ASSET PROTECTION BASICS: HOMESTEAD EXEMPTIONS, RETIREMENT PLANS AND IRAS, AND LIFE INSURANCE AND ANNUITIES

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Homestead Exemptions

Most states have statutory or constitutional protections for a debtor's homestead, i.e., the debtor's primary residential real property. The exemption in many states is relatively small and not particularly useful for significant asset protection planning. However, the exemption in some states is large or unlimited and provides useful planning opportunities.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 added new section 522(p) to the Bankruptcy Code, which limits a debtor's claim of homestead to $125,000 if the homestead was acquired within 1,215 days (about 40 months) of the filing of the bankruptcy petition. There was a brief flurry of controversy as to whether the homestead cap applied in states that have opted out of federal bankruptcy exemptions.[1] However, that controversy has subsided and it appears clear that the cap applies across the board.

Furthermore, bankruptcy courts have provided a "safe harbor" to allow debtors to "roll over" equity gains from a homestead purchased prior to the 1,215-day period, and therefore fully exempt the property acquired within the 1215-day period.[2]

In Florida, at least, the homestead exemption is apparently unassailable, if the debtor makes it past the 1215-day period. In 2001, the Florida Supreme Court ruled that although a bankrupt debtor purchased a $650,000 residence in Florida with the specific intent to protect the equity value of the home from his preexisting judgment creditors, the home is still protected under Florida's constitutional homestead exemption.[3] The court held that the constitutional provisions override the statutory exemptions. Similar protection exists under Texas's unlimited constitutional homestead exemption. However, even in such cases, a bankruptcy court may deny a discharge where a debtor has attempted to shield non-exempt assets by transferring them to his homestead.

Retirement Plans

Title I of ERISA requires that a pension plan provide that benefits under the plan may not be assigned or alienated.[4] This provides near-bulletproof protection to plan balances from the claims of a participant's creditors. However, to be a pension plan under ERISA, a plan must provide retirement income to "employees."[5] Therefore, a plan that does not

[1] See *In re McNabb,* 326 B.R. 785 (Bank. D. Ariz. 2005); and *In re Kaplan,* 331 B.R. 483, 488 (S.D. Fla. 2005).
[2] *In re Blair,* 334 B.R. 374 (N.D. Tex. 2006); *In re Sainlar,* 344 B.R. 669 (Bankr. M.D. Fla. 2006).
[3] *Havoco v. Hill,* 790 So.2d 1018 (Fla. 2001).
[4] ERISA § 206(d).
[5] ERISA § 3(2)(A)

benefit common-law employees (such as a plan that benefits only the business owner and her spouse), is not an ERISA plan. Furthermore, ERISA does not apply to IRAs, SEP and SIMPLE plans, government plans and most church plans.[6]

There are some exceptions to the anti-alienation provisions. Retirement plan assets are subject to division in divorce and to attachment for child support under qualified domestic relations orders ("QDROs") as defined in IRC § 414(p). Federal tax levies and judgments are excepted from the anti-alienation provisions as well.

A debtor's interest in an ERISA pension plan is excluded from the debtor's bankruptcy estate.[7] This includes the interest of a debtor who is a working owner-employee, so long as the plan covers one or more employees other than the owner-employee and her spouse.[8] Outside of bankruptcy, however, a debtor-participant in a pension plan not subject to ERISA must rely on state law protections for his interest in the plan. Many jurisdictions fully protect tax-qualified plans, although the protections of a few states are limited.

Furthermore, ERISA protections apply only to funds held in an ERISA plan; they do not apply to funds distributed from an ERISA plan. Once funds have been distributed, a creditor's rights are enforceable against the participant and are subject to state law exemptions for distributed funds, if any. Some states have such exemptions, most do not.

IRAs

Individually established traditional and Roth IRAs are not covered by ERISA. Thus, an IRA owner must look to state law for protection. Many states provide protection to IRAs. Generally, the state of residency of the IRA owner determines which state law applies to the IRA for exemption purposes. Unfortunately, a "pre-emption" glitch may mean that SEP IRAs and SIMPLE IRA's are protected neither under ERISA nor under state law. SEP and SIMPLE IRAs with less than $1 million have been held to be ERISA pension plans because of employer involvement in the creation of the arrangements.[9] However, the anti-alienation provisions of ERISA do not apply to IRAs.[10] ERISA specifically preempts and makes inoperative any state law relating to ERISA pension plans, including state law protections afforded to ERISA pension plans.[11] Therefore, outside of bankruptcy, owners of SEP and SIMPLE IRAs appear to be in an unprotected no-man's land holding interests in ERISA plans with no ERISA anti-alienation protections, but unable to avail themselves of state law protections because of ERISA preemption.

In bankruptcy, traditional and Roth IRA's are exempt up to $1 million. SEP and SIMPLE IRAs are exempt without dollar limitations, as are rollover IRAs from qualified

[6] ERISA §§ 4(b) and 201
[7] *Patterson v. Shumate*, 112 S. Ct. 2242 (1992).
[8] *Yates v. Hendon*, 124 S. Ct. 1330 (2004).
[9] DOL Regs. § 2520.104-48; *Garratt v. Walker*, 164 F.3d 1249 (10th Cir. 1998).
[10] ERISA §§ 4(b) and 201.
[11] ERISA § 514(a).

plans, 403(b) plans and 457 plans.[12] However, once again, SEP and SIMPLE IRAs appear to be treated anomalously in that rollovers from SEP and SIMPLE IRAs appear not to be qualified for the unlimited rollover protection, because they are not specifically sanctioned in the statute.

Life Insurance and Annuities

Along with exemptions for homestead and retirement plans, state law exemptions for life insurance and annuities are often valuable tools for asset protection planning. Because the asset protection planning undertaken by most estate planners and asset protection planners involves clients with substantial assets, we are primarily concerned with the protection of the cash value of life insurance and annuities. The federal bankruptcy exemption for life insurance cash value is $10,775 where the insured is the debtor or a person on whom the debtor is dependent (including the debtor's spouse).[13]

About a third of U.S. jurisdictions have low-value or no exemption for life insurance cash value. Other jurisdictions have exemptions that provide substantial protection. The exemption statutes of some jurisdictions, such as Florida, Hawaii, Arizona, and Texas, make it clear that the cash value of a life insurance policy or annuity contract owned by a debtor is protected from claims of the debtor's creditors. The statutes of many others, unfortunately, are hardly models of clear drafting. The confusion is precipitated by the fact that there are a number of roles a person can play with regard to a life insurance policy or annuity contract. The debtor might be (1) the owner; (2) the insured; or (3) the beneficiary. Furthermore, many, though not all, exemptions for life insurance and annuities are predicated on protection of a favored class, generally spouses and dependents. Finally, just what are the interests in an insurance policy or annuity contract that are to be exempted?

The clause "proceeds and avails" appears in the exemption statutes of many jurisdictions. In some states, this clause is defined to include cash surrender values and loan values. In the statutes of many states, "proceeds and avails" and similar terms are undefined in the statutes. Therefore, it is left to the courts to decide what is exempted by the statute. Courts in some jurisdictions have found that such vague exemption statutes cover cash surrender value,[14] others have found that they do not.[15] Others have added additional twists in construing the often tortured language of insurance exemption statutes.[16]

State law exemptions for annuities vary widely as well. Some jurisdictions, such as North Carolina and Rhode Island, provide no exemption, while others, such as Florida and Arizona, provide exemptions for payments and cash values. Many others provide

[12] 11 U.S.C. § 522(n).
[13] 11 U.S.C. § 522(d)(8).
[14] *In re Worthington*, 28 B.R. 736 (Bankr. W.D. Ky 1983); In re Gablehart, 138 B.R. 425 (Bankr. D. Vt. 1992).
[15] *In re Monahan*, 171 B.R. 710 (Bankr. D. N.H. 1994).
[16] *In re Sloss*, 279 B.R. 6 (Bankr. D. Mass. 2002) (cash value is protected from owner's creditors for the benefit of the *original* beneficiary; if the beneficiary has been changed since the policy was effected, the exemption does not apply).

some exemption for monthly annuity payments, generally in relatively small amounts ($350 per month is common).

Life insurance and annuities can be valuable planning tools, but planners must be intimately familiar with applicable exemption statutes and the case law interpreting those statutes.