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99 Not Guilty Verdicts

By Charles M. Meadows, Jr., J.D., CPA
& Josh O. Ungerman, J.D., CPA

Chuck Meadows and Josh Ungerman led a team of 14 attorneys who secured 99 "not guilty" verdicts in the U.S. Virgin Islands (the USVI), in what was one of the largest criminal tax trials ever prosecuted by the United States. After a trial lasting over 5½ weeks, all defendants were found "not guilty" on all counts.

The government was well represented and had four prosecutors and almost unlimited resources. In fact, the case was specifically cited in the 2009 budget request of the Tax Division. Seven agents were among the 40 witnesses called by the government to testify.

The government's case began in 2002, when they started an undercover operation and secured over 200 hours of taped conversations involving the defendants and other partners in Kapok. Kapok was a partnership formed to take advantage of a USVI statutory tax incentive program. The government conducted a raid on the headquarters of Kapok in May of 2003. Originally, the case was indicted in the Southern District of Illinois in March of 2007 but was transferred pursuant to a defense motion to St. Croix, USVI in July of 2007.

In September of 2008, almost half of the government's case was dismissed as a result of the Defense's Motion to Dismiss. The government brought new charges in October of 2008, including allegations of violations of USVI statues. The trial started on Jan. 12, 2009 and the "not guilty" verdicts were returned on March 5, 2009.

The key to the case according to Chuck Meadows was that "over this time period, the jury was able to determine that the defendants were not criminals. They were decent reasonable businessmen who were trying to follow the law as it was explained to them by USVI officials and private experts."

The trial involved the USVI EDC program, which is a statutory tax incentive program that allows qualifying taxpayers to receive a 90% credit against what would otherwise be their U.S. tax liability. The program required the taxpayers to be "bona fide" residents and for the income to be "effectively connected" to a USVI trade or business.

In 1986, when the U.S. Congress authorized the program, it mandated that the U.S. IRS issue regulations to define the program and give guidance to taxpayers. Instead of issuing regulations, the IRS started an undercover criminal investigation in May of 2002. In May of 2003, the IRS raided the offices of Kapok and seized all of its documents. After the raid, the entire EDC program in the USVI was effectively shut down, because no one knew for sure what the rules were. A substantial number of EDC beneficiaries left the island and USVI tax revenues were reduced by over 33%.

The defense was simple. The defendants were not criminals and had done their best to follow the law as it was explained to them, and they conducted their business operations in good faith. While the government called 40 witnesses, the defense only called 2. One was Frandelle Gerard, the individual who was the head of the EDC in the USVI when Kapok was started. Contrary to the arguments of government attorneys, she testified that the USVI agency was not deceived or lied to by any of the defendants and the program was working exactly the way that Con-

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gress intended. The program had simply gotten too successful and the U.S. IRS was embarrassed by its failure to issue regulations in a timely manner.

The jury agreed and returned a complete defense verdict of not guilty after three days of deliberations.

The defense team included:

1. Jim Ferguson – Chuck Meadows and Josh Ungerman, Partners and Paralegal, Jessica Ellis of Meadows, Collier, Reed, Cousins & Blau of Dallas, Texas;
2. Peter Fagan – Bob Smith of Fitzpatrick Hagood Smith & Uhl of Dallas, Texas and Treston Moore of St. Thomas;
3. Jamie Auffenberg – Lee Rohn of St. Croix, Cylde Kuehn of The Kuehn Law Firm, Belleville, Illinois and Blair Brown and Lani Cossette of Zuckerman Spader, Washington, DC;
4. David Jackson – Gordon Rhea of Richardson, Patrick, Westbrook & Brickman of Charleston, South Carolina and Ed Fickess of Marcus Andreozzi Fickess of Buffalo, New York;
5. Kapok Entities – Bob Webster of Fitzpatrick Hagood Smith & Uhl of Dallas, Texas; and
6. Auffenberg Entities – Bill Lucco of Lucco, Brown, Threlkeld & Dawson of Edwardsville, Illinois.

The Government was represented by Mike Quinley and Bruce Reppert from the Southern District of Illinois and Michelle Peterson and Greg Tortella of the Tax Division, Department of Justice.

Judge Harvey Bartle from Philadelphia presided.

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IRS Issues Guidance Regarding Deductibility of Theft Losses Arising from Madoff and Other Fraudulent Investment Schemes

By Stephen A. Beck, J.D., LL.M.

The recent economic downturn and credit crunch have shed light on several fraudulent investment schemes perpetrated on investors. Bernard Madoff is at the forefront. Madoff pled guilty recently to eleven felony counts stemming from his operation of a Ponzi scheme that reportedly resulted in investor losses of around $50 billion. But Madoff is not alone. Many others have been accused over the past six months of conducting Ponzi arrangements resulting in reported combined losses in excess of $12 billion.

As a result of the number and magnitude of losses incurred by victims from these fraudulent investment schemes, the IRS recently issued two items of guidance. Revenue Ruling 2009-9 clarifies several issues regarding the treatment and effect of theft losses that were previously unresolved under existing authority. Revenue Procedure 2009-20 provides a safe harbor through which electing taxpayers can claim their theft loss without risk of challenge by the IRS.

I. Revenue Ruling 2009-9.

Revenue Ruling 2009-9 contains the following clarifications regarding the timing and effect of theft loss deductions.

A. Amount of Deduction.

The amount of the deductible theft loss is not limited to the net cash contributions made by the taxpayer to the fraudulent investment arrangement. Rather, the deductible theft loss also includes amounts reported to the investor as income in years prior to the year of discovery of the theft, provided that the investor includes those amounts in the investor's gross income for federal income tax purposes and reinvests those amounts in the arrangement.[1]

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B. Deductibility Limitations.

A loss incurred in connection with a fraudulent investment scheme qualifies as a theft loss, rather than an investment loss.[2] Accordingly, the loss is deductible against ordinary income and is not subject to the capital loss limitations.[3]

In addition, the loss is considered deductible under Section 165(c)(2) of the Internal Revenue Code (the "**Code**") as a loss incurred in connection with a transaction entered into for profit, rather than a personal loss.[4] As a result, the theft loss is not subject to the deductibility limitations in Code Section 165(h).[5]

Furthermore, theft loss deductions are exempted from the limitations on deductibility of itemized deductions under Code Sections 67 and 68.[6]

C. NOL Carryback.

Theft losses generally can be carried back three years and carried forward twenty years.[7] In addition, certain taxpayers with average annual gross receipts of less than $15 million who have a 2008 net operating loss arising from a theft loss can elect to carry back that loss over a period of up to five years.[8]

D. Code Section 1341.

The IRS takes the position that investors are not entitled to calculate under the alternative method in Code Section 1341 their tax liability for the tax year in which the loss is deducted.[9]

E. Mitigation Provisions.

The IRS takes the position that taxpayers cannot invoke the mitigation provisions of the Code to adjust their tax liability for years for which the statute of limitations for filing a claim for credit or refund has expired.[10] Thus, the IRS position is that taxpayers cannot use the mitigation provisions to adjust for the taxation of fictitious income reported by the promoter during all years prior to 2005.[11] The IRS view is that the income reported to the investor from the promoter during each year was properly included in the investor's gross income for federal income tax purposes and can be recovered through a theft loss deduction.[12]

II. Revenue Ruling 2009-20.

Revenue Procedure 2009-20 provides an optional safe harbor through which taxpayers can claim their theft losses from fraudulent investment arrangements, such as the scheme confessed by Madoff, without risk of IRS challenge.[13]

The safe harbor applies to taxpayers who are "qualified investors," which basically means any U.S. citizen, resident or domestically organized entity that transferred cash or other property directly to a "specified fraudulent arrangement" without actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public.[14] A "specified fraudulent arrangement" is essentially a Ponzi scheme.[15]

For those eligible to participate in the safe harbor, the IRS will not challenge

[1] *See,* Rev. Rul. 2009-9, Issue 4.
[2] *See,* Rev. Rul. 2009-9, Issue 1.
[3] *See, id.*
[4] *See,* Rev. Rul. 2009-9, Issue 2.
[5] *See, id.*
[6] *See, id.* Code Section 67 provides that miscellaneous itemized deductions are deductible only to the extent the aggregate amount of the deduction exceeds two percent of the taxpayer's adjusted gross income. ***See*** I.R.C. § 67(a). Losses deductible under Code Section 165(c)(2) or (3) are explicitly excepted from the aforementioned two percent limitation. *See* I.R.C. § 67(b)(3). Code Section 68 provides an overall limit on itemized deductions based on a percentage of the taxpayer's adjusted gross income or total itemized deductions. *See* I.R.C. § 68(a). Again, losses deductible under Code Sections 165(c)(2) or (3) are explicitly excepted from the aforementioned overall limit. *See* I.R.C. § 68(c)(3).
[7] *See* I.R.C § 172(b)(1)(F); I.R.C. § 172(b)(1)(A)(ii).
[8] *See,* Rev. Rul. 2009-9, Issue 5.
[9] *See,* Rev. Rul. 2009-9, Issue 6. Code Section 1341 provides that, where a taxpayer included an amount in income during a prior year and then deducts that item in a subsequent year in which it is determined that the taxpayer did not have a right to that item, the taxpayer's tax liability in the subsequent year of deduction is the lesser of two amounts: (i) the tax computed with the current deduction; or (ii) the tax computed without the deduction, less the decrease in tax for the prior taxable year that would have occurred if the item had been excluded from gross income in the prior taxable year. *See* I.R.C. § 1341(a)(4) and (5).
[10] *See* Rev. Rul. 2009-9, Issue 7.
[11] The statute of limitations for filing a claim for credit or refund expires upon the later of: (i) three years from the time the return was filed; or (ii) two years from the time the tax was paid. *See* I.R.C. § 6511(a). Assuming filing of income tax returns and payment of tax on April 15 of each year, the statute of limitations is currently open for 2005 (filing and payment on April 15, 2006) and subsequent years.
[12] *See* Rev. Rul. 2009-9, Issues 4 and 7.
[13] *See* Rev. Proc. 2009-20, Section 5.01.

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theft loss deductions claimed in the tax year and in the amount prescribed by Revenue Procedure 2009-20, provided that the taxpayer complies with certain procedural requirements discussed below.[16]

A. Timing of the Safe Harbor Theft Loss Deduction.

The theft loss must be deducted in the "discovery year;" i.e., the taxable year of the investor in which the indictment, information, or complaint is filed charging the promoter under state or federal law with the commission of fraud, embezzlement or a similar crime constituting a theft for federal income tax purposes.[17] Thus, calendar-year taxpayers who sustained losses as a result of the Madoff scheme would deduct their theft losses under the safe harbor in 2008 because the United States government filed its complaint against Madoff on December 11, 2008 alleging federal securities fraud violations.[18]

B. Amount of the Safe Harbor Theft Loss Deduction.

The taxpayer can deduct a specified percentage of the excess of the taxpayer's "qualified investment" over the amount of the taxpayer's actual and potential insurance/SIPC recovery.[19] The "qualified investment" is essentially the net assets contributed to the fraudulent investment arrangement plus the reported income from the arrangement included in the taxpayer's gross income for federal income tax purposes.[20]

The specified percentage of the qualified investment that can be deducted differs depending on whether the taxpayer is seeking a potential third party recovery. A "potential third party recovery" is basically a claim for recovery against anyone other than: SIPC; insurers; contractually obligated guarantors; the promoter and his co-conspirators; the investment vehicle used to conduct the fraudulent investment arrangement and its employees, officers or directors; the liquidation, receivership, bankruptcy or similar estate established in order to recover assets for the benefit of investors or creditors; and parties that are subject to claims brought by a trustee, receiver or other fiduciary on behalf of the aforementioned liquidation, receivership, bankruptcy or similar estate.[21]

If the taxpayer is pursuing a potential third party recovery, the taxpayer's theft loss deduction will be calculated by multiplying the taxpayer's qualified investment by seventy-five percent.[22] If the taxpayer is not pursuing a potential third party recovery, the taxpayer will multiply the taxpayer's qualified investment by ninety-five percent.[23]

Once the appropriate percentage has been applied to the taxpayer's qualified investment, the amounts of the actual and potential SIPC/insurance recovery must be subtracted in order to determine the amount of the theft loss deductible under the safe harbor.[24] The actual recovery refers to amounts that the taxpayer actually receives in the discovery year from any source.[25] The potential SIPC/insurance recovery basically refers to the sum of the amounts of all actual or potential claims for reimbursement for the taxpayer's loss made to SIPC, insurers, and contractual guarantors.[26]

C. Procedure for Claiming the Safe Harbor Theft Loss Deduction.

In order to claim the theft loss deduction under the safe harbor, the taxpayer must satisfy certain procedural requirements. For example, the taxpayer must mark "Revenue Procedure 2009-20" at that top of the Form 4684, Casualties and Thefts, included in the taxpayer's federal income tax return for the discovery year.

Also, the taxpayer must attach to the taxpayer's federal income tax return for the discovery year a statement entitled: "Statement by Taxpayer Using the Procedures in Rev. Proc. 2009-20 to Determine a Theft Loss Deduction Related to a Fraudulent Investment Arrangement" (hereafter referred to as

[14] *See* Rev. Proc. 2009-20, Section 4.03.
[15] A fraudulent investment arrangement is defined as an arrangement in which the promoter (referred to in the Revenue Procedure as the "lead figure") receives cash or other property from investors, purports to earn income for the investors, reports income amounts to the investors that are partially or wholly fictitious, makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement, and appropriates all or some of the investors' cash or property. *See* Rev. Proc. 2009-20, Section 4.01.
[16] *See* Rev. Proc. 2009-20, Section 5.01.
[17] *See* Rev. Proc. 2009-20, Sections 5.01(2), 4.04.
[18] *See* Complaint, U.S. v. Madoff, 08 MAG 2735 (S.D.N.Y. Dec. 11, 2008).
[19] The Securities Investor Protection Corporation ("SIPC") is a governmentally created organization that restores missing funds to investors who have transferred amounts to brokerage firms that have since filed for bankruptcy or encountered financial difficulties. *See* www.sipc.org. SIPC reserve funds may provide protection for missing investor assets of up to $500,000, including a maximum of $100,000 for cash claims. *See* id.
[20] The specific methodology for calculating the qualified investment amount is provided in Rev. Proc. 2009-20, Section 4.06.
[21] *See* Rev. Proc. 2009-20, Section 4.10.
[22] *See* Rev. Proc. 2009-20, Section 5.02(1)(b).
[23] *See* Rev. Proc. 2009-20, Section 5.02(1)(a).
[24] *See*Rev. Proc. 2009-20, Section 5.02(2).
[25] *See* Rev. Proc. 2009-20, Section 4.07.
[26] *See* Rev. Proc. 2009-20, Section 4.08.
[27] The form of the Statement is attached as Appendix A to Revenue Procedure 2009-20.

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the **"Statement"**).[27] In executing the Statement, the taxpayer represents under penalties of perjury that the taxpayer is eligible for the safe harbor relief and that the taxpayer has written documentation to support the amounts used in calculating the theft loss deduction under the safe harbor. The taxpayer also agrees to comply with the conditions and agreements set forth in the Statement and Revenue Procedure 2009-20.

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Estate Planning – Now is the Time

By Alan K. Davis, J.D., CPA and Todd A. Kraft, JD., L.L.M.

Three forces have joined which make estate planning imperative. First, the new administration and Democratic control of both houses make it likely that the perceived loophole of valuation discounts will be closed. Second, low interest rates and low asset values make certain planning techniques particularly useful. Finally, there should be no doubt that the estate tax is here to stay and that repeal of the estate tax is a remote dream.

1. H.R. 436—Elimination of Valuation Discounts

Valuation discounts associated with interests in closely-held entities (family-owned corporations, LLCs, and family limited partnerships) are currently a cornerstone of family wealth transfer planning. For decades, the courts have held that standard valuation discounts, such as discounts for lack of control and lack of marketability, are applicable to transfers of closely-held entities. (For instance, in Texas, the law is found in such cases as *Estate of Bright, Kimbell,* and *Adams*).

On January 9, 2009 Representative Pomeroy (D-ND) introduced H.R. 436—Certain Estate Tax Relief Act of 2009, that would change the law. The Act would disallow any valuation discount related to passive assets of a closely-held entity. Similar attempts to address valuation discounts were introduced during the Clinton administration, but were unsuccessful based on the make-up of the Congress at the time. While the fate of this particular bill is uncertain, the current Congress will be much more receptive to eliminating valuation discounts for closely-held entities, as a perceived loophole in the current estate and gift tax law.

Practitioners and their clients should seriously consider wealth transfer planning now—before H.R. 436, or another similar measure, increases the tax on such transfers.

A common example of such planning is the use of a family limited partnership, in which limited partnership interests are transferred to a younger generation rather than transferring marketable assets, such as publically traded stock. The discounts at the entity level reduce the value of the transfer when compared to a direct transfer of the underlying assets in the entity. Such discounts can dramatically lower the estate and gift tax owed on the transfer.

2. Low Interest Rates and Depressed Asset Values

Furthermore, the current economy has produced two effects which, when combined, create an extremely favorable environment for wealth transfer planning. First, interest rates are at historically low levels. The Section 7520 Rate for July 2009 is 3.4%. In fact, the IRS had to recently revise the applicable mortality tables because the existing tables did not include interest rates this low. Additionally, many categories of property, including

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stocks, real estate, and even oil and gas, are depressed in value. The combination of these two phenomena makes transfer planning techniques such as grantor retained annuity trusts (or "GRATs") and sales to intentionally defective grantor trusts (or "IDGTs") quite favorable. At a relatively low current transfer tax cost, these techniques "freeze" the value, with appreciation in the future escaping tax. Rumors abound that Congress might also modify the requirements or even repeal these techniques, so the availability of these techniques might also be limited in the future.

3. The Estate Tax is Here to Stay

H.R. 436 has a second purpose: to make the estate tax permanent. The Bill would reverse the pending repeal of the estate tax in 2010. Further, the Bill would freeze the exemption at $3,500,000 and freeze the estate and gift tax rates at 45 percent. This is the current law for 2009 and also reflects the position President Obama espoused during the presidential election. Whether through H.R. 436 or other legislation, the estate and gift taxes will be extended for the foreseeable future.

In conclusion, the specter of potentially losing the ability to discount closely held entities, along with the economic realities of low interest rates and depressed asset values, create a unique transfer tax planning environment. Further, now is not the time to wait and see what will happen. Now is the time to plan for what we know is coming.

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Summary of Current Exemptions for Property of a Debtor

By Sharon L. Ellington, J.D., CPA, CFP™

We are currently in the midst of difficult economic times which some speculate will only get worse. As such, there will likely be a rise in the seizure of property to satisfy creditors' claims and a rise in bankruptcy filings. Thus, it is essential that debtors and their advisors know what property is exempt from creditors' claims.

Property Exempt from Creditors' Claims under Texas Law

Texas residents may choose between federal and state exemptions. Since the Texas exemptions are much more favorable than federal exemptions, most Texas debtors will want to use Texas exemptions when possible.

1. Homestead Exemption

Texas Property Code Section 41.001(a) provides for an unlimited homestead exemption, as there is no limitation on the value of the property which may be exempt. However, it should be noted that encumbrances for purchase money, property taxes, Internal Revenue Service liens, etc. will prevail over the homestead exemption.[1]

Homestead is defined as an urban home or a combination of an urban home and business that does not consist of more than 10 acres in one or more contiguous lots; a rural home for a family that does not consist of more than 200 acres in one or more parcels; or a rural home for a single individual that does not consist of more than 100 acres in one or more parcels.[2]

Section 41.001(c) states that proceeds from the sale of a homestead are not subject to seizure for a creditor's claim for six months after the date of the sale. Notably, this exemption is in lieu of the homestead exemption in Section 41.001(a), as a debtor may either claim a homestead as exempt or proceeds from the sale of a homestead as exempt, but not both.[3] In addition, Section 41.003 provides that the temporary renting of a homestead will not change its homestead character if the homestead claimant has not acquired another homestead.

2. Personal Property Exemption

In addition to the homestead exemption, debtors are entitled to a personal property exemption. Specifically, a family may exempt personal property with an aggregate fair market value of

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not more than $60,000 and a single individual may exempt not more than $30,000.[4] It should be noted, however, that security interests, liens, or other charges encumbering the personal property will prevail over the personal property exemption.[5]

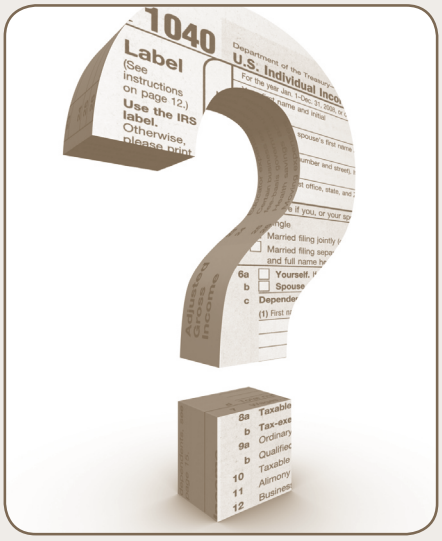
Personal property is defined in Section 42.002 and includes household goods and furnishings; farming and ranching vehicles and implements; tools, equipment, books, and apparatus used in a trade or business; wearing apparel; jewelry; two firearms; athletic and sporting equipment; a vehicle; certain amounts of livestock; and pets.

3. Additional Exemption For Certain Savings Plans

Debtors are also entitled to an exemption for certain savings plans, which is in addition to the personal property exemption. Specifically, a person's right to the assets held in or to receive payments under any stock bonus, pension, profit sharing, or similar plan, or individual retirement account ("IRA"), is exempt.[6] However, the plan or account must qualify under the Internal Revenue Code ("IRC").[7] For example, an IRA inherited from a spouse will be exempt under Section 42.0021(a), but an IRA inherited from someone other than a spouse will not be exempt.[8] This is due to the fact that the IRC analyzes IRAs acquired by spouses and IRAs inherited by non-spouses differently.[9] Specifically, a surviving spouse may treat the IRA as her own asset, treat herself as the beneficiary, or disclaim the IRA, whereas a non-spouse cannot.[10] As such, an IRA inherited from a non-spouse is not a retirement plan and thus is not exempt.[11]

4. Exemptions For Certain Insurance and Annuity Benefits

Pursuant to Texas Insurance Code Section 1108.051, the cash value and proceeds of an insurance policy, to be provided to an insured or beneficiary under an insurance policy or annuity contract issued by a life, health, or accident insurance company, or an annuity or benefit plan used by an employer or individual, are exempt.



Federal Bankruptcy Code Limitations on Texas State Law

If a debtor decides to file for bankruptcy, he may not be entitled to the exemptions under Texas law, or those exemptions may be severely limited.

1. Federal Prerequisite for Utilization of State Exemptions

Pursuant to Federal Bankruptcy Code Section 522(b)(3)(A),[12] to claim state exemptions a debtor must be a resident of the state for 730 days before the bankruptcy filing. If the debtor is not a resident for 730 days before filing, the debtor must use the exemptions in the state where he lived for the majority of the 180 days before the filing period.[13]

2. Federal Limitation on Unlimited Homestead Exemption

The Federal Bankruptcy Code also places a limit on the unlimited homestead exemption. Specifically, a debtor may not exempt any amount of interest that was acquired by the debtor during the 1,215 day period preceding the date of filing that exceeds in the aggregate $136,875.[14] Notably, "any amount of interest" does not include any interest transferred from a debtor's previous principal residence (which was acquired prior to the 1,215 day period) into the debtor's current principal residence, if the debtor's previous and current residences are located in the same state.[15] As such, if a debtor purchases a home in Texas before the 1,215 day period begins, then sells that home and purchases another home in Texas within the 1,215 day period using the equity from the previous home, and then files for bankruptcy and claims a homestead exemption on the second home, the equity of the previous home plus $136,875 will be exempt.

It should be noted that multiple rollovers of equity are permitted.[16] Moreover, making regular loan payments during the 1,215 day period is permissible and will not constitute an "interest acquired,"[17] however, making other loan payments may be problematic.[18]

3. Federal Limitation on Non-Rollover and Roth IRAs

Pursuant to Federal Bankruptcy Code Section 522(n), the exemption for non-rollover IRAs and Roth IRAs will be limited to $1,095,000.[19] The limit is per

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debtor. So, in a joint bankruptcy, up to $2,190,000 may be sheltered if each person has a $1,095,000 IRA. In addition, Section 522(n) states that the limitation "may be increased if the interests of justice so require." Thus, it is possible that more than $1,095,000 may be exempt. Notably, there is no limitation on rollover IRAs, SEPs, or SIMPLEs.

To File or Not to File?

A debtor faced with the decision of whether to file for bankruptcy should consider the fact that the federal limitations do not come into play unless the debtor files for bankruptcy. As such, it may be more desirable for a debtor to not file for bankruptcy and instead to rely on Texas law to protect his assets from seizure. This is especially true if the debtor has not resided in Texas the required 730 days, as he would lose the ability to use any of the Texas exemptions. Likewise, a debtor who recently purchased his home in Texas (i.e. has not owned his home for the required 1,215 days) will be limited to a homestead exemption of $136,875 if he files for bankruptcy. Based on the foregoing, a debtor may want to delay filing for bankruptcy as long as he can and, if possible, until he meets the requirements in the Federal Bankruptcy Code, so that the federal limitations will not apply.

[1] Tex. Prop. Code § 41.001(b).
[2] Tex. Prop. Code § 41.002.
[3] *See Matter of England*, 975 F.2d 1168 (5th Cir. 1992).
[4] Tex. Prop. Code § 42.001(a).
[5] *Id.*
[6] Tex. Prop. Code § 42.0021(a).
[7] *Id.*
[8] *In re Jarboe*, 365 B.R. 717 (Bankr. S.D. Tex. 2007).
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] 11 U.S.C. 522(b)(3)(A).
[13] *Id.*
[14] 11 U.S.C. 522(p)(1) adjusted by 11 U.S.C. 104.
[15] 11 U.S.C. 522(p)(2)(B).
[16] *See In re Wayrynen*, 332 B.R. 479 (Bankr. S.D. Fla. 2005).
[17] *See In re Blair*, 334 B.R. 374 (Bankr. N.D. Tex. 2005) and *In re Burns*, 395 B.R. 756 (Bankr. M.D. Fla. 2008).
[18] *See In re Maronde*, 332 B.R. 593 (Bankr. D. Minn. 2005).
[19] 11 U.S.C. 522(n) adjusted by 11 U.S.C. 104.

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Proceed with Caution: What Businesses and Individuals Need to Know about Fraudulent Transfers under Section 548

By Kristen M. Cox, J.D.

During these difficult economic times, it may be tempting for both businesses and individuals to engage in various transactions in an attempt to protect their assets. However, such businesses and individuals must remain mindful that if their economic situation takes a turn for the worse and they are forced to file bankruptcy, section 548 of the Bankruptcy Code may allow a bankruptcy trustee to classify a prior transaction as fraudulent and avoid the transfer altogether. While this article examines several subsections of section 548 of the Bankruptcy Code, businesses, individuals, and their advisors should also consider the subsections of section 548 not discussed herein, the Texas Uniform Fraudulent Transfer Act[1], and other statutes that may be relevant to contemplated transfers.

Section 548 is far-reaching because it has the potential to apply to any transfer made by a debtor within two years before the debtor's filing of a bankruptcy petition. Courts consider a transfer to be made at the time the transferee's interest is so perfected that a bona fide purchaser from the debtor would not be able to acquire an interest in the transferred property superior to that of the transferee. Furthermore, the Bankruptcy Code's definition of "transfer" is particularly broad, encompassing "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—(i) property or (ii) an interest in property."[2] Sales of property, purchases of annuities, and many other transactions fall within the Bankruptcy Code's definition of "transfer." A bankruptcy trustee may avoid a transfer made by the debtor within two years of the debtor's filing of the bankruptcy petition if the transfer was made with either actual or constructive fraudulent intent.

[1] The Texas Uniform Fraudulent Transfer Act can be used by creditors to set aside fraudulent transfers either in or out of Bankruptcy. The Act provides, in most cases, that a transfer found to be fraudulent may be set aside up to four years after the transfer was made. Tex. Bus. & Com. Code §§ 24.001-24.013.
[2] 11 U.S.C §101(54).

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Actual Fraudulent Intent

Under section 548(a)(1)(A), a transfer is made with actual fraudulent intent if the debtor engaged in the transaction "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became… indebted" on or after the date of the transaction. Because actual intent is very hard to prove with direct evidence, courts allow bankruptcy trustees to present circumstantial evidence to establish the existence of certain "badges of fraud" in connection with the transaction at issue. While there is no single checklist of badges of fraud that all courts consider, Texas's version of the Uniform Transfer Act contains a comprehensive list of the various badges of fraud considered by many courts:

- whether the transfer or obligation was to an insider[3];
- whether the debtor retained possession or control of the property transferred after the transfer;
- whether the transfer or obligation was concealed;
- whether before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
- whether the transfer was of substantially all the debtor's assets;
- whether the debtor absconded;
- whether the debtor removed or concealed assets;
- whether the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
- whether the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
- whether the transfer occurred shortly before or shortly after a substantial debt was incurred; and
- whether the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.[4]

Fortunately, a showing by a trustee that one badge of fraud exists as to a transaction is not sufficient for the court to infer that the transaction was engaged in with actual fraudulent intent. Instead, courts require the presence of several badges of fraud to find that a transfer was undertaken with actual fraudulent intent and to allow the trustee to avoid the transfer.

The avoidance of a transfer is a serious consequence for the debtor to face if the court determines that a transfer was made with fraudulent intent. Nevertheless, a debtor may face more dire consequences if the court finds a transfer was made with actual fraudulent intent. Under section 727(a)(2) of the Bankruptcy Code, a court may deny a debtor's discharge if the debtor transferred property with the intent to hinder, delay, or defraud a creditor within one year of filing a bankruptcy petition. Moreover, a debtor as well as the debtor's advisors could face criminal charges for a fraudulent transfer under 18 U.S.C. 1344, which imposes criminal liability for knowingly executing or attempting to execute a scheme or artifice to defraud a financial institution. Because this statute was drafted so broadly, a debtor or the debtor's advisors could potentially face up to 30 years imprisonment or a fine of up to $1,000,000 for their roles in the planning and execution of a fraudulent transfer.

Constructive Fraudulent Intent

A transfer is not necessarily safe from avoidance if a trustee is unable to show, either through direct or circumstantial evidence, that the debtor engaged in the transfer with actual intent to defraud. Instead, the trustee may still be able to avoid the transfer with a showing of constructive fraudulent intent. Section 548(a)(1)(B) of the Bankruptcy Code sets forth four situations for which a court will find constructive intent to defraud with regard to a transfer. This article will examine two of those situations. To avoid a transfer based upon any of the aforementioned situations, the trustee must show that the transfer was made for less than reasonably equivalent value.

The reasonably equivalent value determination is very case specific. Courts in Texas typically focus on a comparison of what went out of the debtor's estate

[3] The Texas Uniform Fraudulent Transfer Act's definition of "insider" includes, among other things, relatives of a debtor, a partnership for which the debtor serves as the general partner, and a corporation of which the debtor is a director, officer, or other person in control. Tex. Bus. & Com. Code § 24.002(7).
[4] Tex. Bus. & Com. Code § 24.005(b).

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versus what came into the debtor's estate as a result of the transaction. However, there is no percentage threshold to meet for the value received in the transfer to be declared reasonably equivalent. Courts will include in the valuation analysis an economic benefit to the debtor resulting from the challenged transaction. In contrast, when evaluating transfers to family members, abstract benefits such as love and affection and the preservation of family ties have been held not to constitute value.

The first situation in which a court will find that a transfer was made with constructive fraudulent intent is when the transfer was made for less than reasonably equivalent value and the debtor was either insolvent on the date the transfer was made or was rendered insolvent as a result of the transfer. Notably, the Bankruptcy Code defines "insolvent" differently for a partnership than for individuals or other entities. For individuals and other entities, insolvency is a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of—(i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and (ii) property that may be exempted from property of the estate under section 522 of [the Bankruptcy Code]."[5] The solvency determination for a partnership primarily differs from that of other entities in that the excess value of a general partner's nonpartnership property (exclusive of property treated in a fraudulent manner as to creditors) over the general partner's nonpartnership debts is added to the value of partnership property (exclusive of property treated in a fraudulent manner as to creditors) and then compared to the sum of the partnership's debts. For purposes of the solvency determination, "fair valuation" is the price a debtor could obtain at open market.

The second situation, which can be found in section 548(a)(1)(B)(ii)(II) of the Bankruptcy Code, is particularly important for entity taxpayers. Under this section, a court may find that a transfer was made with constructive fraudulent intent if the transfer was not made for reasonably equivalent value and the debtor was engaged in or about to engage in a transaction after which the debtor would be left with unreasonably small capital. The term "unreasonably small capital" refers to a situation in which a debtor is generally unable to generate enough cash flow to sustain operations. Such a financial condition eventually leads to insolvency. Importantly, the Bankruptcy Court for the Western District of Texas has held that a transfer can only be considered fraudulent if it actually caused the unreasonably small capital condition.[6] If the debtor already has unreasonably small capital and then engages in a transfer that worsens the debtor's condition, that transfer may not be avoided under section 548.

A final provision of section 548 that businesses should be aware of is section 548(b), which presents an additional challenge for limited partnerships, their partners, and their management. If a limited partnership is filing bankruptcy, the trustee can avoid any transfer to a general partner within a period of two years prior to the petition if the partnership was insolvent at the time of the transfer or the partnership was rendered insolvent by the transfer. Under this subsection, whether the transfer was made for reasonably equivalent value is not even considered. Because of this, limited partnerships should be very careful about repaying any advances from a general partner or transferring any assets to a general partner when their financial condition begins to deteriorate.

As the economic situation in our country worsens, it is instinctual for businesses and individuals to consider taking actions that will protect their assets both now and in the future. Nonetheless, before engaging in any substantial transfers of property or interests in property, it is advisable to pause and analyze the potential application of section 548 to the transfer should the business or individual later find it necessary to file for bankruptcy.

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[5] 11 U.S.C. § 101(32).
[6] *In re Pioneer Home Builders, Inc.*, 147 B.R. 889 (Bankr. W.D.Tex. 1992).

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