Asset Protection
Part 2

Presented by:
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On behalf of:
Peak Trust Company

Especially Treacherous Liabilities

Liabilities generally not cancelable in bankruptcy include the following:		Liabilities generally not covered by insurance include the following:	
(i)	Government student loans	(i)	Civil rights violations committed by employees or others
(ii)	Trust fund tax liability	(ii)	Environmental liabilities, including sick building syndrome and lead paint issues
(iii)	Hazardous waste liability	(iii)	Criminal acts
(iv)	Breach of fiduciary duty liabilities	(iv)	Charitable and religious board activities
(v)	Child support and alimony	(v)	Jet skis normally cannot be insured for over $250,000 per occurrence
(vi)	Medicare, Medicaid, and sometimes private pay refund liabilities of physicians: Carriers have been suing doctors for not following referral laws for significant refunds	(vi)	Acts of terrorism: Most casualty insurance clauses exempt acts of terrorism. The industry has been paying claims on goodwill up until now

Watch Out for Super Creditors

- IRS

- Department of Justice – when pursuing under federal statutes that allow injunctions or expropriation.

- FTC

- SEC
  - The 2010 case of SEC v. Solow, 682 F. Supp.2d 1312 (S.D. Fla. 2010) permitted the SEC to enforce a Disgorgement Order despite the otherwise applicable Florida creditor exemptions.

- Medicare – for when penalties and fines are due for improper billing or conduct

- Family Law Judges – but when homestead or tenancy-by-the-entireties is owned with next spouse – can it be invaded?

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What Works Against Super Creditors?

1. Charging order protection.

2. Trusts where state law does not allow creditor access <u>and</u> a Trustee is not required to make distributions to the debtor.

3. Foreign assets protected by foreign laws.

4. Assets not owned by the debtor.

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When Murphy’s Law hits you or someone you know!

“Anything that can go wrong, will – at the worst possible moment.”

- - Edward A. Murphy, Jr.,
a U.S. Air Force engineer (1947)


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Reasons That People and Companies End Up In Bankruptcy, Continued

It is usually a combination of things:

1. Took a big risk and much debt.

   A. Knew it was a huge risk.
   B. Didn’t realize what a big risk it was.
   C. Never ran a “worst case scenario and what if this goes bust” scenario.

Reasons That People and Companies End Up In Bankruptcy, Continued

2. Had a high cost of living and personal living commitments.

   A. Resulting in little or no savings.
   B. Resulting in starved operating capital.
   C. Did not decrease cost of living when they could have.

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Reasons That People and Companies End Up In Bankruptcy, Continued

3. Not so honest. While living well, investors or others were taken for a ride and then not paid. This can commonly happen to suppliers and customers. It happened in the Old Testament -- and it happens now.

ENRON - MADOFF - WOOPS

Remember –

Crime pays…that's why people do it!

Don't get caught in someone else's problem.

Don't be a dolphin who get's caught in a shark net because you were swimming around with sharks.

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Reasons That People and Companies End Up In Bankruptcy, Continued

4. And how about the concept of self-deception? See the following page of possible items of concern from the book "You Are Not So Smart."

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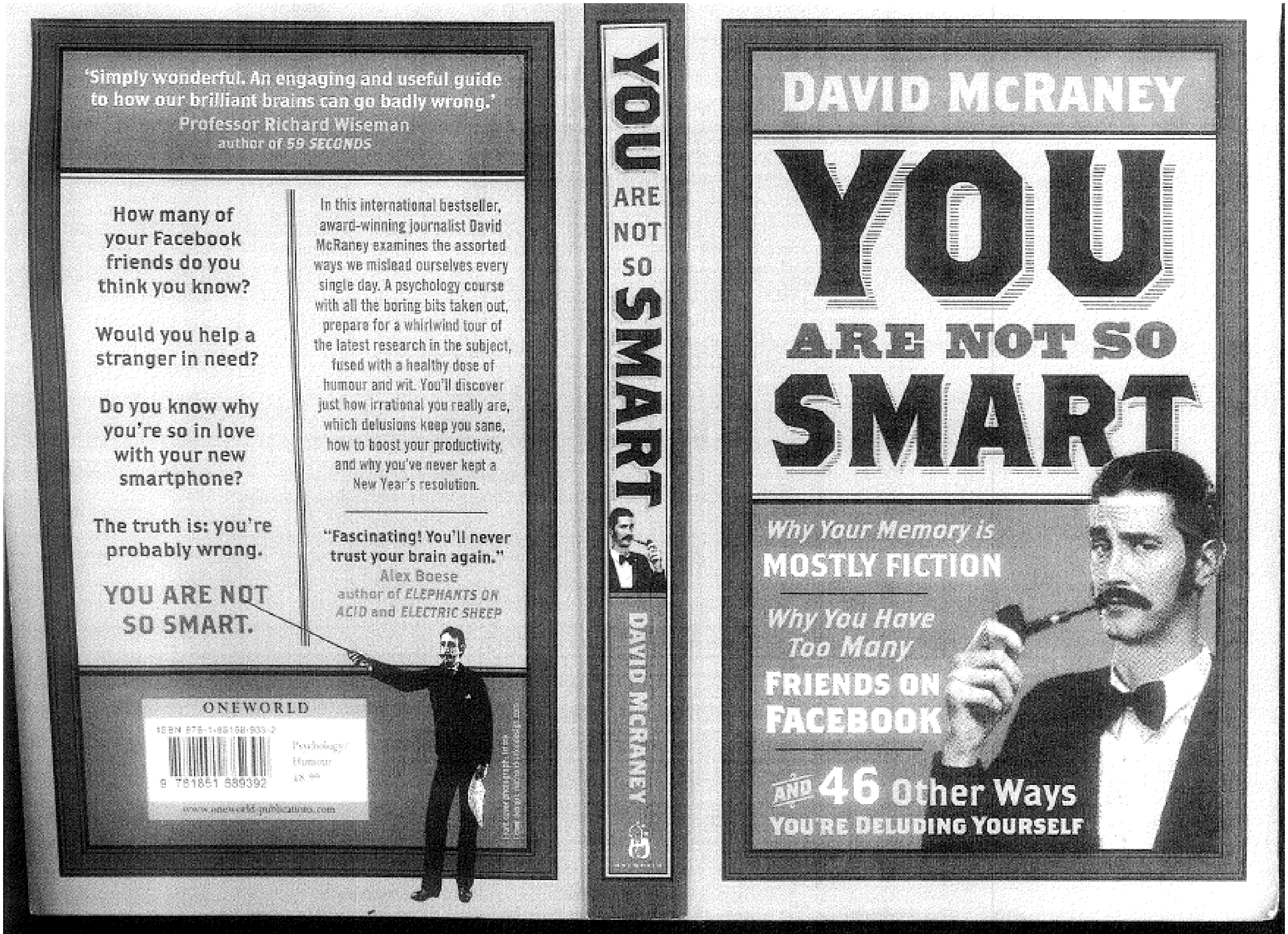
"You Are Not So Smart" by David McRaney is available on Amazon.com



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You Are Not So Smart

(Excerpts from the book *You Are Not So* Smart by David McRaney)

Chapter Title	The Misconception	The Truth
Introduction	You are a rational logical being who sees the world as it really is.	You are as deluded as the rest of us, but that's okay - it keeps you sane.
Chapter 3 - Confirmation Bias	Your opinions are the result of years of rational, objective analysis	Your opinions are the result of years of paying attention to information that confirmed what you believed, while ignoring information that challenged your preconceived notions.
Chapter 5 - The Texas Sharpshooter Fallacy	You take randomness into account when determining cause and effect.	You tend to ignore random chance when the results seem meaningful or when you want a random event to have a meaningful cause.
Chapter 25 - The Affect Heuristic	You calculate what is risky or rewarding and always choose to maximize gains while minimizing losses.	You depend on emotions to tell you if something is good or bad, greatly overestimate rewards, and tend to stick to your first impressions.
Chapter 28 - Self-Serving Bias	You evaluate yourself based on past successes and defeats.	You excuse your failures and see yourself as more successful, more intelligent, and more skilled than you are.
Chapter 32 - The Misinformation Effect	Memories are played back like recordings.	Memories are constructed anew each time from whatever information is currently available, which makes them highly permeable to influences from the present.
Chapter 37 - Learned Helplessness	If you are in a bad situation, you will do whatever you can do to escape it.	If you feel like you aren't in control of your destiny, you will give up and accept whatever situation you are in.
Chapter 38 - Embodied Cognition	Your opinions of people and events are based on objective evaluation.	You translate your physical world into words, and then believe those words.
Chapter 41 - Self-Handicapping	In all you do, you strive for success.	You often create conditions for failure ahead of time to protect your ego.
Chapter 42 - Self-Fulfilling Prophecies	Predictions about your future are subject to forces beyond your control.	Just believing a future event will happen can cause it to happen if the event depends on human behavior.
Chapter 47 - The Illusion of Control	You know how much control you have over your surroundings.	You often believe you have control over outcomes that are either random or are too complex to predict.

Reasons That People and Companies End Up In Bankruptcy, Continued

5. Those who are ripped off by the dishonest.

Reasons That People and Companies End Up In Bankruptcy, Continued

6. The unlucky. STUFF HAPPENS and can happen to anyone.

   But the unlucky commonly did not have enough insurance or left some t's and i's uncrossed or undotted.

Reasons That People and Companies End Up In Bankruptcy, Continued

7. Those who were dependent upon those who became insolvent – policing your accounts receivable and any pre-paid suppliers.

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Basic Bankruptcy Terminology

	Term	Definition
1.	Bankruptcy	The federal law and process that permits debtors to adjust creditor situations and receive a "fresh start" under the separate bankruptcy court system.
2.	Chapter 7 Bankruptcy	A process that provides for the appointment of an independent trustee to liquidate the non-protected assets of a debtor as pre-bankruptcy debts are discharged if certain requirements are met. **DISCUSSION/CONSIDERATIONS:** *In an individual Chapter 7 Bankruptcy all debts may be discharged (eliminated) while exempt assets are retained, and businesses may be sold at arm's-length to related parties in court approved sales. This will be a home run for many unfortunate, but well-advised, debtors. No payment plan is required if the debt is mostly "business debt," as opposed to being mostly consumer debt. You can advise clients of the importance of this ratio. Further discussion of the implications of Chapter 7 Bankruptcy planning is provided below.*
3.	Bankruptcy Estate	Upon filing bankruptcy, non-exempt assets of a debtor become property of the bankruptcy estate, and are then under the control of the trustee in bankruptcy or the debtor in possession, pursuant to 11 U.S.C. § 541. For example, an individual filing bankruptcy who owns a creditor-exempt annuity contract and a bank account will retain ownership of the annuity and lose the bank account. The bank account will become part of the bankruptcy estate.

Basic Bankruptcy Terminology

	Term	Definition
4.	Discharge	The actual order that results in debt being cancelled under a Chapter 7 bankruptcy, or upon completion of a successful Chapter 11 or Chapter 13 bankruptcy plan. No discharge is issued to non-individual entities (such as corporations and partnerships) under the Bankruptcy Code.
5.	Loss of Discharge	What occurs when a debtor in bankruptcy is denied the right to discharge debt by reason of pre-bankruptcy or post-bankruptcy conduct which causes the debtor to never be entitled to receive a discharge of debt then existing, leaving the debtor in "debtor purgatory." **DISCUSSION/CONSIDERATIONS:** *This can occur when the debtor is not truthful about assets, or makes a "fraudulent transfer" within one year before filing bankruptcy. Get any "fraudulent transfers" over well before needing to file bankruptcy, if they are legal to make in the first place (which is one reason that many debtors move to Florida—others are discussed throughout this presentation.)*

Basic Bankruptcy Terminology

	Term	Definition
6.	Chapter 13 Bankruptcy	A payment plan arrangement that individual debtors meeting certain requirements must comply with under payment plan rules in order to adjust their debts. **DISCUSSION/CONSIDERATIONS:** *Normally, this applies when there is mostly consumer debt and results in a five-year payment plan.* *Chapter 13 is only available to individuals (not corporations or other business entities). To be eligible to receive a Chapter 13 payment plan in 2020, an individual or married couple must have unsecured debt of less than $419,275, and secured debt of less than $1,257,850. Chapter 13 repayment plans are for three to five years and are funded by the debtor's disposable income. Once the plan is approved by the court, the Chapter 13 trustee receives and administers payments. In exchange for compliance with a Chapter 13 plan, the debtor can keep his or her assets and a discharge of all debts is received when all payments have been made.*
7.	Consumer Debt	An individual or married couple that would otherwise desire to discharge debt in a Chapter 7 liquidation will be required to have a Chapter 13 or 11 payment plan if most of their debt is "consumer debt," which does not include debt that is the result of typical negligence, such as automobile accidents caused by a debtor.
8.	Means Testing	The term denoting the criteria by which a debtor who would file a Chapter 7 bankruptcy may be required to instead enter into a Chapter 13 bankruptcy, with a payment plan, or a Chapter 11 bankruptcy, as applicable.

Basic Bankruptcy Terminology

	Term	Definition
9.	Net Disposable Income	The amount that a debtor in a Chapter 13 repayment plan can be expected to pay over time in order to satisfy plan requirements.
10.	Chapter 11	A reorganization bankruptcy that will typically apply for businesses, investment entities, and individuals having large amounts of indebtedness or otherwise not qualifying for a Chapter 13 bankruptcy. **DISCUSSION/CONSIDERATIONS:** *The CARES Act has raised the amount of debt that a small business debtor can have while filing a Chapter 11 to $7,500,000. There were many changes in the Chapter 11 laws in 2019 and 2020. These are discussed in detail throughout this presentation.*
11.	Prepackaged Chapter 11	A Chapter 11 bankruptcy where there is advance agreement between the debtor and a sufficient number of creditors to allow for debt to be reduced in a bankruptcy proceeding in order to have the ability to avoid federal income tax on debt discharge or adjustment, and state law documentary, intangible and other transfer taxes that may not apply when transitions and transactions occur in bankruptcy.
12.	Debtor in Possession	A debtor with the right to maintain ownership and control of assets and activities in a Chapter 11 bankruptcy. The debtor in possession is a fiduciary and maintains operating control of the day-to-day business of the company. If the debtor in possession does not follow the rules or acts dishonestly the court can appoint an independent trustee to replace the debtor in possession.
13.	Bankruptcy Schedules	The schedules that must be completed accurately under penalty of perjury and filed with the bankruptcy court for a debtor to file a bankruptcy proceeding.

Subchapter V Bankruptcy

The Small Business Reorganization Act (SBRA) of 2019, enacted what is now known as a Subchapter V, which changed the bankruptcy law to be more debtor friendly by increasing the amount of debt that a small business debtor can have while qualifying in a Chapter 11 bankruptcy, and making the further change described below.

Effective February 2020 a small business debtor could have had up to $2,725,625 in debt and qualify to file a Subchapter V bankruptcy.

The CARES Act increased the threshold from $2,725,625 to $7,500,000, effective for cases filed after Friday, March 27, 2020.

In addition, the CARES Act eliminated the former requirement that any class or classes of unsecured creditors would have to vote on a plan in order to have the court approve the reduction or restructuring of debt.

After the CARES Act, unsecured creditors cannot vote, and secured creditors will be required to be subject to bankruptcy plan terms approved by the court, which will generally provide that a secured creditor’s claim cannot exceed the value of collateral secured by the applicable debt on the date that a Chapter 11 bankruptcy petition is filed.

This will make it much easier and cost effective for debtors to successfully reorganize under a Chapter 11 bankruptcy.

When To File a Chapter 11 Bankruptcy

Typically, a Chapter 11 bankruptcy should not be filed immediately before any creditor may act or refuse to act in any way that would have a catastrophic impact on the business.

In addition, a Chapter 11 bankruptcy should typically not be filed unless a plan of reorganization and a source of future revenue and income will be identifiable and in place within approximately 90 days of the filing of the Chapter 11 bankruptcy petition.

But on the other hand, if the collateral that secures the debt that is held by a creditor who will not be cooperative is lower now than it will be later, it can make sense to file a bankruptcy petition sooner than would otherwise be the case.

For example, where the collateral is accounts receivable and the Coronavirus business shutdown is still in effect, the value of such accounts receivable may be much lower than what it will be once the virus freeze lifts and things hopefully go back to some semblance of "business as normal."

Changes to Net Operating Loss (NOLs) Rules

- The 2017 TCJA provided that NOLs could no longer be carried back to previous tax years, and further provided that the deduction of NOLs was limited to 80% of taxable income.
- The CARES Act provides for a five-year carryback of NOLs for the 2018, 2019, and 2020 tax years.
- Temporarily suspends the 80% of taxable income limitation until 2021, meaning NOLs can offset 100% of taxable income for the 2018, 2019, and 2020 tax years.

	Pre 2017 TCJA	2017 TCJA Changes	CARES ACT
Carryback of NOLs	2 years	No carryback	5 Year Carryback for 2018, 2019 and 2020 tax year
Carryforward of NOLs	20 years	Indefinite	Indefinite
Limitation	Up to 100% of taxable income	Up to 80% of taxable income	2018-2020 – up to 100% of taxable income 2021+ - 80% of taxable income

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Changes to Excess Business Loss Limitation Rules

- Under the 2017 TCJA, an individual taxpayer could only claim up to $250,000 (or $500,000 if MFJ) for business losses.
- Amounts in excess of this amount are carried over to future tax years and treated as a NOL.
- The CARES Act delayed the enactment of this provision until 2021 and therefore allows taxpayers to fully deduct business losses for the 2018, 2019, and 2020 tax years.

Changes to Business Interest Expense Limitation

- The 2017 TCJA limited the deduction of interest expense to 30% of the taxpayer’s taxable income if average annual gross receipts for the previous three tax years exceed $25 million.
- The CARES Act increased the limitation to 50% of taxable income and additionally allows taxpayers to use their 2019 taxable income in applying the limitation for the 2020 tax year.

Section 108 – Income from Discharge of Indebtedness

Cancellation of Debt (“COD”) is in general treated as income and taxable as ordinary income unless the Cancellation is by one of the following reasons:

1. The discharge occurs in a Title 11 case (Bankruptcy Reorganization).

2. The discharge occurs when the taxpayer is insolvent.

3. The debt discharged is qualified farm indebtedness.

4. The debt discharged is qualified real property business indebtedness (does not apply to C-Corps)

5. The debt discharged is qualified principal residence indebtedness (only applies if prior to Jan. 1, 2018).

The taxpayer must reduce “tax attributes” by the amount excluded from income which generally would result in the reduction of NOLs, tax credits, capital or passive loss carryovers, or basis.

THE SECTION 108 INCOME FROM DISCHARGE OF INDEBTEDNESSS SHUFFLE

What entity will help protect a solvent taxpayer from income when his or her entity becomes insolvent and discharges debt?

DISREGARDED LLC

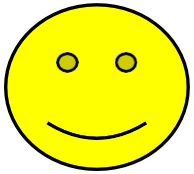
Income from discharge will be considered as having been received by the taxpayer/owner.

LLC TAXED AS PARTNERSHIP

Income from discharge will flow through pro-rata to each partner with insolvency determined at the partner level.

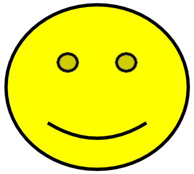
LLC OR CORPORATION TAXED AS S CORPORATION

Insolvency will be determined at the S corporation level and not flow through as K-1 income to the shareholder.



C CORPORATION

Income will be limited to the S corporation - many S corporations will convert to C corporation status before insolvency related sales or other transactions.



Partnership v. S Corporation- Which is Better to Hold Real Estate?

PARTNERSHIP	S CORPORATION
Advantages	*and Disadvantages*
Partners receive basis for indebtedness incurred by the partnership	Shareholders do not receive basis for indebtedness incurred by the corporate, unless the loan is made by such shareholder.
On the death of a partner, the partnership's (inside) tax basis of its assets can receive a step-up in income tax basis, if a Section 754 election is in place for the partnership	No similar basis adjustment mechanism applies to S corporations.
When a new partner buys into a partnership corporation, their depreciation write-off and underlying basis in their partnership interest will be based upon the price that they pay.	When a new shareholder buys into an S corporation, their depreciation write-off and underlying basis if and when the real estate is ever sold has to be based upon the historic basis and depreciation taken, versus being based upon the price they pay.
Appreciated real property can generally be distributed from the partnership tax-free to the partners.	Distributions of appreciated real property to the shareholders are treated as if the property was sold at its fair market value to the shareholders.
No restrictions apply as to who can own partnership interests.	S corporations can only be owned by certain individuals and trusts, and cannot be owned by non-resident aliens, corporations or partnerships
Partnerships can have more than one class of stock, and income and distribution preferences can be drafted in virtually any manner, so long as they have substantial economic effect	S corporations cannot have a "second class of stock," and income allocation and distribution rights must be pro rata to ownership
DOI income insolvency exclusion is determined at each partner's level.	DOI income insolvency exclusion is determined at the corporate level.

Cancellation of Indebtedness and S Corporations

- While LLCs owning real estate are normally recommended to be taxed as partnerships, or to be disregarded for income tax purposes, there are significant advantages to having leveraged real estate in an LLC that is taxed as an S corporation if there is a possibility that there will be debt that exceeds the value of the real estate, and a consequent loan workout to reduce debt owed to a lender, a foreclosure, or a possible reduction in debt due to future legislation.

- An S election can be made up to 75 days in arrears, but only if the Operating Agreement or other corporate documents do not have provisions that would not be permitted under the S corporation rules.

- Capital account language is normally contained in an Operating Agreement that has been prepared for the purposes of being taxed as a partnership or disregarded for income tax purposes and should now be eliminated along with other changes if the entity may want to make a retroactive S election.

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Cancelation of Indebtedness

- Cancelation of Debt ("COD") is in general treated as income and taxable as ordinary income.
- If the debt is discharged without a transfer of the property, all COD will be taxable as ordinary income.
- This is true for both recourse and non-recourse loans.
- If the property is transferred to the lender in satisfaction of the outstanding debt, then the examples on the following slides will apply.

Cancelation of Indebtedness

- If property subject to a recourse loan is transferred to the lender in satisfaction of the loan, then the transaction is bifurcated:
  - For example, if a property is worth $2 million with a basis of $1.8 million and a loan of $3 million, and the property is transferred to the lender in satisfaction of the loan, then the debtor will have
    - an ordinary gain of $1 million from the COD (Outstanding loan balance – FMV), **<u>and</u>**
    - a capital gain of $200,000 from a deemed sale (FMV – Basis).
- This result is created by the debtor being deemed to sell the property for FMV. Meaning a capital gain based on FMV and basis.
- The COD would be $1 million based on the COD income above the FMV of the property.

Cancelation of Indebtedness

- Assuming the same facts as the example on the prior slide, except that the debt is non-recourse, then the taxpayer would calculate his or her gain under Section 1001.

- Thus, if the outstanding loan was $3 million and the basis in the property was $1.8 million, the taxpayer would have a $1.2 million capital gain, assuming that depreciation recapture does not apply.

Strategies for Cancelation of Indebtedness

- (i) If the debt is to be settled, it should be done so in connection with the transfer the mortgaged property, whether to the lender or a third party.
- (ii) If the taxpayer is solvent, the taxpayer should maximize the amount of capital gain by obtaining the highest appraisal possible.
- (iii) If the debt is cancelled in bankruptcy, COD income may not be taxable pursuant to §108(a)(1)(B). In this situation, it may be best to settle the debt without a transfer of the property that secures the debt.

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Cancellation of Indebtedness and S Corporations, Continued

- If the property is in an S corporation that becomes insolvent, then the Section 108 Rules allow for no taxable income to be considered as received by the owners of the S corporation when it restructures its debt, and in situations where there will be taxable income recognized from a debt restructuring the S corporation may convert to being taxed as a C corporation to shield the shareholders from liability.

- This result is not available for disregarded LLCs or LLCs taxed as partnerships.

- Taxpayers should consider modifying their operating agreements now to allow for a retroactive S corporation election.

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Cancellation of Indebtedness and S Corporations, Continued

- Based on *Gitlitz v. Commissioner*, 531 U.S. 203 (2001), cancelation of indebtedness income realized by an insolvent S corp that is excluded pursuant to Section 108(a) will be considered income that increases a shareholder's basis. The flow through of this income takes place prior to the reduction of the S corp's tax attributes.

- The income should probably be reported similar to tax-exempt income on the K-1.


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Advanced Planning for S Corporation Losses

- S corporation shareholders can only use losses that flow through to them to the extent of the sum of (1) their basis in the stock and (2) loans that they have made to the corporation.

- In a great many situations, loans received by S corporations from the government will pay for losses that will not be deductible on the individual income tax return of the shareholders because of lack of basis, and will instead be carried forward.

- Shareholders may need to loan money to the company and allow the company to repay its debt owed to banks or other third party lenders, but this could have negative results if the company does not survive. Clients with this potential situation should consider working with their lenders to have the company repay the loan to the lender simultaneously with the lender loaning the money to the shareholder who will, in turn, be considered to have loaned the money to the company.

Advanced Planning for S Corporation Losses

Example: S corporation owes bank $1,000,000 on a loan secured by corporate assets, and will have considerable losses.

- Shareholder, who has guaranteed such loan, agrees to borrow $1,000,000 from the bank, using the corporate assets as collateral, and to transfer the $1,000,000 to the company as a loan from the shareholder, who will now owe $1,000,000 to the bank.

- No money changes hands, but at the end of the transaction, the shareholder owes the bank $1,000,000, and the corporation continues to have its assets pledged as collateral to the bank, and owes the shareholder $1,000,000.

- Now the shareholder can take $1,000,000 more in losses that flow through on the K-1 from the company's Form 1041 income tax return.

Basic Bankruptcy Terminology

	Term	Definition
28.	Fraudulent Transfer	A transfer which may cause loss of the ability to receive a bankruptcy discharge, if it has occurred within one year before the debtor files bankruptcy, or which may be set aside or subject a transferee to liability if it has occurred within two years before the filing of bankruptcy under the federal Bankruptcy Code, or for whatever longer period of time may apply under state law. **DISCUSSION/CONSIDERATIONS:** *These have nothing to do with fraud, and are also now known in many states as "voidable transfers". These can be set aside in bankruptcy if the filing is within the later of two years from the date of the bankruptcy or the applicable state law period, which is four years in most states (including Florida), and six years in some (including New York).* *In some states, it violates state law and/or ethical rules to assist a client in making such a transfer, and in others it does not.* *There are two types of fraudulent transfers. An "actual" fraudulent transfer is a transfer of an interest or obligation that is made with the intent to hinder, delay, or defraud any creditor. A "constructive" fraudulent transfer is a transfer of an interest or obligation by an insolvent or soon-to-be insolvent entity, without receiving reasonably equivalent compensation in exchange.*

Basic Bankruptcy Terminology

	Term	Definition
29.	Doctrine of Successor Liability	State law which provides that the successor owner of a business or investment arrangement will be responsible for the liabilities of the previous owner if there is a commonality of related ownership, business identity, customers, and business assets. An arm's-length Bankruptcy Court approved sale by a Trustee in Bankruptcy in a Chapter 7 or Chapter 11 Bankruptcy can avoid imposition of the doctrine. **DISCUSSION/CONSIDERATIONS:** *In some states the doctrine may be avoided by engaging in a non-Bankruptcy Assignment for the Benefit of Creditors.*

- The ability to override the doctrine of successor liability. The trustee may commence a Section 363(b) court approved sale to pay off the corporation's debts instead of going through the process of reorganizing. A Section 363(b) sale allows the debtor to sell assets "free and clear of any interest", which essentially preempts the doctrine of successor liability. Outside of the bankruptcy court the doctrine of successor liability may allow a creditor to recover from the "purchaser" of a business. Under this doctrine, when a successor purchases a business they also become responsible for any liabilities the seller may have incurred prior to the sale. This state law doctrine is not presumed; however it may apply when one of the following exceptions are met:
  - (1) Express or implied assumption of liability;
  - (2) Fraudulent conveyance to avoid liability;
  - (3) De facto merger;
  - (4) Mere continuation; or
  - (5) Product line exception, which applies when a successor acquires all of the assets of the other company and performs the same manufacturing operation.

Basic Bankruptcy Terminology

	Term	Definition
30.	Assignment for the Benefit of Creditors (ABC)	A statutory state law proceeding where the state court will oversee the sale or distribution of corporate assets and payment of expenses and liabilities so that creditors are fairly treated, and officers, directors and managers of the debtor entity can avoid liability for fiduciary duties owed to creditors if the ABC plan is approved and carried out. An ABC plan does not discharge debtors in most states or avoid application of the Doctrine of Successor Liability.
31.	Executory Contract	A contract between the debtor and third parties that may be binding upon the trustee in bankruptcy or debtor in possession, because there are contractual obligations on the part of both the debtor and the third party. This can be very important in the following situations: (1) Where the debtor owns LLC member or limited partnership interests and wishes to limit the creditor to having charging order protection in a jurisdiction that provides for this to be the sole remedy. A Limited Partnership Agreement or Operating Agreement may be executory when each partner or member has an obligation to make capital contributions, provide significant services, guarantee indebtedness, or carry out other material responsibilities.

Basic Bankruptcy Terminology

	Term	Definition
32.	Executory Contract continued	(2) A trustee in bankruptcy or debtor in possession may "reject" a non-executory contract, and thus not have legal responsibility, other than as to the damages that might be sued for by the other party. For example, a trustee may choose not to pay a promissory note or to continue with an Operating Agreement where the payee or other party has no affirmative obligations. On the other hand, an Operating Agreement where both the debtor and third parties have affirmative obligations to make capital calls, provide management services, and to guarantee obligations should be characterized as an executory contract, making charging order protection possible, if applicable under state law.
33.	Opting-In or Opting-Out	Every state in the United States has the ability to pass laws which require residents to use only the exemptions provided under state law, or to allow its residents to choose between the state law or federal law exemptions. A state can therefore "opt-out" of the federal exemptions, or a debtor residing in some states may "opt-in" to the state exemptions.
34.	Super Creditors	These are creditors that can break through the exemptions. Super Creditors presently consist of the IRS, the Federal Trade Commission, the Securities Exchange Commission, Medicare (for penalties), federal agencies for penalties, restitution owed to the government as the result of criminal conduct, and the Federal Deposit Insurance Company in some circumstances. **DISCUSSION/CONSIDERATIONS:** *The Small Business Administration also has special collection rights, as discussed in Chapter 9 of our book on Bankruptcy law and planning.*

Basic Bankruptcy Terminology

	Term	Definition
35.	Tenancy by the Entireties	A special status of property reserved for married couples which may be immune from the creditors of either spouse under state law. It is possible that debtors living in a non-tenancy by the entireties state will be able to protect assets held as tenants by the entireties in a state where this is recognized where only one spouse owes the creditor. This specifically includes real estate and has been held to include tangible personal assets by at least one Florida case. Tenancy by the entireties may protect homestead property even where it would not otherwise be protected because of the homestead protection exceptions that were passed in 2005. The six unities that are required to exist simultaneously for tenancy by the entireties to apply are as follows: (1) Possession; (2) Interest; (3) Title; (4) Time; (5) Survivorship; and (6) Marriage
36.	U.S. Trustee's Office	A federal criminal enforcement agency office in Bankruptcy Court buildings which investigates and prosecutes bankruptcy fraud and associated matters.

Basic Bankruptcy Terminology

	Term	Definition
37.	Contempt of Court	An equitable remedy that may be applied by a bankruptcy judge to force a debtor to go to jail in order to induce conduct with respect to making assets available to the trustee in bankruptcy under circumstances where the debtor is believed to have control over the assets or a third party in possession of the assets, or has inappropriately created an impossibility with respect thereto.
38.	Homestead Protection Exceptions	At present, a homestead exceeding $160,375 in value (or $320,750 for a married couple in bankruptcy if owned jointly), and otherwise exempt under state homestead creditor protection law, will be accessible to the trustee in bankruptcy to the extent of such excess net value if one of the following exceptions applies: (1) the home was acquired or its equity value was enhanced by one or more “fraudulent transfers” within ten years of bankruptcy being filed, with the exception to apply to the extent of equity attributable to such fraudulent transfers; (2) the homestead was acquired less than 1,215 days before bankruptcy is filed; or (3) one of the “bad conduct” exceptions under Bankruptcy Code Section 550(a)(1) applies. See the case of *Martinez v. Hutton* (*In re Harwell*), 628 F.3d 1312, 1314 (11th Cir. 2010) discussed in the materials that follow.
39.	Strip-down	Where a mortgage or other collateralized loan is reduced in a Chapter 11 or 13 bankruptcy to the value of the collateral. The excess indebtedness becomes unsecured, and a payment plan must provide for satisfaction of the collateralized debt over time - commonly five years with interest based upon a 30-month amortization schedule.

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Basic Bankruptcy Terminology

	Term	Definition
40.	Cramdown	Where a judge requires creditors to be owed less monies, or under different payment terms, notwithstanding the creditor's objection thereto.
41.	Concealment	The felony of misleading the Bankruptcy Court and creditors by having substantive ownerships and benefit from assets that are not reported as assets of the debtor on a bankruptcy schedule.

When Does Conduct In Contemplation of Bankruptcy Become Criminal?

- Intent to evade payment to the Internal Revenue Service, the Federal Trade Commission (FTC), the FDIC, and other governmental agencies in or out of bankruptcy.

- Concealment - dishonesty with respect to ownership or disposition of assets in bankruptcy, or in violation of anti-fraud laws that prohibit dishonesty with financial institutions and otherwise.

- Engaging in any illegal conduct whatsoever, no matter how minor, as part of a conspiracy that involves a greater crime, whether the participant is aware or not.

- And much more - consult with an ethical and well-qualified debtor/creditor bankruptcy law specialist in any questionable situation.

Lawyer Liability

A 2012 Florida case involved an attorney who became financially responsible for transfers made to avoid creditors that were processed through his trust account, because of a not so well-known provision of the Bankruptcy Code. This case, *Harwell*, establishes that a lawyer may be held liable in Bankruptcy Court for disbursing funds in the way a client wishes, if they are being disbursed with the intent to avoid creditors. The bankruptcy trustee moved to recover the funds under 11 U.S.C. § 550(a)(1) claiming the attorney was the initial transferee under the statute, which reads as follows:

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title [11 U.S.C. § 544, 545, 547, 548, 549, 553(b), or 724(a)], the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from--

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made;

Any intermediate or mediate transferee of such initial transferee.

After appeal, the Bankruptcy Court held that the attorney was the initial transferee and was liable to the trustee for the funds, as further discussed in Exhibit A.

Some transfers that are intended to defeat creditors may be illegal, such as transfers intended to evade collection of taxes by the Internal Revenue Service, under Internal Revenue Code § 7206(4) and 7201.

In addition, any person who (1) conceals a debtor's assets; (2) receives the debtor's assets fraudulently; or (3) transfers or conceals assets on behalf of a corporation intending to defeat the Bankruptcy Code may find herself, and possibly her lawyer, in prison for up to five years. Take for instance *U.S. v. Smithson*, in which the debtor and his lawyer were both convicted and served jail time for a transfer made two days before a bankruptcy filing.

Lawyer Liability

Prosecutors also apply 18 U.S.C. § 371, which prohibits individuals from committing fraud on the United States. The government must prove:

(1) an agreement between two people; (2) a scheme to defraud the United States; and (3) an overt act committed in furtherance of the agreement.

While many states have adopted the Uniform Trust Code, which prevents a normal creditor from reaching into a trust where the trustee can only make distributions as needed for the health, education and maintenance of the debtor, if the creditor is a governmental entity seeking penalties or reimbursement for "fraudulently" obtained monies, the creditor may be able to reach assets that would otherwise have to be paid by the trustee to the debtor based upon the trustee's fiduciary duty to make distributions.

In *U.S. v. Switzer*, an attorney was convicted of conspiring to transfer the assets of one corporation to another in contemplation of bankruptcy under both 18 U.S.C. § 371 and § 152 when the attorney counseled the client to transfer some of the corporation's inventory to another company and then auction off the rest of the company's assets. Switzer set up the transactions and prepared confessions of judgment for favored creditors. The transaction took place prior to the judicial sale for the trustee in bankruptcy's benefit. Switzer's conviction was upheld on appeal because he was found to have attempted, through his advice and participation in the transactions, to defeat the bankruptcy statutes, and thereby defraud the United States of the client's assets in bankruptcy.

In defending any estate or asset protection plan, it is important to have a paper trail that justifies the estate planning purposes behind the transfers, again assuming that the timing is in favor of the debtor. Documentation that proves adequate and reasonable non-creditor planning purposes for the transfers may provide a bankruptcy judge with sufficient ammunition to defeat efforts by a bankruptcy trustee to enforce a claim against the protected assets. For instance, if a debtor's medical condition is one factor that supports an estate or asset protection plan, it is wise to document the debtor's health and include letters or chart notes from treating physicians.

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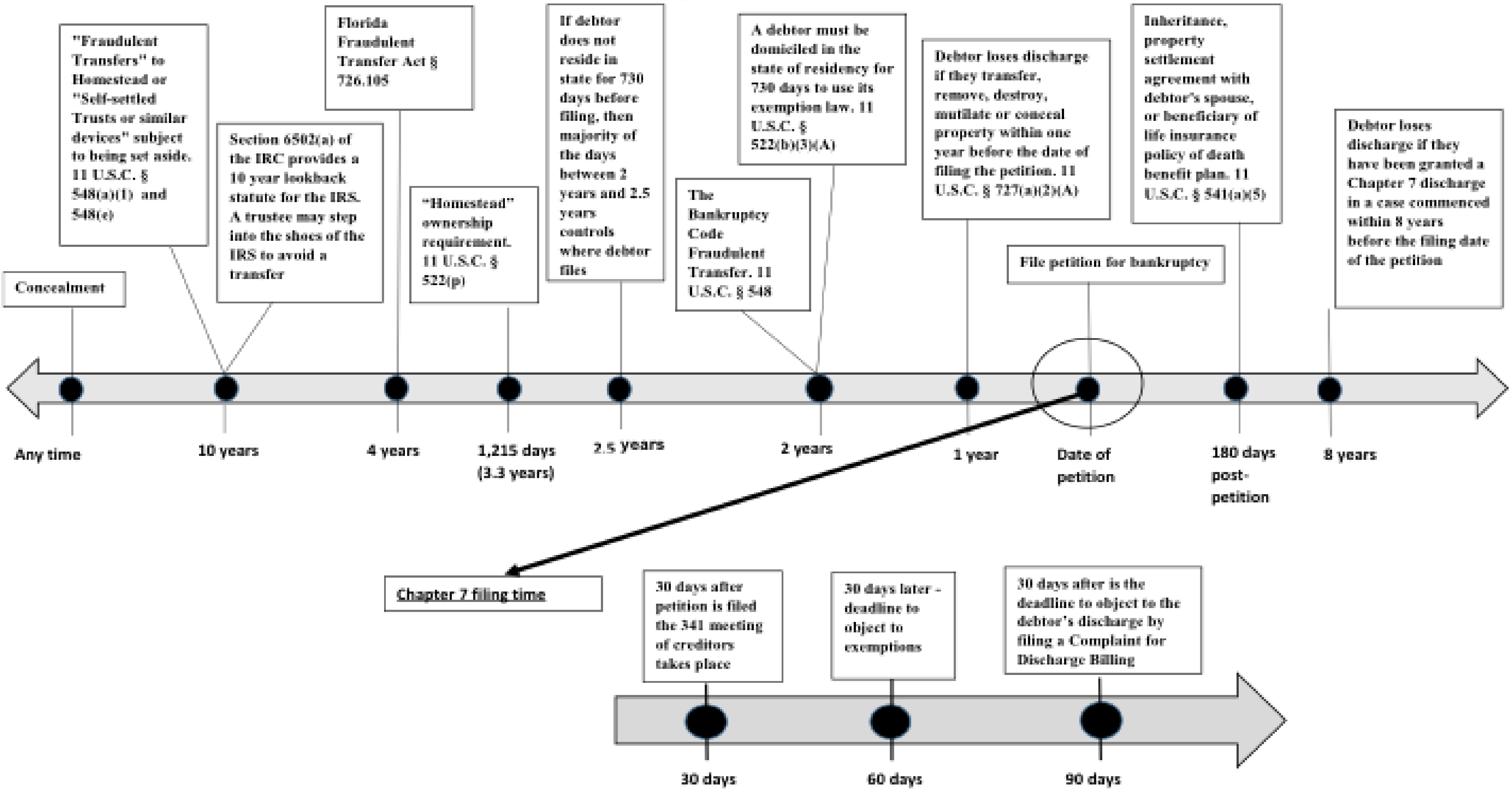
Basic Bankruptcy Terminology

	Term	Definition
42.	Net Operating Losses (NOLs)	These are tax losses which may be used in subsequent years by related parties or purchasers of a business entity, depending upon federal tax law.

Timing That Can Impact The Outcome Of A Bankruptcy Proceeding



Florida Laws – The Most Generous In The United States

<table>
<tr><th>CREDITOR EXEMPT ASSETS</th><th>ASSETS THAT ARE DIFFICULT FOR A CREDITOR TO OBTAIN</th><th>ASSETS EXPOSED TO CREDITORS</th></tr>
<tr><td>Homestead
-Up to half acre if within city limits.
-May be immune from fraudulent transfer statute.</td><td>Limited partnership and similar entity interests.</td><td>Individual money and brokerage accounts.</td></tr>
<tr><td>IRA
-Includes ROTH, Rollover, and Voluntary IRAs, but possibly not inherited IRAs.</td><td>Foreign trusts and companies.</td><td>Joint assets where both spouses owe money.</td></tr>
<tr><td>Permanent Life Insurance
-Must be owned by insured.</td><td>Note – foreign entities are very rarely recommended and must be reported to IRS –</td><td>Personal physical assets, including car, except for $4,000 exemption ($1,000 if homestead exemption is claimed in bankruptcy).</td></tr>
<tr><td>401(k)
-Maximize these!</td><td>Foreign bank accounts.</td><td>One-half of any joint assets not TBE where one spouse owes money.</td></tr>
<tr><td>Tenancy by the Entireties (joint where only one spouse is obligated)
– Must be properly and specially titled – joint with right of survivorship may not qualify.</td><td colspan="2" rowspan="8"><u>Vocabulary:</u>
EXEMPT ASSET – An asset that a creditor cannot reach by reason of Florida law – protects Florida residents.
CHARGING ORDER PROTECTION – The creditor of a partner in a limited partnership, limited liability limited partnership, or properly drafted LLC can only receive distributions as and when they would be paid to the partner.
FRAUDULENT TRANSFER – Defined as a transfer made for the purpose of avoiding a creditor. Florida has a 4 year reach back statute on fraudulent transfers. A fraudulent transfer into the homestead may not be set aside unless the debtor is in bankruptcy. It takes 3 creditors of a debtor who has 12 or more creditors to force a bankruptcy.
Upon filing a Chapter 7 Bankruptcy, an individual debtor may be able to cancel all debts owed and keep exempt assets, subject to certain exemptions.
Annuities and life insurance policies are not always good investments, and can be subject to sales charges and administrative fees.
There is a lot more to know– but this chart may be a good first step.</td></tr>
<tr><td>529 College Savings Plans</td></tr>
<tr><td>Annuity Contracts</td></tr>
<tr><td>Wages of Head-of-Household</td></tr>
<tr><td>Wage Accounts (for 6 months)</td></tr>
<tr><td>Up to $4,000 of personal assets – or possibly less in bankruptcy.</td></tr>
<tr><td></td></tr>
<tr><td></td></tr>
</table>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Peak Trust Company – AP 2

Staying Out Of Bankruptcy

Filing or being forced into bankruptcy can have terrible results. These include the following:

1. Loss of discharge (forever) if there has been a transfer to avoid creditors within a year before filing.
2. Concealment of assets in bankruptcy is a federal crime.
3. Transfers into homestead and asset protection trusts "and similar devices" can be set aside within ten years.
4. Transfers to avoid the IRS, and possibly transfers to avoid any creditor while the IRS was a creditor, will have a 9-year statute in bankruptcy.
5. Besides the 10-year homestead statute, a homestead property has to be owned for at least 1,215 days before filing, and the debtor must reside in the jurisdiction of the homestead for the 730 days before filing, or for most of the 180 days before the 730 days, if the 730 day requirement is not met.

   NOTE: Tenancy by the entireties protection where only one spouse is the debtor may still apply to protect a homestead.

6. Homestead is lost if the debt is the result of a white collar crime or willful or malicious conduct.
7. Preferential transfer rules – transfers from a company that goes bankrupt may be clawed back, and guarantors of corporate loans may be considered to have received "phantom payments" and be subject to claw back.
8. Possible loss of attorney/corporate privilege for corporate communications, or if one debtor "turns on" the others.
9. And more.

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Section 522(q) – Loss of Homestead exemption

11 U.S.C. § 522(q), reads as follows:

(q)(1) As a result of electing under subsection (b)(3)(A) to exempt property under State or local law, a debtor may not exempt any amount of an interest in property described in subparagraphs (A), (B), (C), and (D) of subsection (p)(1) which exceeds in the aggregate $125,000 if—

(A) the court determines, after notice and a hearing, that the debtor has been convicted of a felony (as defined in section 3156 of title 18), which under the circumstances, demonstrates that the filing of the case was an abuse of the provisions of this title; or

(B) the debtor owes a debt arising from—

(i) any violation of the Federal securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws;

or (ii) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase sale of any security registered under section 12 or 15(d) of the Securities Exchange Act of 1934 or under section 6 of the Securities Act of 1933;

(iii) any civil remedy under section 1964 of title 18; or

(iv) any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding 5 years.

Involuntary Bankruptcy

- Sometimes creditors will force a debtor into bankruptcy in order to have the advantage and oversight of federal bankruptcy law.

- Filing an involuntary petition is an aggressive creditor strategy and there are serious and costly consequences if the petition is dismissed. A creditor who files for an involuntary bankruptcy "in bad faith" can be forced to pay the debtor's fees, costs and actual and punitive damages.

- It is well established under Bankruptcy Code Section 303 that it takes three qualified creditors to force a debtor into bankruptcy if the debtor has twelve or more creditors with undisputed claims that together exceed a statutorily established amount.

Baker's Dozen: No Cupcakes for the Uninformed Debtor

by Alan Gassman and Lydia Greiner

I had 12 cupcakes and 3 ex-friends
When we get together, the fun never ends.

Many debtors prefer to stay out of bankruptcy for a number of good reasons,[102] however, under Section 303 of the Bankruptcy Code, a debtor can be forced into bankruptcy through an involuntary proceeding. It is well established under Bankruptcy Code Section 303 that it takes three qualified creditors to force a debtor into bankruptcy if the debtor has twelve or more creditors with undisputed claims that together exceed a statutorily established amount.

In determining which creditor (or three, if there are twelve or more) can force a debtor into involuntary bankruptcy, the court will evaluate the creditor's claims and whether they are non-contingent as to liability and amount and whether the claims are undisputed.[103] Additionally, for a proceeding under 11 U.S.C. § 303(b)(1), the court will need to determine whether the undisputed, non-contingent claims have an aggregate value of $15,775[104] "*more* than the value of any lien on property of the debtor securing such claims held by the holders of such claims."[105]

If there are fewer than 12 creditors, 11 U.S.C. § 303(b)(2) will apply. However, creditors proceeding under Section 303(b)(2) are still subject to some statutory requirements. The aggregate amount of the creditors' claims, for example, must be $15,325 or more.[106] Additionally, certain types of creditors, insiders, are not eligible to initiate the proceeding.[107] Unlike Section 303(b)(1), there is no additional requirement under Section 303(b)(2) that the creditor's aggregate claims exceed the value of any lien on the debtor's property securing the claims by the statutorily prescribed $15,775.[108]

Confusion arises when trying to determine what is an eligible creditor that may be counted as one of the twelve required in a Section 303(b)(1) proceeding. Whether a creditor is eligible to file for involuntary bankruptcy depends on their claim(s) against the debtor.

Although "creditor" only has one definition in these types of proceedings,[109] the type of creditor qualified to file for involuntary bankruptcy *may* differ from those counted in determining whether the debtor has a sufficient number of holders to initiate a Section 303(b)(1). Unfortunately for debtors, the definition of "creditor" under Section 303 is not as broad as the common law definition, and there have been a significant number of inconsistent court cases.


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Courts have reached different conclusions in deciding who is eligible[110] to count toward the required 12 or more creditors. While some illegitimate creditors may easily be identified and discounted, others require the court to examine factors related to the creditor's claim and the relationship between the debtor and creditor. These inconsistencies result in difficulty and confusion when trying to identify eligible creditors.

The primary categories of creditors that will be eliminated in determining if the 12-creditor requirement is met under a Section 303(b)(1) proceeding are as follows:

1. Creditors whose claims are contingent or not finally determined.
2. Creditors whose claims are adequately secured by collateral worth as much or more than is owed.
3. Creditors who are "insiders."

4. Creditors who owe the debtor more than the debtor owes the creditors.
5. Creditors who owe so little that the debt will not be considered to be "real."
6. Creditors who are considered to be an alter ego of the debtor.

Don't share cupcakes with insiders.
They aren't known to be providers.
You'll end up with just a wrapper,
And not feeling so dapper.

In determining the number of legitimate creditors who may trigger involuntary bankruptcy, insiders are a large group of creditors that include different individuals or entities depending on who the debtor is – a natural person, a fictitious entity, or a municipality.[111] Although an insider is not among the creditors who are counted when determining whether the debtor has a sufficient number of creditors to trigger involuntary bankruptcy under 11 U.S.C. § 303(b)(1), they are not barred from pursuing claims against the debtor if a proceeding is initiated.[112] Insiders in an involuntary bankruptcy context include:

(A) If the debtor is an individual --
- i. Relative of the debtor or of a general partner of the debtor;
- ii. Partnership in which the debtor is a general partner;
- ii. General partner of the debtor; or
- iv. Corporation of which the debtor is a director, officer, or person in control.

(B) If the debtor is a corporation –
   i. Director of the debtor;
   ii. Officer of the debtor;
   iii. Person in control of the debtor;
   iv. Partnership in which the debtor is a general partner;
   v. General partner of the debtor; or
   vi. Relative of a general partner, director, officer, or person in control of the debtor.

(C) If the debtor is a partnership –
   i. General partner in the debtor;
   ii. Relative of a general partner in, general partner of, or person in control of the debtor;
   iii. Partnership in which the debtor is a general partner;
   iv. General partner of the debtor; or
   v. Person in control of the debtor.

(D) If the debtor is a municipality, elected official of the debtor, or relative of an elective official of the debtor.

(E) Affiliate or inside of an affiliate as if such affiliate were the debtor.

(F) Managing agent of the debtor.[113]

Additionally, the requirement of "generally not paying such debtor's debts" may resonate differently with different courts depending on where the creditors filed for the involuntary bankruptcy action. Courts will use a totality of the circumstances test and balance the interests of the parties in determining whether a creditor pursuing an involuntary bankruptcy action should be dismissed. A few factors that most courts examine include: the number of unpaid claims; the amount of the claims; the materiality of the non-payments; and the debtor's conduct in financial affairs.

Further, the court in *In re The District of McAllen* found that ad valorem tax authorities, insiders, persons that owe more money than they are owed, and lease deposits that are contingent do not count to make creditors eligible to join an involuntary bankruptcy action, while de minimis claims do count.[114]

There have been many notable decisions, including one by the U.S. Court of Appeals for the Fifth Circuit in *Denham v. Shellman Grain Elevator*,115 where the bankruptcy court refused to count small and recurring claims as "countable" under the 12 creditors' requirement. One Florida bankruptcy case, In re Smith, cited Denham and excluded creditors holding de minimis claims of up to $275.116 Other cases have permitted claims of $65 and $10 to be countable under the Section 303 requirement that the aggregate claims must equal or exceed $12,300.

Courts that have chosen not to follow Denham, and to instead allow small and recurring claims to count, have dismissed the de minimis exception based upon the premise that Congress has not explicitly ruled out small and/or recurring debt, so the statute117 should be applied literally.118 Some courts, however, such as the court in Matter of Runyan have indicated that a $25 debt would not be sufficient, and will evaluate the claims on a case-by-case basis.[119]

While there is no bright line rule to determine which creditors are "legitimate creditors," in every situation involving an involuntary bankruptcy proceeding, the table below may help to provide some general guidelines.

I like cupcakes,
And I eat quite a few,
But every so often,
Instead I get a screw.

Who is a Legitimate Creditor in an Involuntary Bankruptcy Proceeding under 11 U.S.C. § 303			
Factor or Type of Claim	**Legitimate Claim?**	**Law**	**Cupcake?**
Contingent claims	No	Statute: 11 U.S.C. § 303	
Subject to a bonafide dispute as to liability	No	Statute: 11 U.S.C. § 303	
Subject to a bonafide dispute as to amount	No	Statute: 11 U.S.C. § 303	
Held by insiders of the debtor* (See definition from statute above)	No	11 U.S.C. § 303	
Debtor's debt has an aggregate value less than $15,325	No	11 U.S.C. § 303	
Employee	No	11 U.S.C. § 303(b)(2)	
Former Employee	Yes	*In re Demirco Group*, 343 B.R. 898 (B.C. C.D. Ill., 2006).	
Transferee of a voidable transfer	No	11 U.S.C. § 303(b)(2)	

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Who is a Legitimate Creditor in an Involuntary Bankruptcy Proceeding under 11 U.S.C. § 303			
An indentured trustee representing a holder	No	11 U.S.C. § 303	
Creditor to whom debtor's debt is not yet due**	No	*Atlas Machine & Iron Works, Inc. V. Bethlehem Steel Corp.*, 986 F2d 709 (VA Ct. App. 4, 1993).	
Lenders who make loans to debtor without formal loan documentation paperwork	No	*In re Smith*, 415 B.R. 222 (BC ND Tex, 2009).	
Debtor's Accountant	Yes	*In re Blaine Richards & Co.*, 10 B.R. 424 (B.C. E.D. NY, 1981).	
Debt for gasoline when purchased using a credit card	No	*In re Blaine Richards & Co.*, 10 B.R. 424 (B.C. E.D. NY, 1981).	
Small recurring or de minimis claims	Yes	11 U.S.C. § 303; *In re Elsa Designs, Ltd.*, 155 B.R. 859 (B.C. S.D. NY, 1993).	

***Insiders are not prohibited from filing a claim against the debtor; they are only excluded from consideration in determining debtor's legitimate creditors.[120]**

**** A creditor who is paid on time is unable to bring a claim against the debtor, and, thus, the claim would be subject to dispute.[121]**

File Proper Liens Without Delay

Reach out to clients who are owed monies by their business or investment entities.

It can be crucial that any loans or advances from shareholders or related parties be documented with appropriate promissory notes, and also be secured by liens that are properly recorded against real estate (as mortgages) against tangible and intangible non-real estate assets (by Uniform Commercial Code UCC-1 filings), and against any valuable automobiles or other motor vehicles that would be liened by proper registration with applicable State Division of Motor Vehicles and the U.S. Coast Guard with respect to large boats. Failure to have this completed more than one year before the filing of a bankruptcy or a state court creditor action could be catastrophic.

Third Party Spendthrift Trusts

- An interest in a spendthrift trust is excluded from the bankruptcy estate.
  - 11 U.S.C. § 541(c)(2), reads as follows:

    (2) A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title.

  - Therefore, State law will be determinative, and estate planners need to draft very carefully to help assure that inheritance and beneficial trust rights will not advertently be accessible to creditors.
  - The basic rule is that a creditor cannot force a trustee holding assets for the benefit of a beneficiary to give the creditor any of those assets if the trustee has absolute discretion as to if and when to ever make a distribution. See *Safanda v. Castellano.*

Self-Settled Spendthrift Trusts

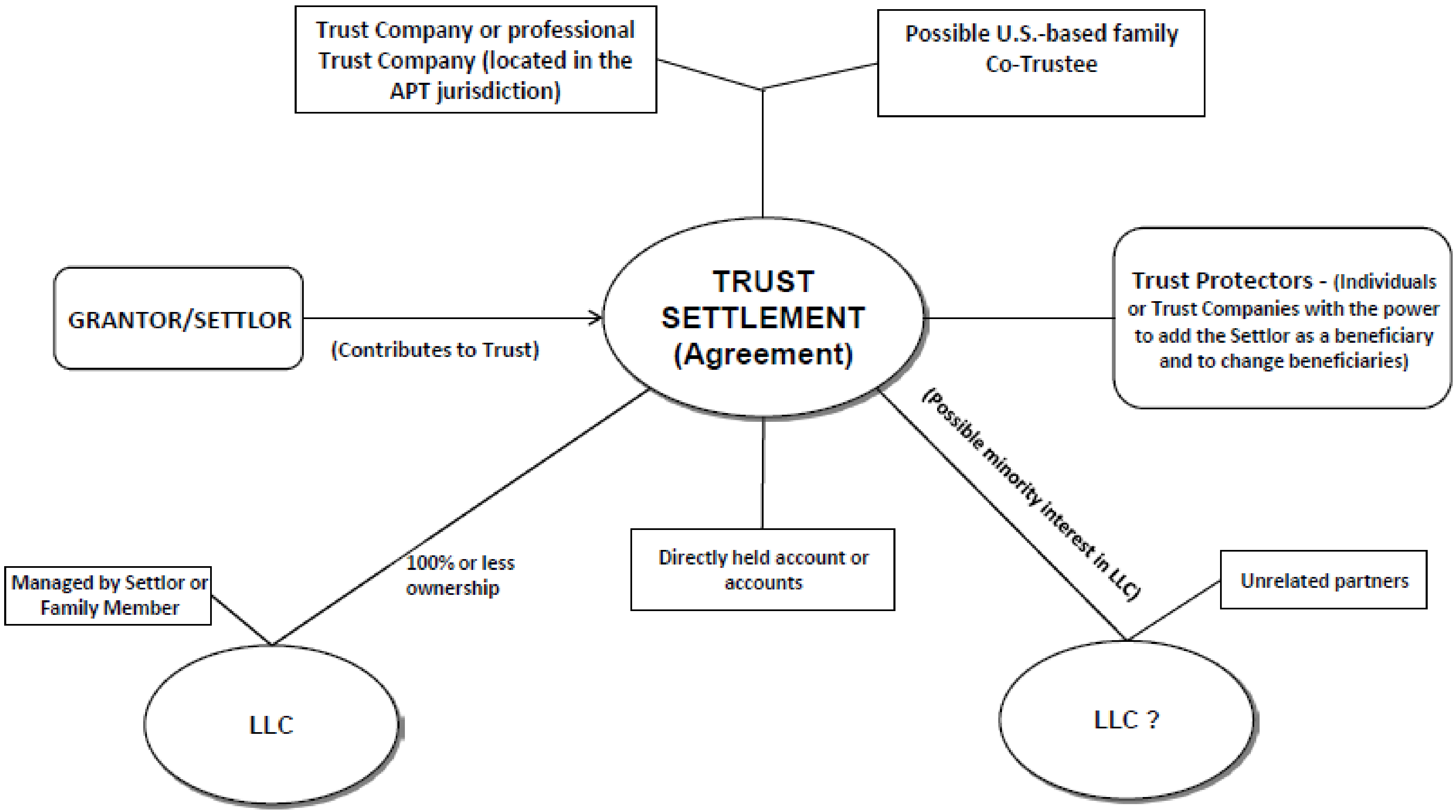
- Florida does not recognize self-settled spendthrift trusts; however, a client may have their trust created under Nevada, Alaska or South Dakota law.

- The following is excerpted from a CCH publication that was recently released on Domestic Asset Protection Trusts by Martin Shenkman and Alan Gassman:

<u>Self-Settled Trusts</u>

The number of states permitting domestic asset protection trusts ("DAPTs") has continued to grow, and some of the newer states joining the ranks have endeavored to push the envelope of protection further in terms of increasing the protection available. This process, as illustrated in the *Klabacka* case discussed below, has been respected by some courts. Meanwhile, the crescendo of DAPT naysayers has grown. The discussion of the UVTA below raises additional concerns about DAPTs. There are positive DAPT developments. In addition to the growing number of DAPT states increasing, and the *Klabacka* case, consider that after decades of practitioners using self-settled domestic asset protection trusts the only cases holding against them have all involved bankruptcy or fraudulent conveyance situations. So while DAPTs may be effective, some practitioners have moved in the direction of using alternative approaches when possible.

The Anatomy of a Typical Offshore or APT State Trust Arrangement



The Anatomy of an Asset Protection Trust

1. Trustee – The Trustee holds the trust assets for the benefit of the beneficiaries pursuant to the terms of the Trust Agreement.
2. Trust Settlement – This is the Trust Agreement, and should be drafted by competent legal counsel with an understanding of:
   a) The law of the jurisdiction
   b) United States tax law
   c) Trust and creditor protection law in general
3. Scheduled Beneficiaries – These are the initial named beneficiaries that the trust is established for. Reputable offshore trust companies will require passports, utility bills, professional letters of reference, and sometimes affidavits from each beneficiary when the trust is established.
4. Trust Protectors – These are individuals and/or trust companies who have certain powers over the trust:
   a) To change the Trustee or Trustees – commonly any replacement Trustee must be a reputable trust company or a lawyer practicing in an asset protection trust ("APT") jurisdiction.
   b) The power to add beneficiaries who are not "excluded persons."
5. Flee Clause a/k/a Cuba Clause – A provision that requires the Trustee to move the trust and trust assets to another jurisdiction in the event of a governmental change, or if a judicial challenge to the trust makes it possible that the trust assets would be invaded within a short period of time.
6. United States Judgment – A judgment from a United States Court, which means nothing whatsoever in the jurisdiction where the trust is sitused (located). In most reputable APT jurisdictions, the creditor will have to file a brand new lawsuit in the jurisdiction and obtain a new judgment against the debtor before then attempting to set aside the trust by proving that the trust is an alter ego of the settlor or a beneficiary, or that the transfer to the trust was for the primary purpose of avoiding creditors.

The Anatomy of an Asset Protection Trust

7. APT Legislation – Special laws passed in a number of offshore jurisdictions which make it extremely difficult, if not impossible, for a creditor to pierce an APT:

8. Contingency Fees Not Permitted – In most asset protection jurisdictions, lawyers must charge their clients by the hour, and not on a contingency fee basis.

   a) Belize has no statute of limitations – unless there is a judgment against the settlor in Belize on the day the trust is formed, Belize law will protect the trust.

   b) Court Registry deposit requirement – Nevis requires a 100,000 Nevis dollars ($37,037.04) deposit into the Court Registry before a trust can be challenged. A 100,000 Nevis dollars ($37,037.04) deposit is also required to challenge an LLC. A Nevis trust and LLC challenge will therefore require a 200,000 Nevis dollars ($74,074.07) deposit.

9. Conflict of Interest Considerations – Typically, there are between two to six dozen practicing lawyers in a popular asset protection trust jurisdiction. Most or all of these lawyers have done work for the more popular trust companies, and would therefore have a conflict of interest in pursuing a trust for a creditor – lawyers from outside of the country must therefore come in as “foreigners before the court” to be admitted to practice law there to challenge the trust.

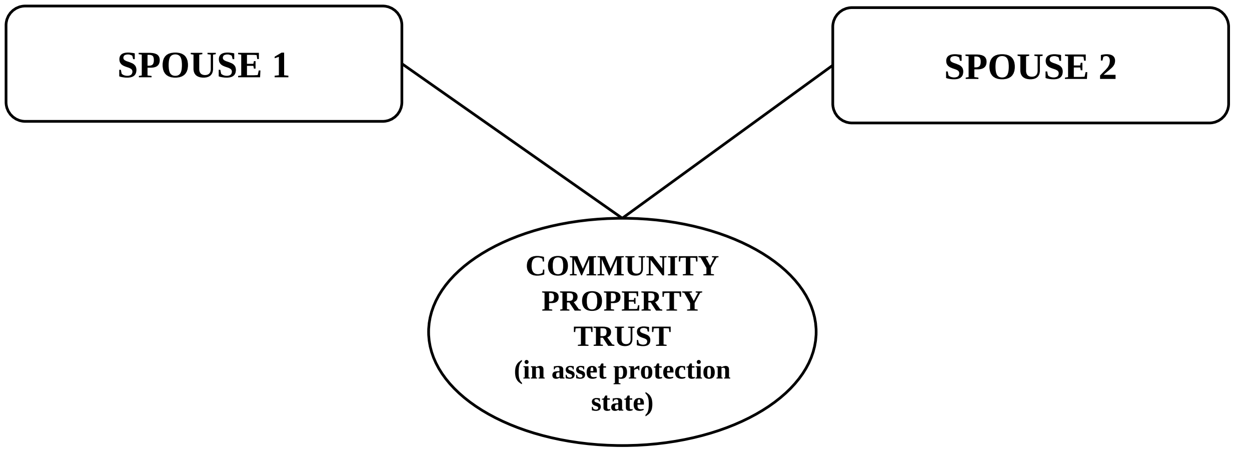
10. Judicial Bias - The asset protection trust jurisdictions derive significant income and lawyer work, not too mention governmental fees that support the local economy. The last thing an asset protection trust jurisdiction economy needs would be a judicial decision that lets creditors into a well intended asset protection trust that was structured in advance.

11. Having Your Cake and Protecting it, Too - The Trustee of the APT can own a 99% limited partnership interest or the ownership of an LLC, with the entity being managed responsibly and transparently by the general partner or manager, which may be the settlor. If and when a challenge might occur, the settlor may transfer control of the subsidiary entity to the Trustee of the trust.

Planners may recommend separating/transmuting community property to avoid all assets being subject to the claims of the creditors of either spouse, or possible use of Alaska or Tennessee Community Property Asset Protection Trusts

(If couple resides in a Community Property State)

Community Property Trust



* May offer creditor protection in asset protection state.

* Step-up basis is more well assured than with JEST - see Zaritsky/Blattmachr articles.

* Deduct your next trip to Alaska to discuss this with Doug Blattmachr.

** See "Tax Planning with Consensual Community Property: Alaska's New Community Property Law (written by Zaritsky/Blattmachr/Ascher) at:

http://www.jstor.org/stable/20782170?seq=1#page_scan_tab_contents

Community Property States

- ✓ Arizona
- ✓ California
- ✓ Idaho
- ✓ Louisiana
- ✓ Nevada
- ✓ New Mexico
- ✓ Texas
- ✓ Washington
- ✓ Wisconsin

NOTE: Alaska and Tennessee are opt-in community property states that give both parties the option to make their property community property under a trust that can protect from creditors and enable all assets to receive a new fair market value date of death income tax basis if one spouse dies.

Homestead Creditor Protection

- In Florida, there is unlimited protection for homestead property and improvements thereon of up to a half-acre in the city or 160 acres in the county, provided the owner is an individual (or perhaps a revocable trust) who resides on the property and is a U.S. citizen or Green Card holder.

- The person must be a permanent resident of Florida and intend to make the property his or her permanent residence.

- Need not qualify for real estate homestead tax exemption to have the benefit of Constitutional creditor protection.

- Florida homestead protection "trumps" fraudulent transfer statutes (*Havoco of America, Ltd. v. Hill)*

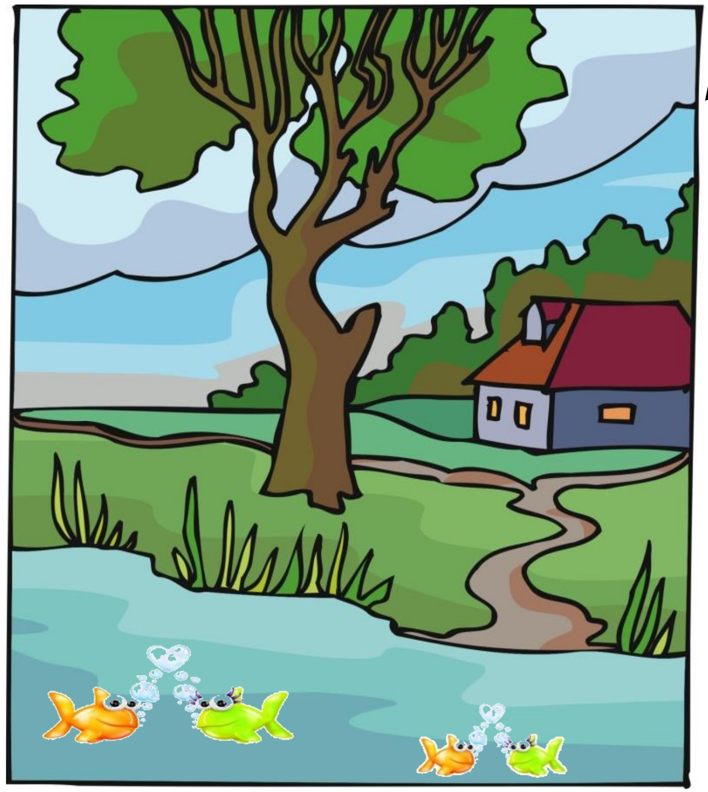
- Beware of bankruptcy law limitations and the ten-year fraudulent transfer look-back period.

Segregated Homestead Planning

Creditors lost in the swamps

Excess Property

Driveway Easement



1/2 Acre Waterfront Home

Buying the House or Condo Next Door

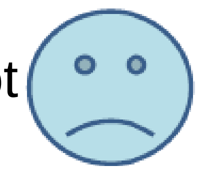
- An adjoining vacant lot may not be considered homestead where it has not been used or considered by logistics and fencing, etc., to be part of the homestead estate. This was the result in *In re: Estate of Ritter*, 407, So. 2d 386 (Fla. Dist. Ct. App. 3d Dist. 1981) where the property in question was never jointly fenced with the residents and was merely a separate, empty lot which served, at best, as an excess side yard to the residence.

- When clients buy adjoining homes, they will be well-advised to make sure that there are no fences between the homes and to build pathways, integrated use, and coordinated appearance from the road and otherwise to promote the concept that the two separate houses are a single homestead. The second house may be referred to as a storage/exercise/guest house.

Protecting the Proceeds From the Sale of a Homestead from Creditors

- **FROM HOMESTEAD SALE DIRECTLY INTO A NEW REPLACEMENT HOMESTEAD** – Florida law will allow the proceeds of a sale of homestead to be invested in a new homestead within a reasonable period of time with continued protection.

- **FROM HOMESTEAD TO OTHER EXEMPT ASSETS** – Unfortunately, homestead is the one exempt asset that cannot be transferred into another type of exempt asset due to an error by the Florida Supreme Court.



- **However**, it is permissible to borrow on a protected homestead and transfer the proceeds to another exempt asset**.**

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Homestead Tax Protection and Planning

- For some clients it is important to make sure that the Homestead tax exemption (up to $50,000) and the 3% cap per year or the Consumer Price Index, whichever is less, on valuation increases for property tax purposes will be available.

- It is possible for the homestead to be owned by an irrevocable trust for the beneficial interest of one party while receiving the homestead exemption attributable to the home being resided upon by another party who signs a ninety-nine (99) year lease on the property.

- Recent legislation allows an individual owning a homestead with a value significantly greater than the capped Tax Assessor value described above to "port" the advantages of the exemption they have in one house into a replacement house based upon some fairly complicated rules.

Other Unique Homestead Activities

- Separate homesteads for separated spouses (but for tax exemption purposes, counties will require separate income tax returns, and that each spouse is separately supporting himself or herself).

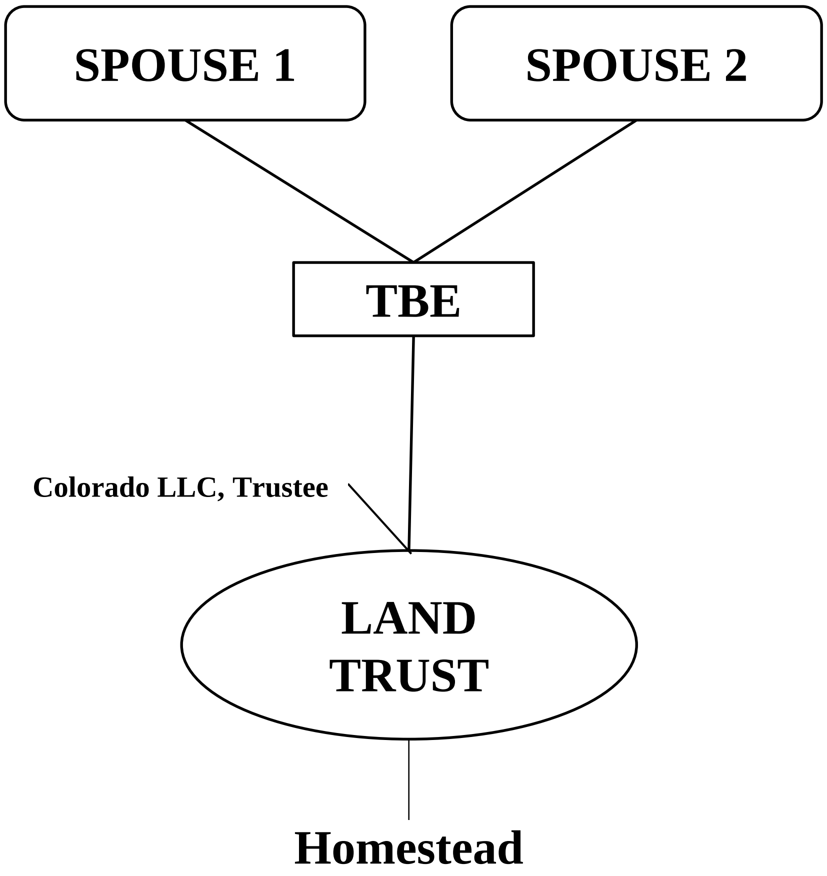
- Mobile homes, houseboats, and other unique homesteads.

- Placing homestead in the name of another.

- Remember the 2005 Bankruptcy Act 1,215 day ownership rule and 730 day occupancy rule – homestead is only protected in bankruptcy for up to $160,375 per debtor if it has not been owned for 1,215 days and occupied for 720 days before filing. (See subsequent slide.)

  Also, there is a 10 year look back on fraudulent transfers into a homestead once the debtor is in bankruptcy. Stay out of bankruptcy by having at least 12 creditors. If the debtor has 12 creditors it takes 3 of them to force the debtor into bankruptcy.

Homestead Confidentiality Arrangement



Homestead Disposition/Devise Limitations

- The Florida Constitution prevents a married homeowner from transferring or mortgaging the homestead property without the consent of the owner's spouse, or an appropriate waiver. Consider using an LLC to avoid such requirements.

- The Florida Constitution restricts the devise of the homestead on death if the owner is survived by a spouse or minor child, except that homestead may be devised to the owner's spouse if there is no minor child, or may be owned jointly with right of survivorship with a spouse.

- However, the Florida Constitution does not address how homestead property descends upon the death of the owner of the homestead. The descent of homestead property is controlled by Fla. Stat. 732.401, which now gives the surviving spouse a choice (effective October 1, 2010):
  - a life estate (the right to live there for life) with remainder interest owned by the decedent's descendants; or
  - a 50% tenant in common interest between the spouse and decedent's descendants.

Not Every Home Will Grow at an “Average Rate”

by Frank Catlett and Alan S. Gassman

Frank A. Catlett is a State-Certified General Real Estate Appraiser (FL), General Real Estate Appraiser (NC), and Certified General Real Property Appraiser (GA) with over 37 years of experience. Mr. Catlett is President of Trigg, Catlett & Associates, located in Tampa, Florida, which provides appraisal and brokerage services to not only the Tampa Bay, but most parts of Florida as well as North Carolina.

A great many senior Americans borrow money on “Reverse Mortgages” based in part on being told that their homes will go up in value with “national or regional averages,” which is often not the case.

For many of these homeowners, the better decision would be to downsize and not try to hold onto more house than they can afford. The decision to stay in a house that is too large causes the loss of investment resources in return and increased expenses. One national study has indicated that the cost of maintaining a home is based upon 3.53% of its value. Having a $200,000 home, when only a $100,000 home is needed, may therefore cost the senior citizen not only the investment return on $100,000, but also an additional 3.53% or more per year in expenses for utilities, taxes, insurance, and maintenance.

The reverse mortgage industry has encouraged many seniors to stay in their “too large” homes, based in part upon showing them projections that will indicate a likelihood of a 4% per year increase in value.

In fact, a 2013 actuarial report prepared for the US Federal Housing Administration (FHA) has indicated that a “worst case scenario” bottom 25th percentile Monte Carlo simulation has predicted that home prices could go down by more than 20% between 2014 and 2018 and might not recover to 2018 levels until 2024. While the “average home” in a given area can be expected to increase in value on average over a term of years, the retiree’s home will typically be expected to go up in value at a slower rate, if it does go up in value, for the following reasons:

Wisdom About Your Home

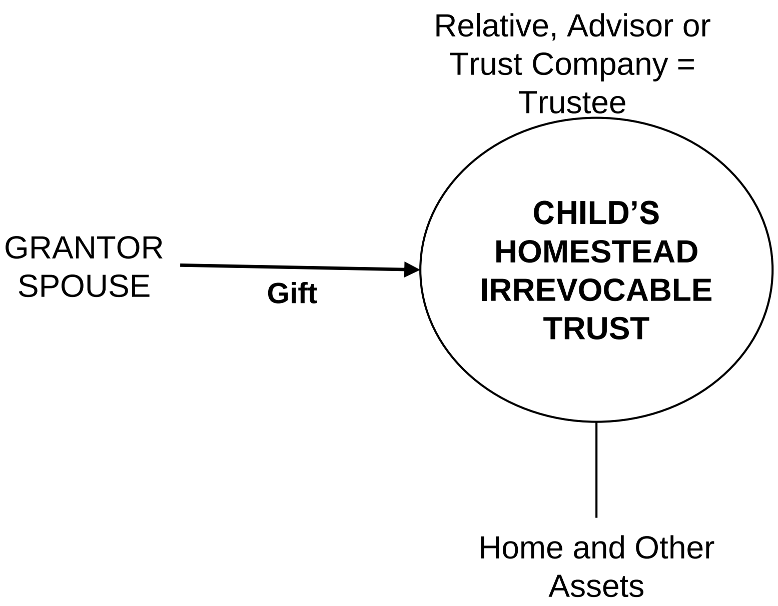
- Buying a completed home from a reputable contractor or builder with excellent warranties, after close inspection, is acceptable.
- Buying a home that you will remodel anytime soon, or building your own home, can be a much more expensive, unpredictable and stressful experience.
- Buying a used home with close inspection that includes review for mold and Chinese wallpaper is normally the best move.
- Please see a psychologist before concluding that you need more than 3,500 square feet to live a comfortable life with your family. Anything over 3,500 square feet is luxury or for in-laws or more than two children.
- One of the best things about any house is who the neighbors are. It may be a great strategy to raise your children in an upper middle class environment, and not in a “rich people only” gated community.
- Your home will grow in value at less than average, because your home is one year older every year.

Wisdom About Your Home, Cont'd

- 1 divided by 60 years is 1.667% depreciation per year. If houses are going up by 4% a year, then your house is going up in value by 2.33% a year, and you have to maintain it!
- If acquisition and selling costs are 10%, then you have to live in the home 4.3 years on average to recoup the cost of buying and selling it.
- "I would rather rent than own" is not a bad conclusion if you would otherwise buy a house that is too small or not where you will eventually settle.
- Statistically speaking, there is as much chance of losing money as there is in making money if you will hold a house for less than 4 years.
- The money you set aside for your future "dream home" in ten years will hopefully grow at a much higher rate than 2.33% per year. A long term conservatively allocated stock and bond or mutual fund equivalent portfolio may average 10% over ten or twenty years by comparison, and doesn't leak when it rains, develop mold, or need to be repainted or redecorated.

Child's Homestead Irrevocable Trust

- Can own a home used by a child to benefit the spouse and descendants
- Can qualify for the State Homestead Exemption and 3% cap
- Can be considered as owned by the Child for income tax purposes to qualify for the $250,000 income tax exemption on sale
- Can be controlled by the Trustee and used for the benefit of various family members
- Will insulate family members from liabilities associated with ownership of the home



Trust assets can be applied for the health, education, maintenance and support of the Trustee-Spouse and children.

One or more children may reside in the house to qualify for the Florida Tax Homestead Exemption.

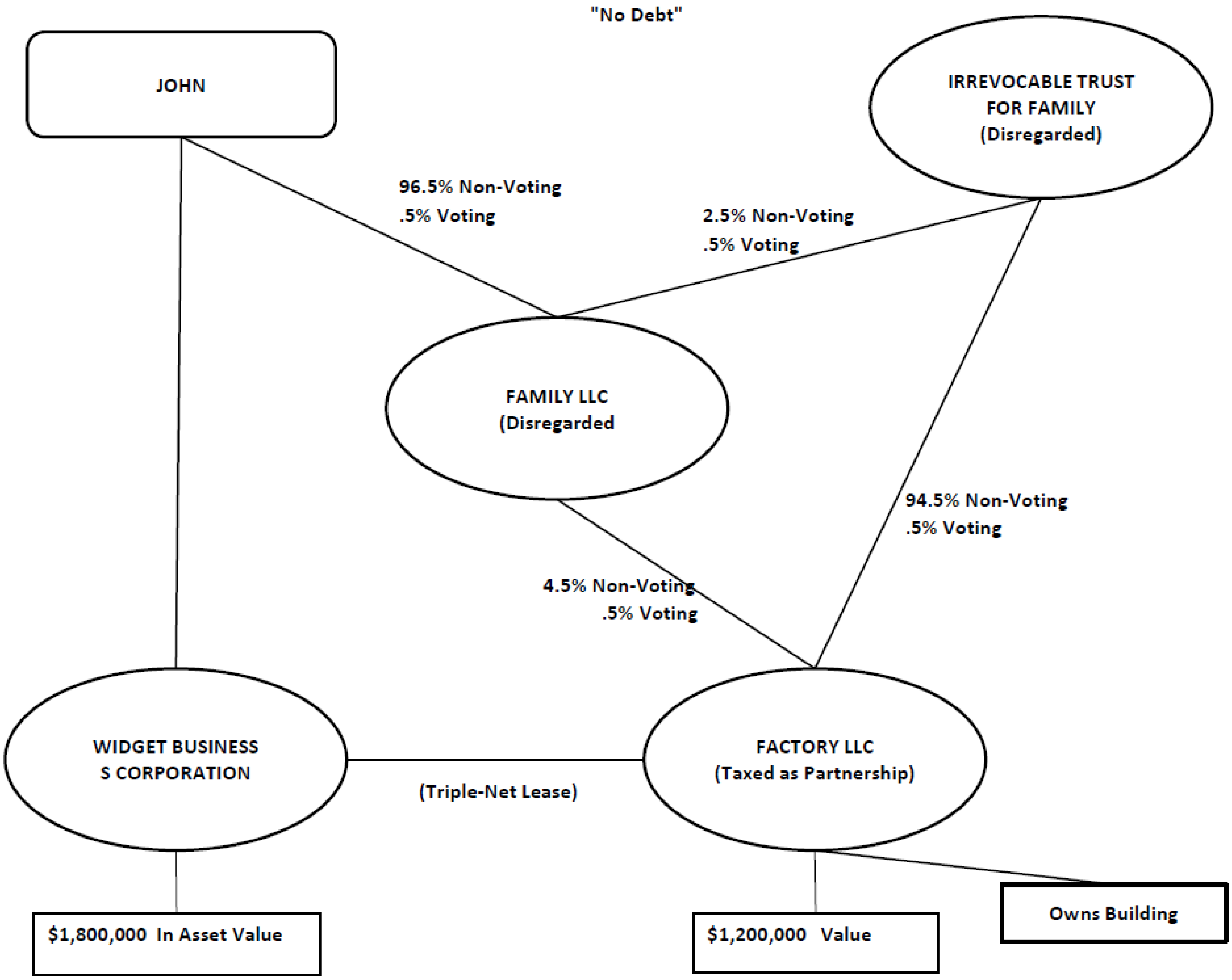
For income tax purposes, the Trust can be considered as owned by the child who lives in the house so that the house can be sold income tax free to the extent of up to $250,000 in appreciation.

The Trust will not be subject to creditor claims of any family member unless (1) the transfer to the Trust by the Grantor Spouse is a "fraudulent transfer," or (2) the child has a right to withdraw more than the gift tax exclusion amount in any calendar year.

NOTE – The Trust must be appropriately drafted, funded, and administered to achieve the above results.

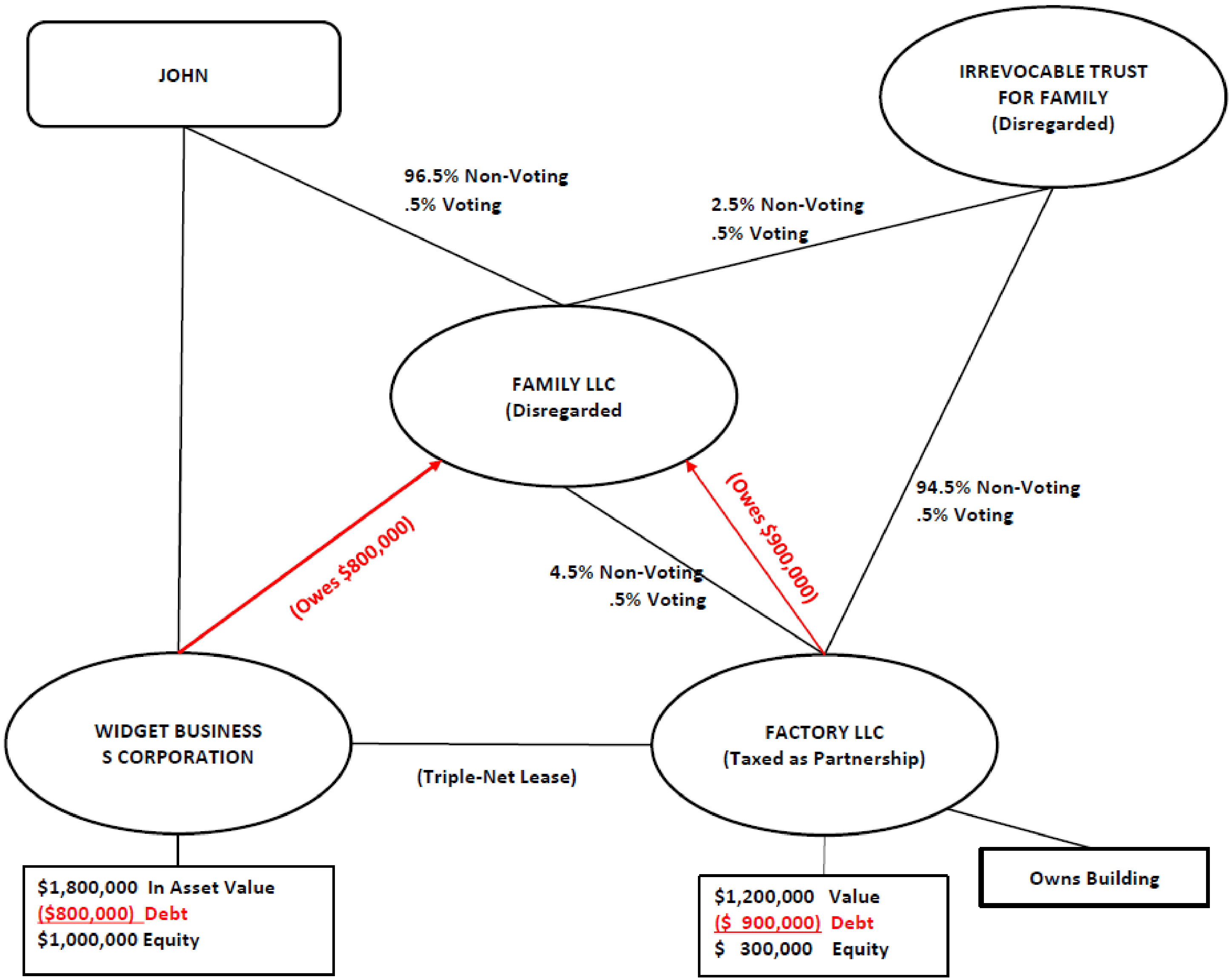
UNDERUSED PLANNING TECHNIQUES

Leveraged Entities That Own Businesses, Real Estate and Other Assets

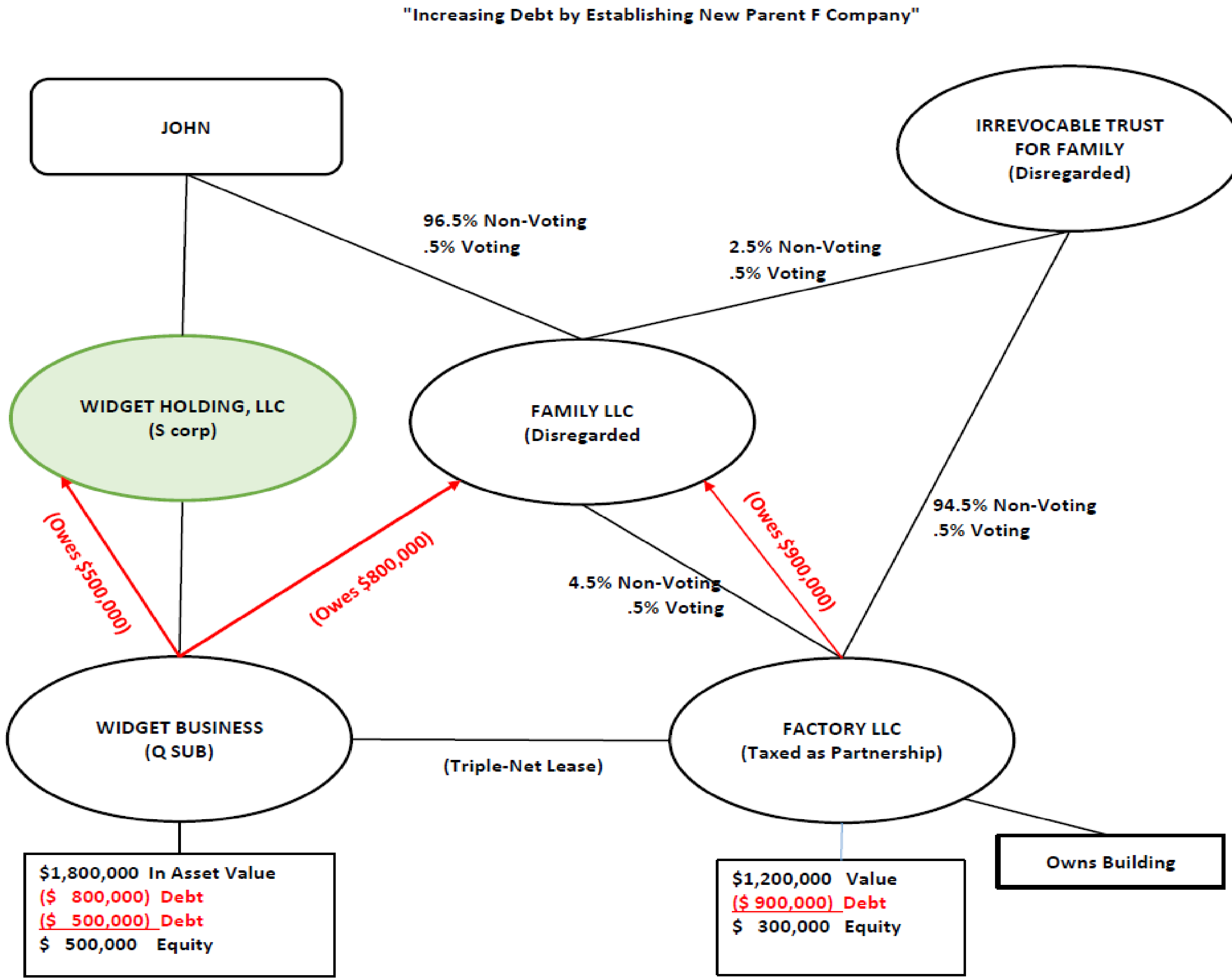


Leveraged Entities That Own Businesses, Real Estate and Other Assets

"With Maximum Debt Possible Without Triggering S Corporation Income"



Leveraged Entities That Own Businesses, Real Estate and Other Assets



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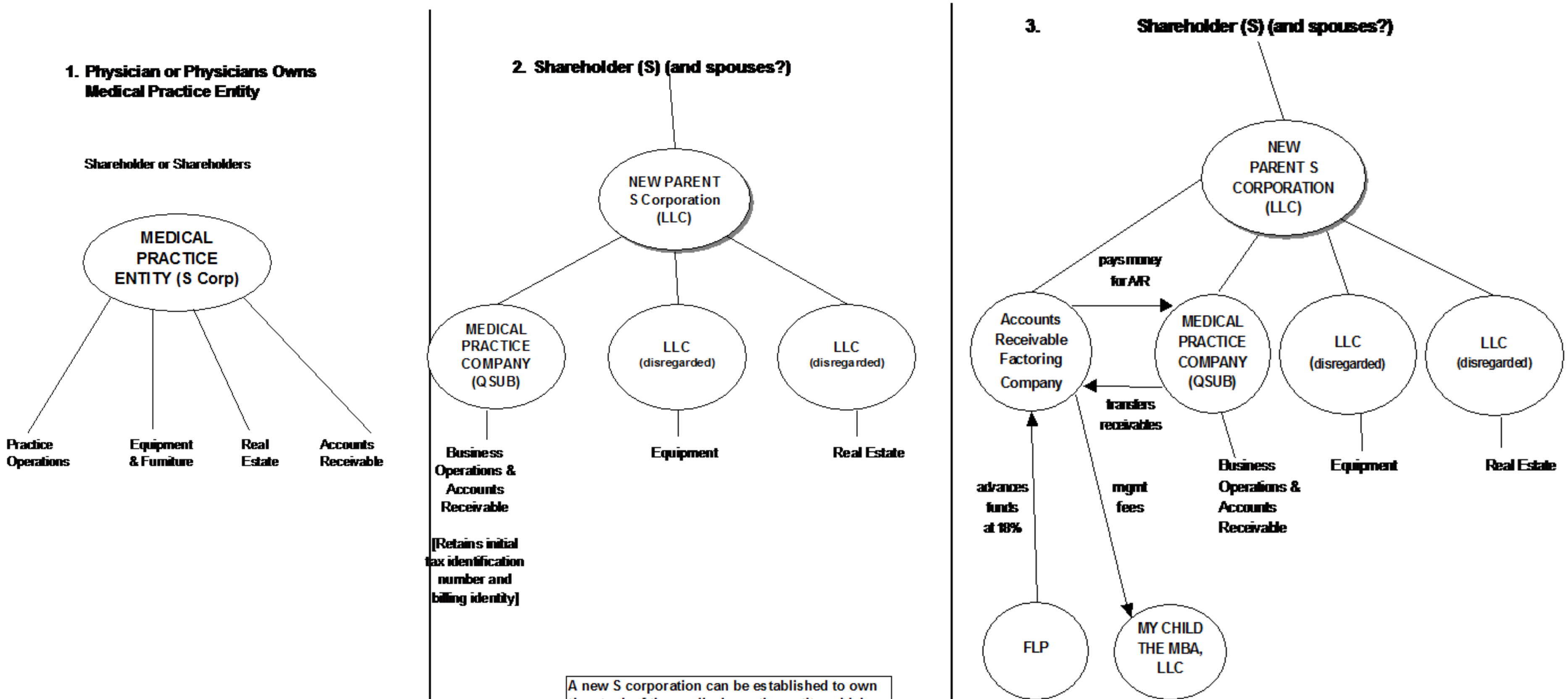
New Parent F Reorganization

(Showing Accounts Receivable Factoring Arrangement)



Initially we have a medical practice entity where valuable assets are exposed to potential malpractice and other entity liabilities.

A new S corporation can be established to own the stock of the medical practice entity, which becomes a qualified subchapter S subsidiary. It can then transfer valuable assets income tax free to other LLCs owned by the same new parent company to protect assets from future creditors of the medical practice entity.

To obtain income tax planning advantages for affiliated family members and entitites, a separate accounts receivable factoring company can be established to work along the lines of the Extended Letter of Protection (ELOPE) System shown in other materials.

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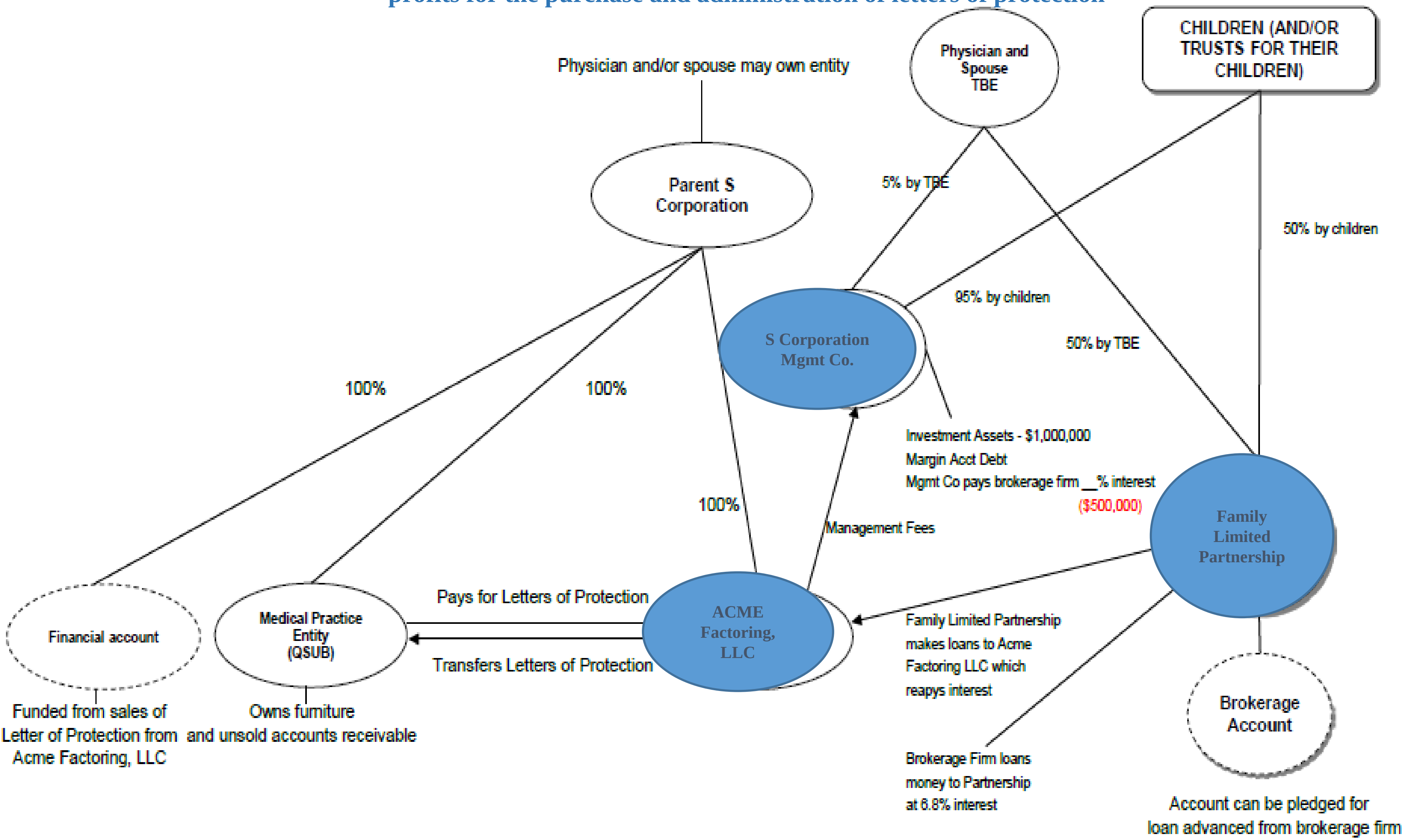
Extended Letter of Protection Enhancement (ELOPE System)

To enable a Family Limited Partnership and child-owned management entity to derive reasonable profits for the purchase and administration of letters of protection



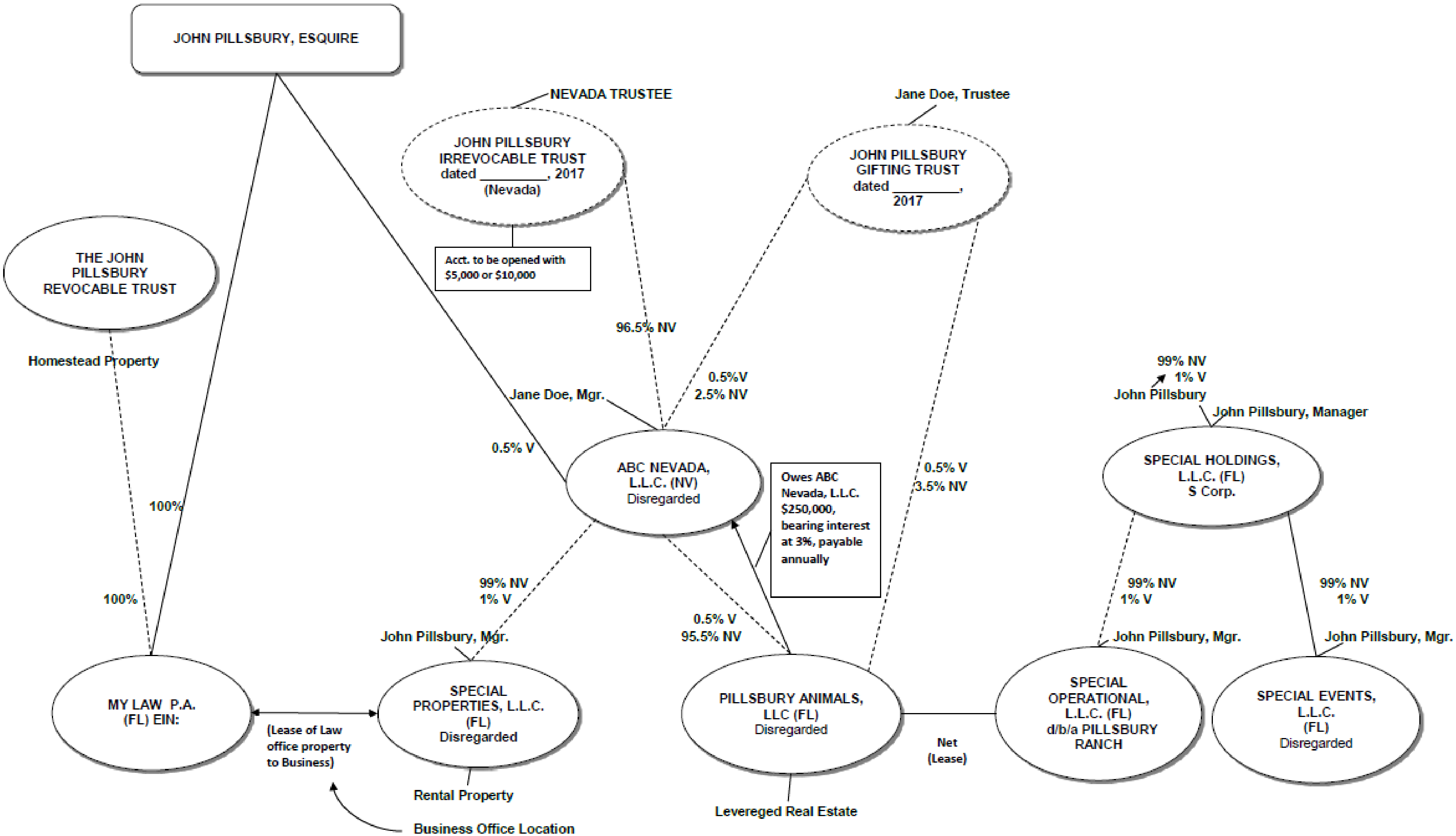
Have a Friendly Judgment Against You

If a debtor with a reasonable income and $200,000 of exposed assets has three separate creditors with potential judgments of $800,000 each, a friend of the debtor can approach each creditor and offer to buy the judgment. The creditor willing to sell their rights to pursue a judgment for the least amount (perhaps $125,000) can sell it to a company that the debtor invests in.

The company obtains the judgment, files it of public record against the debtor in the amount of $800,000, and the debtor can pledge the debtor's assets as additional collateral for a work out that allows the debtor to pay $50,000 a year for three years. Upon default, whatever is left of the $800,000 becomes due and payable.

Are the other two creditors now going to pursue this debtor? Would there be anything for them to get if they do?

Leases and Master Leases, Illustrated



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Confer with a Good Actuary

Quite often clients are underserved with respect to retirement planning. This is often the result of product or general brokerage houses and banks that sponsor simple retirement plans without extensively trained planned design and maintenance personnel.

One example is the possible use of a 401(k) plan that uses the 3% safe harbor. Such a plan can be set up so that the 3% contribution is not required. The client can decide before the end of each year whether the safe harbor contribution will be made for the year, and must give notice to all participants by the end of November stating whether or not the 3% contribution will be made. This is often known as the “flexible safe harbor” or “maybe safe harbor” or “wait and see safe harbor plan.” Many physician groups should be checking with their pension advisors to see if their plan has the flexible safe harbor feature. A plan with a required safe harbor match cannot be managed on a flexible basis.

Appropriate pension planning can also include cross-testing and defined benefit planning.

Cash balance/401(k) plan ABC, Inc.

Name	Age	Compensation	Cash Balance Contribution	401(k) Deferral & Catch-up	Safe Harbor PS Contribution	Additional PS	Total
Owners							
Owner 1	54	$275,000.00	$184,000.00	$24,500.00	$0.00	$100.00	$208,600.00
Owner 2	49	$275,000.00	$141,000.00	$18,500.00	$0.00	$100.00	$159,600.00
Total		$550,000.00	$325,000.00	$43,000.00	$0.00	$200.00	$368,200.00
Non-Owners							
Employee 1	59	$30,000.00	$750.00	$0.00	$900.00	$921.00	$2,571.00
Employee 2	52	$30,000.00	$750.00	$0.00	$900.00	$921.00	$2,571.00
Employee 3	34	$30,000.00	$750.00	$0.00	$900.00	$921.00	$2,571.00
Employee 4	25	$30,000.00	$750.00	$0.00	$900.00	$921.00	$2,571.00
Total		**$120,000.00**	**$3,000.00**	**$0.00**	**$3,600.00**	**$3,684.00**	**$10,284.00**

		Total Employer Contribution to Owners	Total Employer Contribution to Non-owners	Total Employer Contribution to Owners and Non-owners
		$325,200.00	$10,284.00	$335,484
		96.93%	3.07%	100.00%

The presenters would like to thank Stephen Evers at Ascensus TPA Solutions for providing us with this slide

Comparison of maximum contributions

	DB	DC*
Employee age 60	$254,000	$61,000
Employee age 55	$194,000	$61,000
Employee age 50	$148,000	$61,000
Employee age 45	$113,000	$55,000
Employee age 40	$ 87,000	$55,000

Anticipates 401(k) plan catch-up contributions.

Please note: The above numbers are approximations. Actual results will vary based on actual census data, plan assumptions and plan experience.

The presenters would like to thank Stephen Evers at Ascensus TPA Solutions for providing us with this slide.

Employee Census

Name of Employer:

Provide complete information for all employees employed during the year, even if they have terminated.

Employee Name	Date of Birth	Date of Hire	Date of Termination	Annualized W-2 Compensation	Hours per Week	Ownership %

With special thanks to Martin S. Shenkman, Esquire for the use of this slide.

Roth IRA Conversion

Converting an IRA to a Roth IRA and paying the income tax triggered from unprotected assets may be a useful and easy to implement asset protection step.

If state law protects both the IRA and the post-conversion Roth IRA the conversion will use up liquid assets held outside the protection of the IRAs, e.g., funds in a brokerage account, to pay the income tax triggered on the conversion. The result will be full post tax dollars protected by the Roth IRA rather than merely pre-tax dollars protected in the regular IRA.

Roth IRAs have no mandatory distribution rules for the plan holder so dollars will not have to be removed from that protective structure as they eventually will from a regular IRA.

Yes, Your IRA Can Own a Business – the ROBS

Excerpt from Leimberg LISI Newsletter #668, 07-Feb-17, thanks to Steve Leimberg. Full copy available upon request.

Subject: Brandon Ketron & Alan Gassman: *Can I Use My IRA to Start a Business? Maybe, But With Great Power, Comes Great Responsibility.*

EXECUTIVE SUMMARY:

One potential way for an entrepreneur to fund a new business is with his or her retirement plan assets. This is known as a Rollover as Business Start Up Plan (ROBS).

A typical ROBS plan involves forming a new C-Corporation and adopting a simple 401(k) plan. The entrepreneur can then roll over his or her IRA account into the new 401(k) plan. The 401(k) plan then purchases stock in the new corporation. This results in the funding of a new corporation with the entrepreneur's former IRA account.i

While ROBS Plans do not violate the prohibited transaction rules per se, the IRS heavily scrutinizes these plans to ensure their compliance with these complex rules. If a Plan Participant engages in a prohibited transaction, the plan will be disqualified and result in a deemed taxable distribution of the entire account balance, which will also be subject to the 10% excise tax if the Plan Participant is under the age of 59 ½.

It is important to note that while a ROBS plan may satisfy the retirement plan rules initially, any failure to comply with the rules during the life of the plan will also result in a deemed distribution of the entire retirement plan.

Rollover as Business Start Up Plan (ROBS)

Step One – Newco adopts simple 401(k) plan

Step Two – Individual rolls over his or her IRA into 401(k) plan.

Step Three – 401(k) plan purchases stock in Newco

Result – Funding of Newco with IRA account

Benefits:

1. The ability to fund a business with Retirement Assets while avoiding taxes on withdrawal and the 10% penalty on early withdrawals.

2. An alternate to traditional debt based financing.

3. Gains from the sale of stock in the business will be deferred until the assets are withdrawn from the Retirement Account.

4. A creditor protected vehicle that can be safeguarded notwithstanding judgments against a 401(k) account holder who may also receive wages for services rendered that may be creditor protected depending upon applicable state law

Rollover as Business Start Up Plan (ROBS) – Too Good to be True?

The IRS heavily scrutinizes this type of arrangement. The following are some potential traps for the unwary involved with the establishment and maintenance of a ROBS plan:

1. Personal Guarantees of Corporate Loans
2. Payment of Reasonable Compensation to Owner
    a) IRA owned business cannot pay compensation to IRA owner.
    b) Unlike an IRA, ERISA rules do not prevent an employee from taking a reasonable salary from a 401(k) owned business, although the IRS may argue that the immediate payment of compensation to the Entrepreneur results in the indirect use of plan assets for the benefit of the individual. Entrepreneurs may consider only taking a salary from the profits of the company in order to avoid this characterization.
3. Providing Direct or Indirect Services to an IRA
4. Lack of Notification of Plan Existence
5. Plan Assets Used for Personal Expenses
6. Stock Sale Must Be a Transaction for Adequate Consideration
7. Improper Use of Funds to Pay Promoter Fees
8. Discrimination in Favor of Highly Compensated Employees
9. Failure to Issue a Form 1099-R when the Assets Are Rolled Over into the ROBS Plan.
10. Failure to file 5500's

What about life insurance or annuity contracts with offshore carriers that own entities that hold investments and businesses?

- Florida offers unlimited protection of life insurance and the cash values of annuity contracts. The life insurance and annuity industries have come to market with mutual fund wrapped products that provide income tax deferral and creditor protection for policyholders and their families.

- Florida Statute Section 222.14 provides as follows:

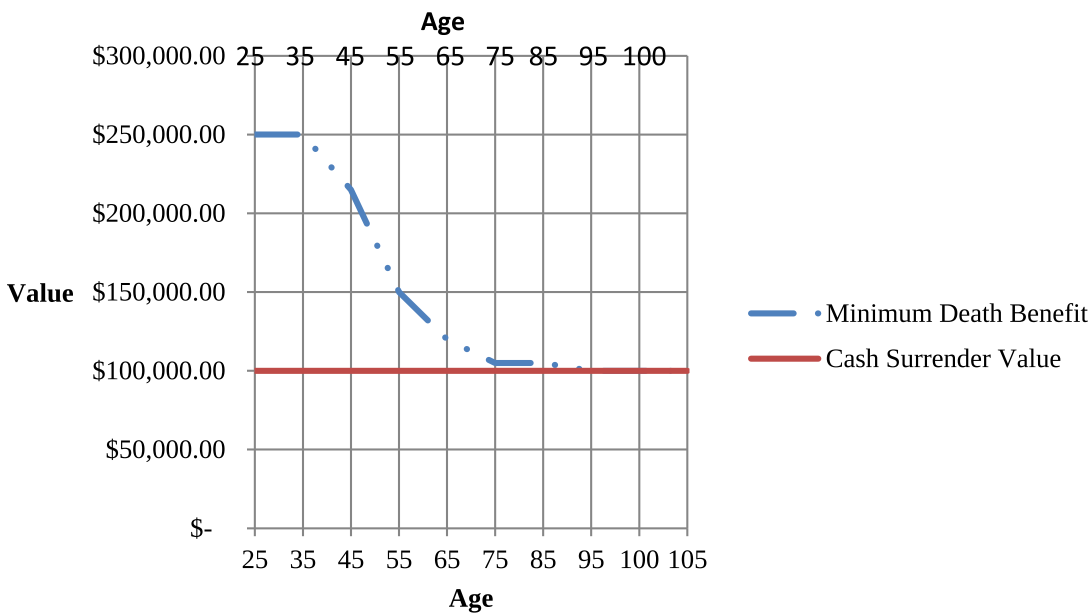
> **Exemption of cash surrender value of life insurance policies and annuity contracts from legal process. -- The cash surrender values of life insurance policies issued upon the lives of citizens or residents of the state and the proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor of the person whose life is so insured or of any creditor of the person who is the beneficiary of such annuity contract, unless the insurance policy or annuity contract was effected for the benefit of such creditor.**

This applies to variable annuities pursuant to a Florida Supreme Court decision.

	Term Life	Whole Life	Universal Life	Variable Universal Life	Guaranteed Universal Life	Equity Index Life Distinguishing Feature
Distinguishing Feature	Provides protection for a specific period	Lifetime protection for as long as premiums are paid	Guaranteed minimum interest rate on investments accumulated in the accounts – interest rates are based on bonds only and can be higher than the minimum guaranteed	Combines premium and death benefit flexibility of universal life with investment choice of variable life	Death benefit is guaranteed if specified premiums are made timely for a given period of years	No loss of cash value in negative stock market years – rate of return will be a portion of index performance
Premium	Fixed, but will increase at each renewal	Fixed	Flexible since they are set by the policyholder	Flexible, like universal life	Fixed	Flexible, like universal life
Cash Value	None	Guaranteed	Account value minus the surrender charges	Not guaranteed; depends on performance of stocks	Can generate significant cash value (albeit at a higher premium)	See above
Death Benefit	Face amount of policy if death occurs within the term	Face amount of policy if in force when death occurs	<u>Option A:</u> maintain level death benefit <u>Option B</u>: face amount increases as cash value grows <u>Option C</u>: death benefit increases to facilitate a return of all premiums on death	Same options as universal life	Guaranteed if premiums paid timely; accelerated death benefit rider for chronic and terminal illness	Same options as universal life
Can Borrow Against Cash Value	N/A	Yes	Yes	50%; Subject to Regulation U	May lose “no-lapse” guarantee	Depends upon policy
Cash Value at Risk if Carrier Fails	N/A	Yes	Yes	No	Yes	Yes
Can be Sold without Series 6 License	Yes	Maybe	Yes	No	Yes	Yes
Life Settlement	Yes	Maybe	Yes	Maybe	Yes	Yes
Regulated By	State	State	State	FINRA and State	State	State

Tax Talk

Minimum Corridor Test Illustration
$100,000 Cash Surrender Value
Minimum Death Benefit



Insured's Age	Percentage
40 or less	250%
45	215%
50	185%
55	150%
60	130%
65	120%
70	115%
75	105%
80	105%
85	105%
90	105%
95 or more	100%

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A good reason to go offshore with life insurance policies – besides to escape State Regulators with regard to investments, and have the added advantage of foreign asset protection laws that apply.

Hampton Freeze

Crag T. Hampton is a tax lawyer who invented or popularized the "Hampton Freeze" in 1995.

The Hampton Freeze is based upon the premise that the mortality element of a life insurance policy can be provided through appreciation in the cash value of a policy. However, the policy owner must be restricted from controlling or directing the assets held by the insurance company in a separate account for the lifetime of the policy.

There are reputable private placement life insurance carriers that are willing to structure policies using the Hampton Freeze, and there are reputable law firms that will issue opinion letters thereon.

Typically a regular policy will be amended to become a Hampton Freeze policy when the insured reaches an older age where a mortality clauses are more material.

The amount received upon death is the sum of:

1. The guaranteed amount of the death benefit from the life insurance policy; plus
2. The cash value on the date of death, less any loans, expenses and fees; plus
3. The policy's mortality reserve value, which is the appreciation in the policy's segregated account less the amount of cumulative premiums.

The amount received upon surrender is the lesser of:

1. The case value (defined in #2 above); or
2. The sum of all premiums paid

Frozen cash value structures are only available in the offshore markets. They don't work in the United States because they are intentionally designed to fail Section 7702(b)(c) of the Internal Revenue Code.

Instead, these structures rely on Section 7702(g) which refers to contracts that qualify as life insurance under "applicable law," which has been interpreted to mean state law, territorial law or foreign law.

Can a private placement life insurance policy own a term life policy in order to provide the necessary death benefit?

Off-shore private placement life insurance is typically more expensive than domestic life insurance because of the higher mortality costs that apply in the life insurance industry outside of the U.S.

There is nothing in the Internal Revenue Code which prevents having the mortality feature of a life insurance policy based upon one or more term policies that the carrier can own under the policy "wrapper".

There are reputable private placement carriers and U.S. law firms willing to use this technique and provide opinion letters as well.

MEC (MESSY ECONOMIC CONUNDRUM)

A life insurance policy that does not qualify under Section 7702A test at any moment in time becomes a MEC, which can have extremely negative tax results.

1. Once outside the "one year to fix it" grace period, the policy can never go back to non-MEC status, even if the insured had no notice that this was happening.

2. Any withdrawal brings income tax out first (LIFO).

3. Any borrowing or pledging can trigger income and is treated as if a withdrawal was made in an amount equal to the loan amount.

4. A 10% excise tax on income applies unless the owner for income tax purposes is over age 59-1/2.

5. Big surprise – dividends used to pay premiums and/or interest on policy loans are taxable to the owner as if distributed.

6. Prominent disclosure of the above does not occur – even the small print does not properly explain the above.

7. When there is limited but some basis, consider exchanging for multiple policies to withdraw more basis when needed. Example: One MEC with $200,000 basis and $400,000 cash value. The owner needs $200,000. Divide into 2 $200,000 cash value policies and 181 days later withdraw all from one policy, paying tax on only $100,000 of income. See 1035 page and discussion.

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LETTER TO CLIENT WHO HAS COMPLETELY MISUNDERSTOOD THE GUARANTEED NATURE OF A VARIABLE ANNUITY PRODUCT THAT HAS BEEN COSTING OVER 3% PER YEAR FROM THE CASH VALUE TO MAINTAIN:

Dear Client:

I wanted to write you this letter to describe the attached Guaranteed Optional Chosen Benefits pages that were provided to me as part of your variable annuity contract. I had started this letter a few weeks ago and noticed that it did not go out to you. There is no charge for writing this letter.

Please note that the Guaranteed Minimum Annual Income Benefit (GMAIB) is an artificial level of contract value that is calculated by compounding your Contributions, adjusted for any withdrawals, at 6.5% annually. There is an annual reset feature based upon the highest Annuity Account Value on each contract anniversary date.

They do not give you the highest value for the year, but instead base this upon the actual market value on each anniversary date.

Typically, the highest value for a particular year will be significantly more than a value given for a specific anniversary date.

It may make good sense to take out 6.5% of the GMAIB amount each year to have a stable GMAIB level until the cash value of the policy goes to zero.

Once the cash value of the policy goes to zero then you would not be able to receive more money out of the contract without electing to “annuitize” the contract.

Once you “annuitize” the contract your guaranteed death benefit disappears, and you receive a set annual amount each year for the rest of your life (or a slightly smaller amount that will pay out for at least ten years even if you die within ten years of making the election).

Once you reach age 85 you have to annuitize (and the death benefit goes away).

Once you annuitize you lose all ability to withdraw anything beyond the annual payment, and nothing will be inherited upon your death.

Why All Appreciated Assets May be Best Owned by Partnership Taxed Entities and Why To Keep Partnerships Owning Securities Separate and Apart From Anything That Would Be Identified as a "Trade or Business"

Recent white papers and presentations in the tax and estate planning community have brought to light that the partnership tax law may allow for basis in one partnership asset to be shifted to another partnership asset before sale in order to defer or avoid capital gains taxes, depreciation recapture and other types of income that must normally be realized on sale or disposition of an asset.

Readers who are not familiar with this concept, or who have not understood its basic application, can benefit from reading the following example, which is also illustrated by exhibits available from the authors.

Grandpa owns 45% of a partnership and has a $5,000 basis in his partnership interest, Son 1 owns 45% of the partnership with a $1,000,000 basis, and Son 2 owns 10% of the partnership with a $222,222 basis. The partnership owns a building that Grandpa put in after it was almost fully depreciated worth $1,000,000, bonds that Son 1 put in worth $1,000,000 with a $1,000,000 basis, and $222,222 of cash that Son 2 put in. The partnership has made what is called a 754 election to cause basis adjustments as below described, and the property has been in the partnership for at least 7 years.

Assume that the partnership has a contract to sell the building for $1,000,000 and first distributes the building to Son 1 in liquidation of his 45% of his ownership interest. When Son 1, with a $1,000,000 outside basis in the partnership, receives an asset in exchange for his partnership interest, Son 1's basis in the exchanged asset is equal to his 1,000,000 outside basis in the partnership. As a result, Son 1 receives a $1,000,000 basis in the building and can sell it and pay no capital gains tax.

As a result of the above basis shift the bond portfolio basis of the partnership moves from 1,000,000 to $5,000, Grandpa owns 81.82% of the partnership, and Son 2 owns 18.18% of the partnership.

When Grandpa dies his partnership interest basis goes to fair market value and this also increases the partnership's basis in the bonds, if a proper 743 election is in place.

Why All Appreciated Assets May be Best Owned by Partnership Taxed Entities and Why To Keep Partnerships Owning Securities Separate and Apart From Anything That Would Be Identified as a "Trade or Business"

This has saved income taxes on $1,000,000 of depreciation recapture on the building, and $1,000,000 of capital gains tax on the bond portfolio.

It is important to note that unless the partnership is considered an investment partnership, as discussed in more detail below, IRC §731(c) treats marketable securities as cash when distributed from the partnership, triggering capital gains to the extent the distribution exceeds the partner's outside basis in the partnership. An investment partnership is a partnership that has never been engaged in a trade or business if 90% or more of the partnership's value consists of investment type assets (i.e. stocks, bonds, cash, foreign currencies, commodities, etc.). Therefore, assuming that the partnership in the above example is not an investment partnership the distribution of bonds to a partner would trigger capital gains to the extent that the distribution exceeds the partner's basis. For example, if bonds worth $100,000 were distributed to Grandpa prior to his death, Grandpa would have a capital gain of $95,000 ($100,000 - $5,000).

What if instead of the above there is a partnership owning only the building and cash, with Grandpa owning 90% and an S corporation owning 10%. Grandpa's basis is still only $5,000. The partnership has made a 754 election and has owned the building for over 7years.

Grandpa asks his tax advisor what to do when he wants to sell the building, and wants to use the above technique. How can he get another asset into the partnership and another partner with a high basis to facilitate the planning described above?

If Son 1 happens to have $1,000,000 of bonds that cost him $1,000,000 then he can contribute the bonds to the partnership and after waiting for at least two years in order to avoid the disguised sale rules of IRC Section 707, Son 1 may receive the building in the same manner as described above with the same result.

What if Son 1 doesn't have these bonds but has good credit? Son 1 may arrange to guarantee a loan to borrow $1,000,000 from a bank to buy $1,000,000 of bonds in the name of the partnership, and Son 1 will agree to be responsible for the $1,000,000 loan. As a result of this, Son 1 has a $1,000,000 basis in the partnership and the partnership has a $1,000,000 basis in the assets.

After waiting two years, Son 1 can receive the building in liquidation of his partnership interest with a $1,000,000 basis, sell it for $1,000,000 and recognize no gain. Son 1 can then pay off the loan, and Grandpa can own 90% of the partnership and his estate and the partnership will receive a stepped up basis when he dies.

Why All Appreciated Assets May be Best Owned by Partnership Taxed Entities and Why To Keep Partnerships Owning Securities Separate and Apart From Anything That Would Be Identified as a "Trade or Business"

As the result of the above, and also for the reasons described below, it is arguable that almost any appreciated asset owned by a family member should be owned by an entity that can be taxed as a partnership so that this type of planning can be implemented.

For example, if Grandpa has stocks worth $1,000,000 with a basis of $5,000 and needs to sell these over time to pay for living expenses, the same technique can be used if Son 1 can contribute $1,000,000 worth of assets to the partnership with a basis of $1,000,000.

In addition to the above benefits, it may be necessary in the future to recommend that senior family members own high basis assets, so as to not be subject to tax on death if the US adopts a "deemed sale on death" capital gains tax like Canada has. Until then Grandpa would want to own the low basis assets or partnership interests to get a step up on death.

By keeping both low and high basis assets in partnerships like the one described above, the family can shift basis to Grandpa or away from Grandpa based upon what the tax law and preferred family planning situation is in the future.

By putting the assets into partnerships now, the family enhances the chances of being grandfathered if the tax laws ever change to prevent this type of planning. Presently no known IRS initiative or effort exists to prevent this type of planning.

In addition to the above, LLC's and Limited Partnerships provide many other benefits, including creditor protection, management opportunities, and valuation discounts to avoid estate tax if needed. Where valuation discounts are not needed for estate tax purposes it can be important to give each partner a "put right" so that on death the valuation of the partnership interest held can be the value of the underlying assets multiplied by the percentage of ownership.

Where different classifications of assets are owned by a family, it will often be advisable to have separate assets in separate partnerships for both tax and state law planning purposes.

As the result of the above, advisors should consider looking at assets and the basis thereof and determining how to be sure that appreciated or hopefully appreciating assets will be under a partnership for at least 7 years when the time may come to sell them.

Why All Appreciated Assets May be Best Owned by Partnership Taxed Entities and Why To Keep Partnerships Owning Securities Separate and Apart From Anything That Would Be Identified as a "Trade or Business"

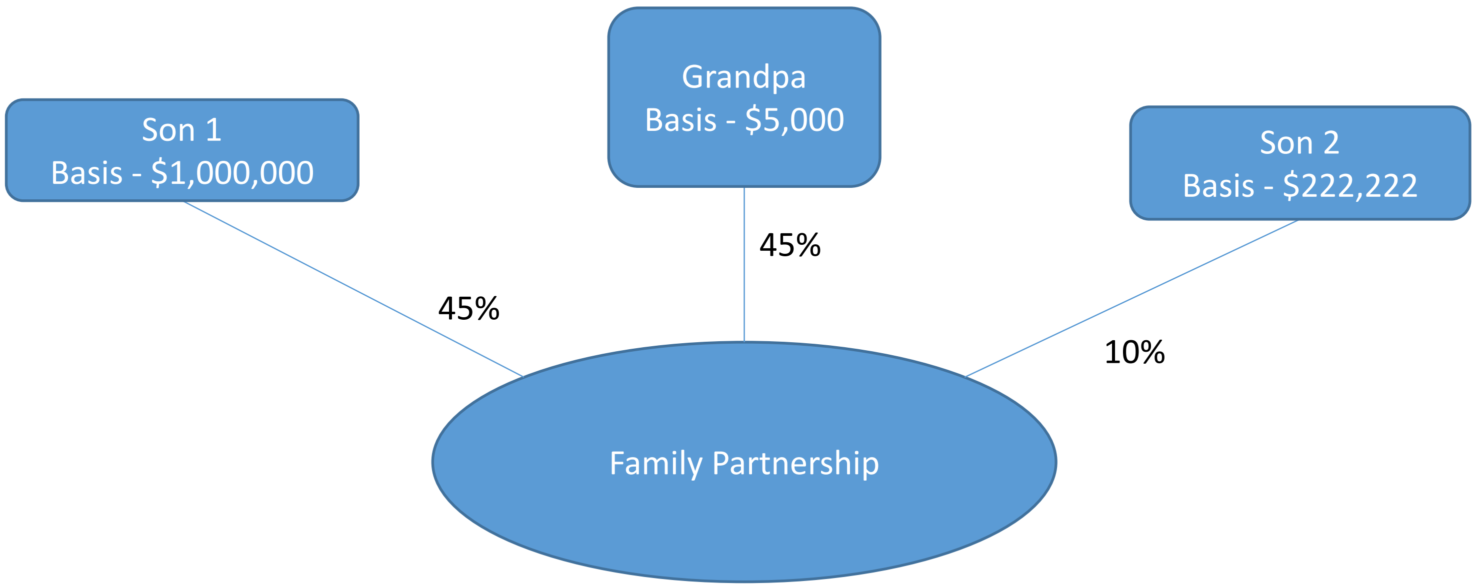
The above strategy can also work for partnerships that own appreciated stocks and/or mutual funds. It is very important that any partnership owning stocks not be engaged in an active trade or business to avoid what is known as the 731(c) rule. This rule treats marketable securities as cash and requires gain recognition on distributions in which the fair market value of the distributed asset(s) exceed the partner's outside basis in the partnership. This rule does not apply if the partnership is considered an investment partnership under 731(c)(3)(C). This is why there will normally be separate partnerships for buildings and other active assets and stocks and other passive assets. 731(c)(3)(c) will also apply to the ownership of stock in non S corporations.

Even if the partnership distribution did not meet one of the exceptions to 731(c) the result of the above examples would not change and no gain would be recognized due to the fact that the partner did not receive marketable securities or cash in excess of his outside basis in the partnership.

Unfortunately S corporation stock cannot be owned by an entity taxed as a partnership, so this technique will not work for S corporation stock.

The authors thank Paul Lee of Northern Trust and Jerry Hesch for their thorough and skillful analysis, white papers and lectures on this topic, and on other topics in the estate and tax area.

Why All Appreciated Assets May be Best Owned by Partnership Taxed Entities and Why To Keep Partnerships Owning Securities Separate and Apart From Anything That Would Be Identified as a "Trade or Business"



Building
FMV -
$1,000,000
Basis - $5,000

Bonds
FMV - $1,000,000
Basis - $1,000,000

Cash
FMV - $222,222

STEP ONE – Distribute Building to Son in Complete Liquidation of Son 1's Partnership Interest

Son 1
~~Basis - $1,000,000~~

Grandpa
Basis - $5,000

Son 2
Basis - $222,222

81.82%

18.18%

Son 1 receives basis in exchanged asset equal to his outside basis in the partnership of $1,000,000

Family Partnership

Building
FMV - $1,000,000
Basis ~~- $5,000~~ $1,000,000

Bonds
FMV - $1,000,000
Basis - ~~$1,000,000~~ $5,000

Cash
FMV - $222,222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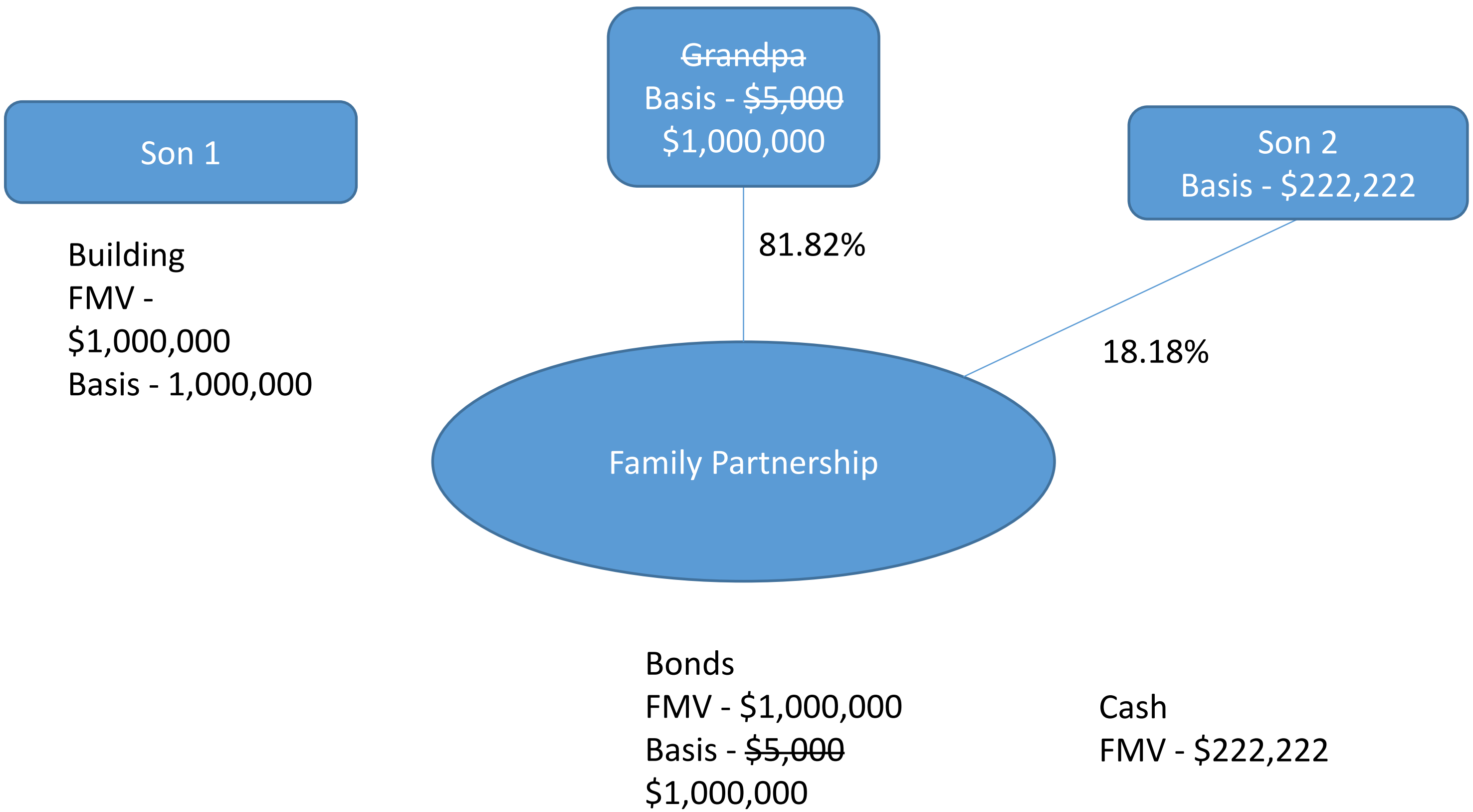
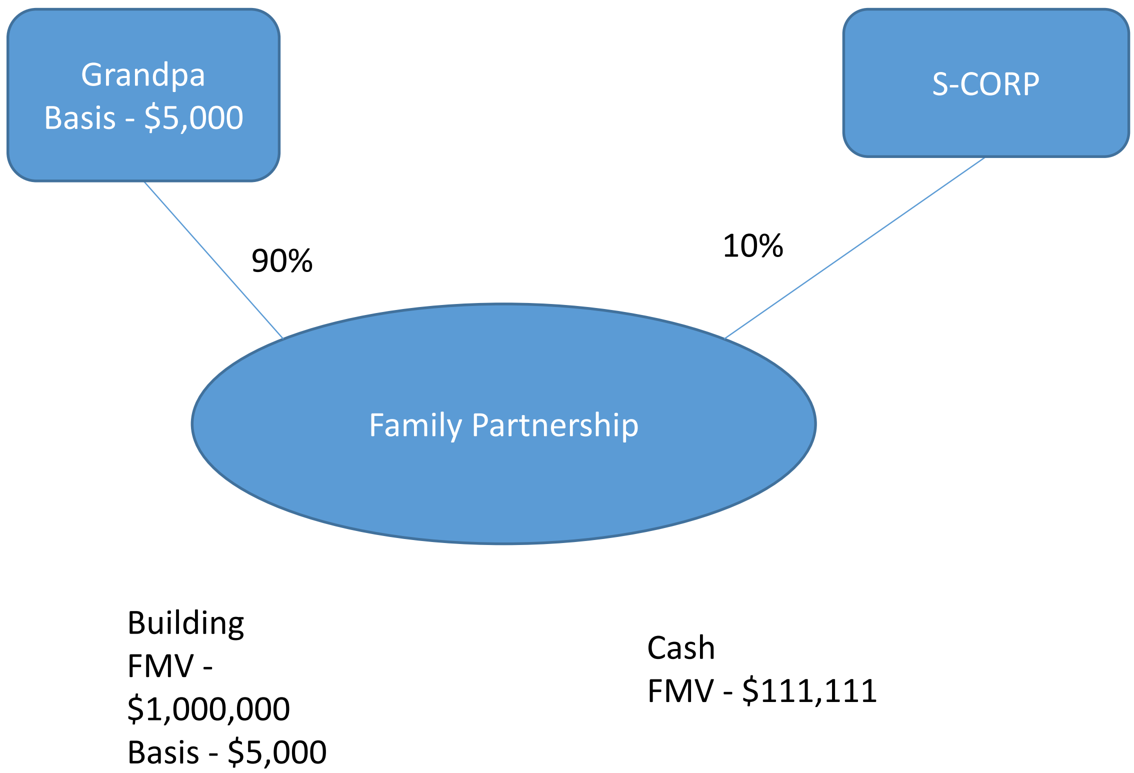
STEP TWO – R.I.P. Grandpa



Why All Appreciated Assets May be Best Owned by Partnership Taxed Entities and Why To Keep Partnerships Owning Securities Separate and Apart From Anything That Would Be Identified as a "Trade or Business"



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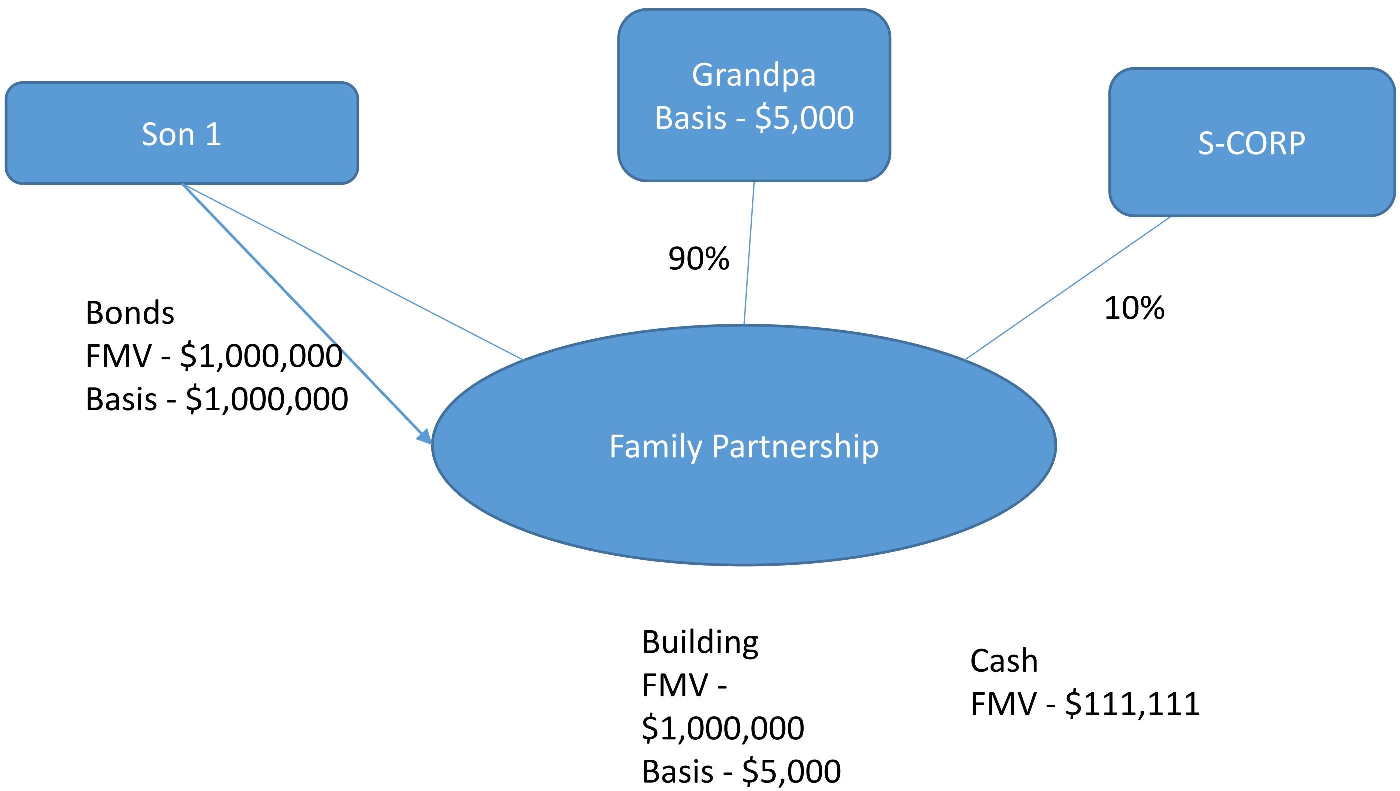
Step One – Son 1 contributes $1,000,000 of bonds with basis of $1,000,000

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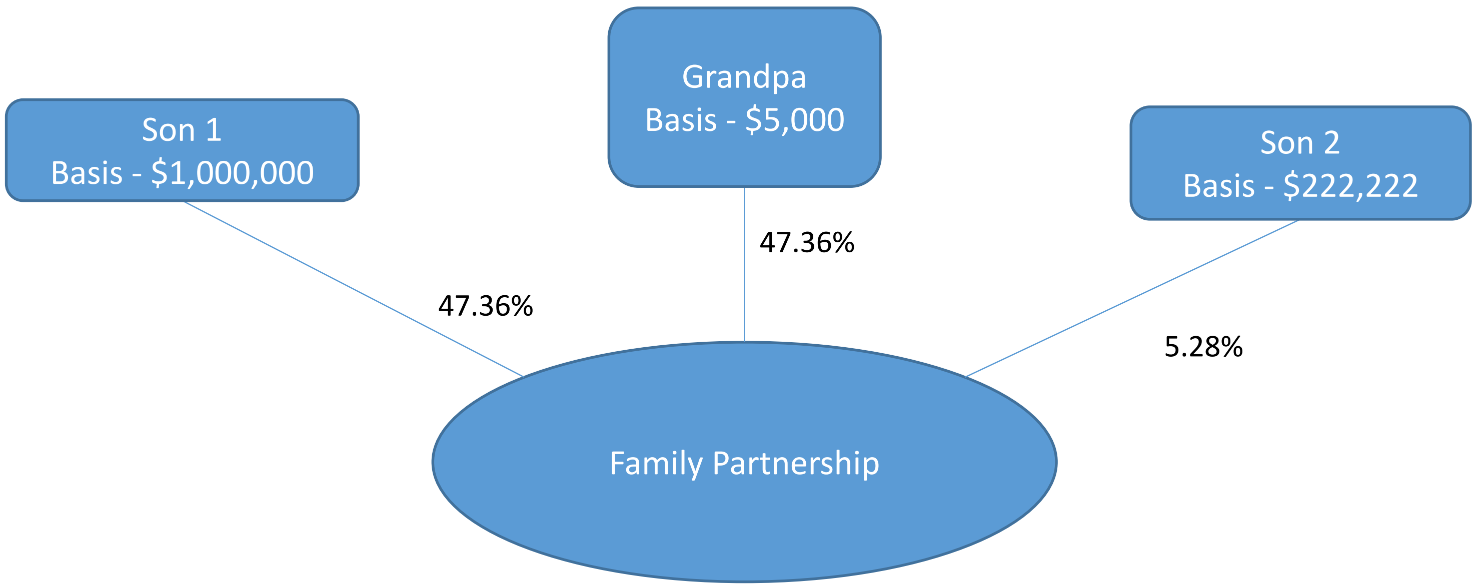
After Step One



Building
FMV -
$1,000,000
Basis - $5,000

Bonds
FMV - $1,000,000
Basis - $1,000,000

Cash
FMV - $111,111

Step Two – Over Two Years Later, Distribute Building to Son in Complete Liquidation of Son 1's Partnership Interest

Son 1
~~Basis - $1,000,000~~

Grandpa
Basis - $5,000

Son 2
Basis - $222,222

90%

10%

Family Partnership

Son 1 receives basis in exchanged asset equal to his outside basis in the partnership of $1,000,000

Building
FMV - $1,000,000
Basis ~~- $5,000~~
$1,000,000

Bonds
FMV - $1,000,000
Basis - ~~$1,000,000~~
$5,000

Cash
FMV - $111,111

STEP Three – R.I.P. Grandpa

~~Grandpa~~
Basis - ~~$5,000~~
$1,000,000

Son 1

Son 2
Basis - $222,222

90%

10%

Family Partnership

Building
FMV -
$1,000,000
Basis - 1,000,000

Bonds
FMV - $1,000,000
Basis - ~~$5,000~~
$1,000,000

Cash
FMV - $111,111

Asset Protection Checklist – Page 1

	PROTECTED OWNERSHIP CATEGORIES	NOTES		LIABILITY INSULATION	NOTES
1	Assets exempt by Florida Constitution, Statute, Common Law or Federal Law. (*Note: The above exceptions do not apply to the IRS, FTC, SEC, or other "Super Creditors", such as the Department of Justice when pursuing RICO perpetrators.)*		1	Make sure housekeeper, in-laws, and all others are covered if they drive your cares or reside in your residence.	
1(a)	Homestead.		2	Car ownership, and which parent signed to be responsible for the driving of a minor.	
1(b)	Tenancy by the entireties.		3	Car driving by children, spouses, employees and others.	
1(c)	Pension and IRA.		4	Firewall protection provided by LLC's, companies and various partnerships (LLP's, LP's and LLLP's).	
1(d)	Life insurance policies.		5	Triple Net Lease language to protect landlord – must give tenant total control of property.	
1(e)	Annuities		6	Managers may get sued.	
1(f)	529 Plans		7	Delegate to management company.	
1(g)	Disability and Social Security Benefits		8	Guests may sign releases.	
1(h)	Others		9	Independent contractor arrangements.	
2	Charging Order Protection.		10	Bartenders for personal parties.	
3	Property owned by others.		11	No guests on wave runners.	
4	Property sold for Note or annuity payment rights.		12	No alcohol served to anyone under the age of 21.	
5	Third Party Settled Trusts.		13	Appropriate underlying and umbrella liability insurance – for each property, car, 4-wheeler, etc. But beware of exceptions and illegal situations that will not be covered.	
6	Self-Settled Trusts in Asset Protection Trust jurisdiction.				
7	Foreign assets, entities and accounts in jurisdictions that do not recognize U.S. judgments.				
	BUSINESS AND INVESTMENT CONSIDERATIONS			**OTHER CONSIDERATIONS**	
1	Liability and casualty insurance review, with personal use interaction and business umbrella to be considered.		1	Income and estate tax avoidance – buy a felony to avoid paying IRS taxes or to conspire to help someone avoid such payment – same applies as to debt owed directly to the FDIC and certain other governmental creditors.	
2	Friendly lenders.		2	Marriage and divorce – ex-spouse cannot invade TBE assets held with new spouse or invade new spouse's interest in a homestead or TBE homestead.	

Asset Protection Checklist – Page 2

	BUSINESS AND INVESTMENT CONSIDERATIONS	NOTES		OTHER CONSIDERATIONS	NOTES
3	Separate activities and exposures.		3	Impact on an estate plan.	
4	Leasing arrangements with landlord rent right secured by UCC-1 on tenant's property.		4	Federal and state criminal law.	
5	Car use.		5	Exposure of the advisor.	
6	Car ownership.		6	Exemptions that apply on death – do not make life insurance or annuities payable to an estate or to a trust that provides that estate obligations must be paid.	
7	Delegate to offshore employees.		7	Client guarantee.	
8	Employee causes of action – make sure they have Workers' Compensation.		8	Confidentiality – use an anonymously owned LLC from Wyoming, Delaware or Colorado to serve as manager of operational LLC's and Trustee of Homestead Land Trust, and file Certificates of Authority in each county where real estate is located.	
9	Separate intellectual property rights.		9	Equity Stripping – debt secured by a mortgage or lien on valuable assets at risk may be payable to arm's-length lenders or related party lenders under a number of various arrangements.	
10	Alcohol at events.		10	Make your children self-supporting.	
11	Using independent contractors.		11	Get divorced soon, or not at all.	
12	Client/Patient/Supplier Arbitration Agreements.				
13	Consider New Parent F Reorganization to separate assets within a company without triggering capital gains.				
14	Consider factoring accounts receivable to a related company that may be held for descendants.				
15	Trusteed or Partnership/LLC based Buy/Sell Life Insurance Arrangement.				
16	Consider leasing use of equipment on a triple net basis – be sure all activities are insured.				
17	Pension contributions.				

THE CPA'S CHECKLIST FOR FLORIDA CREDITOR PROTECTION PLANNING AND MAINTENANCE

1. Do the clients know about tenancy by the entireties protection?	
2. Are the clients' assets held as tenants by the entireties? a. Were the right boxes checked when they opened an account? b. Do they have out of state real estate that needs to be placed under a Florida LLC? c. How will the client's fund a bypass trust on the 1st death if everything is owned jointly? – Disclaimer planning. d. Are K-1's being issued to both spouses or to the correct spouse or entity? If a husband and wife own S-Corporation stock or a partnership interest as tenants by the entireties is it proper to be issuing separate K-1's to them for 50% each of the interest? Often the CPA's file is the only place to find documentation on how stock and LLC interests are owned. e. How do stock certificates read? f. What names are on contracts? g. Is property held in a state that allows for tenancy by the entireties? h. Have the clients considered a TBE owned LLC or family limited partnership. i. Do their LLC's have proper operative language?	
3. Is the homestead more than ½ an acre within the city limits or more than 160 acres in the county? Homestead is owned as tenants by the entireties as well?	
4. Do they understand that the cash value of a life insurance policy is only protected when it is owned by the insured individual?	
5. Is life insurance payable to protective trusts that can benefit the surviving spouse and descendants without being subject to their creditor claims? Does the client own life insurance policies on any other person - if so, it will not be creditor protected.	
6. Is there an inherited IRA - inherited IRAs are not protected from creditors under recent Florida case law.	

7. Who is responsible for making sure that LLCs are properly established and maintained? An improperly drafted LLC will not provide a Florida client with charging order protection or tenancy by the entireties status, even if intended to do so. Many lawyer do not know how to do this properly, so how can accountants and clients themselves even attempt this? Single member LLC's do not have charging order protection. WARNING - It violates the unauthorized practice of law rules to set up LLC's and to provide legal documents for LLC's. This puts the CPA firm at risk for malpractice and licensing purposes.	
8. Do the clients own assets that may cause liability, such as investment real estate, a business or even a charitable activity? Should these be placed in separate LLCs for liability insurance insulation purposes? a. Some clients think that a flow-through tax entity allows creditor claims to flow through, which is not of the case. b. Many clients think that revocable trusts will shield them from creditor claims. There is a big difference between avoiding probate and avoiding creditors. c. Who is the manager? Exposure of the manager? d. Do insurance carriers on agencies know how assets are owned?	
9. Are proper formalities being followed so that one company or person is not considered an alter ego of the other for liability insurance insulation purposes. Are financial statements being prepared? For example, many CPA firms prepare a form 1065 for an entity taxes as disregarded simply to help confirm appropriate fiscal conduct and accountability.	
10. Is the client being realistic about what their risks and exposures are with respect to potential upside down loan situations, guaranties, and real estate debt that may not be renewed. Why do some clients wait until it is too late? A nudge here and there can save significant problems.	
11. How much should the CPA know? Will communications with the CPA and other parties become discoverable? Understand CPA client Florida litigation privilege – copies of letters or information given to third parties will be discoverable.	

THE CPA'S CHECKLIST FOR FLORIDA CREDITOR PROTECTION PLANNING AND MAINTENANCE

13. Is the client being accurate and truthful on financial statements provided to lending institutions? How specific do these statements need to be on issues such as joint assets and changes thereto. Proper footnoting is crucial.	
14. Are insurance agencies and carriers aware of exactly what is being insured? Is the client telling the insurance carrier that the car is personal and not for business, while telling the IRS that the car is 90% business and is owned by a company? Can someone working for the CPA firm call the applicable insurance agencies to make sure that everything is coordinated? Make sure client understands exclusions, such as animals, pools, civic activities, church or synagogue activities, etc.	
15. What is the client's cash-burn rate? Are they waiting for the economy to turn around, and what if it does not and when do they run out of cash?	
16. Schedule an annual review?	
17. Consider new entities and trusts, including protective trust systems and limited liability entities. Segregate voting from non-voting under entities.	
18. Annual input from and participation with qualified lawyer.	
19. Debt at the Debtor's Best Friend a. Is there one creditor who should be ahead of the others? b. Are all loans documented by promissory notes and secured by mortgages and/or security agreements? c. Review various debt-associated strategies, such as cross-collateralization and sale lease backs.	

Asset Protection *Part 2*

THANK YOU FOR PARTICIPATING

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On behalf of:
Peak Trust Company

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