

Protecting What You Have Earned:
*Homesteads, Retirement and
Non-retirement Personal Property Assets,
“Fraudulent Transfers”
and the Effect of
the 2005 Amendments to
The Bankruptcy Code*

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Why You Still Need to Care About Asset Protection Planning Even After the Passage of Texas' Medical Liability Reforms

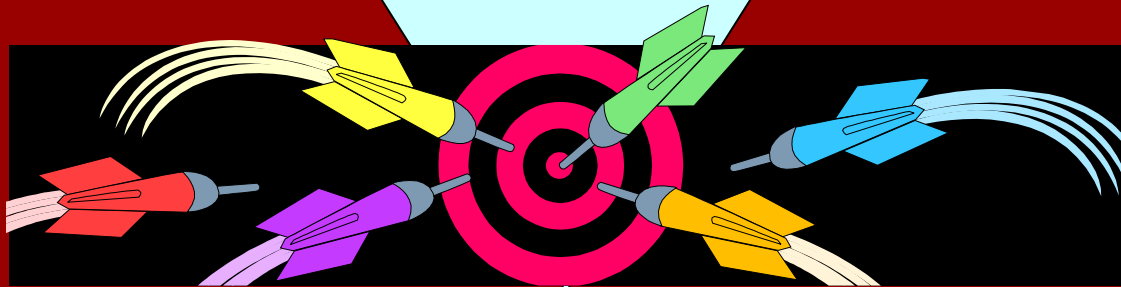
- ◆ Malpractice exposure reduced but not eliminated.
- ◆ Guaranty of your medical business debt (or investment debt).
- ◆ Employment liability claims: sexual harassment, racial discrimination, etc.
- ◆ IRS: Are you a “responsible person” for your firm’s IRS obligations?
- ◆ Unexpected but large liabilities:
 - Child’s best friend drowns in your pool.
 - Gas line at one of your rental properties leaks: your tenants are now at the Galveston burn unit.
 - You kill or severely injure someone while driving and you forgot to buy an excess liability policy.

The best way to protect your assets is to not have them at risk in the first place.

- ◆ Consider buying at least some malpractice insurance so if you get sued your insurer pays your defense costs (up to the policy limit).
- ◆ For non-malpractice risks, buy an “excess” (or “umbrella”) liability policy (auto claim, etc.).

**Lower malpractice insurance limits means
your assets are more at risk than ever before, so:**

**TRY TO
BE
A
SMALLER
TARGET**



Main Topics to Address:

- ◆ **Texas exemption law: What property is protected from creditors' claims under Texas law?**
- ◆ **Non-Texas based asset protection.**
- ◆ **How “fraudulent” transfer rules impact asset protection planning.**
- ◆ **How the new bankruptcy statute changes the asset protection planning landscape.**
- ◆ **Why filing bankruptcy is now much less attractive.**
- ◆ **Concluding thoughts.**
- ◆ **Q & A as time permits.**

Texas Exemption Laws: Buy a Homestead

- ◆ Protected from all non-IRS debt except: mortgage lender, those who repair or make improvements to the home, and local tax agencies.

- ◆ Keep current on what you owe the IRS. Unlike nearly all other creditors, the IRS can get a lien on your home.

- ◆ Pay off the debt on your home (mortgage, home equity loan, etc.)



What is your homestead?

◆ **Urban:**

10 or less contiguous acres.

The value of the improvements is irrelevant.

◆ **Rural:**

- If you are married: 200 acres
Need not be contiguous (“checkerboarding” is okay).

- If you are Single: 100 acres
Need not be contiguous (“checkerboarding” is okay).

- ◆ A homestead is “urban” if: (1) within a municipality, or its extraterritorial jurisdiction, or a platted subdivision, and (2) served by police and fire protection, and at least 3 of these 5 municipal services: electricity, natural gas, sewer, storm sewer, and water.

OK, my homestead is protected. How do I protect my personal property assets?

Have a regular program of donating assets to those you love, such as your spouse (special care is necessary so that the property donated becomes the separate property of the transferee spouse), your children (think 529 plans especially), your grandchildren, or trusts you set up for them.

- ◆ The key: “Donation, donation, donation.”
- ◆ Gift tax: A married couple can give up to \$22,000 annually (\$11,000 for each spouse) to a child (or other recipient) without gift tax liability.
Note: Can “bunch up” 529 donations in a single year and donate \$55,000 with no gift tax liability.
- ◆ Gift tax consequences of “excess” gifts: Merely reduces your “unified credit”: no tax payment due now.

Texas law provides for two classes of assets that are generally protected from creditors' claims: assets for which there is no dollar limitation and assets with a dollar value limitation.

Caveats:

- ◆ Lien creditors
- ◆ The Big Unpaid Gorilla: The IRS can get a lien on any property you have whether or not it is exempt under Texas law.
 - Beware of the “§ 941 responsible person” trap.

No dollar limitation:

- ◆ IRA and Keogh plans (provided you did not exceed IRS annual contribution limits).
- ◆ 529 college savings plans, and Coverdell Education Savings Accounts.
- ◆ Unpaid wages or salary (no wage garnishment unless for court-ordered child support or spousal maintenance).

But: Once wages are received they are no longer protected.

- ◆ Insurance and annuity payments (consider a single premium life insurance policy or a large annuity).
- ◆ “Spendthrift” trusts (for example, a trust set up for you in your deceased parents’ wills provided it contained a “spendthrift” provision.)
- ◆ Support and separate maintenance of debtor or a dependent of the debtor.

Exempt personal property with a dollar value limitation

If a person is single, he is entitled to exempt up to \$30,000,
but if he is married, his family may exempt up to \$60,000
of the following property:



- ◆ Home furnishings (including family heirlooms)
- ◆ Farming or ranching vehicles and implements
- ◆ Tools, equipment, books and apparatus, including boats and motor vehicles, used in a trade or profession
- ◆ Clothes
- ◆ Jewelry (up to a value of \$7,500 for a single adult and \$15,000 for a married person)

- ◆ Two firearms
- ◆ Athletic and sporting equipment
- ◆ Essentially motorized transport for every driver in the house
- ◆ Unpaid commissions for personal services up to \$7,500 for a single adult and \$15,000 for a married person
- ◆ Values are based on current fair market value, not original acquisition cost.

***NOTE: Non-retirement investments are NOT protected
(stocks, mutual funds, bonds, money market funds, etc.)***

Summary of Texas Exemption Law

Asset

- ◆ Homestead
- ◆ Retirement Assets and 529 and Coverdale college savings plans
- ◆ Life Insurance and annuity payments
- ◆ Spendthrift Trust
- ◆ Wages and Salary
- ◆ Cars and most stuff in your house

Extent of Protection under Texas Law

- ◆ Fully protected as long as pay mortgage, local taxes, IRS and those who worked on the property.
- ◆ Fully protected as long as do not exceed contribution limits (subject to the general rule that the IRS can get a lien on all property).
- ◆ Fully protected.
- ◆ Fully protected (before the funds are paid to you) except can garnish for child support or spousal maintenance.
- ◆ Fully protected
- ◆ Single=\$30,000 / Married=\$60,000

I have maxed out on my Texas exemptions and I want to transfer most of my remaining personal assets to protect them.

What other transfers can I make?

Non-Texas Exemption Planning

- ◆ Self-settled trusts: Donate assets to a trust in Delaware or Alaska (or one of six other states, but not Texas) and make yourself the beneficiary.
- ◆ Consider this for assets that Texas law does not protect: your non-retirement stocks, mutual funds, etc.
- ◆ Consider this before marriage if your prospective spouse won't sign a pre-nuptial agreement or you don't want to ask.
- ◆ Offshore Trusts: Probably even more protection than Delaware or Alaska trusts, but higher transaction costs.
- ◆ Family limited partnerships, etc.

POSSIBLE “FRAUDULENT TRANSFER” ATTACKS ON YOUR ASSET PLANNING

All asset planning is subject to possible attack as a “fraudulent transfer” to “undo” the asset planning transaction.

These attacks against physicians may well begin to occur as there is less “easy” malpractice insurance money available for malpractice claimants.

“CONVERSION” RISK

Risk of converting non-exempt personal property to exempt property: the exemption can be disallowed if the conversion was done with intent to hinder, delay, or defraud a creditor.

FRAUDULENT TRANSFER RULE #1

Objective Test

- ◆ Transfers without receiving “reasonably equivalent value” while insolvent (or the transfer makes one insolvent) can be set aside.
- ◆ “Insolvency” is evaluated on a balance sheet basis.
- ◆ Note that the transfer cannot be set aside unless you are insolvent or the transfer makes you insolvent.
- ◆ Consider: Get a financial statement from your CPA showing that you are still solvent after the transfer(s).

FRAUDULENT TRANSFER RULE #2

Subjective Test

- ◆ Transfers with intent to “hinder, delay, or defraud” creditors: A question of intent.
- ◆ A key intent factor: Did you make the transfer after you became aware of an actual or potential malpractice (or other significant) claim?

SO, SHOULD I NOT DO ASSET
PLANNING SINCE ALL MY
TRANSACTIONS CAN
POSSIBLY BE SET ASIDE?



- ◆ Transfer anyway: Do your asset planning as prudently as possible and you will almost invariably “ride out” fraudulent transfer risk.
- ◆ Make regular transfers before the scary event occurs to maximize your probability of success.

Statute of Limitations

- ◆ Fours years from the date of the transfer, except that for that the “fraudulent intent” rule, four years from the date of the transfer OR one year after the transfer was, or reasonably could have been, discovered by the creditor.
- ◆ Exception: Limitations does not begin to run against a minor creditor (*i.e.*, a patient who is a child) until he turns 18.

BIG CHANGES DUE TO THE 2005 BANKRUPTCY REFORM ACT

- ◆ Why should I care about these changes? I have no plans to file bankruptcy.
- ◆ Unexpected events that create large liabilities may make it necessary to consider filing bankruptcy.
- ◆ Given the changes in these amendments, some large creditors may be motivated to try to put you in bankruptcy against your will.
- ◆ The scenarios discussed below assume you are in bankruptcy.

The toughest creditor: The “bedside creditor”

- ◆ Exemptions do not protect you against “domestic support obligations”: support, separation agreement, divorce decree, or property settlement agreement.
- ◆ So you have done great exemption planning and then get married: If you file bankruptcy, or are placed in it against your will, without a pre-nuptial agreement, all your otherwise exempt property is at risk for domestic support obligations.

Old Law: “Texas, here I come!”

New Law: “Not!”

- ◆ The “OJ Rule”: Refugees to Texas who file bankruptcy no longer get the benefit of Texas’ liberal exemption laws unless they have been domiciled in Texas for 2 years before filing bankruptcy.
- ◆ You “carry” your prior state’s exemption laws with you for two years.
- ◆ Unintended consequence: If you are a Texan and move to an “exemption poor” state like California, you get the benefit of Texas’ liberal exemption laws when you file bankruptcy in California after you move there.

How the 2005 Bankruptcy Amendments Change Texas Exemption Law for Someone in Bankruptcy

<u>Asset</u>	<u>Extent of Protection Under Texas Law</u>	<u>How New Bankruptcy Law Changes Texas Exemption Law</u>
Homestead	Fully protected as long as pay mortgage, local taxes, IRS and those who worked on the property.	<p><u>New Homestead</u>: Homestead purchased within 3 years and 4 months of bankruptcy filing limited to \$125,000.</p> <ul style="list-style-type: none"> •This true even if the funds used for the purchase came from a totally exempt source (e.g., life insurance proceeds). •\$125,000 fair market value or \$125,000 equity? Probably the latter. •Exception: No restriction if use sales proceeds from selling old Texas homestead acquired more than 3 years and 4 months prior to bankruptcy filing to buy a new Texas homestead. <p><u>Old Homestead</u> (home owned by you for more than 3 years and 4 months before your bankruptcy filing): Generally continues to be unlimited but limited to \$125,000 if:</p> <ul style="list-style-type: none"> •Convicted felon and filing bankruptcy is abusive. •Intentional or reckless conduct that caused death or seriously bodily injury within last 5 years. Medical negligence not enough. <p>•<u>Note</u>: Both \$125,000 caps probably are <u>per spouse</u> = so \$250,000 cap if married.</p> <p>•Exception to caps for both old and new homesteads: Homestead is reasonably necessary for support of debtor (you) and debtor's dependant(s).</p>

<u>Asset</u>	<u>Extent of Protection Under Texas Law</u>	<u>How New Bankruptcy Law Changes Texas Exemption Law</u>
IRA accounts	Fully protected as long as not exceed contribution limits (subject to the general rule that IRS can get a lien on all property).	<ul style="list-style-type: none"> • Limited to \$1,000,000, but this is probably per spouse. • Other retirement vehicles not affected so fund them before IRA. • Exception: Limit may be increased “if the interests of justice so require.” • What does that mean?! An educated guess: <ul style="list-style-type: none"> ○ Doctor still working earning good money probably could not bust the cap. ○ Retired doctor who needs the IRA distributions to live on probably could bust the cap.
529 and Coverdell college savings plans	Fully protected as long as not exceed contribution limits (subject to the general rule that IRS can get a lien on all property).	<p>Now subject to new limits:</p> <ul style="list-style-type: none"> • Limited to contributions for child, stepchild, grandchild or step-grandchild (can't fund your nephews or nieces if you are single). • Excess contributions not protected. • Funds paid within 720 days and 365 days before bankruptcy limited to \$5,000 per beneficiary. • Funds contributed within 1 year of bankruptcy filing not protected.

<u>Asset</u>	<u>Extent of Protection Under Texas Law</u>	<u>How New Bankruptcy Law Changes Texas Exemption Law</u>
Life Insurance and annuity payments	Fully protected.	•Unclear for persons with higher than median Texas income.
Spendthrift Trust	Fully protected until paid to you.	•Principal should still be protected. Distributions: Unclear for persons with higher than median Texas income.
Wages and Salary	Fully protected (before the funds are paid to you) except can garnish for child support or spousal maintenance.	•For Texans with higher than median income: End of the "asset poor, but income rich" easy ride in a Chapter 7 liquidation - forced into Chapter 13 repayment plan over 5 years.
Self-settled (Delaware, Alaska) trusts	Fully protected until paid to you.	•Payments to trust within 10 years of bankruptcy filing subject to being set aside if done with intent to hinder, delay or defraud
Cars and most stuff in your house	Single: \$30,000 Married: \$60,000	No change: but largely irrelevant for Texans with higher than median state income.

- ◆ The net effect of the bankruptcy amendments may be that large creditors may attempt to put you into bankruptcy against your will so they can get at your assets that would otherwise be protected under Texas law (large uninsured malpractice judgment, contentious divorce, etc.).
- ◆ If you have 12 or more non-contingent creditors not subject to bona fide dispute: 3 creditors can file the bankruptcy petition (otherwise 1 creditor can do it).
- ◆ Test to involuntary bankruptcy: Generally not paying debts as they become due (not counting debts subject to bona fide dispute).
- ◆ Ask for a bond if involuntary bankruptcy filed, plus recovery of your attorney's fees and costs fighting the involuntary filing.
- ◆ If filed in "bad faith", ask for damages caused plus punitive damages.

Why You Should Have Filed Bankruptcy before 10/17/2005 if you needed to:

- ◆ Since you earn more than the median Texas income, under the new law you will have to file a Chapter 13 bankruptcy requiring monthly payments for 5 years, equal to the difference between your income and your reasonable living expenses.
- ◆ “Reasonable living expenses” typically determined by harsh IRS guidelines, not what is actually reasonable for your family.
- ◆ No more “asset poor, income rich” Chapter 7 liquidation bankruptcies.

MISCELLANEOUS CONSIDERATIONS:

- ◆ Recognize that asset planning will likely cause you to be a less attractive borrower to a lender (after all, you've got a lot less stuff!)
- ◆ If you have signed a bank guaranty for your business debt, consult your banker before doing extensive asset planning, as it may violate the terms of your guaranty.

A brief aside: Special medical provisions in the 2005 bankruptcy amendments:

If a “health care business” files bankruptcy:

- ◆ “Health care ombudsman” is appointed by the Bankruptcy Court within thirty days (unless the court finds this is unnecessary under the specific facts of the case) to:
 - monitor the quality of patient care (including interviewing patients and physicians)
 - report every 60 days to the court regarding the quality of patient care
 - If quality of care is compromised, file a report to that effect with the Bankruptcy Court and serve it on “parties in interest”.
- ◆ If insufficient funds to pay for storage of patient records of a health care business: records can be destroyed after one year after notice is given to patients and insurers within the first six months after the bankruptcy filing.

A “health care business” is broadly defined to include public or private (whether profit or non-profit) (1) hospitals; (2) ambulatory, emergency, or surgical treatment center; (3) hospice; (4) home health agency; or (5) “any long term care facility” (skilled nursing, assisted living, etc.).

CONCLUDING THOUGHTS:

- ◆ “Chicago rule”: Give early and often!
- ◆ Keep your personal non-exempt assets low at all times since a large liability can occur at any time.
- ◆ Buy excess insurance on top of home and automobile liability insurance policies.

CONCLUDING THOUGHTS:

- ◆ Be active and don't just lay there:
Doing some asset planning is much better than doing none at all!

Thank You!

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