CECB Carnahan, Evans, Cantwell & Brown, P.C.

on the Subject

August 2013

Respect the Structure

By: John M. Carnahan III

Over the years we have written several articles about the legal theory of "Piercing the Veil", which basically is a theory wherein a creditor attempts to set aside the legal structure of an entity chosen by the owners and go after the assets of the owners individually. There are several factual patterns which lend themselves to the ability of a creditor to use that theory in order to collect the amount owed against the owners, rather than the otherwise bankrupted judgment proof entity. Usually there is a situation where the structure of the entity has been ignored and the entity was set up with the intention of defrauding creditors, or where the entity operated in a manner that those doing business with it, for reasonable cause believed they were doing business with another business or entity.

A recent decision of the Federal First Circuit Court of Appeals involving a Massachusetts Limited Liability Company serves as a reminder that if you want the benefits of the legal structure you have chosen for your business activities, you need to respect that entity and follow some fairly straight forward rules regarding operations. It was the inverse of the normal factual pattern, and the court held that a creditor of the owner had priority over a creditor of the LLC entity which owed the money.

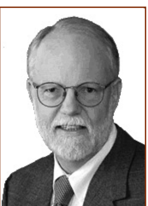
Mr. Livermore owned approximately fifteen acres of undeveloped land in Ludlow, Massachusetts and decided to develop the property into eleven lots. He formed a Massachusetts Limited Liability Company, transferred the property into that entity, borrowed development money from a local bank secured by a mortgage and started the process. Unfortunately the sale of the properties was not as successful as planned and Mr. Livermore defaulted on the loan and the bank foreclosed. At the same time, for the tax years 2006, 2007 and 2008, Mr. Livermore incurred personal unpaid federal tax liabilities arising from the income from the sale of lots which he reported on his individual income tax return, in that apparently it was in what is known as a "single member LLC", also known as a disregarded entity. The Internal Revenue Service recorded a Notice of Federal Lien against Mr. Livermore in regards to these liabilities.

After the bank foreclosed, there was approximately $92,000 of surplus funds, which was interpleaded into a court account. The City of Ludlow was owed a substantial amount of money in that it was required to step in and complete the public improvements for Mr. Livermore's development (i.e., streets, sewers, sidewalks), and therefore obtained a judgment against the LLC for the funds. Unfortunately the IRS smelled money, and sought to enforce its lien against the individual owner against the assets of the LLC. While Mr. Livermore did follow certain formalities, such as transferring ownership of the real estate into the entity, filing the required reports with the state and he kept records of its business transactions, and even maintained a minute book, unfortunately, the United States District Court and the Federal Court of Appeals, both relied on the fact that Mr. Livermore comingled the funds of the LLC with his personal account, and that the LLC entity did not maintain a separate bank account. Therefore, utilizing a variation of the theory of Piercing the Veil, known as the "nominee" theory, the Court held that the owner's IRS Tax Lien took priority and would receive the court escrowed funds belonging to the LLC.

This is just another example of the importance of following the rules of the road. If you are going to use a limited liability company to get the benefits of protection against liability, you need to make sure that you respect the entity. For example, if it sells assets or receives income the funds need to be clearly deposited in an account in its name and it needs to maintain its own insurance policy and hold itself out as a separate entity. If you were using an LLC to own a rental property, you would want the deed in the name of the LLC, the leases in the name of the LLC and signed by an authorized representative of the LCC, the deposit and rent checks deposited in the name of the LLC and the expenses of the rental property paid by the LLC. If there were insufficient funds in the account to pay the bills and you intended to pay them, then the owner (or the technically correct term "member") would deposit the money in as a contribution to the capital, or in some cases a loan, or even a secured loan if concerned about collectability, and then the LLC's account would have the funds necessary to pay its bills.

Maintaining appropriate minutes to reflect the fact that loans are approved, establishing the bank account and authority to enter into agreements and contracts is also another important aspect of respecting the choice of entity and enjoy the benefit of it, including limited liability.

Missouri Governor Nixon Vetoes Senate Substitute for HB 253



By: Frank C. Carnahan

Governor Nixon cited the bill as "an ill-conceived, fiscally irresponsible experiment that would inject far-reaching uncertainty into our economy, undermine our state's fiscal health, and jeopardize basic funding for education and vital public services[, that] … would increase taxes on prescription drugs and college textbooks, provide special treatment for some businesses while discriminating against others, and make our tax code less economically efficient and less fair."

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Status Of Transfer Taxes

By: Thomas D. Peebles, Jr.

For the first time in nearly 12 years, we have a transfer tax system (estate, gift and generation-skipping taxes) which is "permanent." Since 2001, estate planners and their clients have endured temporary tax provisions with scheduled expiration dates. The American Taxpayer Relief Act of 2012, effective January 1, 2013, restored a sense of stability by enacting a permanent set of transfer tax rules to guide us in wealth transfer planning.

The law now provides for a permanent, indexed, exemption for estate, gift and GST taxes. The indexed exemption for 2013 is $5.25 million. A maximum tax of 40% is now imposed on transfers in excess of the indexed exemptions. The "portability" of exemptions between spouses is now a permanent feature of the estate and gift tax (but not GST tax) law. The permanence of these transfer tax provisions is welcome news for clients (and their advisors) and gives us the ability to make longer-term wealth transfer decisions.

Although the "big picture" issues of exemptions, tax rates and portability appear to be settled for the time being, there are other transfer tax issues that have been proposed by the Administration and/or considered by Congress which may be included in future legislation. If enhanced tax revenues are to be considered in the ongoing attempt to reduce budget deficits, transfer taxes would seem to be an attractive target since the tax only impacts the top one-half of one percent of taxpayers. A review of two wealth transfer techniques currently utilized which may become targets for future legislation is instructive.

On April 10, 2013, the Obama Administration released its federal budget proposals for fiscal year 2014, which include recommended changes to the transfer tax system. Two of the key proposals, and their impact on current planning techniques are summarized as follows:

1. Require a Minimum Term of 10 years for GRATs

The use of short-term zeroed-out GRATs has been an extremely effective wealth transfer strategy, particularly in the last 5 years. A GRAT (Grantor Retained Annuity Trust) is an irrevocable trust funded with assets expected to grow in value, in which the Grantor retains an annuity interest for a term of years that the Grantor expects to survive. GRATs can currently be structured so that the Grantor's annuity interest is essentially equal to the value of the assets transferred to the trust, so that no gift tax is imposed upon creation and funding of the trust (gift tax is "zeroed out"). At the end of the annuity term, the assets remaining in the trust after payment of the annuity to the Grantor are transferred to (or held in further trust for) the remainder beneficiaries, generally the children/grandchildren of the Grantor. If the trust assets appreciate in value during the GRAT term in excess of the amount required for the annuity payments, then the appreciated value is transferred to children/grandchildren transfer tax free. Particularly in these times of low interest rates, GRATs have proven to be an efficient technique for transferring wealth while minimizing (or avoiding) the gift tax cost of transfers, provided that the Grantor survives the GRAT term.

The Administration continues to propose that a GRAT have a minimum term of 10 years. This would prohibit the use of short-term GRATs (2 to 3 years) that have been widely used over the last several years and would increase the risk that the Grantor might die during the GRAT term and lose the anticipated transfer tax benefits. The Administration's proposal would also require the remainder interest to have a value greater than zero at the time the interest is created, which would eliminate a true "zeroed out" GRAT for gift tax purposes.

Clearly, short-term zeroed-out GRATs are on the Administration's target list. The good news is that these proposed new rules would apply to transfers to GRATs on or after the enactment date, so existing GRATs and GRATs created and funded before enactment would be unaffected.

2. Limit GST Exemption to 90 Years

The GST tax is imposed on gifts and bequests made to individuals who are two or more generations younger than the person making the transfer ("skip persons"). However, each person has a GST exemption which can be allocated to transfers made to skip persons or to trusts for skip persons ("GST Trusts"). Accordingly, it is possible to "skip" transfer taxes on amounts equal to the GST exemption (currently $5,250,000), plus all appreciation and income on that amount during the existence of a GST Trust.

At the time the GST provisions were first enacted, the law of most states included a common law Rule Against Perpetuities (RAP), or some statutory version of it, which prohibited trusts from continuing in perpetuity. The RAP limited, then, the amount of time that GST Trusts could exist and take advantage of the GST exemption. In recent years, many states (including Missouri) have repealed the RAP or lengthened the amount of time that assets can remain in trust. As a result, it is currently possible to create "Dynasty Trusts" which last in perpetuity and take advantage of the GST exemption forever.

The Administration's proposal would severely restrict the use of "Dynasty Trusts" by directing that a GST Trust would no longer be exempted from the GST tax after it has been in existence for 90 years. Again, the good news is that the proposal would apply to GST Trusts created after enactment and to the portion of an existing trust attributable to an addition made after the date of enactment.

Planning Point: Clients considering the use of short-term zeroed-out GRATs and/or Dynasty Trusts are well advised to consider moving forward now with that planning so as to take advantage of current law and not be restricted if these Administration proposals are, in fact, enacted. If you have questions or wish to discuss those planning opportunities in more detail, please contact any member of the Estate Planning Practice Group.

Tithing And College Expenses Only Conditionally Allowed In Determining IRS Installment Agreement

By: Frank C. Carnahan

The IRS determination that (a)n individual's church tithing expenses were only allowed as "conditional expenses" to determine how much he could pay in a partial installment agreement because the classification: (1) conformed to the Internal Revenue Manual guidelines; (2) did not violate the Free Exercise Clause of the First Amendment; and (3) did not violate the Religious Freedom Restoration Act of 1993 (RFRA). Tithing as a "condition of employment" is related to production of income, and it was not an abuse of discretion to limit "condition of employment" to "compensated employment" (taxpayer was not compensated). The court found it was reasonable to interpret "health and welfare" as not including petitioner's "spiritual" health and welfare. Taxpayer's children's college expenses were also "conditional expenses". Taxpayers must be able to fully pay their tax liabilities within 5 years for "conditional expenses" to be classified as "necessary expenses." George Thompson v. Commissioner, U.S. Tax Court, CCH Dec. 59,469, 140 T.C. No. 4, (Mar. 4, 2013).

In the News

CECB is excited to announce that Richard B. Maltby was named to the Springfield Business Journal's 2013 Class of 40 Under 40. The 40 Under 40 awards honor individuals based on their professional and community accomplishments.

Rich is a Shareholder at CECB and concentrates his practice in the areas of construction, architectural, engineering and development law, business litigation, real estate litigation, and alternative dispute resolution.

We are pleased to announce that attorney Joseph D. "Chip" Sheppard, III was recently named Vice-Chair of the OTC Foundation Board of Directors. The Foundation Board is made up of community leaders representing a broad cross-section of businesses within the College's service area. Chip is a Shareholder at CECB and concentrates his practice in the areas of business, real estate, securities and intellectual property dispute resolution and transactions.

John M. Carnahan, III was recently featured in the Glendale High School magazine, the Quill. During Glendale's first year of enrollment John was a freshman so his class was the first to attend all four years at Glendale. The magazine featured a newspaper clipping showing John standing in front of the school as it was being constructed. Today the office of CECB is located next to Glendale High School.

Employee Privacy: How Not To Violate It

By: Jay Preston

In a world where most jobs require use of a computer or Smartphone and each have internet access employers are faced with the challenge of how to regulate their use, most notably in regard to email. An employer might find it advisable to monitor such in order to increase employee productivity, ensure compliance with company policies, avoid liability for workplace discrimination, and protect confidential company information from theft. While many are probably aware that activities conducted on company equipment are generally open to monitoring by the company, because it is company property, one should not rely entirely on this general principle, especially when with little effort an employer can protect itself from most employee privacy violations. This article addresses how to avoid violations of state privacy laws, the Electronic Communications Privacy Act, and the Stored Communications Act.

In Missouri, there are four common law torts for the invasion of privacy: (1) intrusion upon seclusion; (2) public disclosure of private facts; (3) false light publicity; and (4) appropriation of another's name or likeness. Within the context of the employer-employee relationship the most likely claims are intrusion upon seclusion and public disclosure of private facts. A key element to both of these claims is that the information that is intruded upon or publicly disclosed is private information. Without an explicit company policy to the contrary employees generally maintain some expectation of privacy in their e-mail, and text messages logged on company phones. To protect against these possible state law claims an employer should eliminate, through company policy, any expectation of privacy; thereby eliminating any employee argument that the information at issue was private.

The Electronic Communications Privacy Act prohibits the interception and/or disclosure of any wire (telephone), oral (face to face), or electronic (computer) communications. The ECPA contains three exceptions possibly applicable to employers. First, the provider exception, applicable if the employer supplies and owns the email system. Second, the business exception which exempts communications intercepted in the ordinary course of business. The last exception is applicable when the employee gives prior consent to the interception.

It is important to note that such exceptions have been interpreted narrowly by the courts. For example, in one case an employer monitored an employee's phone calls when the employer suspected involvement in a store burglary. Through review of these calls the employer learned that the employee sold an item at a discount to her boyfriend, a violation of store policy. After her termination the employee brought suit for violation of the ECPA. In ruling for the employee the court stated that while there was a legitimate business reason for listening to the calls initially the employer should have hung up when it learned the calls where personal in nature. As there was no store policy to the contrary the employee had a reasonable expectation that her calls were private.

Due to the narrow nature of courts' interpretations an employer should take advantage of the consent exception; which authorizes interception of communications as long as one party has given their prior consent. The authorization should be explicit that the employee has no expectation of privacy and is aware that the content of any information transmitted will be monitored, including the content of such communication.

The other federal legislation to be aware of in regards to employee privacy is the Stored Communications Act. The SCA makes it an offense for a person or entity to intentionally access, without authorization, a facility that provides electronic communications service. In the employment relationship a violation is most likely to occur when an employer utilizes an employee password, temporarily stored on a company computer, to access personal email or social media accounts. In numerous instances employers have obtained unauthorized access to employee email or social media accounts, and after observing disparaging or inappropriate remarks regarding the employer terminated the employee. Such action is a clear violation of the SCA and may lead to a judgment with civil damages against the employer. Although passwords to personal accounts are temporarily stored on company property an employer should take great care not to access the private portions of employee social media or e-mail accounts.

The biggest key to avoiding employee privacy violations is to take affirmative steps to establish what the expectation of privacy is in the workplace. Whether this is established through a signed authorization, inclusion in the employee handbook, or other method the policy should state what the appropriate uses of the equipment are, that the employee has no expectation of privacy in their communications, and that such will be monitored, including the content of the communication. While many rely on the general rule that communications on company property may be monitored the increasing complexity of technology makes it advisable, if not mandatory, to have written and established procedures and rules regarding the use of computers, internet, email, and cellular phones. Failure to implement such a policy leaves an employer open to civil suit for violations of employee privacy.

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Founded in 1979, Carnahan, Evans, Cantwell & Brown, P.C. is a locally owned and operated law firm noted for its commitment to providing superior client service to a diverse client base, including national and regional businesses, financial institutions, not-for-profit organizations and individual clients. The Firm currently has 18 attorneys, including seven who have their Master of Laws in Taxation. An "A-V rated" preeminent law firm by Martindale-Hubbell, our attorneys are engaged in the general business practice of law with an emphasis in the following areas:

- Business Organization and Planning
- Corporate
- Estate Planning
- Probate
- Trust Administration
- Transactions
- Local Government Law
- Real Estate and Construction
- Taxation
- Employee Benefits
- Banking
- Commercial Litigation and Dispute Resolution
- Environmental and Utility
- Economic Development
- Intellectual Property and Franchise
- Arbitration and Mediation
- Mechanics' Liens and Foreclosures
- Pension and Profit Sharing
- Employment
- Zoning and Land Development
- Wealth Strategies

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