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asset protection | business law | tax law

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Bankruptcy Planning

A. Overview of Bankruptcy Rules

In most asset protection cases, bankruptcy is the debtor's last line of defense. Regardless of all the other planning implemented by the debtor, without the debtor's ability to file for bankruptcy protection the debt will always remain in existence. Once the creditor obtains a judgment, whether the debtor implemented a limited liability company, or a foreign trust, while the debt may go uncollected, the judgment will remain and the lien will continue to exist. Bankruptcy is the only way to permanently remove the judgment from the debtor's life.

To understand the protection afforded by bankruptcy and the planning involved, the practitioner must first understand some fundamentals of bankruptcy law, specifically as they relate to asset protection.

1. Property of the Bankruptcy Estate

Property of the bankruptcy estate is broadly defined in Section 541 of the Bankruptcy Code[1] ("BC"). It provides that the bankruptcy estate shall include the following:

a. All interests in property except for assets in valid spendthrift trusts. This includes all legal and equitable interests the debtor possessed in property as of the date of the bankruptcy petition.

b. Debtor's interest in community property. All interest of the debtor and the debtor's spouse in community property as of the filing date, that is either: (i) under the sole, equal or joint management and control of the debtor, or (ii) is liable for an allowance claim against the debtor.

c. Fraudulent transfers. Property that was fraudulently conveyed by the debtor prior to bankruptcy and recovered by the trustee.

d. 180-day property. Any interest in property that (i) would have been property of the estate if the interest belonged to the debtor on the filing date, and (ii) the debtor acquires or becomes entitled to acquire such property within 180 days after the date of filing. This only applies to gifts, bequests, inheritance, property received under a divorce decree, or as a beneficiary of a life insurance policy.

e. Income, rents and revenue from property. However, debtor's post-petition earnings are not included in the estate.

f. Interest acquired after commencement of bankruptcy case.

Additionally, all powers other than powers that are exercisable solely for the benefit of an entity other than the debtor are property of the bankruptcy estate. Powers that are property of the estate are generally exercisable by the trustee. The following powers are included: (i) the power to revoke a trust; (ii) the right to disclaim property; (iii) tax elections; and (iv) certain other powers.

Only the property owned by the debtor is included. For example, if a debtor owns 99% of the stock of a corporation, only the stock is included in the bankruptcy estate, not the corporate assets. If the debtor holds legal

[1] Title 11 of U. S. C.

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title to property, but not beneficial, then only the value of the legal title is included. Additionally, the bankruptcy trustee cannot acquire rights in property that are great than the rights possessed by the debtor.

2. Fraudulent Transfers under the Bankruptcy Code

BC Section 548 is the federal counterpart to the state fraudulent transfer statutes. It provides for two types of fraudulent transfers (same as the states and the California law discussed above): actual intent to defraud, and constructive fraud based on insolvency. Good faith purchasers are protected just like under state law.

In the context of bankruptcy, the bankruptcy trustee may void a fraudulent transfer only if it was undertaken within two years of the filing of the bankruptcy petition.[2] This means that all pre-bankruptcy planning must be undertaken at least one year prior to the filing of the bankruptcy petition. If the debtor engages in a fraudulent transfer but later reverses the transfer prior to filing for bankruptcy, the earlier fraudulent transfer will be ignored.[3]

Because courts deal sharply with debtors engaging in fraudulent transfers it is important for debtors to complete all pre-bankruptcy planning transfers at least one year prior to the bankruptcy, and to fully disclose the transfers. An attempt to mislead the creditor or conceal a transfer from a creditor should lead to a denial of discharge. Once again, asset protection planning should not involve secretive or unethical conduct. If done right, asset protection should be open, ethical and legal, while remaining effective.

How does one distinguish between a fraudulent transfer and pre-bankruptcy planning? In an often cited decision a California bankruptcy court stated that:

> if the debtor has a particular creditor or series of creditors in mind and is trying to remove his assets from their reach, this would be grounds to deny the discharge. However, if the debtor is merely looking to his future well-being, the discharge will be granted.[4]

In the event of a fraudulent transfer within one year of the filing, not only will the transferred property be included in the bankruptcy estate, but also pursuant to BC Section 727(a) bankruptcy discharge may be denied altogether. Denial of discharge is a highly powerful weapon in the bankruptcy court's arsenal that is primarily designed to deal with pre-bankruptcy planning.

Generally, conversion of nonexempt assets into exempt assets on the eve of bankruptcy would not be indicia of fraud per se.[5] However, depending on the amount of the exemption and the circumstances surrounding the conversion, a court may find the conversion to be a fraudulent transfer. This is especially true when the conversion amounts to nothing more than a temporary arrangement. The cases that held a conversion of nonexempt into exempt assets to be a fraudulent transfer seem to focus on the existence of an independent reason for the conversion.

For example, if a debtor purchased a residence protected by a homestead exemption with the intent to reside in such residence that would be an allowable conversion into nonexempt property. But where the debtor purchased the residence with all of her available funds, leaving no money to live off, that presumed that the conversion was temporary, indicating a fraudulent transfer.[6] Once again, the courts will look at the timing of the transfer as the most important factor. The further the transfer is removed from the bankruptcy, the better it looks to a court.

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[2] 11 USC 548(a)(1).
[3] In re Adeeb, 787 F. 2d 1339 (9th Cir. 1986).
[4] In re Oberst, 91 B. R. 97 (Bankr. CD Cal. 1988).
[5] See, *e.g.*, In re Stern, 317 F. 3d 1111 (9th Cir. 2003). Retirement plans that were not exempt under ERISA converted to qualified plans fully exempt.
[6] In re Sholdan, 217 F. 3d 1006 (8th Cir. 2000).

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3. Exemption Planning

Despite the general rule that all property owned by the debtor is included in the bankruptcy estate, there are certain exceptions. The most important such exception is the exempt property. The purpose of bankruptcy is to allow the debtor a fresh start. To make the fresh start meaningful, the debtor is often allowed to keep certain property (exempt property), such as tools of the trade, household furnishings, clothing, each up to a certain dollar limit. By exempting certain assets from inclusion in the bankruptcy estate the debtor is not left destitute.

All of the states have enacted legislation that sets forth the nature and the amounts of exempt property. The bankruptcy code also sets forth the federal exemptions.

BC Section 522 allows the debtor a choice – the debtor may either exempt from the bankruptcy estate the property listed under the bankruptcy code, or state exemptions. Certain states have opted out of the federal exemption scheme. In those states the debtor must use the state's exemptions and cannot use the federal bankruptcy exemptions. California is one of those states (California exemptions under CCP 704.010 and 703.140(b)(1)-(11), which would also apply to a California bankruptcy, are discussed above).

A debtor can use a state's exemptions if the debtor has been domiciled in that state for 180 days prior to the filing of the bankruptcy petition.[7]

B. Discharge of Debts

Not all debts are dischargeable in bankruptcy. Debts are not dischargeable if either: (i) the claim arose prior to the discharge, or (ii) they are specifically not dischargeable, such as certain taxes, alimony and education loans.

1. Taxes

Taxes are dischargeable in only limited circumstances.

a. Income Taxes and Taxes on Gross Receipts

Three threshold tests must be satisfied.

First, the due date for filing of the tax return on which the tax was disclosed (including extensions) must have occurred more than 3 years prior to the bankruptcy.[8] Thus, for example, if a 2000 income tax return could have been extended until October 15, 2001, then the tax may be discharged if the bankruptcy petition is filed after October 15, 2004.

Second, the return must have been filed at least two years before the bankruptcy.[9] Thus, if the return due on October 15, 2001 was not actually filed under May 1, 2003, the tax will not be dischargeable unless the bankruptcy is filed after May 1, 2005. It is important for the debtor to verify that the return was properly filed and

[7] BC Section 522(b)(2)(A).
[8] BC Sections 532(a) and 507(a)(8)(A)(i).
[9] BC Section 523(a)(1)(B).

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signed and is sufficiently complete to constitute a tax return. A substitute for return filed by the Service may not constitute a filed return.

Third, the taxing authority must have assessed the tax against the debtor at least 240 days prior to the bankruptcy.[10] The 240-day rule is tolled by: (i) the duration of each offer in compromise (that applied to the subject tax) plus 30 days, and (ii) the duration of each bankruptcy (that applied to the subject tax) plus six months.

If the debtor committed an act of fraud with respect to the subject return, or willfully attempted to evade the tax, the discharge of the tax will be denied.[11]

If a tax is dischargeable, then any penalties or interest related to the tax will be discharged as well.

b. Nondischargeable Taxes

The following taxes are not dischargeable: (i) the type of tax for which the debtor was responsible for collecting from the source and remitting to the taxing authority (*i.e.*, sales taxes, FICA, Medicare and other employment withholding taxes – trust fund taxes); and (ii) excise taxes.[12]

C. Preference Payments

1. Generally

The preference rules under the Bankruptcy Code allow payments of certain antecedent debts to be voided.[13] Subject to the exceptions discussed below, an avoidable preference payment is broadly defined as one that is (i) made to a creditor, (ii) with respect to an antecedent debt, (iii) while the debtor is insolvent, (iv) within ninety days before the date of filing the petition (or one year if the creditor is an insider), and (v) that allows a creditor to receive more than he would have otherwise received.[14] Under these rules a debtor is presumed to be insolvent on and during the ninety days preceding the filing of the bankruptcy petition.

The main purpose of the preference provisions is to prevent a creditors' race to the courthouse and thus ensure equality among them so that one creditor does not gain at the expense of others. Generally, any payment that reduces the debtor's bankruptcy estate, and confers on the creditor more than the creditor would have received through the bankruptcy is a potential preferential payment.

Any property that would otherwise be available to creditors can be drawn back into the bankruptcy estate as a preference, including, without limitation, property that has been fraudulently obtained by the debtor.

2. Exceptions

While all creditors are subject to the preference rules, there are certain exceptions designed to allow the debtor to continue its business prior to the filing for bankruptcy.

The exceptions include ordinary business transactions, payments in exchange for value, purchase money security interests and funds earmarked for specific debts.

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[10] BC Sections 523(a)(1)(A) and 507(a)(8)(A)(ii).
[11] BC Section 507(a)(8)(A)(iii).
[12] BC Sections 523(a)(1), 507(a)(8)(C) and (E).
[13] BC Section 547(c)(6).
[14] BC Section 547(b).

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An ordinary business transaction is the most common exception to the preference payment rules.[15] In order to qualify under this exception the transfer must meet three tests: (i) it must be incurred in the ordinary course of the business or financial affairs of the debtor and creditor; (ii) it must be made in the ordinary course of the business or financial affairs of the debtor and creditor; and (iii) it must be made according to ordinary business terms, for the relevant industry.

The first two elements are subjective tests that require an examination of the way the debtor and creditor regularly conduct business. The third element is an objective test that requires the payments to be based on standards prevailing in the particular industry

Other factors taken into account in determining whether payments are in the ordinary course of business include: (i) the timing of the payment; (ii) a change in the method of payment, such as by cashier's check rather than by corporate check; and (iii) payments made pursuant to unusual economic pressure and unusual debt collection or payment practices.

[15] BC Section 547(c)(2).

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