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Asset Protection Fundamentals: What Attorneys Should Know to Advise the Moderate Net Worth Clients

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What Attorneys Should Know to Advise the Moderate Net Worth Clients

(2907)

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January 29, 2019

AGENDA

I. Introduction (Mr. Brown)	1:00 to 1:05 EST
II. Gift Giving (Ms. Fox)	1:05 to 1:10 EST
III. Joint Ownership (Mr. Brown)	1:10 to 1:15 EST
IV. Exemption Planning (Ms. Fox)	1:15 to 1:25 EST
V. and VI. Foreign Annuities and ILIT (Mr. Brown)	1:25 to 1:30 EST
VII. Limited Partnerships and Limited Liability Companies (Ms. Fox)	1:30 to 1:35 EST
VIII. Domestic Trusts (Mr. Brown)	1:35 to 1:45 EST
IX. and X. Redomiciliation to Another State and Retirement Plans and IRA Accounts (Ms. Fox)	1:45 to 1:50 EST
XI. Protecting an Anticipated Inheritance and Close (Mr. Brown)	1:50 to 2:00 EST

<u>Asset Protection Fundamentals:</u>
What Attorneys Should Know to Advise the Moderate Net Worth Clients

January 29, 2019, Denver, Colorado

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I. Introduction

A. Regardless of the size of a client's estate, a client's assets are extremely important to the client – one client's $500,000.00 means as much to him or her as another client's $5,000,000.00.

B. For this reason, it is typically worthwhile for each client to at least consider some degree of asset protection as part of his or her estate planning.

C. This outline offers some fundamental asset protection features available to many clients, regardless of their individual net worth.

D. Fraudulent Transfer Foundation.

Two types (but varies state to state):

1. Actual: a transfer made with the actual intent to hinder or delay a creditor

    - Badges of Fraud serve as evidentiary components to show "intent"

    - Present or subsequent (future) creditor vs. potential non-expected creditor

2. Constructive: No intent, but creditor existed <u>at time of transfer</u>, debtor insolvent after transfer, and transferor did not receive equivalent value in exchange for transfer

3. Remedy: transaction can be avoided (unwound)

4. Resources: Uniform Fraudulent Conveyance Act (1999) (UFCA); Uniform Fraudulent Transfer Act (1984) (UFTA); Uniform Voidable Transactions Act (2014) (UVTA), which restates UFTA

E. Badges of Fraud:

- Whether the transfer or obligation was to an insider.
- Whether the debtor retained possession or control of the property transferred after the transfer.
- Whether the transfer or obligation was disclosed or 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.
- Whether the debtor transferred the essential assets of the business to a lienholder who transferred the assets to an insider of the debtor.

II. Gift Giving

A. A family transfer which is motivated by asset protection goals is sometimes referred to as "poor man's asset protection." The classic example is the professional spouse placing title to the family residence in the other spouse's name. This approach to asset protection planning is certainly not limited to the family residence or to the spouse.

B. A number of problems do exist with respect to this asset protection planning technique:

1. The planning and the results thereof leave the client subject to the risks of the domestic legal system. A creditor or claimant could attack the donee:

    a. As a fraudulent transferee;

    b. As a resulting trustee for the donor;

    c. On the basis that following the transfer the donor failed to cut the strings by retaining benefit and/or control; or

    d. By proceeding with litigation against the donee either in the interest of a suit on the merits of the claim under applicable state law, or in the interest of attempting to force a settlement by the donee.

    The uncertainty to which the donee will likely be subject may provide the creditor with leverage that may not otherwise exist under other planning techniques.

2. To have a chance of success, this form of planning does require the donor to in fact gift away any and all rights, title and interest he or she may have in and to the property.

    a. However, such a gift may not be consistent with the client's other planning goals (whether at the present moment or as circumstances change in the future).

    b. In the case of a gift to a spouse, consideration should be given to the consequences under applicable state law in the event of a dissolution of the marriage.

        i. Will the gifted property be the separate property of the spouse in a community property state?

        ii. Will the property be separate from the assets subject to equitable distribution in a common law state?

    c. In the case of a gift to a minor child, consideration should be given as to whether the donor should be the custodian under applicable gifts to minors law. The issue is whether control in the hands of the debtor would jeopardize the security of the gifted property. Additionally, gift tax implications may result.

d. The laws of some community property states provide that all community assets are subject to the separate obligations of either spouse.

i. Accordingly, a common asset protection technique is to partition the community assets into separate property.

ii. By doing so, however, the spouses lose the benefit of a double step-up for the basis of the partitioned property, which would otherwise be available under Code Section 1014(b)(6), the pertinent provisions of which read as follows:

> "In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country [shall be considered to have been acquired from or to have passed from the decedent for purposes of Code Section 1014(a)] if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate...."

3. While family transfers have their place in overall family wealth planning, in the authors' view, family transfers made for asset protection reasons are not a favored technique.

III. Joint Ownership

A. Joint ownership of property offers at least a modest opportunity to achieve a level of asset protection.

B. Through joint ownership, property can be rendered either:

1. unavailable to a judgment creditor (at least for some period of time);

2. more difficult to levy against; or

3. less attractive to a creditor as an asset to pursue.

C. Whether the debt involved is a joint debt of the co-owners of the subject property or a separate debt of one of the co-owners, the type of property involved and the manner in which the property is titled are relevant factors as to just how much protection jointly held property will enjoy.

D. Joint vs. Separate Debt.

1. A debt may be either a joint debt or a separate debt. A joint debt is a debt for which some or all concurrent owners of property (often both spouses) are liable. A separate debt is a debt for which only one owner is liable. The commission of a tort or the signing of a contract may create either a joint debt or a separate debt.

2. Joint ownership generally protects debtors only against separate debts. If a creditor is owed on a joint debt, the creditor can usually proceed directly against any joint property of the co-debtors as well as against their separate property.

3. Therefore, joint ownership as a planning tool is more effective when the subject property is co-owned by one or more debtors and one or more non-debtors.

E. Types of property.

1. Property types that can be co-owned include cash, stocks, bonds, managed accounts, copyrights, personal property, undeveloped land, developed land, residential real estate, investment real estate, etc.

2. Any particular property may itself have a variety of rights associated with it. For example, ownership of investment real estate will represent the rights to its ultimate net value on sale, the right to occupy it, as well as the right to income therefrom.

3. The nature and extent of these rights will certainly serve to determine the value of the property to someone who might want to proceed against it in the process of collecting on a judgment.

4. The type of property involved, the identity of the persons who are the co-owners of the type of property, whether the interests or welfare of innocent parties are involved and trends in local case law or other judicial determinations are all factors that relate to property types and whether a court will allow a judgment creditor to proceed against jointly owned property.

F. Types of joint ownership.

1. There are four types of joint property interests that do not involve holding property through an entity:

   a. Tenancy in common;

   b. Joint tenancy;

   c. Tenancy by the entirety; and

   d. Community property interests.

2. Tenancy in Common

   a. Tenancy in common is the form of ownership in which two or more persons own an undivided interest in the same property. Unless some contractual restriction exists, each tenant has the right to freely sell, transfer, gift, devise, or dispose of his or her interest.

   b. The amount of asset protection provided by a tenancy in common is dependent upon the type of property subject to joint ownership.

   c. If the property consists of liquid assets or unimproved real estate, a creditor may force the sale of the debtor's interest as a tenant in common at a judicial foreclosure sale, purchase such interest, or obtain a judicial order to partition the property and sell the underlying property. In this case, tenancy in common provides little, if any, asset protection.

   d. If the property is rental real estate or an intangible, the debtor's interest in the property may be sold at a judicial foreclosure sale. Generally, a tenancy in common interest in property will sell at a substantial discount when compared to the debtor's proportionate interest in the fair market value of such property.

   e. If the property is the debtor's homestead, in some states a creditor may still obtain the judicial foreclosure sale of such tenancy in common interest. The purchaser of such tenancy in common interest would be entitled to receive a proportionate share of the proceeds when the house was sold.

3. Joint Tenancy (with Right of Survivorship)

   a. Similar to a tenancy in common, each joint tenant is considered to be the owner of an individual interest in the entire estate.

   b. However, in a joint tenancy, upon the death of a joint owner, the surviving joint tenant(s) continues as the owner(s) of the entire estate.

   c. Unless the joint tenants have made an agreement restricting transfer, generally each party may freely sell, gift, or transfer his or her interest during life.

   d. When a husband and wife are the joint tenants, the sale, gift, transfer, or judicial foreclosure sale of one of the interests immediately causes the joint tenancy to cease and ownership becomes a tenancy in common.

   e. In the asset protection context, if a creditor levies or forecloses upon property held in joint tenancy, the joint tenancy is severed and the interest seized is now held as a tenancy in common. The actions by the creditor would have the same results as for any tenancy in common property. In this respect, joint tenancy provides no more asset protection than a tenancy in common.

4. Tenancy by the Entirety

   a. Although the definition of a tenancy by the entirety varies from state to state, some features are consistently present.

   b. Tenancy by the entirety is similar to a joint tenancy with right of survivorship, but only a husband and wife may be the tenants. Upon the death of the first spouse, by operation of law the deceased spouse’s interest automatically vests in the surviving spouse.

   c. During the life of both spouses, the husband and wife as a unit have the right to the current use and enjoyment of the property.

   d. In some states, this present right may be transferred only with the consent of the other spouse. Also, in some states, neither spouse may alienate or encumber the property without the consent of the other spouse.

e. Most states that allow tenancy by the entirety restrict a tenancy by the entirety to the residence (and/or to other real property). The practitioner should become familiar with the applicable law in the respective jurisdiction. In addition to restricting property eligible to be held in tenancy by the entirety, the various states provide differing levels of asset protection under this form of property ownership.

f. Personal Residence

    i. Most states that allow tenancy by the entirety will not permit a creditor to force a partition to sell a debtor spouse's interest in his or her personal residence.

    ii. However, in the event that a nondebtor spouse predeceases a debtor spouse, their entire residence would thereafter be owned by the debtor spouse and therefore be vulnerable to creditor attack.

    iii. More specifically, a creditor could then proceed directly against the entire personal residence (subject to any applicable homestead exemption that may be available in such state).

    iv. In addition to the creditor having rights against the full value of the property upon the death of a nondebtor spouse, some states allow the creditor to lien (i.e., encumber) the entire property with the debtor spouse's separate debt.

    v. In this respect, both the husband and wife would generally find it difficult to use the personal residence for any future credit needs.

g. Bankruptcy proceedings

    i. In the event that a debtor owns tenancy by the entirety property and declares bankruptcy, the creditor's interest in the spouse's right of survivorship is not disturbed by bankruptcy.

ii. In re Arango, 992 F.2d 611 (6th Cir. 1993).

(A) In Arango, the debtor initiated an adversary proceeding under the U.S. Bankruptcy Code to void a judicial lien obtained by a creditor.

(B) Under the U.S. Bankruptcy Code, a debtor may exempt from the bankruptcy estate:

> . . .[A]ny interest in property in which the debtor had, immediately before the commencement of the case, an interest, as a tenant by the entirety or joint tenant to the extent that such interest as a tenant by the entirety or joint tenant is exempt from the process under applicable nonbankruptcy law. 11 U.S.C. § 522(b)(3)(B)

(C) The debtor in *Arango* argued that because the possessory interest in property held in tenancy by the entirety was exempt from a creditor under Tennessee law, the entire property should be exempt and the creditor's lien should be voided.

(D) The appellate court held that only the possessory interest was exempt from attachment under state law.

(E) The appellate court also held that the judicial lien in the spouse's right of survivorship remained intact after the debtor's bankruptcy.

(F) Therefore, in the event that the nondebtor spouse predeceases the debtor spouse, the creditor would be entitled to recover the full value of the property.

5. Community Property

a. The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin.

b. Alaska, South Dakota, and Tennessee allow individuals living within or outside the state to opt into community property laws via trust (i.e., an individual can opt-in through the creation of a community property trust governed by the laws of that respective state). Essentially, opting into community property laws via trust within one of these three states allows married persons from any of the fifty states to achieve a double step up in basis in assets held in the trust because such assets are treated as community property even though the Settlors' don't otherwise live in a community property state.

c. In a community property state, there are typically at least two types of property:

   i. separate property; and

   ii. community property.

d. Separate property is generally any property acquired prior to marriage or acquired by inheritance, bequest, or gift.

e. Community property is generally property acquired during the marriage and any separate property that was commingled with marital property.

f. Because in some states the whole of a community property interest is exposed to certain debts or obligations of either spouse, in these states a "partition" or "transmutation" agreement might be considered by the advisor and his or her client. The effect of such an agreement is to change the character of property from community property to separate property, thus freeing the one spouse's interest in the property from liability exposure to the creditors of the other spouse.

g. As with any other marital agreement, typical watchwords include "full disclosure" between the spouses and "separate counsel" for each spouse. Also to be considered is the loss of the double step-up in basis that would result from converting community property to separate property. Also, because such agreements involve transfers of property, fraudulent transfer considerations will apply to any transfers so made.

IV. Exemption Planning

A. In the context of asset protection and integrated estate planning, exemptions are valuable in that they provide categories of assets that are free from legal process as a judgment creditor attempts to collect a judgment.

B. Exemptions exist under both state and federal law, and they may apply in a bankruptcy or non-bankruptcy setting. If an exemption is available for specific property, the debtor retains all rights of ownership of the property, including the right to the use, possession, and enjoyment of the property free from creditor interference.

C. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Pub. L. No. 109-8 (2005)) overhauled the Bankruptcy Code and made it more difficult for individuals to simply "walk away" from their debts. The Act has application only to claimant and creditor issues in the bankruptcy setting, and not in the non-bankruptcy setting. Among other things, this Act amends four different types of exemptions in the bankruptcy setting: namely the homestead, personal property, retirement plan and education plan exemptions.

D. Under certain circumstances, the following creditors are not subject to state exemption laws:

   1. The federal government is exempt with regard to the collection of taxes and to forfeiture cases.

      a. In <u>Securities and Exchange Commission v. Jamie Solow</u> (682 F.2d 1312 (S.D. Fla 2010)) a key element of the case was that a disgorgement order was involved, not a judgment, with the Court stating "[d]isgorgement orders operate to wrest ill-gotten gains from the hands of a wrongdoer…A disgorgement order is more like an injunction for the public interest than a money judgment…It is this feature, the similarity to an injunction, that allows disgorgement orders, unlike judgments, to be enforced by civil contempt." (citing <u>Steffen v. Gray, Harris & Robinson, P.A.</u>, 283 F. Supp. 2d 1272, 1282 (M.D. Fla. 2003).)

      b. The Court then stated it had "broad equitable powers to reach assets otherwise protected by state law to satisfy a disgorgement," and cited a string of cases, including a case that holds a "disgorgement is not a 'debt' under the Federal

Debt Collection Procedures Act, and the *defendants could not avail themselves of the state law exemption under the Act.*" (emphasis added)

2. State governments—state tax statutes generally provide that no property is exempt from sale for failure to pay taxes.

3. Alimony and child support—claims for court-ordered alimony and child support are debts against which debtors generally may not assert exemption rights.

4. Purchase money creditors—creditors who sell property and retain a security interest in such property.

5. Mechanic's liens and materialman's liens—claims for payments as a result of work completed or materials supplied.

6. Debts for the improvement of exempt property.

E. Many states provide for an exemption of some amount or value in each of the following six areas:

1. Homestead;

2. Life insurance/annuity contracts;

3. Wages and earnings;

4. Nonwage income;

5. Personal, household, and other possessions; and

6. Retirement benefits.

F. Homestead Exemption.

1. This exemption usually extends only to real estate owned and occupied by the debtor as his or her principal residence.

2. States generally impose some type of limitation on the homestead exemption. Although Florida and Texas have an unlimited dollar exemption, both states limit the homestead exemption to a maximum specified amount of land.

3. On the other hand, many states have adopted a monetary limitation. The amount of the value limit varies, ranging from as

high as $550,000 in Nevada to as low as $2,500 in Arkansas (with an accompanying acreage limitation).

4. The value limit is typically measured by the debtor's equity in the property as opposed to the fair market value of the property. In determining the equity of the property, the amount of all liens, mortgages, or other encumbrances is subtracted from the fair market value. Many states allow any debt secured by the homestead to be deducted from fair market value, irrespective of when the homestead was acquired or declared. On the other hand, some states provide that debts incurred before the homestead was acquired or declared may not reduce the equity for purposes of computing the equity in the residence.

5. Dean White v. Julie Dawn White, Case No. 20160273-CA (Utah Ct. App., August 3, 2017).

   a. In White, a Utah Court of Appeals case, Dean and Julie White owned a Utah residence that was placed into an LLC as the LLCs only asset.

   b. During a later divorce, Dean began to use that Utah residence as his primary home. Dean was also awarded the LLC as part of the property settlement in the divorce. However, Dean later failed to satisfy some of the monetary awards that he owed to his ex-wife Julie. For this reason, Julie obtained a charging order against Dean's ownership interest in the LLC so that she could foreclose on the Utah residence and thereafter collect what was owed to her from the proceeds stemming from a forced sale of the residence.

   c. Thereafter Dean liquidated the LLC which resulted in him having to sell the residence on behalf of the LLC, and thereafter he collected the proceeds from the sale. Consequently, these proceeds became exposed to Julie's charging order wherein she sought monetary awards from Dean.

   d. Dean defended the liquidating of the LLC and subsequent sale of the residence by claiming that the proceeds were protected by Utah's homestead laws because the proceeds were directly related to the sale of his home.

   e. The court ultimately held, however, that the homestead exemption applied only to a residence owned by an individual, not by an LLC; and the fact that the home had been in a single-member LLC, which defaults to being a totally disregarded entity for tax filing purposes, was completely irrelevant.

5. Dejesus v. A.M.J.R.K. Corp., Case No. 2D17-2374 (Fla. Dist. Ct. App., Feb. 9, 2018).

   a. Similar to the holding discussed in the White case immediately above, the Florida District Court of Appeals recently held that a residence owned by a business entity (specifically a corporation) does not qualify for Florida homestead protection.

   b. In Dejesus, the subject corporation on two separate occasions had attempted to transfer certain property to the corporation's president and sole shareholder by two quitclaim deeds that were subsequently found by the court to each be defective on its face for various reasons.

   c. The court hinged its decision on finding that the respective grantee to the deeds (i.e., the corporation's president and sole shareholder) did not have an ownership interest in the subject homestead property (for example, she wasn't a beneficiary of the trust that owned the property) and further noted that she did not have the right to use and occupy the subject property. For these reasons, the court in Dejesus found that because the property was never effectively transferred from the corporation to its president and sole shareholder, the property was consequently not entitled to homestead protection.

G. Life Insurance/Annuity Contracts.

1. Many states (and the U.S. Bankruptcy Code) grant an exemption to a debtor's life insurance and annuity contracts. See 11 U.S.C.A. §§522(d)(7), (d)(8), (10)(E) and (11)(C).

2. Some states place no monetary limit on the amount of life insurance or annuities owned by the debtor. Other states limit the exemption by imposing a ceiling on the face amount of the policies held by the insured. If the face amount is exceeded, creditors of the insured can reach payable proceeds exceeding the limitation and, presumably, a proportionate share of the cash surrender value.

3. Some states have an exemption ceiling based on the annual premium. If the annual premium exceeds the monetary limit, the exemption extends only to that part of the insurance or annuity that could be bought with the maximum premium allowed by statute.

H. Wages and Earnings Exemptions.

1. Some states have exemption statutes preventing a creditor from attaching a certain percentage of wages. However, many states instead rely on garnishment statutes. A garnishment statute is similar to an exemption statute in that it limits the amount of earnings a creditor may attach for the purpose of satisfying a claim.

2. The federal Consumer Credit Protection Act limits garnishment to the lesser of 25 percent of disposable earnings per week or the amount by which disposable earnings for a week exceed 30 times the federal minimum hourly wage.

3. Two states that have adopted the federal garnishment limitations include Kansas and Kentucky.

4. Some states that have adopted the general structure of the federal scheme, but give greater protection to the debtor include Illinois, Missouri, New Mexico, Nevada, Virginia and Washington.

5. Indiana's statute also applies to consumer credit sales, consumer leases, and consumer loans. <u>See</u> Ind. Code §24-4.5-5-102. Similarly, Utah's statute applies to credit extended for personal, family, or household purposes. <u>See</u> Utah Code Ann. §70C-1-201. Pennsylvania generally prohibits garnishment of earnings, with exceptions such as proceedings relating to divorce or actions for support. <u>See</u> 42 Pa.C.S.A. § 8127. The Connecticut statute allows a court, upon request, to modify the amount of earnings subject to levy. C.G.S.A. § 52-361a. The New York statute allows creditors to establish that the amount of exempt earnings received by the debtor is "unnecessary for the reasonable requirements of the judgment debtor and his dependents." <u>See</u> N.Y. C.P.L.R. §5205(d)1.

6. Wage assignments can be a device to circumvent wage exemption laws. As a result, a growing number of jurisdictions prohibit such assignments. Some states, such as Colorado, have passed statutes that allow assignment, but only under rigid requirements.

I. Nonwage Income Exemptions.

1. Many states place public assistance, aid to families with dependent children, and aid to the blind, elderly, or disabled beyond the reach of creditors. These statutes not only prohibit a creditor from garnishing the state for such payments but also exempt the assistance funds after they have been paid to the debtor.

2. With regard to the payment of child support or alimony, some states exempt a divorced person's earnings from the claims of creditors to the extent that they are necessary to meet support obligations. The U.S. Bankruptcy Code provides an exemption for alimony, support, or separate maintenance to the extent reasonably necessary for the support of the debtor or any of the debtor's dependents.

J. Exemptions for Personal, Household and Other Possessions.

1. In addition to household furnishings, states often exempt personalized items such as family pictures, bibles, wedding rings, jewelry, pets, guns and cemetery plots.

2. Also, states generally exempt tools of the trade such as books, machinery and farming implements.

3. Many states also provide protection for one vehicle whether or not it is used in the debtor's business.

K. Section 529 Plans.

1. All states have college savings tuition programs. The provisions of these programs vary state by state, but in general they allow an individual to own an account under the plan for the benefit of a beneficiary's post-secondary school educational needs.

2. Qualified tuition programs may present a simple, tax efficient way to protect assets and save for a beneficiary's education. Not all plans may be protected from creditors, however, because Code Section 529 does not address the issue and not all states have provided for creditor protection for qualified tuition programs.

3. One advantage of Section 529 plans is that contributions can be accelerated into one year, up to five times the annual exclusion amount, and be treated as if they were made pro rata over five years.

4. That being said, a donor may contribute up to $75,000 per beneficiary in 2019 and treat it as his annual exclusion gifts for 2019 through 2023.

5. Further, a spouse may contribute up to $150,000 per beneficiary at one time if both the five-year election and a split-gift election are made.

6. Section 225 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 provided rules for the exclusion of qualified state tuition programs for secondary education (i.e., Section 529 plans) from bankruptcy estates.

    a. Educational funds placed into a Section 529 plan account **at least 720 days before** a bankruptcy petition is filed are fully protected from an individual's bankruptcy estate. Educational funds placed into a Section 529 plan account **within 365 days before** a bankruptcy petition is filed are not protected from one's bankruptcy estate.

    b. Further, educational funds deposited **between 720 days and 365 days before** a bankruptcy petition is filed are protected up to a maximum of $5,850.00, provided that the following conditions are satisfied:

        i. the designated beneficiary is a child, stepchild, grandchild or step grandchild of the debtor for the taxable year for which funds were placed in such account;

        ii. the educational funds are not pledged or promised to any entity in connection with any extension of credit; and

        iii. the funds are not "excess contributions" as described in Code Section 4973(e), which are defined as the sum of:

            (1) the amount by which the amount contributed for the taxable year to such accounts exceeds $2,000.00 (or, if less, the sum of the maximum amounts permitted to be contributed under section 530(c) by the contributors to such accounts for such year), and

(2) the amount determined under Section 4973(e) for the preceding taxable year, reduced by the sum of:

(A) the distributions out of the accounts for the taxable year (other than rollover distributions), and

(B) the excess (if any) of the maximum amount which may be contributed to the accounts for the taxable year over the amount contributed to the accounts for the taxable year.

V. Foreign Annuities

A. While a foreign annuity should not constitute an individual's sole or even primary asset protection vehicle, it can under the appropriate circumstances be a useful addition to the individual's overall integrated estate plan.

B. Several foreign jurisdictions have laws that expressly protect that jurisdiction's annuities from seizure by a client's creditors.

C. The laws in these jurisdictions vary, but the general intent is that both the cash value will not be subject to the creditors of the client or of the client's estate. Such would be the case, for example, if a U.S. court were to order the seizure of an annuity or include it as an asset of a bankruptcy estate.

D. A court in a foreign jurisdiction may also not be bound by another court's finding that the purchase of the annuity amounted to a fraudulent transfer, but the foreign jurisdiction will likely have its own fraudulent conveyance laws that must not be violated.

E. Switzerland's statutory provisions protecting annuities are among the most well known in the asset protection community.

1. Subject to certain exceptions, if a person residing outside of Switzerland purchases an annuity and irrevocably designates a beneficiary, the policy will be protected from seizure by the purchaser's creditors. The annuity will also be protected if the client designates his spouse and/or descendants as beneficiaries, even if he does so through a revocable designation.

2. There are also protections available with respect to payments received by the beneficiaries, though the effectiveness of these protections may be problematic outside of Switzerland.

3. However, a judgment creditor of a U.S. judgment debtor may still be able to obtain recovery against the annuity if the U.S. court has jurisdiction over the judgment debtor and/or other relevant persons (such as the designated beneficiary). In such case, through the exercise of its jurisdiction the U.S. court might very well be able to compel a turnover of the annuity or of the proceeds from its surrender.

4. The Swiss annuity arguably provides some conflict of law or choice of law issues that would need to be addressed by a domestic court before a creditor would be able to attach the asset. In other words, as applied to the annuity, the court would need to determine whether Swiss law applies or whether domestic law applies. This could cause the claimant additional expense and legal fees to litigate the conflict of law issues.

5. However, in a domestic court with an action originating domestically, it is most likely that a domestic judge will apply domestic law and simply order the client to make the Swiss annuity available to the client's claimants.

6. If the client has the power to so direct the annuity or insurance company, then this "planning" has gained little for the client.

VI. Irrevocable Life Insurance Trust ("ILIT").

A. The ILIT is an arrangement between the "Settlor" and "Trustee(s)." The Trustee has a fiduciary obligation regarding taking title to assets for the benefit of another (the "Beneficiary(ies)").

B. The trust must be irrevocable.

C. The ILIT removes life insurance from the client's taxable and probate estate, as well as from the client's asset base.

D. The Trustee holds all "incidents of ownership," such as the power to change the beneficiary or to borrow on the policy. <u>See</u> Treas. Reg. §20.2042-1(c)(4).

E. The ILIT provides liquidity to an otherwise illiquid estate.

F. Leverages the Generation-Skipping Transfer Tax (“GSTT”) Exemption.

1. Provided that an ample GSTT exemption is allocated to the contributions to the ILIT, the ILIT can avoid the payment of GSTT on any distributions made by the trust to future-generation beneficiaries. If the ILIT is created for multiple future-generation beneficiaries for an extended period of time (a “dynasty” or “long-term” trust), then the GSTT is avoided for multiple generations.

2. Even though contributions to the ILIT may avoid gift taxes due to the annual exclusion, the GSTT exemption must still be allocated to the related gifts to avoid GSTT.

G. The ILIT is also useful for group term life insurance.

1. Assignment of certificate of participation to the ILIT can be made, provided the group term policy allows for such assignment.

2. Also need to designate beneficiary to be the ILIT.

3. This type of ILIT effectively removes policy proceeds from the insured’s taxable estate (See Rev. Rul. 72-307), even though the insured could effectively terminate the policy by terminating his or her employment.

5. Each time an employer pays a premium, the employee effectively gifts that amount to the ILIT. (See Rev. Rul. 76-490.)

6. The IRS has suggested that Crummey notices can be satisfied by providing the beneficiaries with a schedule in advance that specifies which days the premiums will be paid and the periods that the beneficiaries have to exercise their withdrawal right. (See TAM 9045002.)

7. Do not have beneficiaries waive right to Crummey notices or else contributions to ILIT will not qualify for the annual exclusions. (See TAM 9532001.)

H. Single versus “Surviving Spouse.”

1. Life Insurance on the Settlor’s Life.

2. Second to Die Policy on Settlor and Settlor’s Spouse.

a. Spouse can be a beneficiary of the ILIT if he or she only has right to income after premiums of policy are paid. (See PLR 9451053.)

b. Many planners prefer to not have spouse be a beneficiary of a second-to-die ILIT, to be safe (risk of relying on a PLR).

I. Contributions to ILIT.

1. If an existing policy is transferred, then the transferor must survive the transfer by more than three years.

2. To make contributions a more affordable amount, consider a reverse split-dollar ILIT in which the settlor contributes a portion of the premium sufficient to cover the term insurance component, and another family member can loan the difference to the ILIT in exchange for pledging the life insurance policy to pay back the lender of the greater of the loaned premiums or the policy's cash value. The lender/family member can be a beneficiary of the ILIT as well without causing the ILIT's assets to be included in the settlor's estate. (See PLR 9636033.)

J. Crummey Notices

1. At the same time any contributions are made to the ILIT, the Trustee should send a letter, known as a "Crummey Notice" to the ILIT's beneficiaries notifying them of their respective withdrawal rights.

2. Crummey Notices should be sent either via certified mail, return receipt requested or via e-mail (with a proviso in the e-mail stating that the beneficiaries should send a return e-mail to the Trustee acknowledging receipt of said notice).

K. Asset Protection.

1. Irrevocable trusts such as an ILIT routinely include provisions stating that the beneficiaries cannot pledge, assign or otherwise encumber their interest in the trust and that the creditors of beneficiaries cannot attach, levy against, or seek a forced sale of a beneficial interest in a trust.

2. These provisions are designed to avoid allowing a creditor of a beneficiary to attach his or her interest in the ILIT's assets.

3. The concept of a "spendthrift trust" is further discussed in Part VIII.B. of this outline.

VII. Limited Partnerships and Limited Liability Companies

A. Family limited partnerships ("FLPs") and their progeny (e.g., limited liability companies, limited liability partnerships, limited liability limited partnerships, limited partnership associations, and their various offshore counterparts) have become popular tools for protecting accumulated wealth. The focus of this part of the outline is on FLPs, and in certain cases the planning opportunities available through an FLP will also be available through its progeny (though this will be a function of the governing statutory law and its interpretations).

1. Assets that would otherwise be attractive to a creditor are rendered unattractive by transferring them to an FLP in exchange for a general and/or limited interest(s) therein.

2. Following the transfers, the transferor owns one or more interests in a partnership rather than the transferred assets.

3. State partnership laws provide that a creditor's remedy against a limited partnership is to obtain a "charging order," which is typically somewhat of a limited remedy. Whether or not this remedy is the exclusive remedy will be a function of the specific statutory provisions or of judicial interpretation.

4. Moreover, a creditor who has successfully obtained a charging order against interests in a limited partnership runs the risk of receiving phantom income from the partnership. See Revenue Ruling 77-137.

b. Almost all states have adopted some form of the Uniform Limited Partnership Act. Article 7 of the Uniform Limited Partnership Act (1976) with 1985 Amendments provides in relevant part as follows:

> " **701. Nature of Partnership Interest**. - A partnership interest is personal property.
>
> " **702. Assignment of Partnership Interest** - Except as provided in the partnership agreement, a partnership interest is assignable in whole or in part. An assignment of a partnership interest does not

dissolve a limited partnership or entitle the assignee to become or to exercise any rights of a partner. An assignment entitles the assignee to receive, to the extent assigned, only the distribution to which the assignor would be entitled. Except as provided in the partnership agreement, a partner ceases to be a partner upon assignment of all his [or her] partnership interest.

" **703. Rights of Creditor**. - On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. This [Act] does not deprive any partner of the benefit of any exemption laws applicable to his [or her] partnership interest.

" **704. Right of Assignee to Become Limited Partner**. - (a) An assignee of a partnership interest, including an assignee of a general partner, may become a limited partner if and to the extent that (i) the assignor gives the assignee that right in accordance with authority described in the partnership agreement, or (ii) all other partners consent."

b. Rev. Rul. 77-137 involved a limited partnership whose agreement provided that an assignee of a limited partnership interest did not become a substituted limited partner without the consent of the general partners. A limited partner assigned his interest and the general partners did not consent to substituting partners. The Service ruled that for Federal income tax purposes the assignee was nevertheless a substituted limited partner, and therefore the assignee "must report the distributive share of partnership items of income, gain, loss, deduction, and credit attributable to the assigned interest...in the same manner and the same amounts that would be required if [the assignee] was a substituted limited partner."

i. FLPs are not only useful in rendering attractive assets unattractive, they are also extremely useful in separating ownership from control. Even though substantial value can be gifted through transfers (either outright or in trust) of limited partners' interests, control over partnership assets as well as possession thereof can be retained by the client who retains the general partner's interest.

ii. As useful as FLPs may be for rendering attractive assets unattractive, they are not the panacea which some believe them to be. A number of disadvantages exist in this regard:

(A) The client remains subject to the whims of the domestic system by limiting the client's planning to domestic tools. Consider Evans v. El Dorado Improvement Co. (119 Cal. Rpts. 889 (1975)), wherein the court held that a limited partnership was merely a "business conduit" and should therefore be disregarded for the purpose of levying on the property of the judgment debtor partners, where the two debtors owned all of the shares of the corporate general partner as well as all interests of the limited partners.

(B) A client will be limited in his ability to freely access partnership assets if a charging order has been obtained by a creditor.

(C) Concern exists that a court may require a principal purpose for the creation and funding of a partnership other than protecting assets, and in the absence thereof a creditor's remedy may not be limited to obtaining a charging order.

(D) Independent of the "principal purpose" concern is the issue of whether the charging order is in fact a creditor's "sole remedy."

iii. In Centurion Corp. v. Jon R. Perreton (208 Cal. App. 3d 1, 255 Cal. Rptr. 794 (Feb. 1989)), it was held that a judgment creditor was not limited in its collection remedies to obtaining a charging order and was in fact able to attach and sell a partnership interest toward satisfaction of the unsatisfied judgment the creditor had obtained some years earlier.

(A) Although the facts of this case are relatively narrow, the case can certainly serve (and has in fact served) as precedent for a subsequent adverse FLP decision.

(B) The court states that "[c]ases requiring creditors to obtain charging orders also indicate that sale of the partnership interest is permissible where the creditor has first obtained a charging order and has demonstrated that monies collected under the charging order are insufficient to satisfy that judgment.

(C) In Hellman v. Anderson (233 Cal. App. 3d 840 (1991)), the court held that interests in a limited partnership may be foreclosed by a judgment creditor when foreclosure of the interest will not unduly interfere with the business of the partnership.

v. The In re Priestly (93 B.R. 253 (D.N.M. 1989)) court held that the debtor's interests as general partner and as limited partner in various limited partnerships were property of the bankruptcy estate and that the trustee had the power to sell them.

vi. But consider:

(A) First Union National Bank v. Allen Lorey Family Limited Partnership (34 Va. Cir.14 (19th Cir., 1994)), which held that a creditor of a partner may not petition the court for judicial dissolution of a limited partnership.

(B) United Colony Bank v. United Bank of Greeley National Association (832 P.2d 1112 (Colo. Ct. App. 1992)), wherein the Court states that "the charging order operates, in effect, as a substitute for execution."

(C) The In re Stocks (110 B.R. 65 (N.D. Fla. 1989)) court held that the Uniform Limited Partnership Act "made the statutory charging order the only means by which a judgment creditor can legally command payment from the debtor's partnership interest." The court does imply, however, that if the creditor was able to make a showing that there were insufficient assets "in this bankruptcy estate with which to satisfy its judgment in full after an orderly liquidation of those assets by the trustee," then it might have created a judicial exception.

(D) In Chrysler Credit Corp. v. Peterson (342 N.W.2d 170 (Minn.App. 1984)), the court cites Matter of Smith (17 B.R. 541, 547 (Bankr. M.D. Ga. 1982)), and Matter of Pischke (11 B.R. 913, 917 (Bankr. E.D. Va. 1981)), in holding that "[t]he charge order is the exclusive remedy for a judgment creditor of a limited partner."

vii. The terms of the charging order itself may be rather onerous. Consider the following language from an Order Re Motion And Application To Charge Partnership Property as entered on May 3, 1994 in a case in the U.S. District Court for the District of Colorado:

> "The partnership is directed to pay to the [plaintiff's] law firm, as for (sic) the Petitioners' receiver, present and future shares of any and all distributions, credits, drawings, or payments to said law firm (sic) until the judgment is

satisfied in full, including interest and costs.

“Until said judgment is satisfied in full, including interest and costs, the partnership shall make no loans to any partner or anyone else.

“Until said judgment is satisfied in full, including interest and costs, the partnership shall make no capital acquisitions without either Court approval or approval of the Judgment Creditor (sic) herein.

“Until said judgment is satisfied in full, including interest and costs, neither the partnership nor its members shall under take (sic), enter into, or consummate any sale, encumbrance, hypothecation, or modification of any partnership interest without either Court approval or approval of the Judgment Creditors herein.

“Within ten days of service of a certified copy of this Order upon the registered agent of the partnership, the partnership shall supply to the Judgment Creditors, a full, complete, and accurate copy of the Partnership Agreement, including any and all amendments or modifications thereto; true, complete, and accurate copies of any and all federal and state income tax or informational income tax returns filed with (sic) the past three years; balance sheets and profit and loss statements for the past three years; and balance sheet and profit and loss statement for the most recent present period (sic) for which same has been completed. Further, upon ten-day notice from Petitioners to the partnership, all books and records shall be produced for inspection, copying and examination in Petitioners (sic) office.

> "Until said judgment is satisfied in full, including all costs and interest thereon, all future statements reflecting cash position, balance sheet position, and profit and loss, shall be supplied to Petitioners within thirty days of the close of the respective accounting period for which said data is or may be generated."

viii. FLPs are very useful in the IEP setting in the context of facilitating a gift giving program based on discounted values for federal gift tax purposes, and as a means to gift equity without losing control over the subject assets.

VIII. Domestic Trusts

A. What is a trust?

1. The concept of the Trust dates back to 11th century England, and began as an expression of a person's desire for his property (generally land) to be enjoyed by his dependents.

   a. Property was transferred to a relative or friend relying on his good faith and directing him to "use" it in a certain way.

   b. As a result the creator no longer owned the property and feudal dues were avoided.

2. A trust's "settlor" is the individual who created the trust. A "beneficiary" or "beneficiaries" refers to the individual(s) for whom the settlor created the trust.

3. Central to the concept of the trust is that of separating legal from equitable title.

4. Beneficiaries have equitable title in a trust's assets.

5. The "trustee" is the individual (or entity) to whom the settlor transfers legal title to the trust's assets. Although the trustee has legal title and is the record owner of the assets, the trustee may not use the trust's assets for his or her individual gain. The trustee under the trust is held to a fiduciary standard and must hold and administer the assets only as prescribed by the settlor in the trust agreement and as provided for by law.

6. As can be seen, although the trustee has legal title to the trust assets, and the beneficiaries hold the equitable interests in the assets, nobody "owns" the trust assets outright and for their own benefit. This is why a trust can be used so successfully for asset protection purposes—neither the settlor nor the beneficiaries own the assets in a fashion that leaves them available to his or her creditors.

    a. The settlor has parted with ownership of the assets, and unless, for instance, he or she has fraudulently conveyed the assets into the trust, the future potential creditors will not have access to the assets, because creditors can generally obtain only what the debtor owns, not what the debtor used to own.

    b. The trustee, while holding legal title, has no right or claim to benefit under trust assets, so they are not accessible by his creditors.

    c. If the trust contains a competently drafted spendthrift provision (discussed in Part VIII.B.), a beneficiary's creditors should generally also be unable to pursue the trust's assets.

7. Trusts are today utilized around the world, mainly in common law countries having historical ties to the English legal system. Trusts in general are not recognized under other legal systems such as under the civil law legal system (unless the civil law country is a party to the Hague Convention on the Law Applicable to Trusts and on their Recognition, or unless the civil law country has statutorily superimposed common law trust law on its civil law systems).

B. What is a spendthrift trust?

1. If one establishes a trust for the benefit of others, and if the trust contains a "spendthrift clause," then the trust may be referred to as a "spendthrift trust." A sample spendthrift clause is as follows:

> No beneficiary of the trust estate shall have any right, power, or authority to sell, assign, pledge, mortgage or in any other manner to encumber, alienate, or impair all or any part of his or her interest in the trust estate or in the principal or income thereof. The beneficial and legal interest in, and the principal and income of, the trust

> estate and every part of it shall be free from interference or control of any creditor of any beneficiary of the trust and shall not be subject to the claims of any such creditor, including claims for the payment of alimony, nor liable to attachment, execution, bankruptcy, or any other legal or equitable process. The income and principal of the trust estate shall be paid over to the beneficiary directly, or, in the event of the minority or incompetency of any beneficiary, to the legal representative of that beneficiary, or in any form allowed by law for gifts to minors, or to or for the benefit of that beneficiary, in such manner as the Trustee in the Trustee's sole discretion deems advisable, at the time and in the manner provided by the terms of the trust, and not upon any written or oral order nor upon any assignment or transfer by the beneficiary nor by operation of law.

2. A trust can often shield the transferred assets from creditors of the trust's non-settlor beneficiaries. A spendthrift trust is usually created to provide a fund for the maintenance of a beneficiary and at the same time to secure the fund against the beneficiary's improvidence or incapacity and to place the fund beyond his or her creditors' reach.

3. It is in a real sense a trust set up to protect a beneficiary from spending all of the money to which he is entitled. It is also a trust that by its terms or by statute constitutes a valid restraint on the voluntary and involuntary transfer of the interest of the beneficiary (See Restatement (Second) of Trusts § 152).

4. A spendthrift provision is simply a provision in a trust document that expressly prohibits beneficiaries from transferring, encumbering or pledging their respective beneficial interests in the trust. It also typically expressly prohibits any creditor of a beneficiary from attaching, levying against or seeking a forced sale of the beneficiaries' respective beneficial interests (See Estate of Sowers, 574 P.2d 224, 228 (Kan. Ct. App. 1977)).

5. Although there is some erosion of this concept, generally spendthrift provisions are enforced by U.S. courts when the debtor-beneficiary is someone other than the transferor of the sought-after property (See Scott's Abridgement of the Law of Trusts, §§ 151-152.1, Little, Brown and Company (1960) and Scheffel v. Krueger, 782 A.2d 410 (N.H. 2001)). As a result, except for a potential application of fraudulent conveyance laws to "avoid" the transfers,

in theory the beneficiary's creditors would be unable to access the transferred assets.

6. The following demonstrates how two different state supreme courts may reach differing opinions when it comes to spendthrift trusts:

   a. Scheffel v. Krueger, 782 A.2d 410 (N.H. 2001).

      i. In Scheffel, the mother of a minor child who was sexually assaulted appealed a lower court's ruling that refused to allow the defendant's beneficial interest in a trust to be attached in order to satisfy a judgment.

      ii. The defendant sexually assaulted the plaintiff's child. A lower court held the defendant liable for over $550,000 in damages. The plaintiff sought to attach the defendant's beneficial interest in a trust in order to receive payment. According to the trust, none of the income was subject to the control of the beneficiary's creditors. Additionally, the income was not to be reached by any legal or equitable process in satisfaction of any liability. The trial court held that the spendthrift provision was enforceable against the plaintiff's claim.

      iii. The plaintiff argued that the legislature did not intend to shield the trust's assets from tort creditors in a situation where the beneficiary's conduct constituted a criminal act. The court found that the plain meaning of the statute indicates the spendthrift provision is enforceable unless the beneficiary is also the settlor or the assets were fraudulently transferred to the trust. Neither exception applied in this situation. Therefore, the plaintiff's argument failed.

   b. Sligh v. First National Bank, 704 So.2d 1020 (Miss. 1997).

      i. Sligh was involved in an automobile accident with Gene Lorance, an uninsured motorist who was driving under the influence. Sligh suffered a broken spine and paralysis below the waist. Lorance was convicted of driving under the influence and sentenced to 10 years in prison.

ii. Lorance's mother had settled two spendthrift trusts with Lorance as a beneficiary. Sligh attempted to garnish both trusts, claiming it was a violation of public policy to enforce and give priority to spendthrift trust provisions over involuntary tort judgments against the beneficiary.

iii. Sligh also urged the court to recognize and enforce a public policy exception to the spendthrift trust doctrine in favor of involuntary alienation by tort creditors by subjecting Lorance's beneficial interests to the payment of their tort judgment.

iv. The lower court ruled that a tort judgment creditor cannot garnish the trustee of a spendthrift trust in the situation where the defendant is only a lifetime discretionary income beneficiary, nor are the assets of such trust subject to the claims of the tort judgment creditor.

v. The Mississippi Supreme Court outlined four exceptions stated in the *Restatement (Second) of Trusts* where the interest of the beneficiary can be reached in satisfaction of an enforceable claim against the beneficiary.

vi. These exceptions allow for the satisfaction of claims made:

(A) by the wife or child of the beneficiary for support or alimony;

(B) for necessary services rendered to the beneficiary or necessary supplies furnished to him;

(C) for services rendered and materials furnished that preserve or benefit the interest of the beneficiary; and

(D) by the United States or a state to satisfy a claim against the beneficiary (See Restatement (Second) of Trusts § 157).

vii. In its decision, the Mississippi Supreme Court went against the grain in holding as a matter of public policy that a beneficiary's interest in spendthrift trust assets is not immune from attachment to satisfy the claims of the beneficiary's intentional or gross negligence tort creditors, and that such claims take priority over any remainder interests in such assets. The court reversed the lower court's decision and allowed Sligh to recover against Lorance's interests in both spendthrift trusts.

viii. As a result of Sligh, the Mississippi State legislature enacted the Family Trust Preservation Act of 1998. The relevant portion states: "[I]f the trust instrument provides that the trustee shall pay to or for the benefit of a beneficiary so much of the income or principal or both of a trust as the trustee in the trustee's discretion sees fit to pay, a transferee or creditor of the beneficiary may not compel the trustee to pay any amount from the trust that may be paid only in the exercise of the trustee's discretion."

ix. This statute appears to be a direct attempt to contradict the Mississippi Supreme Court's holding in Sligh.

7. The Federal Bankruptcy Code recognizes the validity of spendthrift trusts. Section 541(c)(2) provides:

> "A restriction on the transfer of a beneficial interest of a debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title."

Therefore, if the restriction on the transfer is not enforceable under applicable non-bankruptcy law, it is not enforceable in the bankruptcy proceeding; the restriction will not be honored by the court.

C. What is a self-settled spendthrift trust?

1. When one establishes a spendthrift trust for himself/herself and/or others, and/or according to some decisions retains control over a spendthrift trust he or she has settled, the trust is a self-settled spendthrift trust.

2. The weight of authority is that self-settled spendthrift trusts are indeed valid trusts; however, depending on the applicable law they may or may not afford protection against the settlor's creditors.

3. Importantly, this is not only the case with respect to the settlor's present or subsequent creditors, but this is the case as to future potential creditors as well, and for so long as the trust may be in existence. Trust assets would continue to be available to satisfy judgments against the settlor on the basis that the "door to trust assets" remains open as a self-settled spendthrift trust; a judgment creditor would not need to resort to a fraudulent transfer theory or other claim to access trust assets.

~~4.~~ Approximately 25 offshore jurisdictions and 15 states (depending on how one categorizes) statutorily recognize the validity of the self-settled spendthrift trust. This legislation commenced offshore in December of 1989 when the Parliament of the Cook Islands enacted the International Trust Amendment Act 1989, amending the Cook Islands International Trust Act 1984.

5. Choice of Law Analysis

a. E.g., a New York business incorporating in Delaware or Nevada.

b. <u>In re Renard</u> (437 N.Y.S.2d 860 (N.Y. 1981)) - Decedent was born a French citizen in 1899. From 1941 to 1971 she was domiciled in New York. She became a U.S. citizen in 1965. In 1971, she returned to live in France, where she died seven years later. While in France she executed a will wherein she left the bulk of her estate in equal shares to a French friend and a French charity. She selected New York law as the law governing her will, for New York law did not provide her surviving son with a forced share, as did French law. Upon her death, her son challenged the proposed distribution of property, claiming that French law should govern and that he was therefore entitled to one-half of his mother's estate. The court upheld the decedent's choice of New York law, and, accordingly, the son did not prevail.

c. For an excellent analysis of choice of law principles as applied by U.S. courts considering offshore trusts, see "Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?" (authored by Jonathan G. Blattmachr, Gideon Rothschild, and Daniel S. Rubin, *Vanderbilt Journal of Transnational Law*, Volume 32, Number 3.)

d. Why should one limit his or her choice of law to the law of his home jurisdiction when other governing law is available?

D. Planning Possibilities Using Restatement (Second) of Trusts (1957).

1. "Section 156. Where the Settlor is a Beneficiary

"(1) Where a person creates for his own benefit a trust with a provision restraining the voluntary or involuntary transfer of his interests, his transferee or creditors can reach his interest.

"(2) Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit."

2. Comments d. and e. of this Section 156 provide:

"d. <u>Trust for settlor's support</u>. Where the settlor creates a trust for his own support, he can assign his interest and it can be reached by his creditors. They can compel the trustee to pay to them the maximum amount that he could pay to the settlor-beneficiary or apply for his benefit.

"e. <u>Discretionary trust for the settlor</u>. Where by the terms of the trust a trustee is to pay the settlor or apply for his benefit as much of the income or principal as the trustee may in his discretion determine, his transferee or creditors can reach the maximum amount which the trustee could pay to him or apply for his benefit."

3. Thus, the Restatement (Second) of Trusts provides that a creditor will be able to reach the maximum amount distributable to the settlor/beneficiary. Many cases have turned on this Section 156 in determining whether creditors can reach the interest of the settlor in a spendthrift trust. While the use of a domestic trust wherein the settlor is also a beneficiary may be limited in application in some states, planning possibilities do exist.

    a. Settlor, as one of a class of beneficiaries, would only receive distributions as determined by reference to an ascertainable standard (health, support, and maintenance), and only if distributions to the settlor would not jeopardize distributions to other beneficiaries.

    b. Retention by settlor of an interest in income only; special power of appointment over principal. The income interest would be available to creditors, but not the retained power over the principal. A special power of appointment is not exercisable by a trustee in bankruptcy. This gives the settlor flexibility and a "second look." Further, this renders the gift in trust incomplete for federal gift tax purposes. (<u>See</u> Treas. Reg. Section 25-2511-2(b).)

4. Case law.

    a. <u>DiMaria v. Bank of California National Ass'n.</u>, 46 Cal. Rptr. 924 (1965).

        i. <u>DiMaria</u> involved a widow (Mrs. Walton) with two adult children who transferred most of her assets to an irrevocable trust. Mrs. Walton was to receive all of the net income of the trust estate, and so much principal as the trustee deemed advisable if, in the trustee's discretion, the trust income, together with the widow's other resources, proved insufficient for her reasonable support, medical care and comfort.

ii. Mrs. Walton later commenced an action to cancel the trust, which effort was unsuccessful.

iii. Attorney fees for the action were in excess of $10,000. The attorney attempted to collect from the trust, and was not successful.

iv. The court stated:

"To permit [the claimant to recover] from the corpus without showing an inadequacy of Mrs. Walton's income from the trust and from other sources for her support would give him access to trust assets not reachable by [Mrs. Walton] nor payable to her within the <u>sound</u> discretion of the trustee. The general rule is that the creditor of a beneficiary under a trust has no more rights and can secure no greater benefits from a trust the beneficiary himself."

"[The claimant cites the Ware case, the Greenwich case, and] section 156 of the Restatement of Trusts, and contends that we here have a "settlor's discretionary trust" which constitutes an exception to the general rule enunciated above. The cases cited are clearly distinguishable from the present case. In *Ware*, the settlor beneficiary's creditor was allowed to prevail against trust property where payments to the beneficiary from both income and corpus were subject to the trustee's <u>absolute discretion</u>. In *Greenwich*, the court permitted the creditor of a settlor-beneficiary to come against the trust income where the payment thereof to the beneficiary was subject to the absolute discretion of the trustee. In both cases, the trust contained specific provisions against the alienation of their interest by the beneficiaries and the imposition of creditor's claims. Under these circumstances, it is understandable why the court should conclude that the trust was a mere subterfuge to insure the unbridled financial demands of the settlor and, at the same time, insulate his estate against the just claims of creditors."

"In the instant case, the trustee exercises no discretion in regard to the payment of the income from this sizeable estate. It must be given outright to the settlor and is subject to her alienation and to the claims of her creditors. Furthermore, the trustee's discretion over the payment of corpus is <u>limited</u> rather than <u>absolute</u>. The corpus can be invaded only if the income therefrom, together with Mrs. Walton's income from other sources, is insufficient to provide <u>reasonable</u> support, medical care and comfort. The discretion granted the trustee would clearly be abused by any arbitrary withdrawal not justified under this proscription. . . ."

b. <u>Avera v. Avera</u>, 315 S.E. 2d 883 (Ga. 1984).

i. <u>Avera</u> involved a wife who claimed that the corpus of a trust established by her husband was subject to her claims of alimony and child support. The terms of the trust provided the settlor-beneficiary (husband) with an income interest for his life. In holding favorably for the settlor-beneficiary, the court stated:

> While we acknowledge there is a discretion in the trustee to encroach upon the corpus, we note he may do so only in the limited circumstances of "misfortune, illness, accident or infirmity," and for necessary sums when there are no other "funds reasonably available" to meet the particular need. This provision does not empower the trustee to invade the corpus with unlimited discretion.

E. Beneficiary Controlled Trust

1. Overview

a. If possible, most property owners would want the ability to place their property into a structure whereby they could manage and control it; use the property and income for whatever purpose they desire; have the ability to give the property to whomever they want; and protect the property against lawsuits and taxes.

b. Many property owners would like to pass their wealth to their children and more remote descendants at such time that they perceive that the donees have attained a sufficient level of responsibility. In addition to shifting control at a sufficient level of responsibility, there generally is the desire to pass the wealth so that the donees can also obtain the beneficial enjoyment virtually equivalent to outright ownership over the property without the exposure to potential creditors. The desire is to avoid the exposures of outright ownership while also avoiding the restrictions and controls inherent in the traditional trust arrangement. This allows the beneficiary to possess full enjoyment without exposure.

c. The Beneficiary Controlled Trust ("BCT") accomplishes the above-referenced objectives. A BCT can be designed to give a beneficiary control that is essentially equivalent to outright ownership in addition to the insulation of the assets from taxes and creditors, as long as the trust is properly settled and funded by an individual other than the beneficiary.

d. A BCT can give the beneficiary all of the benefits for life of a gift or inheritance "in trust." Also, the beneficiary can be in almost full control of the trust (including control over the trust's assets and operations approaching outright ownership). A typical BCT continues this structure in perpetuity, giving the control to the senior generation on a per stirpetal basis. This is subject to change by the use of a special power of appointment.

2. Characteristics Of A Typical BCT

a. A BCT is most efficiently designed as a discretionary trust. It is a trust arrangement that continues for the child's lifetime; and for the successive lifetimes of the child's descendants, generally on a per stirpetal basis with each family branch (the primary beneficiary's family unit) having a separate trust. Also, when specified ages are attained, instead of requiring outright distributions to the child, a BCT puts the child in control of their trust. This transfer of control may be deferred if the child's parents (or their designees) believe the child is not currently able to take on the responsibilities of control. This deferment might last until such time that the age(s) that outright distributions would have been made had a traditional trust been used.

b. The trust splits on a per stirpetal basis for each family branch at which time the primary beneficiary, if he has attained the projected age of maturity or upon attaining that age is in control of his separate trust. The use of separate trusts for each branch will avoid conflicts between siblings; permit ease of portability if a primary beneficiary moves to another state; avoids the necessity of trying to match benefits, distributions or advances; and enables each primary beneficiary to be in control of his family unit's investments. Therefore, each primary beneficiary (and his family unit) will benefit from his investment experience and will not have to absorb a partial reduction resulting from the poor investment performance of a sibling. In other words, each family unit can be placed in the same position as it would be if the distribution were outright.

3. Special Powers of Appointment

a. A special power of appointment can essentially amount to the ability to re-write the trust. A broad special power of appointment would give the power holder (usually the primary beneficiary) the right to appoint the property to anyone other than the holder of the power, his estate or the creditors of either, outright or in trust. Alternatively, the BCT's settlor may desire to restrict the class of potential appointees (e.g., to lineal descendants, trusts for their benefit and charities).

b. A special power of appointment plus a power of amendment given to a third party essentially converts the irrevocable trust into a revocable, amendable, irrevocable trust while preserving the protection from creditors and the IRS. The special power of appointment coupled with a power of amendment results in virtually unlimited flexibility. The special power of appointment enables the primary beneficiary to make adjustments to deal with changing family circumstances as well as changes in the law. The power of appointment also protects the trustee from interference by other beneficiaries. Simply put, the power holder can remove a secondary beneficiary.

F. Personal Residence Trusts ("PRTs") and Qualified Personal Residence Trusts ("QPRTs")

1. Personal Residence Trusts

a. Code Section 2702 specifies how certain gifts are valued for gift tax purposes. Generally, this Code Section applies to a transfer of assets to a trust in which the transferor retains an interest. Grantor Retained Annuity Trusts are, for example, subject to Code Section 2702. This Code Section disregards, with certain exceptions, the value of the retained interest in determining the amount of the taxable gift, and therefore increases the value of the taxable gift. In other words, the retained interest is valued at zero, with certain exceptions.

b. A transfer of a personal residence, however, to a trust in which the transferor retains the right to live in the residence for a period of time is excepted from the valuation rules of Code Section 2702. Instead, the gift to the trust is valued taking into account that the transferor is retaining the right to use the property as his personal residence for a period of time (and therefore decreases the taxable gift amount). The retained interest is therefore *not* valued at zero.

c. The transfer of the personal residence to a trust in which the transferor retains the right to live in the residence for a period of time can be designed as either a PRT or a QPRT. Treasury Regulation Section 25.2702-5(b) describes the PRT. Treasury Regulation Section 25.2702-5(c) describes the QPRT. Due to the added flexibility under the Treasury Regulations for QPRTs (discussed below), most planners design such trusts as QPRTs as opposed to PRTs.

d. A PRT can hold only one personal residence.

e. "Personal residence" is not defined under Code Section 2702.

f. Treasury Regulations, however, define a personal residence to mean the principal residence and one other residence of the term holder or an undivided interest in either.

g. An apartment represented by shares of stock in a cooperative housing corporation qualifies as a personal residence (<u>See</u> IRS Letter Ruling 9151046).

h. A residence is deemed to be held for personal residence use provided it is not occupied by anyone other than the term holder (or the spouse or dependent of such individual.)

i. The PRT must also require that the residence be available to the term holder at all times for use as a personal residence. The residence cannot be sold or otherwise transferred during the period the term holder is allowed to use the residence.

j. The PRT must also prohibit the sale or transfer of the residence to the transferor, his or her spouse, or any entity controlled by either of them after the term holder's term expires, except for a distribution (for no consideration) of the residence to the transferor's spouse.

k. The governing trust instrument of the PRT must prohibit the holding of assets other than the residence (e.g., personal property, household furnishings, etc.). However, in the event insurance payments or a condemnation award is paid as a result of the destruction of the home, the proceeds must be required to be reinvested in a replacement personal residence within two years.

2. Qualified Personal Residence Trust

a. In general, a QPRT is the same as that of a personal residence trust. The QPRT, however, is allowed some added flexibility, as noted below.

b. The Treasury Regulations make it clear that although the term "personal residence" does not include personal property or household furnishings, it does include appurtenant structures such as a guest-house or adjacent land that is reasonable for residential purposes.

c. The governing instrument may permit improvements to the residence to be added to the trust.

d. A QPRT will fall within the statutory exception to Code Section 2702 even though the trust may hold certain additional assets (Treasury Regulation Section 25.2702-5). Additional assets are as follows:

    i. Sufficient cash to pay trust expenses (including mortgage payments) or any improvements to the property to be incurred within a six-month period.

    ii. Cash to purchase a personal residence within the next three months, provided that a contract to purchase the residence has been entered into.

    iii. Proceeds from the sale of any personal residence for up to two years from the date of the sale, if the trustee intends to use the proceeds to purchase another personal residence.

    iv. Policies of insurance on the residence as well as the proceeds of any casualty insurance that the trustee intends to use within two years for repair, replacement or improvement. Treasury Regulation Section 25.2703-5(c).

e. The governing instrument may also permit the sale of the residence, except that no sale or transfer of the residence can be made to the transferor, his or her spouse, or any entity controlled by either of them after the term holder's term expires, except for a distribution (for no consideration) of the residence to the transferor's spouse.

f. The proceeds of any permitted sale of the residence may be required to be held in a separate account qualifying as a grantor retained annuity trust. Treasury Regulation Section 25.2703-5(c)(8)(i).

g. Alternatively, the proceeds can be required to be distributed to the term holder.

h. The trust instrument can specify which of the two options (in f. and g. above) must be exercised, or may leave it open to the discretion of the trustee. A qualified annuity will usually be the more protective strategy in light of the fact that certain states provide an exemption for annuities from the claims of creditors.

i. Further, the annuity payments may be less attractive to a creditor than the liquidation of an asset for immediate cash.

j. Also, the annuity's terms would be a factor in determining the attractiveness of this asset to a creditor.

3. Concepts Applicable to Both PRTs and QPRTs.

a. QPRTs and PRTs are better created when interest rates are higher because the retained right to use a residence is higher (and the remainder gift is valued at a lower amount).

b. QPRTs and PRTs may also offer asset protection in the sense that the creditor gains no more rights to the trust assets than those possessed by the settlor/beneficiary.

c. The creditor may be able to receive the rights to use the residence for a term of years, which may equate to collecting rent on the property, which may be less attractive to a creditor than the liquidation of assets.

G. Revocable Living Trusts ("RLT")

1. An asset owned by an RLT avoids probate, which is usually among a client's estate planning goals.

2. However, from an asset protection standpoint, it is as if the asset is still in the client's own name and the property thus remains exposed to creditors.

H. The Foreign Situs Integrated Estate Planning Trust ("IEPT")

1. Established offshore…not in another state.

2. Almost always designed to be tax neutral for U.S. income, gift and estate purposes.

3. Major advantages of foreign trusts domiciled in a protective jurisdiction when compared to domestic trusts.

4. A domestic trust can be created now for a modest to medium sized estate, with the offshore element added at a later date, with redomiciliation of the trust then occurring.

IX. Redomiciliation to Another State

A. A client may decide to relocate from a state with a relatively unfavorable exemptions to a state with a relatively favorable exemptions.

B. As previously stated, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") essentially overhauled the entire Bankruptcy Code and made it more difficult for individuals to simply walk away from their debts.

C. Section 322 of the Act pertains to limitations on the homestead exemption. This section, which amended 11 U.S.C. § 522, states:

> Except as provided in paragraph (2) of this subsection and sections 544 and 548, as a result of electing under subsection (b)(3)(A) to exempt property under State or local law, a debtor may not exempt any amount of interest that was acquired by the debtor during the 1215-day period preceding the date of the filing of the petition that exceeds in the aggregate $160,375 in value in—
>
> (A) real or personal property that the debtor or a dependent of the debtor uses as a residence;
>
> (B) a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence;
>
> (C) a burial plot for the debtor or a dependent of the debtor; or
>
> (D) real or personal property that the debtor or a dependent of the debtor claims as a homestead.

D. Therefore, under the Act, unless a debtor opts to use the federal bankruptcy exemptions, the debtor may only protect an interest in his or her residence if and to the extent the interest is exempt pursuant to state law. If state law exempts more than $160,375 in equity, then "the extent" will be limited under the Act to $160,375 if the equity was acquired within the 1,215-day period preceding a filing of a bankruptcy petition.

E. Moreover, under the Act there are additional limitations to the use of the homestead exemption that may apply.

F. Specifically, if a court determines, after notice and a hearing, that a debtor has been convicted of a felony demonstrating that the bankruptcy filing was abusive, or if the debtor owes a debt arising from any violation of the federal or state securities laws, fraud, deceit, or manipulation in a fiduciary capacity, or has committed any criminal act or intentional tort that caused serious physical injury or death to another person in the preceding five years, then regardless of the time frame that the debtor acquired the equity in his or her residence, he or she will be able to exempt a maximum of $160,375.

G. The homestead provisions of the Act also permit a rollover of equity in a former residence to a new residence without requiring a new 1,215-day holding period, but only if the former and new residences are located in the same state.

H. Seemingly, a debtor who moves from Texas (an unlimited homestead exemption state) to Florida (another unlimited homestead exemption state) would have to start a new holding period.

I. In order to claim the exemption benefits of certain states, the client will need to check each state in question regarding the rules as to what residency or domicile criteria must be met in order to be eligible for any related exemption protection.

J. For example, factors that may come into play include the individual's intent as to the location of his permanent home (i.e., the place to which he intends to return whenever he may be absent), the days in and out of the state, the location of his family, location of his business and social ties, where he votes, the state in which his driver's license is issued, the domicile declared in certain official documents such as a Last Will, the relative value of homes in different states, where he goes to church, or even where he visits his dentist.

K. States may also have require that the domiciliation in the state of choice existed for a certain period before being able to assert that state's exemption protections.

L. Domicile can be declared to commence simply by filing a sworn statement to that effect in Florida. Of course, the declarant's actions from that point forward need to be consistent with such declaration.

X. Retirement Plans and IRA Accounts

A. Deferral of Income Tax Strategy.

1. IRAs and other retirement assets (“401”) can be subject to three separate taxes:

   a. federal estate taxes;

   b. federal income taxes; and

   c. state income taxes.

2. Strategy to Defer Tax:

   a. Pay estate taxes with non-IRA and non-401 assets. To ensure estate has sufficient non IRA/401 liquid assets to be able to pay estate taxes can be achieved by having an ILIT in place.

   b. If IRA/401 assets are used to pay estate taxes, then such assets will be treated as (income) taxable distributions, and therefore compound the tax burden.

   c. The ILIT, although available to “monetize” the estate assets, will not increase the taxable estate.

   d. In order to defer income taxation of IRA/401 distributions, the beneficiary should be named as a “designated beneficiary,” who can then defer taxation of that income over that beneficiary’s lifetime versus basing the timing of distributions on the age of the participant or shorter period.

3. Avoiding Penalty: Distributions can be received from an IRA without penalty so long as the recipient has attained the age of 59 ½.

4. When an individual reaches age 70 ½, he or she must take required minimum distributions (unless it’s a Roth IRA).

5. Distributions are taxed at ordinary income tax rates when they are withdrawn (unless it is a Roth IRA), and everything remaining in the IRA and not withdrawn continues to grow tax deferred.

6. Therefore, taking only the required minimum distribution will allow client to accumulate more tax-deferred wealth in one’s IRA.

7. When a beneficiary inherits an IRA, distributions can be made according to that beneficiary’s age. If the beneficiary is younger

than the participant, the distributions can be stretched out over a longer period of time (and therefore defer the income taxes).

8. The "stretch" can be maximized by only withdrawing the required minimum distribution amounts.

B. Are inherited IRAs protected from creditors?

1. Clark v. Rameker, 109 AFTR 2d ¶2012-405 (Dist. Ct. Wisc. 2012); 134 S.Ct. 2242 (2014).

a. Facts

i. Ruth Heffron established an IRA in 2000 and named her daughter, Heidi Heffron-Clark as the sole beneficiary.

ii. Ruth died in September 2001. In November 2001, Heidi established an inherited IRA, and in December 2001, the remaining balance in Ruth's IRA was transferred into Heidi's inherited IRA.

iii. Heidi and her husband (Debtors) took monthly distributions from the inherited IRA.

iv. In October 2010, Debtors filed a Chapter 7 bankruptcy petition and claimed the inherited IRA (containing $293,300) as exempt under 11 U.S.C. § 522(b)(3)(C) as well as under Wisconsin law.

v. The bankruptcy trustee and a judgment creditor objected to the exemption.

b. Procedural History

i. The bankruptcy court denied the exemption, holding that the inherited IRA did not contain retirement funds. Moreover, Heidi was required to begin taking required minimum distributions even though she was still working. Therefore, the bankruptcy court concluded that the inherited IRA funds could not be classified as retirement funds because the funds were not segregated to meet the needs of any person's retirement.

ii. Additionally, the bankruptcy court also claimed to be unable to determine any authority for the inherited IRA being tax exempt as these IRAs do not seem to satisfy any of the criteria listed in Code Section 408(a).

iii. Debtors thereafter appealed to the federal district court, which *reversed* the bankruptcy court's holding.

(A) The district court indicated that the majority view on this issue was that funds in a debtor's inherited IRA do not have to be the retirement funds *of the debtor* to satisfy the bankruptcy exemption requirements.

(B) On reviewing the bankruptcy court's decision, the district court stated that, contrary to the majority view, it could be argued that it is implicit in the Bankruptcy Code provisions specifying the property of the debtor that retirement funds must mean retirement funds of the debtor.

(C) On the other hand, words excluded from a statute must have been excluded for a purpose, and the Bankruptcy Code omitted a specific reference to the debtor's interest in the retirement fund exemption even where there is a specific reference to the debtor's interest in other exemption provisions of the same Bankruptcy Code section.

(D) The district court concluded that while there may be reason to question whether inherited IRA funds should be exempt from bankruptcy as a matter of policy, any revisions would have to come from Congress.

(E) Therefore, the district court reversed the bankruptcy court's holding and held that

Heidi's inherited IRA could be exempted from her bankruptcy estate.

c. United States Supreme Court (the "Court")

i. The Court unanimously held that an inherited IRA is not an exempt asset in bankruptcy.

ii. The Court ruled that the inherited IRA would not be exempt from Heidi's creditors in her bankruptcy proceedings because the IRA was not considered an exempt "retirement funds" to Heidi.

iii. If Ruth had named an IRA trust as the beneficiary, her IRA would have been excluded from Heidi's bankruptcy estate.

d. This is not the only asset protection advantage to creating an IRA "stand-alone trust." If the IRA trust is an "accumulation trust," IRA distributions can be kept in trust and protected from frivolous spending by the beneficiary, lawsuits against the beneficiary, and other creditors of the beneficiary (which could include a soon-to-be ex-spouse).

2. In re Andolino, Case 13-17238-RG (Bankr. D. New Jersey 2015).

a. On April 4, 2013, Christopher Andolino ("Debtor") filed a voluntary Chapter 7 bankruptcy petition.

b. On May 28, 2013, Debtor filed a motion to convert the Chapter 7 case to a Chapter 13 proceeding. This motion was granted on August 6, 2013.

c. In Debtor's initial schedules, he disclosed an IRA valued at $120,000, to which he claimed a full exemption pursuant to 11 U.S.C. § 522(d)(12). Prior to the case being converted to Chapter 13, Debtor amended his schedules to reflect that the IRA was inherited from his mother, and claimed that the inherited property does not form a part of the bankruptcy estate.

d. On August 30, 2013, Debtor filed his Chapter 13 plan, to which the bankruptcy trustee (the "Trustee") objected. As this case was before the Court prior to the United States Supreme Court's (the "Supreme Court") decision in Clark

v. Rameker, the parties agreed to await the Supreme Court's decision and then file supplemental briefs on the issue.

e. Trustee attempted to apply the Supreme Court's decision in Clark v. Rameker, to the current case. As stated in 1. Above, the Supreme Court in Clark v. Rameker determined that funds held in an inherited IRA are not "retirement funds" within the meaning of 11 U.S.C. § 522(b)(3)(C), because an inherited IRA has differing characteristics from a traditional IRA in terms of how the underlying funds may be used.

f. Trustee contended that the traditional IRA, established by Debtor's mother, morphs into an asset that is property of the Debtor's bankruptcy estate by virtue of its new status as an inherited IRA.

g. The Andolino court (the "Court"), however, refused to "take the proverbial 'leap' in linking the U.S. Supreme Court's ruling that an inherited IRA is not ***exempt*** from the bankruptcy estate, to an automatic determination that an inherited IRA is necessarily ***included*** in the bankruptcy estate."

h. According to the Court, it must first determine whether the inherited IRA at issue is in fact property of the bankruptcy estate pursuant to 11 U.S.C. § 541, and only then would the Bankruptcy Code's 11 U.S.C. § 522 exemption scheme become relevant.

i. 11 U.S.C. § 541(c)(2) specifically carves the following from bankruptcy estate property: "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title."

j. Next, whereas the inherited IRA at issue in Clark v. Rameker was determined to be an asset of the bankruptcy estate pursuant to nonbankruptcy (i.e., Wisconsin) law, the Court must now apply relevant New Jersey law to determine whether the Debtor's inherited IRA is property of the bankruptcy estate.

k. New Jersey's applicable exemption statute, N.J.S.A. §25:2-1(b) states:

> "Notwithstanding the provisions of any other law to the contrary, any property held in a qualifying trust and any distributions from a qualifying trust, regardless of the distribution plan elected for the qualifying trust, shall be exempt from all claims of creditors and shall be excluded from the estate in bankruptcy . . . .
>
> For purposes of this section, a "qualifying trust" means a trust created or qualified and maintained pursuant to federal law, including, but not limited to, section . . . 408 . . . of the federal Internal Revenue Code of 1986."

l. Neither party disputed that the IRA held by Debtor's mother was a qualifying trust when it was initially created. Therefore, the Court must determine whether the IRA transformed to something other than a qualifying trust when it passed to the Debtor as an inheritance.

m. The Court next stated that the Clark v. Rameker opinion's analysis was limited to whether the funds held in an inherited IRA could be considered "retirement funds." As such, the Court indicated that the distinctive factors discussed in Clark v. Rameker were not determinative of whether a traditional IRA loses its status as a qualifying trust when the IRA is inherited.

m. The Court held that the IRA's status as a qualifying trust remained unchanged, notwithstanding the Debtor's receipt of the IRA as a beneficiary, and therefore, cannot be included as property of the bankruptcy estate.

n. The Court further stated that its ruling is not to suggest that an inherited IRA will always be excluded from the bankruptcy estate. If applicable non-bankruptcy law specifically excludes inherited IRAs from a state's exemption statute, then the inherited IRA would be included as an asset of the bankruptcy estate.

3. In Re Todd, No. 15-11083 (Bankr. N.D.N.Y. March 23, 2018).

a. Laurie Todd (the "Debtor") was the beneficiary of one of her mother's IRAs. After the Debtor's mother passed away, the Debtor used the funds received to establish an inherited IRA through Charles Schwab. In this regard the facts of the case provide that the Debtor did not make any contributions to the inherited IRA from her own funds; had unfettered access to the funds in the inherited IRA; and continued to withdraw funds from the inherited IRA at the time of the case decision.

b. Seven years or so after the Debtor established the inherited IRA she filed a chapter 11 bankruptcy case and claimed the inherited IRA to be exempt from her bankruptcy estate pursuant to New York statute, N.Y. C.P.L.R. § 5205 ("Section 5205"). Debtor claimed the inherited IRA to be exempted because she was an individual indemnitor subject to joint and several liability to a surety under a general indemnity agreement, and she wanted to protect the inherited IRA from such a claim given that it was the largest asset in her bankruptcy estate.

c. Notably, Section 5205 provides several circumstances in which IRAs may be exempt from the judgment of a creditor under New York law. More specifically, Section 5205(a)(1) states in relevant part that an exemption from the satisfaction of a money judgment is provided for "all property while held in trust for a judgment debtor, where the trust has been created by, or the fund so held in trust has proceeded from, a person other than the judgment debtor . . ."; however, the Court noted that if the debtor is capable of using funds in the account without restriction, then the Section 5205(a)(1) exemption would not be available to the debtor. As noted above, the facts of the case provide that the Debtor had unfettered access to the funds in the inherited IRA and continued to access funds at the time of the case decision; as a result, the Court held that the Debtor could not avail herself of the exemption provided under Section 5205(a)(1).

d. Next, the Court looked at Section 5205(a)(2) which provides in relevant part an exemption for an account which is qualified as an individual retirement account under

Internal Revenue Code Section 408 ("Section 408"). In its analysis, the Court noted that neither Section 5205 nor Section 408 defined the word "qualified", and given such ambiguity the Court looked to the legislative history of Section 5205 for further clarification. In this regard the Court found that a review of the legislative history clearly provided that the purpose of Section 5205(c)(2) was "to protect individuals' accounts established for their retirement." Thus the Court stated that a holding that inherited IRAs are "qualified" under Section 5205(c)(2) "would be fundamentally inconsistent with the statute's purpose" because (i) inherited IRA holders cannot contribute to the account, and thus "cannot be used to actively save money for retirement"; (ii) funds in inherited IRAs can be "accessed at any time without penalty"; and (iii) "inherited IRA holders are under an obligation to draw down their accounts". For these reasons, the Court found that the Debtor's inherited IRA was not exempt as a qualified retirement account under Section 5205(a)(2).

e. In addition, the Court noted that while many other state legislatures (such as Alaska, Arizona, Florida, Missouri, North Carolina, Ohio, and Texas) have amended their state exemption statutes to specifically exempt inherited IRAs, the New York legislature has not done so.

f. Ultimately the United States Bankruptcy Court for the Northern District of New York held in this case that a debtor's inherited Individual Retirement Account ("IRA") is property of the debtor's bankruptcy estate and consequently not exempt from creditors under New York law.

C. The Stand-Alone Stretch IRA Trust.

1. Instead of naming an individual as the beneficiary of the IRA/401, certain trusts that have only individual beneficiaries who are younger than the participant can allow for stretched distributions.

2. This type of trust can ensure the beneficiary never takes more than the required minimum distribution amount each year from the IRA via the trust.

3. Normally, when a trust is the beneficiary of an IRA, the required minimum distributions will be made according to the age of the

oldest beneficiary, which in many cases might be the surviving spouse. Therefore, the spouse should not be a beneficiary of the stretch IRA trust.

4. The surviving spouse is able to inherit the IRA, so that he or she can then be treated as the participant who can then name a stretch trust as the beneficiary of the IRA after that spouse's death.

5. The IRS recently ruled that with proper planning, a stretch IRA trust can be divided into separate trusts so that portions of the IRA can be stretched over the life expectancy of each respective beneficiary.

6. Also consider a non-stretch IRA for asset protection purposes.

D. Exemption for Retirement Benefits.

1. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 provided an exemption for tax-exempt retirement funds without regard to whether the debtor elected state or federal exemptions. (See 11 U.S.C.A. §§ 522(d)(7), 522(d)(8) and 522(d)(10)(E) (2014), which permits an exemption of "any unmatured life insurance contract owned by the debtor; the debtor's aggregate interest and the debtor's right to receive a payment under an annuity.") Pursuant to Section 224 of this Act, the aggregate value of retirement assets to be exempted under Sections 402(c), 402(e)(6), 403(a)(4), 403(a)(5), and 403(b)(8) of the Internal Revenue Code may not exceed $1,000,000 in a case filed by an individual debtor, except that such amount may be increased if the interests of justice so require.

2. Further, eligible rollovers are protected without dollar limitation. The Act clarifies that retirement accounts that are tax exempt under the Internal Revenue Code are exempt from the debtor's estate. The Act also responds to a line of cases regarding the treatment of retirement loans and contributions and clarifies that such amounts should not be treated as disposable income.

XI. Protecting an Anticipated Inheritance

A. A client of modest to greater means might, of course, receive an inheritance from his or her parents, another relative, etc., or might be the beneficiary of an insurance policy insuring the life of someone else.

B. Coordinating these expectancies should be considered when planning, and they may indeed impact the level of planning implemented for the client.

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