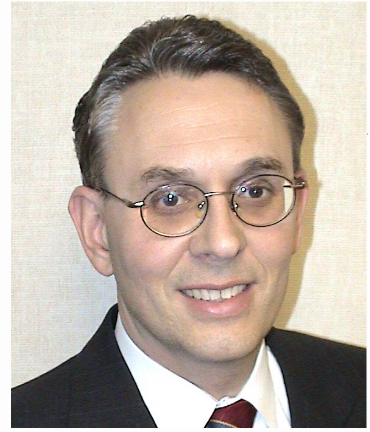
Asset Protection Changes by the New Bankruptcy Act



by Robert J. Kolasa

The Bankruptcy Abuse and Consumer Protection Act of 2005 (Public Law No 109-8, *i.e.*, the "Act") was signed into law by President George W. Bush on April 20, 2005, and is generally effective on October 17, 2005.[1] This is the second part of a two-part analysis of the Act. The prior article (which appeared in the July issue of *The Docket*) outlined how the Act forces many individual consumer debtors from Chapter 7 to Chapter 13 proceedings, requiring five years of payments to unsecured creditors. This article discusses how the Act significantly changes the rules relating to bankruptcy forum shopping, exemption planning and asset protection trusts.

Limitations on Forum Shopping

In general, an individual has various bankruptcy "exemptions" which exclude selected assets from the reach of creditors. Section 522(b) of the Bankruptcy Code gives an individual debtor the choice of utilizing the federal exemptions, or the state exemptions of the debtor's domicile (unless such state has "opted out" of the federal exemptions, wherein only the state exemptions can be utilized). Illinois has opted out of the federal exemptions, therefore, in a bankruptcy proceeding, individual Illinois debtors have available the specific exemptions detailed in 730 ILCS 5/12-1001, *et seq.*

There are tremendous differences between the federal exemption rules and the laws of the various states. For example, Illinois law (735 ILCS 5/12-901) exempts $15,000 of a joint debtor's principal residence (*i.e.*, homestead) from creditor collection. By comparison, debtors domiciled in Texas and Florida have an *unlimited* homestead exemption. On the other hand, under 735 ILCS 5/12-1006, Illinois seemingly provides an unlimited exemption for retirement plans and IRAs, whereas many states (prior to changes made by the Act, discussed below) had less generous exemptions.

Accordingly, debtors under prior law were encouraged to engage in pre-bankruptcy planning which entailed moving at the last second to some other jurisdiction (and residing there 180 days) in order to select the most favorable exemption law. Egregious abuses resulted, such as the well-publicized cases of former baseball commissioner, Bowie Kuhn, and movie actor, Burt Reynolds, both of whom were able to shelter million-dollar homes from creditors. In a humorous note, the situation got so notorious that one Miami bankruptcy judge told the *New York Times*, "You could shelter the Taj Mahal in this State and no one could do anything about it."[2]

Two new rules now dramatically curtail last-minute residency changes in order to utilize favorable exemption laws:

A. <u>730-Day Residency Requirement for State Exemptions</u>. Section 522(b)(3)(A) of the Bankruptcy Code now requires that a debtor be domiciled in a state 730 days (prior law was 180 days) immediately preceding the bankruptcy petition in order to claim that state's exemption. If the debtor's domicile has not been located in a single state for such 730-day period, the place in which the debtor's domicile was located for 180 days immediately preceding the 730-day period (or the longer portion of such 180-day period) controls.

B. <u>$125,000 Homestead Exemption if Debtor does not meet 1,215-Day Residency Rule</u>. In addition to the above 730-day rule, Section 522(b)(2)(A) generally imposes an aggregate monetary limitation of $125,000 on the homestead exemption that a debtor may claim as exempt under state law unless the debtor owned the property for more than 1,215 days (3 years, 4 months) prior to the filing of the bankruptcy petition.

Importantly, the $125,000 limitation does not apply to the principal residence of a "family farmer" or to any amounts rolled over from a prior residence (acquired prior to the 1,215 day period) to a new principal residence, as long as both residences are located in the same state. Going the other way, the $125,000 exemption always applies (regardless of home ownership) for debtors who are convicted of various specified financial crimes (Bernie Ebbers, where do you live?).

While indisputably the above rules go a long way in dealing with last minute shifting of domicile to enjoy favorable exemptions, critics complained that they did not go far enough. National dollar caps (ranging from $125,000 to $1 million) to the homestead exemption were unsuccessfully proposed during the legislative process. Accordingly, the rule seems to be that you can indeed "shelter the Taj Mahal" in Florida and Texas, as long as you have lived there for more than 1,215 days and not committed any financial crimes.

IRAs & Retirement Plans

Sections 522(b)(3) and 522(d)(12) enact a broad sweeping federal bankruptcy exemption for "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457 or 501(a) of the Internal Revenue Code of 1986." Since such exemption depends upon qualification under the Internal Revenue Code, this covers most retirement plans, including IRAs and Roth IRAs. However, Section 522(n) limits the exemption to an aggregate of $1 million for Roth IRAs and traditional IRAs (other than SEPs or SIMPLE retirement accounts). Section 522(n) then excludes rollover contributions from retirement plans to IRAs from this rule, which means (since most IRAs are funded from qualified plan rollovers), the $1 million limitation should not practically apply to most IRAs.

For Illinois residents, the new federal bankruptcy exemption may not be meaningful as Illinois already has an expansive exemption statute (735 ILCS 5/12-1006) which, subject to fraudulent transfer attacks, seems to cover almost ALL plan balances in retirement plans and IRAs. However, Sections 522(b)(3) would appear to exempt Roth IRAs (up to the $1 million cap) and other retirement structures which (depending how you read the statute) may not be exempt under Illinois law. The big change is that the new law will make it easier for Illinois residents to switch domiciles and obtain continued protection of retirement plans and IRAs without fear of being bushwhacked by restrictive state exemption laws.

There is a troublesome technical glitch that some lawyers have raised questioning whether Illinois' unlimited IRA exemption is capped at $1 million under the new law. This is due to a hyper-technical construction that the $1 million cap of Section 522(n) modifies the Illinois exemption statute. This reading ignores Congress' clear intent to liberalize (not restrict) retirement plan exemptions and there is nothing in the legislative history to suggest otherwise. It would seem that if somehow an industrious creditor convinced a bankruptcy judge to accept this argument, Congress would immediately pass a technical correction of Section 522(n) to reverse the judge. Moreover, as discussed above, this matter is really a paper tiger in that since most IRAs are funded from qualified plan rollovers, the $1 million limitation should not practically apply in most circumstances. For conservative planners, until further clarification is released, the advice is to keep IRAs funded with rollover contributions separate from those funded with annual contributions.

New Preferred Exclusion for 529 Plans and Education IRAs

In a major boost for education savings, Sections 541(b)(5) & (b)(6) of the Bankruptcy Code were amended to provide an *exclusion* from the bankruptcy estate of certain amounts contributed to educational IRAs and Section 529 tuition plans. First, in order to achieve exclusion, contributions to such accounts must be made 720 days prior to the filing of the bankruptcy petition (funds deposited between 720 and 365 days prior to filing receive only a $5,000 exclusion). Second, the account-designated beneficiary must be a child, stepchild, grandchild or step-grandchild of the debtor for the taxable year during which funds were placed in the account. Third, specified dollar limitations are imposed for new contributions: (i) for education IRAs - the paltry $2,000 allowed under existing tax law; (ii) for Section 529 plans - the very generous benchmark of necessary college education expenses (which is set on a plan-by-plan basis, with most plans accepting contributions until a beneficiary's account reaches $250,000).

Section 529 plan contributions may permit significant assets to escape creditors of the bankruptcy estate. For example, 720 days before bankruptcy, a debtor with four children could generally contribute $250,000 each to four new Section 529 plans for his children in order to exclude $1 million from the bankruptcy estate. As long as such transfers were not found to be fraudulent transfers, the debtor after his bankruptcy discharge still has access to $1 million. This is because under current tax rules, the debtor as account owner of the Section 529 plans could distribute the accounts directly to himself, with only income taxes and a 10% penalty on account appreciation. Needless to say, the perceived abuse of pre-bankruptcy contributions to Section 529 plans may likely lead calls to change this provision, while at the moment it remains a glaring loophole/planning opportunity.

Negative Effect on Asset Protection Trusts?

<u>Background on Foreign and Domestic Asset Protection Trusts</u>.

In general, Asset Protection Trusts ("APTs") are self-settled trusts wherein the settlor remains as a trust beneficiary. Most states have historically precluded a settlor from obtaining creditor protection if he remains a trust beneficiary. APTs generally rely on statutory law, which modifies this result.

"Foreign APTs" are trusts administered by trust companies in foreign jurisdictions (such as the Cook Islands or Nevis) that permit the trust settlor to remain a discretionary beneficiary, but still obtain creditor protection as long as the transfer is not found to be a fraudulent transfer. The real drawback from a creditor perspective in pursuing collection actions against these trusts is that arguably the creditor has to obtain a judgment in the foreign jurisdiction (the foreign trustee ignores the U.S. judgment) in order to get at trust assets. Debtors in recent cases[3] have been jailed (or threatened with incarceration) for refusing to comply with court orders to repay domestic creditors with Foreign APT trust assets administered by foreign trust companies. These courts generally rejected the debtor's argument that performance of the turnover order was "impossible," effectively finding that such trusts were really controlled by the debtor. Proponents of Foreign APTs contend that these cases are based on bad facts (settlor had too much control and/or creditors were known at time of transfer) and that as long as there is less control and an "old and cold" time lag between the trust contribution and creditor event, such trusts are effective. The case law is developing in this area.

"Domestic APTs" are domestic trusts having their situs in states that have passed legislation permitting a settlor to remain a trust beneficiary and achieve spendthrift creditor protection. Eight states (Alaska, Delaware, Nevada, Rhode Island, Utah, Oklahoma, South Dakota and Missouri) have adopted asset protection rules for self-settled trusts. While the legislation varies among the states, in order to bolster local banking business, most of the states require the Domestic APT to have a corporate or individual trustee domiciled in the same state. However, there is strong doubt among many whether Domestic APTs really "work." For example, how could an Alaskan court ignore the Full Faith and Credit clause of the Constitution and not enforce an Illinois judgment against an Alaskan APT? Nevertheless, Domestic APTs have recently been heavily marketed by corporate trust departments even though their asset protection benefits are unsettled, especially for nonresidents of the enacting state. Until the cases rule otherwise, it may be that such trusts offer practical asset protection by imposing a "hurdle" (who's going to pay the costs to litigate this issue?) that only a well-heeled creditor will bear.

<u>New Bankruptcy 10-Year Fraudulent Transfer Statute for Self Settled Trusts</u>.

During the Senate's consideration of the Act, the *New York Times* on March 2, 2005, ran an article touting the hypocrisy of denying average Americans a bankruptcy discharge while the rich were able to shelter their assets from creditors through APTs. This article propelled the Senate (after considering different versions) to adopt Senator Talent's amendment[4] to the fraudulent transfer provisions of Section 548(e)(1) which now provides for a 10 year statute of limitations for any transfer made "to a self-settled trust or similar device...with actual intent to hinder, delay, or defraud." The 10 year limitations period is a big change from the general limitations period of Section 548(a)(1) which imposes a 2-year lookback (extended from 1 year by the Act) and the Illinois fraudulent transfer statute (740 ILCS 160/10), which the bankruptcy trustee can utilize, which generally imposes a 4-year lookback.

The touchstone of the Act's impact on APTs depends on how the courts will interpret the "actual intent to hinder, delay, or defraud" language of Section 548(e)(1). This is the same language that appears in the fraudulent transfer statutes of Section 548(e)(1) of the Bankruptcy Code and the Illinois Uniform Fraudulent Transfer Act (740 ILCS 160/5). The requisite intent under these statutes relates to the debtor's "state of mind" (not necessarily insolvency) when establishing the APT. A debtor admitting that the principal purpose of implementing the APT was for creditor avoidance would go a long way to help a creditor establish an intent to hinder, delay, or defraud. For debtors not making damaging admissions, intent can also be proved by circumstantial evidence under the enumerated "badges of fraud" test (740 ILCS 160/5(b)), the principal factors being retaining control of the property, concealing transfers, absconding, transferring substantially all assets, insolvency and not receiving reasonably equivalent value.

To combat allegations of prohibited intent under Section 548(e)(1), it would seem helpful to document all possible *bona fide* independent reasons for the APT structure other than asset protection. For Foreign APTs "exporting the assets" (*i.e.*, assets are always located overseas), a strong reason would be for the settlor to gain access to overseas markets not available to American investors. For Domestic APTS and Foreign APTs "importing the law" (*i.e.*, assets remain in the United States until an "event of duress"), this is a harder task. It has been suggested that one document the "estate planning" reasons for APTs, although from a tax angle this is illusory as APTs are largely conduits (grantor trusts) for tax purposes, not carving assets out of the debtor's estate. However, having a testamentary scheme inside the APT of "who gets what" upon the settlor's death arguably develops some reason for the APT structure other than asset protection.

Defenders of APTs contend, "nothing has changed" by Section 548(e)(1), in that the same fraudulent transfer finding needed to be made by the judge before or after passage of the Act. Opponents answer that the Act signals the death knell for APTs and that to implement one at this point probably constitutes malpractice. In many ways, this seems to be a continuation of the opposing viewpoints existing before the Act as to whether APTs really "work," which should ultimately be determined by future case law. However, the long 10-year period by itself has to sow anxiety even in the hearts of the staunchest defenders of APTs - this is quite a while for aggressive creditors to poke about in a debtor's past. A practical chilling effect for APT practitioners is that the 10-year discovery period means that they most likely will be on the hook for malpractice claims during this period. Perhaps any lawyer setting up APTs should correspondingly review his or her malpractice insurance policy and have their assets in an APT that "works."

<u>Unintended Consequences of Section 548(e)(1) to Include Structures other than APTs</u>?

What type of interest constitutes a

"self-settled trust or similar device" within the meaning of Section 548(e)(1)? Clearly, APTs fit under such definition. However, does the statute relate to other traditional estate planning structures such as Qualified Personal Residence Trusts (QPRTs), Charitable Lead Trusts (CLTs), Grantor Retained Annuity Trusts (GRATs) or just about any other trust where the settlor retains a right to future payments?

A construction of Section 548(e)(1) to include trusts other than APTs seems like a stretch. Senator Talent clearly was referring only to APTs as he remarked on the Senate Floor, "My amendment is simple. It closes the asset protection trust loophole by empowering the bankruptcy courts to go back 10 years to take away fraudulent transfers that criminals have sheltered away in an attempt to avoid paying back their debts."[5] Unfortunately, the inherent vagueness of the statutory language probably needs to be clarified by technical corrections or case law and until then, there is some room for creditors to arguably apply the statute to encompass non-APT estate planning structures.

Conclusion

The Bankruptcy Abuse and Consumer Protection Act of 2005 significantly changes pre-bankruptcy exemption planning. Under the new rules, debtors must live in a state for at least 730 days in order to use any of their home state's bankruptcy exemptions, with a longer 1,215 day residency requirement before they can exempt more than $125,000 in homestead equity under that state's law. In addition, the Act provides for a broad federal bankruptcy exemption of retirement funds, although Illinois already has a sweeping exemption for IRAs and retirement plans. A liberal new bankruptcy exclusion is also enacted for educational IRAs and Section 529 plans. Finally, in an effort to foreclose perceived abuses of asset protection trusts, Section 548(e)(1) provides a new 10-year limitations period for fraudulent transfers to asset protection trusts and similar devices. The determination of whether this new provision significantly affects asset protection trusts, and possibly other traditional estate planning structures, will be determined by future case law and technical corrections to the Act.

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1. For an excellent link to the statutory language and articles relating to the Act see http://www.bankruptcyfinder.com/bankruptcyreformnews.html. Also see http://thomas.loc.gov/ under Public Law 109-8 for links to the Committee Reports, Congressional Record and complete legislative history of the Act.

2. House Report 109-031. Part 1, Dissenting Views, footnote 14, which can be accessed at http://thomas.loc.gov/.

3. *Federal Trade Commission v. Affordable Media, Inc.*, 179 F3d 1228 (9th Cir. 1999); *In re Lawrence*, 227 B.R. 907 (S.D. Fla 1998); 238 B.R. 498 (S.D. Fla 1999); 251 BR 630 (S.D. Fla 2000); 279 F. 3d 1294 (11th Cir. 2002); *Eulich v. U.S.*, 2004 WL 1844821 (N.D. Tex. 2004).

4. See remarks of Senator Talent on the Senate floor explaining his amendment, 151 Cong. Rec. S2427, S2428 (Mar 10, 2005), which can be accessed at http://thomas.loc.gov/.

5. *Id.*