks and Austrian banks, whereby there is no record in the U.S. of the ownership of these accounts.

But first, you have find some way to get the money out of the country without leaving a paper trail of any kind - and that's extremely difficult. You can legally take up to $10,000 out of the country with you on a trip without having to report the transport of the funds. If your spouse travels with you, he or she can take another $10,000. As I understand it, each child could take $10,000 out of the country - if it's their money. But if you use this exemption too often or just use your kids as a conduit, you will be guilty of a crime called "structuring". This crime was created to prevent drug dealers from laundering money through multiple smaller transactions, but it's a crime without regard to whether you are a drug dealer and without regard to whether you are even engaged in money laundering. As a practical matter, if you, your spouse and each of your five children are searched (or questioned) when you depart from the U.S. or when you enter another country, the fact that each of you are carrying almost $10,000 in cash is likely to be viewed as a crime by the customs official and you will then have to spend a lot of time to try to prove you haven't committed any kind of crime. It's also highly likely that the cash will be confiscated (forfeited) by the customs personell.

Of course, you can transfer funds to a foreign bank account with a check or a wire transfer, but that leaves a trail that could be found by a determined creditor. And you are still faced with the decision of whether to lie on the part of your tax return that asks if you have a foreign account. It may be possible to hide some of your assets in a numbered foreign bank account, but it "ain't easy". It will require a great deal of careful subterfuge - which most people are not capable of accomplishing.

In the past year or two, it's become even more difficult because of pressure by the major countries (like the U.S., England, Canada, France, Germany, Japan and others) on other countries to adopt rules to ostensibly deter money laundering. More international banks are refusing to take funds from new customers without first engaging in an extensive review of their credit and financial records. There are fewer and fewer banks in the world that will accept deposits that are secret.

Beginning in 2001, the U.S. began to require foreign banks to provide information to the IRS regarding the status of their depositors as to whether the depositors are U.S. persons. Failure to provide that information would subject the foreign bank to a 30% withholding tax on all payments to that bank from any U.S. financial institutions. Most of the banks of the world have complied with the witholding disclosure rules. This makes it virtually impossible for a U.S. peprson to have a foreign bank account with funds that are invested in U.S. securities. The funds in a foreign account must be invested in foreign securities. But -- the vendors (usually banks) of foreign (non U.S.) securities will not sell them to a U.S. person. So the funds in your foreign account will sit there without earning any investment income.

There are additional obstacles to the use of secret foreign accounts to avoid creditor claims or to evade taxes that are described in a detailed report on our subscriber's web site.

## The Last Minute Foreign Trust

Another scheme that requires some careful implementation is the transfer of funds to a foreign trust shortly before you are expecting to be served with a judgment by a creditor. In all but a few jurisdictions in the world, a determined creditor can bring suit against your foreign trust and have the transfer overturned under the fraudulent transfer laws of that jurisdiction. With no exceptions that I can think of, a transfer immediately before or after being sued will be a fraudulent transfer in the foreign jurisdiction. And, in some cases, even if your transfer can't be overturned in a foreign court, a U.S. court might demand that you repatriate the assets on the theory that you will have retained that power - whether directly or indirectly. If you refuse, the court can put you in jail for contempt. You might argue in an appeal that you don't have the legal power to recover the funds (because of a duress clause in your trust), but you might have to stay in jail until the appeal is heard and decided.

The bottom line is that this kind of last minute asset protection is a game of serious "hard ball" and you may be faced with having to decide between your liberty or your money.

## Bearer Share Corporation Schemes

Some promoters are selling packages consisting of a Nevada corporation or an international business company (IBC) as a way to protect your assets from creditors and even to "save taxes". The key to these schemes is that the ownership of the entity is evidenced by bearer shares. There is no public record of who owns the shares of the corporation and the shares can be quickly transferred to someone else without the time and delay of registering the change in ownership with the corporation.

Basically, the protection -- and the tax savings -- rely on secrecy.

This is a legitimate way to prevent potential plaintiffs (or their lawyers) from discovering all of your assets with a quick computer search. That may deter a predatory plaintiff from suing you and it's almost certain to deter a lawyer working for a contingent fee from taking the case. If the potential plaintiff has to pay cash to hire the lawyer, that is usually the end of the matter. Thus, when properly used, the Nevada Corporation or foreign IBC can make it a lot more difficult for legal predators to find out if you are worth suing.

But most of the promoters of these arrangements claim a lot more in the way of benefits.

If you lose a lawsuit, the plaintiff can require you to disclose all of your assets under penalty of perjury. If you have substantial assets that have been moved into a bearer share corporation, any half witted investigator can easily discover that there is an unexplained loss of assets. You will be grilled. If you refuse to disclose where the assets are, the plaintiff will then hire a really good auditor who is a specialist in forensic accounting. They will demand your tax returns and complete details of your credit files and applications for credit for the past few years. They will demand an explanation of any discrepancy in your assets from year to year. If you still refuse to explain a sudden and substantial loss of assets, they can get a judge to put you in jail for contempt of court.

The promoters of the Nevada Corporation also claim that you can save income taxes because Nevada does not have a state income tax. This is true if you are doing business in Nevada and have an ooffice in Nevada and if your corporation is making a profit. But if you don't read the fine print, you might not realize that the tax savings only apply to state income taxes -- and not to federal income taxes. And if you live in a high tax state with a corporate income tax, you need to be sure that they don't have some laws that limit the extent to which you can transfer profits from their state to another. Merely having a paper entity in Nevada that bills your operating corporation for some phony service will not stand up to a challenge by your state tax collector unless there is some substantial substance to the work that is being done in Nevada. But when you incur extra expenses to establish and maintain an office in Nevada, the tax savings become less attractive. For example, if you have a corporation that is making $100,000 a year in profits, and if your state imposes a corporate income tax of $5,000 on that profit, you clearly need to spend less than $5,000 a year to operate your Nevada corporation. If you really like this idea, at least take the time to run the numbers before you spend your money to set up a Nevada corporation. And also check with some local tax professionals to find out if your state has some tax laws that allow them to challenge this kind of profit stripping activity.

The Nevada corporation doesn't do anything to reduce your federal income taxes. In fact, by reducing your state income taxes, you will some incur some added federal income taxes.

The promoters then offer you an offshore corporation as a way to "save taxes" at the federal level. What they don't tell you is that this is extremely difficult to do without committing tax evasion -- which is illegal. The reasons are multiple and are far beyond the scope of this warning. You can get further details in our in-depth report - **The Controlled Foreign Corporation Tax Guide**.

# Myths about Asset Protection

There is a common misunderstanding about "lawsuit protection" techniques. There really isn't anything that can prevent someone from suing you for virtually any reason at all. The real object of lawsuit protection is twofold.

1. If your assets are adequately protected, **you will not be an attractive target** for lawyers who are contemplating suing you on a contingent fee arrangement for an indigent plaintiff.

2. If you do get sued and lose, **your asset protection plan should allow you to start over** with some money that is beyond the reach of potential creditors.

The **"Paradox of Insurance"** is that the more insurance you have, the more attractive you are to potential plaintiffs and their lawyers. The best lawyers who work on a contingent fee arrangement use investigators to find out how much insurance and/or assets you have before they will agree to take a case on a contingent fee basis. If the lawyer discovers (or even suspects) that you have insurance, he will take the case on a contingent basis in order to negotiate a quick cash settlement with your insurance carrier. If the award is more than your insurance coverage and if you have additional assets that are easy to convert to cash, the lawyer will then use the insurance proceeds to pursue your other assets.

If they don't find any at first, they may just look harder. But if it's obvious it will be harder to get your assets than to win the case, the lawyer will often require the plaintiff to pay cash in advance for a large part of the legal fees. Unless the plaintiff has a deep pocket, that is often the end of a potential lawsuit.

A well designed asset protection strategy will make it possible for you to start over if you are sued and lose the case.

Some legal advisors claim that the "best" form of asset protection is to put all of your money into a family limited partnership and to transfer your partnership interest to a foreign situs asset protection trust. This device has proven to be effective when implemented by qualified and experienced legal advisors and when properly administered.

However, some legal advisors argue that you shouldn't remove more than 30% to 40% of your assets from potential creditors; because if they can get a sizable judgment, they are far more willing to write off the rest and leave you alone. If you remove all of your assets from access by creditors, they may decide to spend the time and money to get it all - at any cost. Offshore Asset Protection Trusts are one of the more controversial parts of the subject of asset and lawsuit protection and are discussed in four separate articles in our subscriber's web site.

A practical solution is to have enough insurance so the insurance company will pay the legal fees and will settle a bona fide claim where you are (or might be) at fault. Then, do everything that is reasonable to protect your personal assets from unnecessary exposure and to protect some of your assets from the most determined creditor.

Extreme asset protection measures should not be considered until all of the more reasonable and less expensive measures have been utilized.

## Some Lawsuit Protection Myths

There seems to be a lot of bad advice from alleged and self proclaimed experts who don't really know enough about the subject or aren't concerned with the critical details. Here are some popular myths and misconceptions about lawsuit protection.

***1. "Lawsuit/asset protection is only for the wealthy or for crooks."***

The truth is that anyone with any assets that are worth more than the cost of litigation is a potential target. And you don't have to be guilty of any crimes to be a potential lawsuit victim.

***2. "If you buy "Package Z", you can thumb your nose at potential creditors."***

Run - don't walk - to the nearest exit if anyone tries to assure you that their packaged plan is a cure all. Be particularly wary of those who tell you that their plan will also eliminate your income and estate tax obligations if you are a U.S. citizen or resident.

***3. "You can avoid lawsuits by going bare and canceling your insurance."***

Legal predators and lawyers do prefer to make claims against people who have a lot of insurance because the insurance company will usually settle to avoid the cost of litigation. For the lawyers, that's a quick piece of small change and they use that kind of money to pay the bills while they are working on a the big cases.

However, if you don't have any insurance, the predators will look to see if you have any assets. A lack of insurance may discourage some of the lawyers who don't use the services of well qualified investigators, but **a good investigator can find your assets.** Going bare does not make you judgment proof unless you have also divested yourself of all your non-exempt assets. "Give the dog a bone". Keep a reasonable amount of liability insurance in force. (However, not all asset protection lawyers agree with this tactic. Some experts say that the insurance will just give the plaintiff's lawyer some working capital to go after the rest of your assets.)

***4. "Corporations will protect you from business claims."***

Corporations offer more protection than some other forms of business, but plaintiffs usually sue the officers, the directors and the corporation. When the corporation doesn't

have enough assets or insurance to satisfy a claimant, they will find some reason to sue you as an officer or director of the corporation And, if you fail to observe the legalities of the corporation, the courts will often ignore its existence and hold you liable for the obligations of the corporation.

***5. "Liability insurance is all I need."***

Judgment creditors will not stop with your insurance. They want it all. Sometimes, insurance companies will pressure you to admit guilt to something in order to make a settlement. And some insurance companies go to great lengths to deny coverage when there is a claim. But ... the worst problem is that your insurance company might be insolvent when you need them the most. (See Insurance company solvency.)

***6. "I'll just transfer my assets to my family."***

If you don't make transfers to your family long before a claim occurs, the courts will take the money back from those to whom you gave it. Or ... if you made yourself insolvent by giving property away, the gifts will be legally invalid. And, giving property to family members exposes the assets to their creditors.

***7. "Family limited partnerships will protect your assets from creditors."***

The family limited partnership (FLP) is often being promoted as a cure-all asset protection device. On closer study, you will find that the FLP is a useful part of an asset protection plan, but it's no iron fortress - particularly if its only purpose is to hinder, delay or defraud creditors.

***8. "I'll just hide my assets where they can't be found."***

That seldom works except for small amounts. The most substantial assets like real estate, a pension plan or a small business can't be hidden.

***9. "An offshore asset protection trust will prevent a creditor from being able to get a judgment against you in a foreign jurisdiction."***

If the assets can be found (and they usually can), the U.S. courts can hold you in contempt if you refuse to make the assets available to your creditors **if you have the legal power to do so**. Therefore, you must effectively divest yourself of legal control over those assets. Otherwise, your offshore trust will be a formidable deterrent to a judgment creditor, but it's not an "ironclad fortress".

# How to Avoid Fraudulent Transfers

If you wait to protect your assets until someone brings a lawsuit against you, it's too late.

Anything you do to remove your assets from the reach of your creditors after a lawsuit is filed is likely to be a "fraudulent conveyance." That means the courts can and will seek to obtain repossession from the transferee. One specialist in the field says that if you are in a high risk profession or occupation, you must keep some assets (or insurance) available to your creditors or the courts can recover any assets you transfer to relatives or protected entities.

**You must take steps to protect your assets before there are any potential claims against you.**

Like estate planning, if you wait until you have a problem, it's too late to solve it. Like insurance, **lawsuit protection planning must be done when you don't think you need it.**

The various state courts have indicated that there must not be any reasonable prospect of a specific claim against you at the time that you put your assets beyond the reach of your creditors. In most states, that seems to be a period of one to three years before any claim is filed against you.

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## Protecting Assets Without Defrauding Creditors

When you are seeking to use an irrevocable trust to protect some family assets from future lawsuits, it's important to be aware of the legal rules against defrauding your present and potential creditors by transferring your property in a manner to prohibit them from getting an attachment in satisfaction of their claims. The law refers to this as a fraudulent conveyance.

. According to Bill Comer, "fraudulent conveyances under the Uniform Fraudulent Conveyance Act are defined as those:

> 1. **made when the transferor was insolvent** or was rendered insolvent by incurring an obligation or making a transfer and the obligation incurred or the transfer made was without a fair consideration;
>
> 2. conveyances **made without fair consideration** when the transferor was engaged in or about to be engaged in a business or transaction which leaves the transferor with an unreasonably small capital;

3. conveyances made or obligations incurred without fair consideration **when the transferor believes he will incur debts beyond his ability to pay** as they mature, and

4. conveyances made or **obligations incurred with actual intent to hinder, delay or defraud** either present or future creditors."

Generally, a fraudulent conveyance/transfer requires that you have the intention of hindering, delaying or defrauding your creditors. Because intent is difficult to prove, the courts have developed a set of guidelines they use to determine if a transfer of assets without adequate consideration is a fraudulent transfer. These are referred to as "badges of fraud".

However, if you are solvent at the time that you transfer some assets to another person without adequate consideration, you are far less likely to be found guilty of a fraudulent transfer. Thus, a critical aspect of avoiding a fraudulent transfer is to know whether you are solvent.

## Privacy Versus Secrecy

A fraudulent transfer is not necessarily a felony. But when there is an overt effort to hide what is being done or to hide the assets, then the effort may become a full blown felony under U.S. law.

Some subscribers who have talked to me by phone have asked why I don't devote much space to the subject of privacy. That's gotten us into a discussion of the difference between financial privacy strategies and a desire to ensure secrecy from all sources -- including the government. Those who are seeking to evade taxes (which is a felony in the U.S.) and to launder money are looking for some way to hide their assets and income from the government under the guise of seeking privacy. Many government employees involved with these issues regard the subject of privacy as a code word used by those seeking help to implement illegal transactions.

Where there is an excessive or near paranoid concern for privacy (aka secrecy), there is likely to be a fraud against potential creditors.

Most of the lawyers who actually do a lot of asset protection work advocate full disclosure to the various tax agencies and any other regulatory agencies. (I believe the other lawyers are living on borrowed time.)

Partnerships, limited liability companies, corporations and private foundations are entities authorized by law. Individuals have certain rights and powers without the consent of the state. A corporation or partnership only exists as a creature of the law. Without virtually

full disclosure of the financial affairs of the partnership or corporation, the state won't grant the entity the benefits of a separate entity with it's own rights under the law. Trusts do not require registration with any government agency because they are simply contracts between the grantor/creator of the trust and the trustee. While revocable trusts don't provide any asset protection, an irrevocable trust might provide some protection.

**But there are some forms of asset protection that rely on secrecy and evasion** rather than on openly making use of the law. When that happens, **the desire for privacy can overlap into a potential felony**. If secrecy, subterfuge or fraud is essential to the success of an asset protection device, the odds are that it's illegal.

# The Solvency Defense

ll of the books I've read about asset protection emphasize the importance of solvency in being able to make transfers of assets to exempt forms or to entities that remove the assets from the reach of future creditors.

None of these books really get into the meat of the question,

**"How Do You Compute Solvency or Insolvency?"**

As I reread my various books on Asset Protection in the context of **fraudulent conveyances** and the solvency defense for claims of constructive fraud, it became apparent that measuring solvency in the context of the **bankruptcy**/creditor exemptions is vastly different from measuring solvency in terms of generally accepted accounting principles.

The more I read, the more obvious it became that a person could be totally solvent under traditional methods of computing assets, liabilities and net worth, while being seriously insolvent after eliminating all exempt assets and after including all contingent debts.

It seems to me that **this is a seriously undefined issue** in the context of asset protection planning. So, I'm "rushing in where wise men fear to tread" and I've attempted to provide an explanation of how to adjust traditional financial data for a solvency analysis.

Asset protection planning, estate planning and even some family income tax planning methods usually involve the transfer of ownership of various assets to other family members by gift. If you want to be sure that your transfers will protect those assets from the claims of your creditors in the event that you might be sued, then you need be sure that you are solvent at the time you make the transfers. Where asset protection is your primary concern, your lawyer or financial planner is likely to insist that he or she conduct an insolvency analysis for you. Many of the articles about asset protection in professional journals are now warning legal and financial advisors that they could be held accountable for helping a client to commit a fraud against the client's creditors.

If you make transfers that render you insolvent or unable to meet your obligations, then the courts may give your creditors the right to recover any property from the transferee where there is a lack of fair value given in exchange for the property.

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## An Example Of A Solvency Analysis

While you may think that you couldn't possibly be insolvent, **an insolvency analysis might result in a huge surprise**. For example, assume you have $3 million in assets and only $1 million in current debts. You are thinking of putting $1 million of your net worth

in an asset protection plan that will include a domestic trust, some gifts to your spouse and some gifts to your children. When your advisor gathers the data for a solvency analysis, you remember that you have $500,000 of contingent liabilities on some loan guarantees that you made for your son. If you live in Texas, your homestead is exempt from the claims of creditors for a residence on land of up to one acre in a city. Your home equity amounts to $250,000. In addition, your pension fund assets of $750,000 are exempt. Another $500,000 of your assets are in a partnership, which are exempt under the laws of most states, including Texas.

### Insolvency Analysis

| Property Type | Traditional Method | Solvency Format |
|---|---|---|
| Home Equity | $250,000 | None |
| Pension Assets | $750,000 | None |
| Partnership Equity | $500,000 | None |
| Other Assets | $1,500,000 | $1,500,000 |
| Total Assets | $3,000,000 | $1,500,000 |
| | | |
| Actual Debts | $1,000,000 | $1,000,000 |
| Contingent Debts | | $500,000 |
| Total Debts | $1,000,000 | $1,500,000 |
| | | |
| Net Worth | $2,000,000 | None |

Based on this simplified example, any other assets that are transferred to family members or irrevocable trusts could be treated as a fraudulent conveyance by the courts and would be subject to recovery by the courts within the applicable statute of limitations.

If you make transfers to an **offshore trust**, it might be more difficult for the creditors to get to that money, but then the courts might not be willing to grant you any relief in bankruptcy if you should be sued. The claim would then be hanging over your head for many years to come and if the assets were brought back, they would be available to satisfy the claims of any waiting creditors.

## The Critical Importance Of A Solvency Analysis

If a creditor can prove that there was an actual intent to hinder, delay or defraud the creditor, then that is a fraudulent conveyance, even if the taxpayer is solvent. But intent is very difficult to prove, so the courts most often look for "badges of fraud" to establish

"constructive fraud". These badges of fraud include a lack of adequate consideration and any one of the following three elements.

1. Insolvency, or
2. unreasonably small capital, or
3. an intent to incur debts that could not be paid.

The unreasonably small capital element generally applies to a business type of bankruptcy. However, if a transfer is made without adequate consideration for estate planning or asset protection purposes and the transferor has a business that is left without adequate capital, then a creditor could attempt to use this element rather than the insolvency element. Thus, **where a business is involved, solvency is not enough**.

**The business must also be left with sufficient capital to meet its obligations** as they become due and the debtor must be reasonably able to foresee that a lack of working capital could result in not being able to meet any claims that might become due. In addition, this element gives standing to future creditors, where the solvency element doesn't. As a practical matter, if the debtor is solvent and can demonstrate a reasonable belief that existing resources and future cash flow would permit the debtor to meet all known or foreseeable obligations, then it should be very difficult for a creditor to prevail on a claim of insufficient capital.

As for the element of intentionally incurring debts beyond the ability of the debtor to pay those debts, this element goes back to the difficulty of proving intent. So long as the transferor can show that he attempted to retain sufficient assets to meet his obligations, it should be extremely difficult for a creditor to prevail on this element of constructive fraud.

Thus, the measure of solvency becomes a critical element in any asset protection plan. It also needs to be considered in connection with any estate planning or family income tax planning. So long as you are solvent, as defined below, and so long as you can show that you have a reasonable basis to believe that you can fulfill your future obligations, then your asset protection or estate planning transfers should hold up to a challenge

# Bankruptcy Exemptions

*The purpose of the U.S. bankruptcy laws is to "relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh ..."* (U.S. Supreme Court)

The "Bankruptcy Reform Act of 1994" was described by Donald W. MacPherson, Esq., as "... the first significant change in the Bankruptcy Code since 1978 ... (for) citizens burdened with state or federal income tax debts." (Tax Freedom Institute News, 1/95).

Bankruptcy is often the only method of asset protection for those who are unprepared for future lawsuits. For those who do plan ahead to avoid being wiped out by a lawsuit, the threat of bankruptcy is a significant weapon in negotiating with a creditor.

The bankruptcy system has two conflicting objectives.

One is to permit the debtors the have a "fresh start" so they won't become a ward of the state. To accomplish this, some of the debtor's assets are protected from the claims of creditors and in most states, up to 75% of the future income of the debtor is protected. In nine states, the full value of the equity in a home is protected (except from creditors who have a mortgage interest on the home). In most of the other states there is a set dollar value of the equity n a home that is protected. Each state exempts a variety of personal assets with dollar limits -- such as an automobile, the tools needed to earn a living and certain items of personal property. Most states impose limits on the claims of creditors with respect to retirement plans. Many of the states provide some protection for assets in an IRS, an annuity contract or a life insurance contract.

The second objective of the bankruptcy system is to protect the rights of creditors and to make an orderly liquidation of the non-exempt assets of the debtor so that the various creditors are able to get the maximum possible recovery from the debtor. In addition, the states and the Federal bankruptcy system have laws to prevent the debtor from disposing of assets in a manner that is intended to prevent creditors from getting paid. These are referred to as fraudulent transfer laws or fraudulent conveyance laws.

When your debts exceed the value of your assets or when your loan payments don't leave you enough to live on,, the law provides some relief. But bankruptcy isn't always a matter of choice. In some cases, one or more creditors can force a debtor into bankruptcy so that all the creditors may receive a "fair settlement".

The federal bankruptcy laws are included in Title 11 of the U.S. Code. Chapters 1 through 5 and 9 of the Bankruptcy Code address general provisions, case administration and other matters.

Chapter 7 covers the liquidation of assets and a complete settlement of all dischargeable debts of the debtor.

Chapter 11 (of Title 11) is primarily for business reorganizations in which the business continues to operate while paying off a portion of its debts. This section includes all forms of businesses, including a sole proprietorship. Family farms are reorganized under Chapter 12.

Chapter 13 is generally known as the "Wage earners" bankruptcy, where the debtor can pay all or a portion of his or her debts out of future income.

# Using a Corporation for Asset Protection

The oldest and best known form of legal entity for asset protection is a corporation. However, it's not suitable for the ownership of passive investments or personal property. For tax reasons, personal assets such as a home, automobiles, art or jewelry should be held personally or in a trust. Investments should either be held in a trust, a partnership or LLC. The assets of a business should be held in a limited partnership, LLC or corporation.

Partnerships, LLCs and corporations are generally presumed to exist to make a profit. When non income producing assets like a home or personal art are the primary assets of a partnership or corporation, it causes a lot of tax problems. And the tax law has a number of rules that are designed to strongly discourage the use of a corporation to own investment assets like stocks and bonds. Thus, there are very few cases where a corporation is a useful way to own assets other than the assets of an operating business.

The historic purpose of the corporate form of business was to provide protection to investors from the creditors of a business. This has been extremely effective for small investors who have no involvement with the operations or policy decisions of the corporation. Where an investor is an executive of the corporation and makes management decisions, an injured party (plaintiff) will attempt to sue the manager as well as the corporation. Thus, the corporate form of business does little to protect the personal assets of the investors who also are involved in running and operating the business. Nor does the corporate form of business help to protect the corporation's assets from the claims of creditors of the corporation.

In addition, if a closely held business is operated as a corporation and if more than 50% of the stock is owned by a single person, then a creditor of that individual owner could get control of the stock -- which would then give the creditor control of the corporation. The creditor could then vote to liquidate the corporation in order to get the assets of the corporation.

Most of these problems can be solved through the careful use of multiple corporations or with other entities such as trusts, limited partnerships or limited liability companies.

## Asset Protection With Multiple Corporations

I've had a number of questions from subscribers about whether multi-state corporations combined with a Nevada corporation can be used to avoid state income taxes and/or to also provide greater asset protection. With respect to having offshore corporations and U.S. corporations, the question is whether such an arrangement can result in some U.S. tax savings by shifting income to the offshore corporation.

From an asset protection perspective, it seems to me that having more than one corporation affords far more protection than just having one. If one corporation is sued and loses, the assets of the other corporation are not exposed unless the second corporation is directly owned by the first. Thus, two corporations provide greater asset protection when assets owned by a non-operating corporation are leased to an operating corporation.

For federal income tax purposes, multiple domestic corporations will not help to save corporate taxes.

In a very few instances where a foreign corporation can generate profits from business operations that are unrelated to the domestic business, it may be possible to defer some taxes on the profits of the foreign corporation. However, there are a number of very complex tax rules that must be followed with care.

As for the state income tax benefits of "upstreaming" corporate profits to a Nevada corporation (where there is no state income tax) I have heard that California and some other high tax states have challenged this arrangement with some succcess. "Upstreaming" is a concept where a Nevada corporation provides administrative services to an affiliated corporation in another state and charges fees to the non Nevada corporation to effectively transfer most of the profits from the non Nevada corporation into the Nevada corporation. This concept only works with respect to state income taxes on corporate profits. It is not useful with respect to federal income taxes on the corporation.

## Asset Protection With U.S. Domestic Trusts

The laws relating to trusts are enormously confusing because there are so many technical exceptions to every general rule. I'm going to try to cut through some of the confusion as much as possible, while avoiding any serious misstatements of law. Part of the confusion arises because certain rules applicable to trusts are different for tax purposes and for other purposes such as asset protection. Unless otherwise stated, the comments in this report deal with asset protection.

### Parties to a domestic trust

Every trust will have a grantor/settlor, one or more beneficiaries and one or more trustees. Here are brief explanations of these terms.

**1. Grantor/settlor**

The person who establishes (whether directly or indirectly) the trust is known as the grantor, settlor, trustor or creator. In this report, I will refer to this person as the grantor.

**2. Beneficiaries**

Anyone who is to benefit from the income or the corpus (assets or property) of the trust is a beneficiary. Generally, there are two types of beneficiaries. An income beneficiary is entitled to receive some or all of the income of a trust. The remainder beneficiary is to receive whatever is left at the termination of the trust. A beneficiary may be a contingent beneficiary and/or a discretionary beneficiary.

**3. Trustee(s)**

In order to have a trust, there must be property that is transferred to one or more trustees. The trustee is the person or organization that is empowered to carry out the terms of the trust agreement. Where asset protection is a major concern, the grantor of the trust should not also be a trustee.

## Powers of Appointment

When anyone (usually a beneficiary or grantor) is given the power to direct the disposition of trust property, the law calls that a "power of appointment". A power of appointment can be a general power or can be limited.
A general power of appointment is one exercisable in favor of anyone including the donee, his creditors, his estate, and creditors of his estate. A power of appointment is limited when it is exercisable only in favor of persons (or a class of persons) designated in the instrument creating the power.
A power of appointment can be created within a trust or as part of a power of attorney where the POA grants the attorney-infact a general or limited power to appoint any trust property.

## Revocable and irrevocable trusts

There are many different types of trusts because a trust is simply a legal instrument that can be drafted to accomplish a wide range of personal or financial goals. Some trusts are "living trusts" that are created when the grantor is alive. "Testamentary trusts" are created by a person's will.
A living trust can either be revocable by the grantor or it can be irrevocable. The income tax, estate tax and gift tax rules vary greatly between revocable and irrevocable trusts.

## Asset protection

A revocable grantor trust provides absolutely no legal protection for the assets in the trust from the grantor's creditors.

If a grantor puts property into an irrevocable trust for his spouse and if the transfers are not found to be "fraudulent conveyances" (as explained later), then that property may be protected from the future creditors of the grantor. This assumes that the transfer to the spouse's trust does not cause the grantor to become insolvent at the time of the transfer. If the spouse is also subject to the claims of creditors, then a transfer into an irrevocable trust for the spouse would protect the assets in the trust but not the income from the trust.
When a grantor puts property into an irrevocable trust for the benefit of his spouse, children, grandchildren or other heirs, the only way that future creditors can reach the assets is to convince a court that the transfer was made to intentionally "hinder, delay or defraud" current or potential creditors of the grantor and that the grantor was insolvent as a result of the transfers to the trust.

Unless a trust has a "spendthrift clause", the beneficiaries of an irrevocable trust can transfer the present value of their future income from the trust, thereby making the money available to their creditors.

## Asset Protection With Life Insurance & Annuities

In most states, life insurance contracts where a spouse or child is the beneficiary are exempt from the claims of creditors without any dollar limit. In a few states, the same protection is given to annuity contracts. But, if the annuity contract is part of an ERISA qualified plan, it will be exempt in most states. A Swiss annuity contract will be protected from the claims of your creditors if your spouse or children are the beneficiaries or if there is an irrevocable beneficiary.

Where an annuity is being paid to a named beneficiary over their life expectancy, the cash value now belongs to the insurance company and the insurance company has an obligation to pay the annuity income for the lifetime of the annuitant or for some term of years. The annuitant no longer has the power to cancel the contract and take out the cash value. If there are any contracts that do allow the annuitant to cancel the contract and take the remaining cash value, then that contract should be subject to the same rules as one that is not yet converted into a lifetime income.

The extent to which the cash value and/or the death benefits of a life insurance policy are protected varies greatly from state to state. As with the Swiss annuity, a life insurance policy issued by a Swiss insurance company will be protected from the claims of creditors if your spouse or children are the beneficiaries or if you have named an irrevocable beneficiary.

Any discussion here about the transfer of the cash values of an annuity or life insurance contract to someone else (or even to some other entity) assumes that you are not making a fraudulent conveyance to hinder, delay or defraud your creditors.

## Asset Protection with a Limited Liability Company

Unlike a FLP, no one needs to be a general partner of a LLC. This makes the LLC much more attractive as a way to divide the ownership of the family business among the family. The personal assets of all partners (called members) are protected from claims against the LLC. Another benefit of the LLC over a FLP is that limited partners are prevented from having any participation in the management of the FLP. With a LLC, all members can be involved in the management of the LLC.

Any partnership losses of a limited partner may not be deductible by a limited partner because of the passive activity loss tax rules. However, if a member of a LLC is an "active participant" in the LLC, any losses should be deductible by the member - but that's likely to be an issue that will vary with the facts for each member of a LLC. (It took the IRS 200 pages to define "active participation" in a business entity, but the practical distinction is whether you devote more than 500 hours a year as a manager or member of the entity.)
Like the FLP, the creditor of a member of a LLC is only allowed to attach future distributions to the specific member (a charging order) and is not permitted to attach the assets of the LLC.

Also, like the FLP, the charging order does not protect the assets of the LLC from claims by judgment creditors of the LLC who have been injured by the acts of employees or managing members of the LLC.

A major difference between the FLP and LLC is that there are foreign jurisdictions (like Nevis) where you can establish a LLC to secure the benefits of a more hospitable legal jurisdiction and the protection of a LLC. The FLP is not available in most other countries.

## Asset Protection With a Family Limited Partnership

What if you could sign a document, write a check for a few thousand dollars and begin to ....

**(1) save thousands of dollars in income taxes every year,**
**(2) save hundreds of thousands in future estate taxes,**
**(3) insulate your assets from the lawsuit epidemic and**
**(4) also retain total control over your assets?**

Are you interested?  Those are the promised benefits of a "family limited partnership" or FLP.

Among some financial planners, a limited partnership is called "an arrangement where a general partner with experience teams up with some limited partners who have capital. A few years later, the general partner has the capital and the

limited partners have the experience". Thousands of investors have lost billions in bad investments that were structured as limited partnerships. Many investors therefore have an aversion to anything remotely connected with limited partnerships. However, huge amounts have also been lost by investors in corporations. Over time, the greatest losses occur in unincorporated proprietorships and informal general partnerships. It isn't the form of the business that causes the losses.

A limited partnership is simply a legal arrangement where investors are treated like partners for tax purposes, but like corporate stockholders for liability purposes. The limited partner is not subject to any debts of the partnership in excess of the limited partners' capital. Each limited partnership must have one or more general partners who are personally liable for any debts of the partnership. In order to avoid partnership liability, the limited partner gives up any management of the partnership. The general partner(s) have total discretion regarding the management of the partnership.

A "family" limited partnership (FLP) is a limited partnership where all of the partners are members of the same family group. For this purpose, the "family" label is simply an adjective. The law doesn't really distinguish between a family limited partnership and any other type of limited partnership. In addition, in a FLP, someone in the family is the general partner so that control is retained by one or more family members. When a FLP operates a family business, the parent that manages the business is the general partner. The children, a spouse or other family members are limited partners. When the FLP is used to own family investments, the high risk spouse and children are often the limited partners and a spouse who is not susceptible to lawsuits is usually the general partner.

The asset protection benefits of the limited partnership are based on a general rule of law that limits the claims of a creditor to a "charging order" that gives the creditor of a partner the right to take any amounts that are distributed to that partner. However, the creditor is not usually able to secure access to the assets held by the partnership or to force the partnership to make distributions. This of course does not protect the partnership assets from claims against the partnership as an entity. And, there have been some cases where the courts have granted creditors the right to force some distributions where the partnership is not distributing any funds to the partners.

## Asset Protection & Tax Savings With Charitable Trusts

If it weren't for a great void of other forms of tax shelter, there wouldn't be nearly as much interest in the tax benefits of the charitable remainder trust (CRT). But ... because of the dearth of other tax saving devices, the CRT has become one of the really HOT financial planning tools for Americans in the 1990s and until the passage of the 2003 tax law.

Proponents claim it will do virtually everything anyone could ever want. According to the more exuberant advocates, you can use a CRT to avoid income taxes, to avoid capital gains taxes, to avoid estate and gift taxes and to protect your assets from the claims of every form of predatory creditor.

Cooler heads argue that when you examine the details and run the numbers, it's just another of a wide range of financial options. Those who make their living helping taxpayers to establish and administer the charitable trust are the most vocal in arguing that this device is not a tax dodge or tax "loophole". You (or someone in your family) gets an income for life or for a term of years. Later, a charity gets what's left. In many ways, **the charitable remainder trust is an alternative to a life income annuity with an insurance company**, but with a few extra bells and whistles and with a lot more tax benefits.

One of the primary motivating factors in using a CRT was the deferral of the capital gains tax on the sale of highly appreciated assets such as the stock of a successful family business. During most of the Clinton era, the top federal tax rate on long term capital gains was 28% and many states would add another 10% to the total tax. Investors and business owners were very reluctant to pay that tax and were willing to consider the alternative of leaving some assets to a charity rather than giving the money to the IRS. When the top rate on long term gains was reduced to 20% in 1999, this reduced the financial benefit of the CRT but did not eliminate the interest of many investors. Then, in 2003, Bush introduced a top federal tax rate of 15% on long term gains -- which was enough to cause many investors to lose interest in the CRT.

In addition, the federal estate tax has been another substantial motivation for use of the CRT. But, since 2001, the federal estate tax exemption has been increased from $675,000 per taxpayer to $1,500,000 (for 2004 and 2005). For those taxpayers whose primary motivation is to leave as much of their estate as possible to their children and grandchildren, the appeal of the CRT has been reduced.

But for those who have no children or grandchildren or those who believe that a large bequest of funds would be detrimental to their well being, the CRT is still an excellent tool to defer taxes, insure a lifetime income, be able to manage the funds in the CRT and then leave a substantial endowment to a charity or charities of your choice. It also offers substantial protection for the assets in the CRT during your lifetime.

## Asset Protection With An Offshore Trust

In theory, an irrevocable domestic trust for the benefit of your spouse or your children will remove the trust property from exposure to your future creditors, so long as

you don't retain any control over the use of the trust property, and

you don't put property in the trust when you are insolvent.
Under the best of circumstances, you have to make a complete and irrevocable gift of the property to someone else while you are solvent in relation to any current or potential creditors.
But theory doesn't always prevail in U.S. courts.
And ... such gifts will either (1) use up your available annual gift tax exemptions, (2) use up part or all of your lifetime exemption from the estate and gift tax, or (3) they may trigger an immediate obligation for gift taxes.

## Objections To Domestic Asset Protection Trusts

Those who are urged to establish an irrevocable domestic trust for asset protection may be reluctant because;
(1) they have no power to revoke or alter the terms of the trust,
(2) the grantor can't be a beneficiary of a U.S. trust that provides any creditor protection by means of a spendthrift provision, and
(3) the grantor can't be a trustee of his own trust and also enjoy any asset protection benefits.
A common practice in establishing domestic trusts is to combine all types of assets in the trust. But, according to Jeffrey Verdon, "Lumping (high) risk and non-risk assets into a ... trust without considering a possible liability claim (arising from the high risk asset) is a mistake commonly made by financial advisors and lawyers, who may glibly suggest buying liability insurance - which is not always an adequate solution."
Furthermore, if you are concerned about the potential for the future imposition of currency controls or the future confiscation of assets by government, having your money in a U.S. trust won't help if the government takes control of the trust assets. The U.S. can quickly impose currency controls because such an action only requires an executive order by the President.

**Advantages of The Foreign Asset Protection Trust**

A foreign trust can overcome most of the problems connected with using a domestic trust for asset protection. The following is a list of these benefits, which I'll explore in more detail.

To hold assets in a more friendly legal system
Foreign trusts are not favorable to creditors
A trust protector can retain veto powers over the trustee
Foreign trusts can be used to avoid probate
Foreign trusts can function as credit shelter trusts
Contingent legal fees are not allowed
The grantor can be a beneficiary
The trust can be revocable or irrevocable
The trust location can be moved
The foreign trust can pay taxes & expenses of a beneficiary
The grantor can retain some control over the assets in the U.S. with a family

limited partnership or limited liability company and can get the money back as loans, partnership distributions or as compensation to the general partner.

These comments represent an extremely simplified overview of the benefits of an offshore trust and there are many restrictions and limitations on the use of these benefits. There is also some controversy among international tax lawyers as to whether the foreign trust is an appropriate method for asset protection.

## Tips on Administering A Separate Legal Entity

A number of subscribers have asked about what's involved in managing and administering a legal entity such as a family partnership, a trust or a corporation. Some of their concern is about what needs to be done to ensure that the legal benefits of the entity are not lost because of a failure to do whatever is required to preserve the separate existence of the entity. At a more basic level, some subscribers are asking about more mundane procedures, such as separate bank accounts, bookkeeping and reports to the IRS.
First, I'll offer some general suggestions that I believe will help you to operate and administer a limited partnership, limited liability company, a trust or a corporation - regardless of it's unique features. Then I'll offer some comments on any special requirements that might apply to any of these specific entities.

After the entity is formed, the first thing that needs to be done is to request a taxpayer identification number for the entity. The request should be made to the IRS using form SS-4, which is technically a request for an employer identification number. (That can now be done on the IRS web site for dopmestic entities.) Most public accountants and tax preparers will have copies of this form. Even if you have no employees and don't expect to have any, this is the taxpayer identification number that will be used on any information returns that are sent to you and any tax returns you will send to the IRS. Any banks or brokerage firms with whom you set up an account will ask for that number. If any reports need to be filed before the number is assigned by the IRS, you can just put "Pending" in the appropriate box on the form.

The next thing you need to do is to open a bank account in the name of the separate legal entity. It would usually be a good idea to have a checking account with minimal charges for deposit and checking transactions, with a separate money market account for any medium term cash savings. The bank will usually ask you to sign a form giving information about each of the officers, partners, members or trustees who have any authority to act for the applicable entity. They may also ask for a copy of the corporate charter and by laws, the trust agreement or the partnership (or LLC) agreement. It would be helpful for you to have a supply of those documents available. If you are attempting to open a foreign bank account, the foreign bank is likely to ask for a lot more information in order to comply with the various money laundering laws.

As a precaution against losing valuable original documents, you might want to

open a bank deposit box in the name of the entity to keep any original documents and valuable papers.

Where the entity is to own various kinds of investments, it will be necessary to open an account with a brokerage firm.

## Appraisals May Be Needed To Avoid Valuation Penalties

Making transfers of interests in family limited partnerships or shares of a family corporation are key elements in protecting your family assets from future lawsuits. Gifts to a charitable trust, family foundation or an irrevocable trust or even outright gifts of property to various family members are also widely used methods of asset protection and estate preservation for family property.
All of these inter-family and charitable transfers have one critical problem that is seldom discussed in articles or books on asset protection.

There are transfer tax valuation implications.

The gifted property needs to be properly valued to avoid future tax penalties. The estate and gift taxes are generally based on the value of the property at the date of the transfer. With cash or publicly traded stock or bonds, valuation is not much of a problem. With every other asset it can become a huge problem in the future.

Contributions of property to a charity require a "qualified appraisal" by a "qualified appraiser" as defined in tax code section 170. Gifts of property to family members are to be valued at the "fair market value", which is the theoretical amount at which the property would change hands between a willing seller and a willing buyer, where both parties have reasonable knowledge of the relevant facts. Applying this theory to the valuation of real estate or a family owned business is more of an art than a science.

Penalties for undervaluing any part of an estate can be severe, but won't usually be incurred until the estate tax return is audited by the IRS. The most significant penalty provisions are spelled out in tax code sections 6662 through 6664, dealing with penalties relating to accuracy or to fraud. These sections impose a 20% penalty on any understatements of value if the value of the property claimed on any return is 50% or less of the "correct" value (as determined by the IRS). Where the reported value is 25% or less of the "correct" value, the penalty is increased to 40% of the difference in the tax.

How can you avoid the penalty? The key is to show that you relied in good faith on a well qualified expert - an appraiser. The better qualified the expert, the less the chance of a penalty. Be sure the appraiser is also well informed on any related tax laws.

### A Tip On Choosing An Appraiser

When you are making a transfer of property that can't be valued by reference to an auction market, the most critical element is the valuation appraisal. A well qualified appraisal will protect you from substantial penalties down the road and will make it hard for the IRS to successfully dispute the value placed on your property. On behalf of a client, I recently spent quite a bit of time helping the client to select an appraiser. About two months before that, I wrote an article for a technical journal about business valuation software. As a result of the research I did on the subject of valuations, I concluded that the reputation of the appraiser is far more important than the software.

With the software I still have, I could compute the value of a business at least 20 different ways. But I won't and if I would, it would be a mistake for anyone to hire me for that purpose. Why? Because I have no experience or relevant credentials. Being a CPA doesn't mean that I'm fully qualified to put a value on a business. The reason I'm not fully qualified is because I don't choose to specialize in this field. Anyone who doesn't devote at least 60% of their work time to valuation issues isn't a genuine specialist - in my opinion. And anyone who hasn't been doing business valuations almost full time for at least three years isn't going to be presumed to be an expert.

The "secret" in getting an appraisal is to get someone with a reputation that will make it impossible for the IRS to convince a judge that your appraiser wasn't qualified and didn't know what he or she was doing. You want your appraiser to be so well qualified that it will make their appraiser look like an amateur by comparison.

How did I make the choice for my client? I called about a dozen estate planning lawyers in the area and asked for recommendations. Then I called the five who were mentioned the most and asked for a professional bio and a sample appraisal report. Then we interviewed three of the five. Then I suggested the client hire the one with the largest firm that did the most appraisals. And, the appraiser we selected wasn't any more expensive than the others.

How much did it cost? The fee was about $7,000 to prepare a valuation analysis for a business (in 1998) with about ten employees and with annual sales of about $3 million. Based on the valuation provided by the appraiser, the taxpayer was able to immediately remove more than $1.2 million in assets from his estate and to be able to remove an additional $80,000 per year, thereafter. The estimated estate tax savings will be far in excess of the appraisal fee - and I believe that an appraisal by an experienced specialist with a good reputation is a bargain when you are planning to make transfers of assets for asset protection and/or estate planning.

By the way. The Taxpayer's Relief Act of 1997 included a provision that will take much of the uncertainty out of the question of how the IRS will value prior gifts when they do an estate tax audit. Previously, it was their practice to not value a gift until they looked at the estate tax return. Even though the three year statute

of limitations had run on a gift tax return, the IRS contended that they could still value the gifted property as part of the estate tax audit. The 1997 law put an end to this little bit of duplicity on the part of the IRS. Now, they only get "on bite at the valuation apple". If they don't audit the gift tax return within the three year statute of limitations, they can't come back years (or decades) later and argue about that value when they examine the estate tax return.

## How To Protect Your Home Equity

For many people, their home equity is their largest single asset and a major retirement resource.

For most people, their three largest assets are their home equity, their pension plan and their business. This brief article will review the various strategies you can use to protect your home equity from the claims of future creditors.

Your first line of defense if a creditor seeks to take your home is the **homestead law** in your state. If that's not available or not adequate, you need to check on whether your state permits married couples to own real estate as **"tenants by the entirety"**. If you're single or your state doesn't provide that form of protection, the next step is to explore the benefits of a **qualified personal residence trust**. Some advisors advocate putting your home into a family limited partnership - but I disagree due to tax considerations. Instead, you can borrow against your equity and put the cash into a FLP. A final resort is to put your home into a foreign grantor trust. For residents of California, any change in the form of ownership must be considered in relation to the proposition 13 lid on property tax exemptions.

### Qualified Personal Residence Trusts

A strong form of protection is available with the use of a "Qualified Personal Residence Trust" (QPRT). This device is best suited to situations when there is a substantial estate tax problem and when the home (or a vacation home) has a substantial value. However, it seems to me it could also be used as a pure asset protection device for family real estate even when estate taxes are not a significant concern.

In a nutshell, the QPRT involves making a future gift of your residence (or a vacation home) to your children at the end of a term of years selected by you. The house is put into a grantor trust to hold the property until the term of the trust has expired. Until the end of the term of years, you continue to use the home. At the end of the term of years (selected by you), the home belongs to the beneficiaries of the trust - usually your children.

By making a delayed gift, the value of the gift is discounted at an interest rate prescribed by the IRS, based on the term of years that you select. The longer the

term of years, the lower the current value of the property for gift tax purposes. **Gideon Rothschild** wrote an article on this subject that gives an example of a 50 year old man who sets up a QPRT when the IRS prescribed interest rate is 7% - and the trust is to last for ten years. The value of the future gift would be about 46% of the current value of the property. Where the same trust is set up for 20 years, the value of the future gift would be 19% instead of 45%. **Scott Blakesley** computed the same amounts based on a December, 1994 prescribed interest rate of 9.4%, resulting in a value of 37% for a ten year term and 12% for a 20 year term.

If you die before the end of the term of years for the QPRT, the home is included in your estate and you've gained nothing in terms of estate taxes. But - your home has been protected from creditors while the trust was in existence. Thus, a QPRT could be worthwhile purely as an asset protection device.
If you live beyond the term of years of the QPRT, the home is transferred to your children. Until recently, you could arrange to buy it back from them if you made the purchase before the end of the term of the trust. However, the IRS has recently ruled that type of repurchase arrangement will result in the loss of the estate tax benefits.

Scott Blakesley reminded me that if interest rates drop, the use of a Qualified Personal Residence Trust (QPRT) is **less attractive** as a way to reduce future estate taxes because the computed value of the future gift increases as interest rates decrease.

For example, with a 7% interest rate, the present value of $100,000 in twenty years is just $25,842. At a 6% interest rate, that value increases to $31,180 and at 5% the present value is $37,689. With a ten year period, the differences are not as great, but they are significant. For a ten year example, the present value of $100,000 in ten years at 7% is $50,835. At 6%, the value increases to $55,839 and at 5%, it is $61,391. Gideon Rothschild reminded me that you can elect to use the highest rates for the current month and the two previous months, so if rates start back up, you can catch a lower rate. (These rates do not include a life expectancy element.)

The basic concept with a qualified personal residence trust (QPRT) is that you are making a gift of your home in trust at a future date, which can be any number of years in the future. If you survive for the term of the trust, then the property goes to the trust beneficiary. If you die before the end of that term, the property is still included in your estate. By making a deferred gift, you get a substantial discount on the value of the gift. The value of the gift is computed by using IRS prescribed interest rates, which are based on the interest rate paid on federal obligations of a similar duration. As the market interest rates change, the rates that must be used for a QPRT also change. As shown above, if the prescribed interest rate for a QPRT falls, the present value of the gift increases. Thus, the prospect of falling interest rates provides an incentive to do it before the rates actually fall. Of course, if interest rates should rise, the opposite would be true.

## Asset Protection For Real Estate

A subscriber has asked if there are some ways to protect U.S. real estate from the litigation epidemic besides converting the equity into cash and going offshore. According to Bob L.

> *"I have always been leery of those islands. The tale is a little too sunny and breezy. Nifty way for the rip-off artists and lawyers to get rich. The islands are fine for folks in the narcotics business. What the hell, in that world, tax dodging is not something you are going to lose a lot of sleep over. Aren't there other subjects that you could cover in detail? I think of real estate ... (and) I am not alone. There are plenty of people who own real estate (of various kinds). As I understand it, real estate is one the most vulnerable assets you can have."*

Residential real estate can be best protected in states with generous homestead laws, such as Florida, Texas and Kansas. A secondary option for a residence is available for those who live in the states that provide for tenancy by the entireties for the ownership or real estate by a husband and wife. A third option would be the use of a qualified personal residence trust.

Mark Warda suggested the use of dual living trusts for a husband and wife in those states that do not recognize tenancy by the entireties as a form of ownership. Another form of protection is to borrow out the equity as much as possible and then put that money into some protected form - such as a family limited partnership or a life insurance contract. A more extensive explanation of these tactics are available in the November, 1994 issue of APS. More information on tenancy by the entireties is available on the internet at http://www.protectyou.com. This is a web site sponsored by Howard D. Rosen, Esq. For more information on qualified personal residence trusts, ask for a free article on that subject by Gideon Rothschild, Esq.

It seems that the preferred method of protecting the equity in rental or commercial real estate is to put the real estate title into a family limited partnership, limited liability company or sub chapter S corporation.. Borrowing out the equity and putting the cash into a more protected form (like a homestead or life insurance contract) is another device that is often suggested. Another option is to transfer ownership of the real estate to a trust in which children are irrevocable beneficiaries.

## Strategies to Protect Your Retirement Savings

If your plan meets the tests of being an ERISA qualified plan, the assets in the plan can't be taken by a trustee in bankruptcy. Second, even if your plan is not an ERISA qualified plan, it may be protected from the claims of creditors under state

law. However, there are some exceptions to these general rules, and the laws are still evolving. Finally, if your retirement savings are not protected by ERISA or by state law, there are other ways to protect those assets.

In 1992, the Supreme Court made a landmark decision (Patterson v. Shumate) relative to the rights of creditors to tax qualified savings subject to the Employee Retirement Income Security Act (ERISA). Basically, the court held a person's qualified plan assets are protected from creditors in bankruptcy. Many commentators imply that this is the final word on the topic.

However, Al Martin (an ERISA lawyer in the Kansas City area) tells me there have been a variety of new cases about the rights of creditors to tax qualified assets since that Supreme Court decision. These new cases raise exceptions to the Supreme Court decision. Meanwhile, state laws are in a state of flux.

Gideon Rothschild tells me that New York has recently passed new laws that extend their state bankruptcy exemptions to include all forms of tax qualified retirement savings plans, including IRAs. These changes bring New York into line with about half the other states that have already passed similar laws. A syndicated column by Kathy Kristof (L.A. Times Syndicate) said that Congress overhauled the Federal bankruptcy laws in late October, 1994. According to Kristof, the law was effective on the date it was signed and will make it easier for the IRS to collect their taxes, but she made no comment about any changes that relate to tax qualified retirement plans.

In March, 2004, the U.S. Supreme Court ruled on the subject of whether the working owner of a business qualifies as a "plan participant" in a pension plan covered by ERISA. At issue was the question of whether the sole shareholder and President of a professional corporation was a plan participant because the plan covers one or more employees other than the sole shareholder and his spouse. This appears to support the view that if there are no plan participants other than the sole shareholder and his spouse that the plan is not protected by ERISA. (Yates v Hendon, U.S. Sup. Ct. 3/2/04)

In the absence of ERISA protection, differing degrees of protection are afforded by state law. A number of states even protect non-ERISA plans (such as an IRA) from being taken by creditors.

In states where the degree of protection is not adequate it may be possible to invest the assets of a self directed plan into a limited liability company or even in an offshore annuity or a foreign LLC.

## Asset Protection for the Self Employed

There are two kinds of legal risk for those who own a business or are self employed professionals.

The first (and the most likely) is the legal liability that arises from the conduct of a trade or business. Thus, any business could be sued because of some claim by a customer or employee of the business. The same can happen with respect to the tenants of any rental properties. When you own <u>and manage</u> a business, regardless of the legal form, a plaintiff will usually sue you as the owner, president, officer and/or director in addition to suing the business itself. Thus, the liability claim will usually be aimed at the owner as well as at the business. If the plaintiff prevails, the owner's personal assets will also be at risk if the business assets and insurance are not enough to settle the claim.
Even if there is enough insurance to settle a claim from the first lawsuit, it will then become very difficult to get insurance or to find insurance that doesn't cost more than the profits generated from the business.

It isn't practical or reasonable to protect all of the business assets from claims that arise within the business. The practical solution is to segregate some business assets and to protect non business assets (or assets of other businesses) from exposure to claims from within a business.

The second form of risk arises from claims coming from outside the business rather than from within the business. This is much less likely unless you have more than one type of business. If you have invested some of your money in rental property, that could become the source of a claim.

For example, the owner of a retail business also owns an apartment building. Someone is injured by an automobile owned by an employee of the retail business. The employee doesn't have any money or insurance and the accident occurred while going to or from work. The plaintiff sues the retailer and may win a judgment far in excess of the insurance and the assets of the business. The judgment will usually give the plaintiff the right to take any other property of the owner - including his apartment building and any personal assets.

In most cases, any jointly owned property can also be taken. Thus, if the building owner is a joint owner of savings accounts and securities with a parent, the parents' assets could be taken. If the owners' spouse is a joint owner of property with the defendant, the spouse's jointly owned assets can be taken. If the spouse is a joint owner of property with his or her parents, those assets could be taken if the spouse is named as a defendant in the suit.
The same thing can happen in the opposite direction if a claim arises from the retail business. The judgment creditor can take the apartment building and any personal assets or any jointly held assets.

There are a variety of ways that a self employed person or professional can reduce the chance of losing assets in a business because of a personal lawsuit and/or from a lawsuit against the business. To protect the business assets from claims against the owner, the business can be organized as a limited partnership or a limited liability company. To protect the assets of the business, it may be

necesary to to have some of those assets owned by separate entities. Critical equipment can be owned by an equipment leasing trust, family limited partnership or LLC that is owned by family members. Other methods of protection can include equity stripping, which involves taking out loans with specific assets used as collateral. The funds from the loan then need to be placed in a protected entity such as a LLC or perhaps in a life insurance policy if state law provides protection for such policies. Numerous other methods are discussed in detail in our **subscriber's web site**.

NOTICE: This Information is intended only for educational purposes and may be regarded as controversial by some legal experts. Readers should consult with a qualified  professional who is familiar with their specific financial and tax circumstances before adopting any ideas that are discussed in this article.

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