

Business Brief

Business and Client Advisory



A MAJOR DISADVANTAGE WITH INCORPORATING IN NEVADA

Unscrupulous promoters have created a continuing boom in the formation of Nevada corporations by business owners outside Nevada and the United States. Closer to home, it has been reported that roughly 40% of the corporations formed in Nevada in 2004 are owned by Californians. While there are often legitimate business reasons for incorporation in the State of Nevada, one commonly hyped benefit, the ability to reduce or avoid California income tax, is false.

The promoters suggest to California business owners that they may quickly form a shell Nevada corporation, and use a variety of schemes to transfer California earned income to the Nevada corporation and thereby take advantage of the fact that Nevada has no individual or corporate income tax (as opposed to California's maximum 9.6% corporate tax rate). A common suggestion is for the California business to transfer title to its tangible assets, such as equipment or vehicles, and then enter into an equipment lease with a Nevada corporation, which creates deductions against income earned in California.

As the saying goes, if it seems too good to be true, it probably is. Recently, the California Franchise Tax Board (FTB) has begun to actively investigate reports that there has been a surge in Nevada incorporations by California businesses in order to fraudulently under-report California income. As a result, numerous FTB audits have been initiated. The State of California takes the position that money earned in California is taxable in California. The general tax rule is that income which is "effectively connected" to California cannot be diverted to a foreign shell corporation in order to avoid taxes.

For a variety of legal and administrative reasons, including Nevada's business privacy laws and its refusal to enter into a "taxpayer information sharing agreement" with the Internal Revenue Service, it is currently very difficult for the FTB to trace the use of California income once it is transferred to Nevada. In response, tax investigators are relying increasingly on modern technology: computer databases which can compare bank, sales and payroll records linked to California addresses. Continuing improvements in this technology will increase the risk that those who misuse Nevada corporations will be held liable for under-reporting of income, including interest and penalties.

There are several legitimate advantages, however, for a California-based business to incorporate in Nevada and register as a foreign corporation in California. For instance, Nevada laws make it more difficult than in California to "pierce the corporate veil," thus providing stronger protection for officers and directors against claims by shareholders for breach of fiduciary duty, and generally abolish joint and several liability for defendants in a personal injury action. Please contact our firm if you would like more information regarding the advantages and disadvantages of incorporating in the State of Nevada.

\$1,291,670 JUDGMENT OBTAINED AGAINST WACHOVIA SECURITIES

Recently, Vogt & Resnick, working in association with an Ohio law firm, obtained a \$1,291,670 judgment against Wachovia Securities, LLC in a binding arbitration conducted before the National Association of Securities Dealers (NASD). Our client (the "Client"), was the former manager of a Wachovia Securities branch office who, notwithstanding years of highly successful branch office management and stellar performance reviews, was abruptly fired. A panel of three NASD arbitrators found that Wachovia's termination of our Client was in violation of California fundamental public policy, and they also found that his termination was in breach of an implied contract requiring his employer to adhere to a three-step disciplinary procedure prior to termination.

Prior to being fired, our Client had suspected that some of his subordinates had been involved in untoward dealings with Wachovia's clients. Following Wachovia's procedures for policing the activities of its own employees, our Client began making direct telephone calls to clients in order to evaluate the activities and performance of his subordinates. His investigation revealed evidence of wrongdoing. When our Client reported his findings to his superiors, he was ordered to cease making further client inquiries, and directed not to pursue disciplinary action against the suspected employees.

The judgment rendered by the NASD has significance for all employers. While Wachovia's Employee Handbook clearly provided that employment was "at will," that same handbook provided for a three-step Discipline and Dismissal procedure. The arbitrators acknowledged that these were conflicting statements. So while our Client could reasonably expect to be terminated "at will" (i.e. at any time, for any reason, with or without cause), our Client could also reasonably expect that Wachovia's three-step Discipline and Dismissal procedure would be applied to his case. Under California law, which generally interprets any ambiguities in an employment contract in favor of the employee – as opposed to the employer, the NASD arbitrators found that the three-step Discipline and Dismissal policy trumped the "at will" clause in Wachovia's Employee Handbook.

It was the Employee's position that while his employment with Wachovia was "at will" under California law, his termination was in violation of fundamental public policy. Vogt & Resnick successfully argued that the United States Congress created the Securities and Exchange Commission (SEC), which delegates the policing of securities dealers to the NASD. Therefore, the rules and regulations adopted by the NASD for this purpose constitute "fundamental public policy." On this basis, the NASD arbitrators found that Wachovia's ordering the Employee to cease investigating possible wrongdoing by his subordinates, and then ultimately firing the Employee because of his refusal to do so, constituted a violation of public policy and wrongful termination.

All too often, the language of an employee handbook "comes back to bite" the employer who prepared it. This is why a legal review your company's employee handbook, policies and procedures, is critical. It is also important for an employer to strictly adhere to both the letter and the spirit of their policies once they are in place. Vogt & Resnick represents employees and employers in diverse lawsuits conducted in arbitration proceedings, as well as in the federal and state courts. With respect to our clients who are employers, our experience with cases like the Wachovia matter, further enhances our ability to effectively review and evaluate our employment handbooks, policies and procedures and to assist with compliance on an ongoing basis, the primary benefit of which would be the avoidance of judgments like the one awarded to the Employee. For more information about this article, or to discuss how we may assist you with a specific employer-employee issue, please contact this office.

ARE YOU TREATING EMPLOYEE EXPENSES PROPERLY?

Could your employees' reimbursed expenses be subject to employment and income tax withholding? It depends on whether your expense reimbursement arrangement is an "accountable plan," as defined by the Internal Revenue Service (IRS). How do you know if you have an accountable plan in place? The IRS looks at the following three criteria to make this determination:

(1) There must be a "business connection" to the expense;

(2) The employee must "substantiate" all of his or her reimbursed expenses (most businesses require that the employee execute a monthly "expense report" or "expense reimbursement form" and produce the relevant backup documentation or receipt); and

(3) The employee must be required to return all reimbursement monies paid in excess of the substantiated amounts.

Some expenses are "deemed substantiated," by the IRS, (i.e. employee car and travel expense reimbursement to which per diem or automatic mileage rates apply), but please note that there is no such thing as "do-it-yourself" substantiation. For instance, employers may not substitute a "reasonable estimate" of expenses, based on statistical data (i.e. how much an auto repair shop worker, who uses his own tools, generally spends those tools) and the number of hours worked for substantiation by "actual expenses," without some explicit guidance (i.e. a Revenue Ruling specific to the industry) from the IRS. Unfortunately, the IRS will not consider the cost to the employer of collecting records, and reconciling the amount of expenses with reimbursements as supporting relief from the "accountable plan" rules.

The bottom line is, while the burden for the employer who is collecting and reviewing individual expense reports and receipts from its employees prior to reimbursing expenses under an accountable plan may be considerable, the employer who uses a do-it-yourself plan, which is not based on actual expenses or those deemed substantiated by the IRS, may face a considerably larger burden in the event of an audit. For any other individual or corporate tax inquiries, please feel free to contact our office.

BY THE WAY, DID YOU KNOW THAT....

A U.S. Department of Justice report, issued on August 17, 2005, disclosed that the number of tort cases tried in federal courts has declined an incredible 80 percent in the last 18 years? The number of federal court trials dropped from 3,600 in 1985 to 800 in 2003. The report cited the popularity of alternative dispute resolution (arbitration) and the higher cost of bringing actions in federal court as the two main reasons for this phenomenon. It is a little known fact that the number of trials (as well as cases filed) in State courts has also been on the decline, albeit not as dramatically. These statistics contradict the widely held belief that there has been a dramatic explosion in litigation matters in recent years and that abuse of the U.S. legal system is on the rise.

LAW EUROPE UPDATE

Barry Resnick, Managing Partner of Vogt & Resnick, has recently returned from a Law Europe Managers' meeting in Brussels, Belgium. Mr. Resnick is one of five Managers directing the activities of Law Europe, an organization consisting of twenty-six Member Firms worldwide, two of which represent the United States out of California and Florida.

At the Managers' Meeting, Mr. Resnick proposed that all of Law Europe's Members consider becoming "foreign legal consultants" in association with Vogt & Resnick, LLP. This would significantly enhance Vogt & Resnick's ability to provide counsel to its clients who wish to conduct business or address legal matters throughout the world.

The next Annual Meeting of all Law Europe Members will take place in Glasgow, Scotland in May, 2006.

If you wish to learn more about Law Europe and its Members, please visit the Law Europe website at www.law-europe.com , or feel free to contact our office.

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