

LEGAL UPDATE

CLIENT NEWSLETTER OF CARR, MORRIS & GRAEFF, P.C.

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EMPLOYMENT

COBRA BENEFITS – WHAT IS REQUIRED

The Consolidated Omnibus Budget Reconciliation Act of 1986 (“COBRA”) provides employees the ability to continue coverage in an employer-sponsored group health insurance program upon the occurrence of a *qualifying event* – most commonly the separation of employment for reasons other than gross misconduct. However, the federal COBRA law only applies to employers who employ 20 or more employees. Thus, employees of smaller employers are left without an opportunity to continue coverage following a qualifying event. In an effort to rectify this situation, many states and the District of Columbia stepped in with their own health insurance continuation laws.

In the District of Columbia and Virginia employers with fewer than 20 employees are required to give employees the opportunity to elect up to three months of health insurance continuation coverage following the loss of coverage under the group plan. In Maryland employers with between two and 19 employees are required to provide for up to 18 months of continuation coverage when the separation (and attendant loss of coverage) was without cause and up to six months of continuation coverage when the employee is terminated with cause.

COBRA also places certain requirements on employers with 20 or more employees. First, the employer is required to give each employee participating in a group health insurance plan a notice upon enrollment advising the employee of his/her rights under COBRA. Upon the occurrence of a *qualifying event* the employer is

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TAX

INCOME TAXATION OF PUERTO RICO RESIDENTS – PART II

The special rules for gain on the sale of intangible personal property (stocks and bonds), diamonds, and gold resemble the Twilight Zone of international tax which we have come to love and appreciate. A taxpayer is subject to these special rules if he or she meets **both** the following conditions:

- 1 – For the tax year for which the source of gain must be determined taxpayer is a *bona fide* resident of Puerto Rico.
- 2 – For any of the ten years preceding that year taxpayer was a citizen or resident alien of the U.S., but not a *bona fide* resident of Puerto Rico.

If taxpayer meets both those conditions gain from the disposition of the property will not be sourced to Puerto Rico and, therefore, taxpayer may not exclude the gain on his or her U.S. tax return. For example, in 2000 taxpayer, a U.S. citizen, lives in the U.S. and purchases 100 shares of stock in Widget, Inc., a U.S. corporation. In 2003 taxpayer moves to Puerto Rico and in 2006, while a *bona fide* resident of the island, taxpayer sells the stock at a gain. The gain is sourced to the U.S. and not to Puerto Rico.

The source of scholarships, fellowships, grants, prizes, and awards is generally the residence of the payer regardless of who actually disburses the funds. Therefore, in order for these payments to be Puerto Rico income the payer must be a resident of Puerto Rico, such as a *bona fide* resident individual or a corporation organized in Puerto Rico. This rule does not apply to amounts paid as salary or other compensation for services, which are sourced to where services are performed.

Effectively connected income. In limited circumstances some kinds of income from sources outside Puerto Rico must be treated as effectively connected with a trade or business in Puerto Rico. The three circumstances, **all** of which must be met are:

- 1 – Taxpayer has an office or other fixed place of business in Puerto Rico to which the income can be attributed.
- 2 – The office or place of business is a material factor in producing the income.
- 3 – The income is produced in the ordinary

course of the trade or business carried on through that office or other fixed place of business.

The three kinds of income from sources outside Puerto Rico to which these rules apply are rents and royalties for the use of intangible personal property located outside Puerto Rico, including intellectual property such as patents, copyrights, trade secrets, goodwill, trademarks, and franchises if the rents and royalties are from the active conduct of a trade or business in Puerto Rico; dividends or interest from the active conduct of a banking, financing, or similar business in Puerto Rico; and, income or gain from the sale of inventory outside of Puerto Rico through the office in Puerto Rico.

For example, taxpayer is a *bona fide* resident of Puerto Rico and his or her business, which taxpayer conducts from an office in San Juan, is developing and selling specialized computer software. The income from selling the software in the U.S., Puerto Rico, or anywhere else is sourced to Puerto Rico.

U.S. citizens and resident aliens who have income from Puerto Rico must file a tax return with Puerto Rico’s Treasury Department (*Departamento de Hacienda*). *Bona fide* residents of Puerto Rico will generally pay tax to Puerto Rico on their worldwide income. U.S. citizens and resident aliens who are also *bona fide* residents of Puerto Rico during the entire tax year must generally file the following returns:

- 1 – A Puerto Rico tax return reporting income from worldwide sources. If taxpayer reports U.S. source income on his or her Puerto Rico return taxpayer can claim a credit against Puerto Rico tax for income taxes paid to the U.S.
- 2 – A U.S. tax return reporting income from worldwide sources but excluding Puerto Rico source income.

If all of taxpayer’s income is from Puerto Rico sources he or she is not required to file a U.S. return.

If taxpayer is not a *bona fide* resident of Puerto Rico for the tax year he or she generally files tax returns with both Puerto Rico and the U.S. U.S. citizens and resident aliens who are not *bona fide* residents of Puerto Rico during the entire tax year must generally file the following returns:

- 1 – A Puerto Rico return reporting only

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QUESTIONS AND ANSWERS ON ASSET PROTECTION

1. What is meant by *asset protection planning*?

Essentially, structuring the holding of family wealth so that some family assets are protected from the claims of creditors. Effective asset protection is really only a subset of effective estate planning—it's one issue of many, such as taxes. There are two basic approaches: one involves divesting ownership, the other retaining ownership but holding in a manner that is less attractive to potential creditors.

2. Why the recent concern about asset protection?

First, the recent recession and the resulting business failures and bankruptcies; second, the litigation and liability crisis which seems to afflict our society.

3. Can everyone benefit from asset protection planning?

No. People who are concerned about asset protection planning tend to be business owners and entrepreneurs, developers, professionals such as physicians, or some other type of "target" defendant. People who have international experience with political upheaval, expropriation or persecution also appreciate the value of asset protection planning.

4. Who is a target defendant?

A person with some type of potential liability for a particular type of risk and who is perceived as having a "deep pocket"—the ability to pay a large judgment or who will pay a large settlement to avoid risking a judgment. Examples are: physicians, lawyers, stockbrokers, landlords, car dealers and so forth.

5. How can asset protection planning protect a person?

It's a type of worst-case contingency planning—an opportunity to insulate a portion of a family's wealth in the event of a catastrophic liability situation.

6. Suppose a person is facing an imminent liability, either because of debts, or a lawsuit? What can they do?

It depends, but the first point you need to understand is that it is illegal to go out and dispose of your assets in order to delay, hinder or defraud your creditors. So if someone facing a large liability, on the eve of a judgment being entered, suddenly retitles all his property in the name of his spouse, his children, a nominee... these transactions can and will be set aside by a court, if either there was intent to defraud, or if the transferor was insolvent at the time of the transfer. There are persons for whom it is too late to do any type of planning.

7. Are you talking about *fraudulent*

conveyances?

Yes. That's the technical term for transfers which can be set aside because they are made without consideration while insolvent, or with the actual intent to delay or hinder creditors.

8. What kind of transactions can be considered as fraudulent conveyances?

Any type. Gifts, sales for less than full value, any transfer of any type of property, as long as it is made with intent to delay, hinder or defraud.

9. What do you mean "delay, hinder or defraud?"

Generally, to make a creditor's enforcement of legal collection rights more difficult.

10. How does a creditor show intent?

Because it's impossible to read a debtor's mind, intent is usually inferred from certain "badges of fraud." I call it the "smell test." Some of the typical hallmarks of a fraudulent transfer are:

- Retaining an interest in, or possession of, the property, supposedly transferred.
- Transfers between family members for allegedly antecedent debt.
- Pursuit by creditors at time of transfer.
- Gross inadequacy of consideration.

11. Suppose it's sometime before the 11th hour, and the situation is not desperate. What can a person do?

First, stop bundling the entire family net worth. Divide it and don't risk it all to loss from a single catastrophe. For example, if a wife and husband have all their assets in joint names, and they jointly undertake a liability, they've risked it all. Assets and asset holdings should be diversified.

12. That sounds like good investment advice.

Yes, some asset protection planning really involves investment advice and risk reduction. Planning ought to begin with a review of insurance protection (including umbrella coverage) and creditor-protected insurance product investments. My basic approach is to set aside a nest egg which is not at risk, and to minimize other risks where you've decided to take risk. I don't endorse the "magic pills" promoted by some hucksters, such as retitling everything the name of family limited partnerships, or offshore trusts, or whatever, regardless of your personal situation and objectives.

13. What are some examples of techniques that can be used?

Some of the approaches which can help insulate assets from unrelated claims are:

- Incorporating your business, or using either limited partnerships or limited liability companies.

- Titling assets tenants by the entireties.
 - Maximizing the use of qualified retirement plans.
 - Outright gifts to family members or trusts for their benefit.
 - Gifts to trusts, including life insurance trusts.
 - Foreign situs planning. Offshore investments, through revocable or irrevocable trusts.
 - Distributing ownership through family limited partnerships or family limited liability companies.
- ### 14. Is there a single panacea for every situation?

No. Each technique has other benefits, and the principal reason for using it should be those other benefits. Asset planning needs to be done in an estate or business planning context. Most importantly, planning should always take place *before* liabilities ripen and insolvency is an issue.

ROY MORRIS

EMPLOYMENT

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required to give the employee notice of his/her ability to continue health insurance under COBRA and the time period the employee has to request COBRA benefits, as well as the cost of continued benefits. By law an employer is permitted to charge a up to 102% of the actual cost of the health insurance coverage to a COBRA participant. It is also important to recognize that while the *qualifying event* usually is separation of employment, there are other *qualifying events*. Other events could include (i) a reduction of work hours to part-time which would also entail a loss of benefits; (ii) divorce; or (iii) loss of health insurance eligibility by a child of an employee as a result of the child ceasing to be a qualified dependent of the employee, as defined by the group health insurance contract.

While not part of COBRA, the Health Insurance Portability and Accountability Act of 1996 ("HIPAA") plays an integral role in employer-sponsored group health insurance. Prior to implementation of HIPAA, a health insurance carrier could exclude or place restrictions on benefits for certain pre-existing medical conditions of new enrollees. Following the implementation of HIPAA, group health insurance plans were severely limited in their ability to exclude benefits to new enrollees for pre-existing conditions when the new enrollee was covered by another health insurance plan without a significant gap in coverage before switching to the new plan.

PHILIP SCHWARTZ

EMPLOYMENT**EMPLOYERS: FAMILY LEAVE FOR MILITARY FAMILIES**

First a quick review of the present state of federal law. The Family and Medical Leave Act of 1993 (Pub.L. 103-3) (the "FMLA") is a labor law allowing an employee to take unpaid leave due to a serious health condition that renders the employee unable to perform his job or to care for a sick family member or to care for a new son or daughter (including by birth, adoption or foster care). The law recognizes the growing needs of balancing family, work and obligations and promises numerous protections to workers. Some of these protections include: twelve workweeks of leave per twelve months for various reasons such as caring for the birth, adoption or foster care placement issues, caring for a sick child, spouse or parent, or being physically unable to perform one's job; restoration to the same, or substantially equal, position upon return to work; protection of employee benefits while on leave; and protection of the employee from retaliation by employer. Generally, the FMLA ensures that all workers are able to take extended leaves of absence from work to handle family issues or illness without fear of being terminated from their jobs or being forced into a lower job upon their return. The leave guaranteed by the act is unpaid and is available to those working for employers with 50 or more employees within a 75 mile radius. The FMLA also applies to all U.S. government employees and state employees.

On January 28, 2008, President Bush signed into law H.R. 4986, the National Defense Authorization Act for Fiscal Year 2008 (Pub. L. 110-181) (the "NDAA"). Among other things, §585 of the NDAA amends the FMLA to permit a "spouse, son, daughter, parent, or next of kin" to take up to 26 workweeks of leave to care for a "member of the Armed Forces, including a member of the National Guard or Reserves, who is undergoing medical treatment, recuperation, or therapy, is otherwise in outpatient status, or is otherwise on the temporary disability retired list, for a serious injury or illness." The provisions in the NDAA providing this leave are effective as of the date of the President Bush's signing on January 28th. The Department of Labor ("DOL") is working quickly to prepare comprehensive guidance regarding rights and responsibilities under this new legislation. In the interim the DOL's Wage and Hour Division is requiring employers to act in good faith in providing the leave available under the NDAA. The NDAA also permits an employee to take FMLA leave for "any qualifying exigency (as the Secretary [of Labor] shall, by regulation, determine) arising out of the fact that the spouse, or

a son, daughter, or parent of the employee is on active duty (or has been notified of an impending call or order to active duty) in the Armed Forces in support of a contingency operation." This provision of the NDAA will not become effective until the Secretary issues final regulations defining "any qualifying emergency."

The expectation is that these amendments will permit the immediate family of armed forces members to take FMLA leave to address family issues related to military deployments. As an example the spouse of a recently deployed military member could potentially use FMLA leave to coordinate childcare, to attend pre-deployment briefings, family support sessions, or simply see the military spouse off or welcome the spouse home. DOL is preparing regulations and employers are advised in the interim to provide this type of unpaid leave for qualifying employees on a good faith basis. Following DOL's final regulations concerning the NDAA's impact on FMLA leave, employers should review all of their FMLA policies, handbooks, notices, forms and other related documents to determine what compliance amendments may be necessary. Because military family medical leave (up to 26 weeks to care for a family member injured in combat) lasts for a longer period than other FMLA leave (up to 12 weeks), employers may need to revise their health and welfare benefits plan, insurance policies and associated documents to provide for such benefits over a longer period. For employers in the D.C. metro area, these military family medical leave amendments may be especially poignant given the large concentration of military personnel and their families. The FMLA and frequently asked questions concerning compliance can be found at <http://www.dol.gov/esa/whd/fmla/index.htm> and additional information at <http://www.dol.gov/esa/whd/fmla/fmlaAmended.htm>.

JUSTIN BANFORD

TAX

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income from Puerto Rico sources.

2 – A U.S. return reporting income from worldwide sources. Generally taxpayer will be able to claim a foreign tax credit for income taxes paid to Puerto Rico on Puerto Rico income.

If a taxpayer is a U.S. citizen, a *bona fide* resident of Puerto Rico, and has income from sources outside both Puerto Rico and the U.S., that income is treated as foreign source income under both tax systems. In addition to filing a Puerto Rico and a U.S. tax return taxpayer might have to file a return in the foreign source

jurisdiction. To avoid double taxation a foreign tax credit is generally available in either the U.S. or Puerto Rico return. For example, taxpayer is both a *bona fide* resident of Puerto Rico and a U.S. citizen. He travels to the Dominican Republic to work in the construction industry for one month and earns \$20,000. Because the wages were earned outside Puerto Rico and outside the U.S. taxpayer must file returns with Puerto Rico and the U.S. He might also have an obligation to file with the Dominican Republic. Any income taxes paid to the Dominican Republic are creditable either on the U.S. return or Puerto Rico return. In order to avoid double taxation the U.S. and Puerto Rico have a mutual agreement procedure to settle such cases. The rules applicable to non-resident aliens with Puerto Rico contacts are beyond the scope of this summary article.

A taxpayer who is excluding Puerto Rico income from his U.S. tax return is not allowed to take deductions and credits which apply to the excluded income. For example, deductions such as employee business expenses will not be allowable on the U.S. return if the employee's income is excluded Puerto Rico income. Deductions which do not specifically apply to any particular type of income must be divided between the excluded income from sources in Puerto Rico and income from all other sources to find the portion which can be deducted on the U.S. return. Alimony, the standard deduction, medical expenses, charitable contributions, real estate taxes, and mortgage interest must be allocated. The percentage of the deduction allowable is obtained by dividing gross income subject to U.S. tax by gross income from all sources, including Puerto Rico.

A final word about tax policy. It now appears the U.S. has four Federal income tax regimes: one for citizens and residents, a second one for nonresident aliens, a third one for *bona fide* residents of Puerto Rico and other possessions, and yet a fourth one for tax expatriates. There is a certain tax logic to this scheme. Tax logic, however, is not the only goal of tax policy, especially when tax logic breeds unbearable complexity. Congress must ask itself whether four separate schemes are really necessary, and, if so, whether the complexity within each scheme is also really necessary. The rules described in this article can be considerably simplified at the cost of some tax logic but the end result would be a tax regime which is simpler to administer. Simplicity is also an important goal of tax policy in that it usually results in fewer resources devoted to tax avoidance thereby increasing tax revenues, not to mention reducing taxpayer headaches.

NÉSTOR CRUZ

**CARR, MORRIS
& GRAEFF, P.C.**

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

The firm strives to provide full service representation to its corporate and individual clients. It is designed to provide such service by organization and presentation of an array of attorneys with diverse backgrounds in specialized areas of the law as well as a generalized background which enables them to look beyond a narrow specialty or need. The academic and cultural backgrounds of the attorneys of the firm are as diverse as their experiences and specializations.

Carr, Morris & Graeff, P.C., specializes in the following areas: Corporate/General Business; Taxation/Estate Planning; Civil/Commercial Litigation; Criminal Representation; Alternative Dispute Resolution; Employment/Labor; Discrimination; and Wage-Hour.

The firm maintains its office in the Metro Center region of downtown Washington. It has attorneys admitted to all of the local judicial jurisdictions—the District of Columbia, Maryland and Virginia.

STAFF NOTES

Néstor Cruz has just completed his first four-year term on the Virginia Opera Board of Governors for Northern Virginia.

Roy Morris was recently named to the prestigious D.C. Estate Planning Council.

How many lawyers does it take to boil water? We're not sure...but it only took Phil Schwartz five days to diagnose and repair his hot water heater. Phil skillfully replaced the thermocoupler in his home unit in a matter of minutes. The family is thrilled—no more trips to the club for daily showers. Phil now carries a spare thermocoupler with him at all times...you never know when these skills will be needed again.

On May 16, Phil Schwartz reached a milestone—20 years with the firm. In 1988, Phil joined us as a law clerk while attending George Washington University School of Law.

CARR, MORRIS & GRAEFF, P.C.

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