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Trusts and Estates Forum

Asset Protection Planning After the 2005 Bankruptcy Act

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As members of the trust and estate bar we craft estate plans which achieve a client's family, business, and philanthropic goals, ever mindful that all such plans are for naught if the family wealth is dissipated through unforeseen events. Thus, the careful advisor incorporates an element of asset protection planning into every plan, whether it be protecting income producing property with a limited liability company wrapper or insulating a "nest egg" of wealth within a protective trust. Whatever technique is utilized, it is axiomatic that asset protection planning when done correctly takes place well before a potential creditor problem arises. Early planning is the key. But the future is unpredictable, and our client may unexpectedly find himself in bankruptcy. Therefore, in order to best advise our clients, we need to understand the implication for asset protection planning of the new Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") which amended the Bankruptcy Code (the "Code") . What follows is a thumbnail summary of the important provisions of the Act, which is available on the Library of Congress website at http://thomas.loc.gov (Pub. L. 109-9). It is important to remember that this article is focused on bankruptcy; the rules are often different outside of the bankruptcy court.

Domicile: Certain property is exempt from the reach of creditors in bankruptcy. The Code permits a debtor to choose between the exemptions in the Code, other federal law, and the exemptions of the state of a debtor's domicile, provided the state permits such election, as Massachusetts does. This choice is often referred to as "forum shopping" – a time honored bankruptcy tradition which has become more difficult under the Act. Prior law looked to the debtor's domicile during the 180 days immediately prior to the filing of the bankruptcy petition. The Act has increased the domicile look-back period to 720 days (about two years). But what if the debtor has moved around and has not been a domiciliary of any one state for the prior 720 days? In this case, the Act looks back 720 days, then looks back an additional 180 days to see where the debtor was domiciled during that time. If the debtor was not domiciled in one state during the entire 180 day period, domicile is determined by where the debtor spent the majority of time.

> Example: Debtor lives in FL for 100 days, then lives in MA for 90 days, then lives in NH for a year, then back to FL for a year, then to MA for 30 days. A petition is then filed. Looking back 720 days, no continuous domicile is established. Looking back the next previous 180 days, the debtor lived 40 days in NH, 90 days in MA, and 50 days in FL. The longest period of domicile during this time is the 90 days in MA, and thus MA should be the domicile of the debtor under the Act.

Note that if the there is a "tie" between states, then the debtor defaults to the federal exemptions.

Homestead Protection: Generally speaking, the homestead exemption is a creature of state law which protects a debtor's primary residence from creditors. In Massachusetts, the homestead protection is $500,000 (with special rules that apply to those 62 or older). Often, the primary focus of pre-petition forum shopping was to establish domicile in a state that has very liberal homestead protection, such as Texas or Florida, and choose that state's exemption to apply in bankruptcy. For example, a debtor that saw bankruptcy on the horizon could hot foot it down to Florida, purchase a $5 million principal residence, establish domicile in 180 days, and thereafter file for bankruptcy and choose to utilize the unlimited Florida homestead exemption. If successful, the homestead protection of the principal residence in bankruptcy would be $5 million, with certain acreage limitations (one-half acre within a municipality, 160 contiguous acres outside a municipality). A good debtor deal.

Congress has closed this loophole for last minute planners. To take advantage of the state homestead exemption, the debtor must jump through three hoops. First, the debtor must establish domicile under the new 720 day rule. Second, even if domicile is established, the homestead in bankruptcy will be limited to $125,000 unless the debtor can establish that the interest was acquired 1,215 days prior to filing of the bankruptcy petition. However, there are liberal "same state rollover rules" that permit a debtor to tack on the holding period from one principal residence to another within the same state to achieve the 1,215 day period, and family farmers are entirely exempt from the 1,215 day rule. Third, even if the 180 day domicile test and the 1,215 day acquisition test are met, a debtor may still be held to the $125,000 limit if the debtor was convicted of a felony, or convicted within the past five years of securities fraud or other intentional tort, or if can be shown that the debtor converted non-exempt assets into the exempt homestead asset with the actual intent to hinder, delay, or defraud the creditor.

Finally, note that recently a bankruptcy court in Arizona narrowly construed the homestead provisions of the Act to hold that the $125,000 limitation does not apply to debtors domiciled in a state such as Arizona which has opted out of the federal exemptions. <u>In re McNabb</u>, 326 B.R. 785 (Bankr. D. Ariz. 2005). Two Florida cases, a Nevada case, and most commentators, disagree with the Arizona court. <u>In re Kaplan</u>, 05-14491-BCK-RAM (Bankr. S.D. Fl. 2005); <u>In re Wayrynen</u>, Case No. 05-32144-BKC-SHF (Bankr. S.D. Fla. 2005); <u>In re Virissimo</u> and <u>In re Heisel</u>, Nos. BK-S-13605-LBR and BK-S-05-15667-LBR (Bankr. Nev. 2005).

Retirement Benefits: The Act substantially increased the protection of retirement benefits in bankruptcy. A debtor's tax-exempt retirement plans, such as a 401(k) plan, rollover IRA, SEP IRA, and SIMPLE IRA now have unlimited protection, whether or not the debtor chooses federal or state exemptions. The protection for a traditional IRA and a Roth IRA is $1 million in the aggregate. The best practice going forward would be to advise a client not to combine a rollover

IRA with a traditional or Roth IRA, and to deplete first the traditional and Roth IRA when taking required minimum distributions.

Educational Accounts: A new provision of the Code grants limited protection to certain educational IRAs and §529 Plans. The protection is limited to accounts for the benefit of a child, stepchild, grandchild, or stepgrandchild. The protection for these accounts cannot exceed the applicable Internal Revenue Code funding limitations, and contributions are protected only if made not later than a year before the filing of the bankruptcy petition. There is also a two-year prefiling cap of $5,000 in the aggregate for all accounts of the same type having the same designated beneficiary.

Fraudulent Transfers: Prior law permitted a trustee in bankruptcy to avoid any transfer made within one year of the filing of the bankruptcy petition. The Act has increased the avoidance period to two years. A special ten year avoidance period applies to self-settled trusts or "similar devices", which are discussed next.

Self-Settled Trusts and Similar Devices: As is commonly understood, a self-settled trust is typically a fully discretionary irrevocable trust settled and funded by the client for the client's own benefit, often including the client's family within the class of permissible discretionary beneficiaries. The general rule in Massachusetts, and 43 other states, is that a creditor of the settlor can reach the assets within a self-settled trust to the maximum extent a trustee could distribute those assets to the settlor, even if the trust contains spendthrift provisions. For example, if client settles and funds a self-settled spendthrift irrevocable trust in Massachusetts and retains only a discretionary income interest, absent the application of fraudulent transfer rules, a creditor of the settlor can only reach the income of the trust. Seven U.S. jurisdictions (AK, DE, MO, NV, OK, RI, and UT) and many offshore jurisdictions hold the opposite. That is, a client can settle and fund an irrevocable trust, retain the right to discretionary payments of income and principal, and the trust will be outside the reach of the client's creditors under the law of that jurisdiction. Again, fraudulent transfer rules apply to varying degrees, and certain "super creditors" are given preferential rights against the trust. [Note that Oklahoma's law is very different from the other domestic jurisdictions as it is applicable to a revocable trust of which the settlor is not a beneficiary.]

During Congressional deliberations, a New York Times editorial decried the protections afforded by these domestic and offshore asset protection jurisdictions, and asserted that corporate executives involved in Enron-like transgressions would avoid the reach of the bankruptcy court by transferring funds to an offshore trust or to a trust within a protected domestic jurisdiction. In response, Senator Schumer proposed a $125,000 limit on self-settled spendthrift trusts (similar to the homestead limit). This was rejected in favor of a proposal by Senator Talent which added a new Code section that imposes a special ten year reach-back provision for self-settled trusts or "similar devices".

The Code had always contained a protection for spendthrift trusts enforceable under applicable state law, but a question persisted as to whether this protection included self-settled spendthrift trusts. The addition of the ten year reach-back in the new section seems to indicate that the Code does protect self-settled spendthrift trusts as long as the applicable state law protects them. Why else include a limitation on that protection? This good news aside, the reach-back provision will bring many asset protection trusts within the reach of the bankruptcy trustee if five conditions are met. The conditions are: (1) there is a transfer within ten years of the filing of the bankruptcy petition; (2) the transfer is to a self-settled trust or similar device; (3) the transfer is by the debtor; (4) the debtor is a beneficiary of the self-settled trust or similar device; and (5) the debtor made the transfer with the actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted.

There are many issues raised by this new section. For example, what is a "similar device"? Are the estate planner's tools under Chapter 14 of the Internal Revenue Code (QPRTs, GRITs, GRATs) implicated as a similar device? And what about retirement plans? Clearly a self-created and funded plan is similar to a self-settled trust. Does this mean that the unlimited protection discussed above for some retirement benefits are limited to the funding which occurred more than ten years prior to the filing of the bankruptcy petition? Can we plan around the application of the reach-back section if the debtor is not a beneficiary of the trust, but his wife and children are? And what if there is a trust protector that can add the debtor (among others) as a discretionary beneficiary at a later date? Can a debtor fund a ten year charitable lead trust that pours over into a self-settled trust in, say, Delaware, and circumvent the Act? These are just a few of the unanswered questions being discussed within the asset protection bar, and which will probably be resolved in the courts.

Effective Dates: The Act was enacted on April 20, 2005 and by its terms made effective 180 days later. Thus the Act's provisions are generally not applicable to bankruptcy filings prior to October 17, 2005. There are three notable exceptions. First, the limitations on the homestead exception were effective upon enactment. Second, the fraudulent transfer provisions are applicable to bankruptcy filings commenced more than one year after enactment (April 20, 2006). Third, the ten year reach back for transfers to self-settled trusts was effective upon enactment.

As the Act is implemented through bankruptcy filings, estate planners will learn more regarding its impact on our clients. Several CLE programs are planned in Boston and the surrounding area within the coming year to flesh out the issues briefly presented here. The dialogue generated by such programs provide an invaluable service to all of us.