Asset Protection and the New Bankruptcy Act

Retirement Plans and Asset Protection Trusts

By Robert J. Mintz

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In my last column I wrote about changes in the law affecting your ability to protect the equity in your home from a potential judgment (Protecting Your Assets Under the New Bankruptcy Act, MDNet Guide November 2005). The new law is part of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") which became effective in October 2005. In addition to the rules covering the homestead exemption the Act impacts the treatment of retirement plans and certain types of trusts used as a part of many asset protection strategies.

Retirement Plans

The Act is very favorable for corporate and individual retirement plans and protects them from almost any claim or judgment. For ERISA qualified defined benefit and profit sharing plans, the rules are clarified. Any amount, without limit, in these plans, is entirely exempt in a bankruptcy collection action. The new law codifies this protection and extends the protection, in general, to all company plans-even those not previously covered.

The biggest change applies to IRA's and SEP-IRA's. Generally, these accounts have had limited and varying degrees of protection. In most cases, the exemption only applied to amounts deemed necessary for the defendant's basic necessities, which could be any amount at all based upon the standards applied by the judge. In many cases, because the defendant was able to continue working and provide his own support, the entire IRA amount was made available for the creditor. The outcome turned on a subjective judicial evaluation of the defendant. Since the determination of an individual's financial needs and earning capabilities were always uncertain, the results were unpredictable and varied widely from case to case. Proper protection planning for this, sometimes significant asset was often a matter of guesswork.

The Act favorably resolves this uncertainty by providing that all contributory IRA's (including Roth IRA's) are now protected up to one million dollars. Additionally, any amounts which have been rolled over into and IRA from a company plan have the complete exemption. So, for any IRA account, the amount now shielded is all contributions and earnings up to one million dollars plus an unlimited amount of any rollover. Educational Saving Accounts and Section 529 college savings plans are also exempt from collection except that amount contributed within a year of a bankruptcy filing is limited to five thousand dollars.

These clearly favorable new rules should be carefully considered in your asset protection planning. Moving savings into a sheltered retirement plan or IRA makes sense if the economic factors (number of covered employees and tax consequences) are justified.

Asset Protection Trusts

On the eve of passage of the Act, a New York Times article claimed that the law was biased toward the wealthy and contained unfair loopholes for the rich. According to the article, individuals with resources and access to legal talent could shield their assets prior to a filing by using "asset protection trusts" to avoid the harsh impact of bankruptcy.

The specific concern addressed is what are known as "self settled" trusts-those in which the person creating the trust (the "Settlor") is also the primary beneficiary. For example, if you put all of your savings into a trust, reserving the right to use the income and principal that is considered to be a self-settled trust.

Though often useful for estate planning (such as the popular Living Trust), traditionally self settled trusts have had little role in asset protection. The law has always been that amounts placed in trust by a settlor for his own benefit, will not be protected from the claim of a creditor. Over the past ten years, however, in an effort to attract banking and trust services, a number of states including Alaska, Delaware, Nevada and six others attempted to alter this rule. They each passed legislation which protects amounts in self settled trusts, formed in their states, if certain specific rules are followed.

In practice, because their legal viability was always in doubt, these self settled domestic trusts were rarely used for asset protection planning. But Congress, in response to the New York Times article, reacted to the perceived abuse by hastily amending the Act. New language was included to provide that a bankruptcy trustee could set aside any self-settled asset protection trust which had been formed within the previous 10 years for the actual purpose of hindering or defrauding a creditor.

Although we know that the Act now covers the self settled trusts developed by the various states, the extent of the impact is far from clear. Does it mean that after 10 years these trusts are good and valid and will effectively protect assets against any claims? Also, what does an "actual intent to defraud" mean in this situation? Would it apply to a patient who is first treated after the trust is formed? Over time, these issues are likely to be resolved but for now the law regarding self-settled trusts remains murky. The most sensible approach for now may be to stick to the traditional planning strategies and, as always, seek competent professional advice to ensure that these important issues are handled correctly.

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