Creditor Protection Techniques Other Than Asset Protection Trusts

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Because of page limitation requirements this paper excludes 163 pages which were intending to be the introductory materials.

The table of contents for these 163 pages can be provided upon request at agassman@gassmanpa.com.

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Alan S. Gassman is a board certified Trust and Estates lawyer practicing with the Clearwater, Florida law firm of Gassman, Denicolo & Ketron, P.A., which he founded in 1987. The firm focuses on the representation of high net worth families, physicians, and business owners and their companies in estate planning, taxation, and business and personal asset structuring.

Mr. Gassman is the primary creator and developer of EstateView software, which allows for the design, illustration and analysis of estate tax, estate planning and charitable strategies. Jerry Hesch, Jonathan Blattmachr, Robert Keebler and Mr. Gassman serve as the Creative Team that continues to develop this software.

He is also the lead author of many books, including Gassman and Markham on Florida and Federal Asset Protection Law, The Estate Planner's Guide to Bankruptcy, Florida Law for Tax, Business & Financial Planning Advisors, Eight Steps to a Proper Florida Trust and Estate Plan, A Practical Guide to Kickback & Self-Referral Laws for Florida Physicians, The Florida Power of Attorney & Incapacity Planning Guide, The Florida Advisor's Guide To Counseling Same Sex Couples, and is co-author of the Legal Guide To NFA Firearms and Gun Trusts, among others.

Mr. Gassman is a frequent speaker for continuing education programs and has published well over 200 peer reviewed articles with publications such as Bloomberg BNA Tax & Accounting, Trusts and Estates Magazine, Estate Planning Magazine, The Florida Bar Journal, Forbes, and Leimberg Information Services Inc. (LISI).

He is also a past President of the Pinellas County Estate Planning Council and has co-chaired over 40 Florida Bar continuing legal education programs, including over 15 years each for Wealth Protection and Representing the Physician. Mr. Gassman is also an Adjunct Professor of Law at Stetson University College of Law in Gulfport, Florida, where he created a course entitled “Law Practice Management and Professional Mastery” and lectures occasionally on estate planning topics. He has also served as an expert witness in tax, creditor protection and estate planning matters in both Federal and State Court.

Mr. Gassman holds a law degree and a Masters of Law degree (LL.M.) in Taxation from the University of Florida, and a business degree from Rollins College. Mr. Gassman is board certified by the Florida Bar Association in Estate Planning and Trust Law and was inducted into the Estate Planning Hall of Fame Class of 2021 and has received the Accredited Estate Planner Designation from the National Association of Estate Planners & Council (NAEPC). Mr. Gassman has maintained an AV rating from the Martindale-Hubbell for over 20 years and is listed in both Best Lawyers in America and Florida Super Lawyers.

2025 Edition

Alan Gassman and Mike Markham are to be commended for having written and compiled an excellent reference source for any legal practitioner involved with bankruptcy law, debtor/creditor issues, asset protection, and any other related litigation. Mr. Gassman and Mr. Markham are colleagues who have labored in the legal trenches for many years. Their insight and experience will be invaluable to any practitioner involved in representation relating to this area of law and Gassman & Markham on Florida and Federal Asset Protection Law will be a leading reference source for years to come.

- Al Gomez, Esq., Litigation and Corporate Bankruptcy Attorney and Shareholder with Morse & Gomez, P.A.; Tampa, Florida

This guide to Florida and Federal Asset Protection Law should be on every Florida estate planning attorney's bookshelf. It will soon be regarded as the go-to reference guide of its kind, similar to how Natalie Choate's retirement account guides are thought of. If you are planning a client's estate and not considering asset protection issues, you are only doing half the job. This reference tool quickly points you to the answers you need.

- Craig R. Hersch, Florida Bar Board Certified Wills, Trusts & Estates, CPA, Partner at Sheppard, Brett, Stewart, Hersch, Kinsey & Hill; Fort Myers, Florida

Alan Gassman has long had a reputation for being a solid asset protection planning attorney who focuses on the technical issues of the subject, doesn't get carried away with the latest flavor-of-the-day planning hype, and provides solid and dependable services to his clients. This book should aid lawyers and other advisors immensely in understanding both the basic and complex issues involved in Florida asset protection planning-with the refreshing absence of the marketing hype that is otherwise so prevalent in this field.

- Jay D. Adkisson, Nationally-known Collection Attorney and Co-author of the Bestselling "Asset Protection: Concepts & Strategies"

Alan Gassman is a leader in the asset protection field and is nationally known for his abilities and experience. Anything he writes is a must-read by anyone, including both practitioners and prospective clients. If my own family member needed an asset protection attorney, Alan is one of the very few attorneys in our industry who would be on my short list to do the work. His knowledge and dedication to making sure the Florida law is well understood and used by those who live and practice there is to be commended."

- Steve Oshins, Nationally Known and Respected Estate and Creditor Protection Expert

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GASSMAN & MARKHAM ON FLORIDA & FEDERAL ASSET PROTECTION LAW

Includes State and Federal Statutes and Other Resources

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INTRODUCTION

Florida has a unique body of creditor protection planning laws that come from a number of different sources, and a number of different practice areas. The laws can be found in the Florida Constitution and Florida Statutes, and many stem from common law principles. This book aspires to explain these principles in a clear and simple manner so that advisors can tailor asset protection plans to each client's needs.

Chapter 1 focuses on the definition of creditor protection, who qualifies, and the key rules that apply.

Chapter 2 discusses tenancy by the entireties, originally a common law protection for a husband and wife, which has been codified in the Florida Statutes. Tenancy by the entireties, or "TBE," provides strong protections for married couples that title property and assets as such.

Chapter 3 discusses annuities and annuity contracts, and how Floridians can protect their assets through permanent life insurance and cash value annuities.

Chapter 4 gives an in-depth review of life insurance policies as described in Florida Statutes Section 222.

Chapter 5 discusses the vast homestead protections offered under Florida law. This chapter explains the relevant case law and recommended methods for protecting an individual's homestead and homestead proceeds from creditors.

Chapter 6 is regarding wages and wage accounts – which are protected under the head of household exemption of the Florida Statutes in Section 222 – and can be a valuable asset protection tool for families.

Chapter 7 is on disability insurance and proceeds, which are exempt from creditor claims. This chapter reviews the relevant statutes and case law.

Chapter 8 on pension plans, IRAs, and other qualified retirement plans, presents the current case law on these subjects. To date, there is not a settled consensus among courts as to whether such funds can be withdrawn for personal interests. The chapter also provides the relevant IRS provisions.

Chapter 9 provides a brief discussion on five subsidiary types of asset protection, including alimony rights, unemployment compensation benefit rights, Florida Prepaid Tuition Fund and 529 Plans, hurricane savings accounts, and physical asset exemptions.

Chapter 10 reviews the federal non-bankruptcy exemptions, including survivor benefits and retirement plans.

Chapter 11 is on Asset Protection Trusts, particularly Domestic Asset Protection Trusts (DAPTs). This chapter provides an in-depth look at minimizing the impact of the Medicaid tax and Florida's rules for lifetime QTIP Trusts.

Chapter 12 looks at Asset Protection Trusts overseas, and includes the famed Oshin's State Ranking Charts for categories such as best states to decant a trust and best states for Domestic Asset Protection Trusts.

Finally, Chapter 13 briefly touches on one of the newest entrants to the asset protection and estate planning game: non-charitable foundations.

CHAPTER 2:
TENANCY BY THE ENTIRETIES

Tenancy by the entireties dates back to the English Common Law, as discussed below, and offers significant opportunities, as well as dozens of traps for the unwary, as described below. Practitioners should be especially careful in this area given the uncertainties and factual issues that can exist.

Please note that while many states do not recognize tenants by the entireties or provide creditor protection, the U.S. Bankruptcy Code does recognize tenancy by the entireties and the inability of the creditors of one spouse to reach tenancy by the entireties assets if both spouses are not responsible for the liability. As the result of this, many non-Floridians are well advised to jointly own real estate in Florida, or elsewhere as tenants by the entireties, so that one spouse could file a bankruptcy anywhere in the country and not lose his or her half of the tenancy by the entireties assets. This is a greatly oversimplified suggestion, but should be worthy of consideration. Section X of Chapter 5 of this book goes into a significant discussion of bankruptcy law and the implications of homestead protection.

INTRODUCTION.

Tenancy by the entireties "immunity" dates back to the English common law and the time when a married woman could not hold property individually. Tenancy by the entireties is a form of property ownership whereby a husband and wife can hold property as an indivisible fictional unit. An ownership interest in tenancy by the entireties property is non-severable without consent of both spouses, except in limited situations.[1] The property is not divisible on behalf of one spouse alone, and therefore cannot be reached to satisfy the obligations of only one spouse.[2] However, a creditor owed by both spouses can attach to tenancy by the entireties property.

States other than Florida which recognizes tenancy by the entireties, at least to some extent, include Alaska, Arkansas, Delaware, District of Columbia, Michigan, Illinois, Indiana, Kentucky, Maryland, Massachusetts, Michigan, Missouri, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Hawaii, Vermont, Virginia, Washington, and Wyoming. Where one spouse lives in Florida and another spouse lives in one of the other states that recognize tenancy by the entireties property, it is likely the creditor protection will apply for the Florida resident spouse. The treatment of the other spouse will be subject to the law of the state where the other spouse resides.

There have been a great many cases and situations where creditors have been successfully challenged by the tenancy by the entireties status of property. There have been, and will continue to be, many factual situations that will necessitate litigation in order to determine an outcome that is quite unpredictable.

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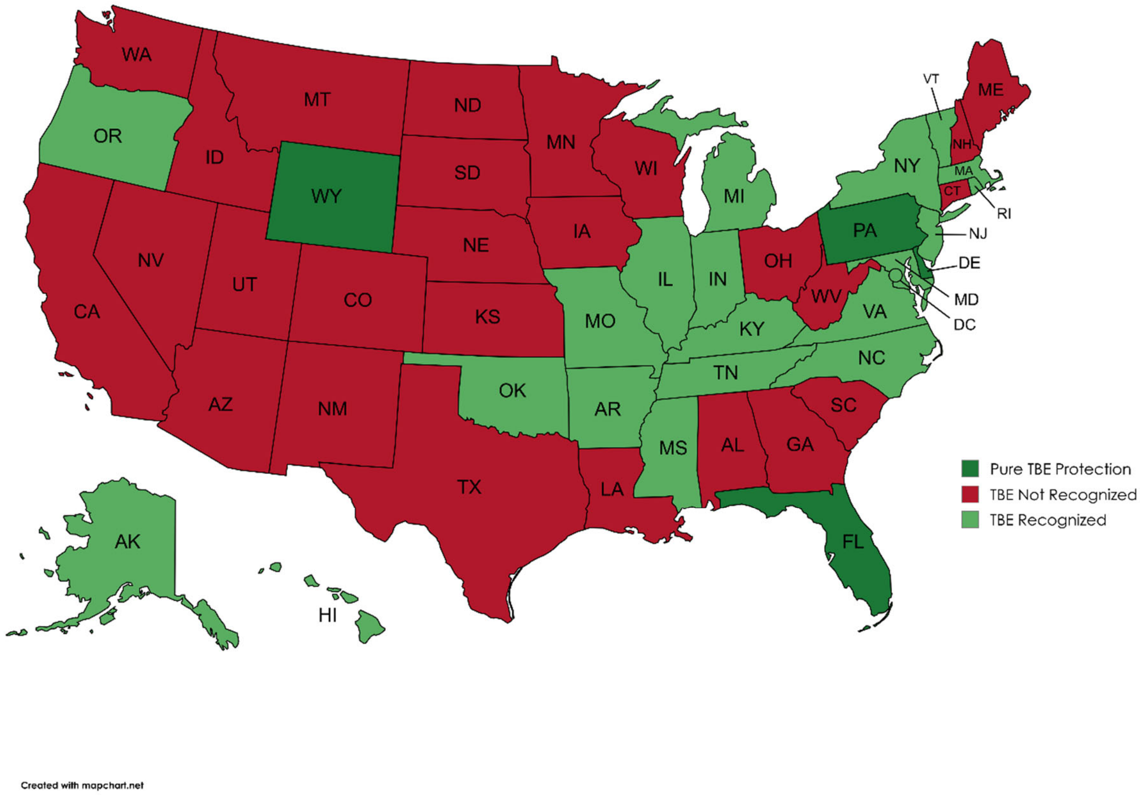
[1] See *Hector Supply Co.,* 254 So.2d 780 (Fla. 1971).

[2] See generally *Winters v. Parks,* 91 So. 2d 649, 651 (Fla. 1956).

States that recognize tenancy by the entireties are listed below, but not all of them allow for protection of tenancy by the entireties assets from the creditors of a spouse. States that do offer "pure" creditor protection for almost all kinds of assets include Delaware, Florida, Pennsylvania, and Wyoming.



DEFINITION OF TENANCY BY THE ENTIRETIES.

Tenancy by the entireties is created when six "unities" are met, which are as follows: [3]

Unity of possession - both spouses have joint ownership and control - it may be acceptable that a deposit agreement allows either spouse to withdraw independently of the other on the theory that the power to withdraw is an expression of an authority of agency given by each spouse to the other.

Unity of interest - each spouse has the same interest in the account - it is not a problem if one spouse deposits all or most of the funds into the account as long as each spouse has the same interest immediately after the deposit.

Unity of time - the interests of both spouses in the asset must originate simultaneously in the same instrument, such as on the signature card. **Do not try to convert an individual account into a tenancy by the entireties account. Instead, transfer assets from the individual account to a new tenancy by the entireties**

[3] For an explanation of the types of concurrent ownership, watch the animated masterpiece, "Types of Concurrent Ownership: THE HOLIDAY SPECIAL," written and directed by one of Alan's law clerks: https://youtu.be/FaRV8Mzduzk.

account.

> **TRAP** - If one spouse is the owner, do not just add the other spouse's name to the title. At a minimum, make a complete transfer from the initial spouse as owner to both spouses as tenants by the entireties.

Unity of title - both spouses must have ownership under the same title.

Survivorship - on the death of one spouse, the other spouse becomes the sole owner of the entireties property. A general power of appointment given to one spouse over joint assets may vitiate tenancy by the entireties status.

Unity of marriage - of course, the owners must be legally married under Florida law. Many clients become confused and believe that joint accounts with any third party or a significant other will be protected, but this is not the case.[4] **NOTE**: In the case of *In re Caliri*, joint accounts created before marriage were found not to qualify as tenancy by the entireties where the couple did not overtly transfer their interests to themselves as tenants by the entireties after the marriage.[5]

> **PLANNING OPPORTUNITY** - Assets held jointly before the marriage should be re-transferred from the spouses jointly to themselves as tenants by the entireties. Couples who entered into non-recognized same-sex marriages should determine whether they need to re-convey their joint assets to tenancy by the entireties in order to have this protection.

DIRECT TRANSFERS FROM ONE SPOUSE TO TENANCY BY THE ENTIRETIES — IS A STRAWMAN NEEDED?

Before 1776, English Common Law required tenancy by the entireties ownership to originate from a person or entity other than one member of the married couple, and the law therefore required a "straw person" to take title from one spouse and then transfer it to tenants by the entireties. Florida did not immediately adopt this requirement, as evidenced by the Florida Supreme Court Case, *Johnson v. Landefeld* in 1939, which was codified in Florida Statutes Section 689.11.[6] This statute applies to real estate and does not mention non-real estate assets. Support for the proposition that non-real estate assets, such as stock certificates and bank and brokerage accounts, may be transferred from one spouse to tenancy by the entireties can be found in recent case law.

According to what the authors believe to be an inaccurate September 2011 Florida Bar Article cited below, the law in this area is still uncertain and legislative efforts to clarify the confusion in the statute have been unsuccessful.

The authors have concluded that one spouse can transfer virtually any kind of asset into tenancy by the entireties, as the following letter to the editor of the Florida Bar Journal from December 2011[7] explains:

> A Florida Bar Journal article titled *Are Florida Laws on Tenancy by the Entireties in Personalty as Clear as We Think?*, [dated] September 2011 raised concern that Florida law

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[4] *In re Caliri*, 347 B.R. 788 (Bankr. M.D. Fla. 2006).
[5] *In re Caliri*, 347 B.R. at 796.
[6] 138 Fla. 511 (Fla. 1939).
[7] Alan S. Gassman, *Tenants by the Entirety*, FLA. B.J., Dec. 2011.

> is unclear on the question of whether a married couple can own personalty as tenants by the entirety (TBE) unless authorized under the Florida Statutes. The author also questioned the clarity of Florida law regarding the creation of an entireties estate in personalty after the 2001 Florida Supreme Court decision in *Beal Bank, SSB v. Almand & Assoc. Inc.*
>
> Extensive research and review of several Florida Supreme Court cases, DCA opinions, and bankruptcy court decisions has led us to conclude that the law with respect to these issues is much more settled than the article seems to imply. Practitioners will want to review the three Florida Supreme Court cases that were not referenced in the article, and other citations mentioned in this letter.

One of the author's favorite law professors left the following voicemail after the above letter came out, making the author's day:

> Alan this is C.D. Miller, voice out of the past, College of Law and so forth and so on. I just wanted to call and say thank you for writing the letter to the Editor and straightening them out with respect to tenancy by the entirety law in this state. I was so tempted to do something but you know, I'm an old war horse, so I guess I just didn't have the hay anymore, but I appreciate what you wrote. It was a well written letter and it certainly laid it out in a way, that I think, most people would be able to now understand the law. Which was certainly misstated in the article. So, on behalf of everyone, thanks!

Florida law clearly permits a married couple to own all forms of personal property as TBE. As stated by the Florida Supreme Court in *Bailey v. Smith*, "[u]nder the law in force in this State there may be a tenancy by entireties in both real and personal property; and whether such an estate exists as the result of the acquisition of property by and in the names of both husband and wife, must be determined by a consideration of the nature and terms of the transaction as portraying the intent of the parties and of the rules of law applicable thereto."[8] *Beal Bank, SSB* only modified *Bailey* by applying a presumption that jointly owned bank accounts are held as TBE unless there is evidence showing a contrary intent. Florida courts have consistently applied this presumption to all forms of personal property.

The following discussion from a 2011 Florida Bar Journal article provides further summary of the case law:

> Furthermore, the case law confirms that one spouse is a separate entity from a TBE, and can, therefore, transfer property to the marital unit without the use of a strawman, as explicitly held in the 1939 Florida Supreme Court decision of *Johnson v. Landefeld*, 138 Fla. 511 (Fla. 1939). Florida courts have followed suit with respect to personalty. See e.g., *Hurlbert v. Shackleton*, 560 So. 2d. 1276 (Fla.1st D.C.A. 1990) (recognizing a spouse's right to transfer stock he owned individually to both himself and his wife as TBE); *In re Kossow*, 325 B.R. 478 (Bankr. S.D. Fla. 2005) (permitting a spouse to assign his interest in tangible personal assets he owned before marriage to TBE) for some of the several cases that reach the same conclusion.[9]

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[8] 89 Fla. 303, 307 (Fla. 1925).

[9] Alan S. Gassman, *Tenants by the Entirety*, FLA. B.J., Dec. 2011 at 4; For an in-depth analysis of these issues and the current state of Florida law, please read our article, "Florida Supreme Court Cases Confirm Tenancy by Entireties in Personal Property and Ability of One Spouse to Transfer Assets to Tenancy by the Entireties."

Florida case law has left uncertain the question of whether one spouse may add another spouse to an existing bank account or stock certificate, but that is much different than one spouse making a distinct transfer from himself or herself to facilitate the creation and funding of a new TBE account, stock certificate, or other asset. The District Court of Appeals in *Versace v. Uruven, LLC* found that one spouse could designate a solely owned account to become a tenancy by the entireties account, notwithstanding that the unities of time and title would not be met because only one spouse opened the account.[10] However, on nearly the same facts, the District Court of Appeals in *Loumpos v. Bank One* held that the designation of a solely owned account into a tenancy by the entireties account was invalid for lack of meeting the time and title unities.[11] Both courts relied on *Beal Bank*, however, the court in *Loumpos* argued that *Beal Bank* had not abrogated the requirement that the six common law unities must be met to create a tenancy by the entireties. The *Loumpos* decision is currently on appeal from the Second DCA to the Florida Supreme Court, which should shed light on the answer to whether a spouse may be added to an existing bank account to form a tenancy by the entireties.

JOINT ACCOUNTS – BEAL BANK, SSB v. ALMAND AND ASSOCIATES.

NOTE TO READER: In 2008 the Florida Legislature passed Florida Statute Section 655.79(1) that provides that deposit accounts opened by a married couple will be presumed to be tenancy by the entireties. This statute appears to eliminate the need to thoroughly review the 2001 Florida Supreme Court case of *Beal Bank* with respect to financial accounts, but the Supreme Court's opinion has important implications for other types of assets. We have therefore left in the previous discussion that was written before the enactment of Florida Statute Section 655.79(1), which reads as follows:

> (1) Unless otherwise expressly provided in a contract, agreement, or signature card executed in connection with the opening or maintenance of an account, including a certificate of deposit, a deposit account in the names of two or more persons shall be presumed to have been intended by such persons to provide that, upon the death of any one of them, all rights, title, interest, and claim in, to, and in respect of such deposit account, less all proper setoffs and charges in favor of the institution, vest in the surviving person or persons. Any deposit or account made in the name of two persons who are husband and wife shall be considered a tenancy by the entirety unless otherwise specified in writing.

The *Beal Bank* discussion is as follows:

On March 1, 2001, the Florida Supreme Court issued its decision in *Beal Bank*[12] after the Fifth District Court of Appeals certified that the question of whether certain bank accounts were considered as tenancy by the entireties was of great public importance.

The Florida Supreme Court endeavored to shed light on "what has been termed a morass in the common law . . . We hope to bring greater predictability and uniformity to the common law governing accounts

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[10] *Versace v. Uruven*, LLC, 348 So. 3d 610 (Fla. App. 4 Dist. 2022).

[11] **Error! Main Document Only.** *Loumpos v. Bank One*, 392 So. 3d 841 (Fla. App. 2 Dist. 2024).

[12] 780 So.2d 45 (Fla. 2001).

held at financial institutions and to eliminate the confusion that has arisen from our prior decisions."[13] As the dissent in this opinion points out, however, the effect that this opinion will have on many different aspects of joint ownership will remain to be seen.[14]

The court reviewed precedent wherein married couples had the burden of proving their intent to have a tenancy by the entireties where brokerage firm account agreements and bank account signature card agreements did not explicitly provide for tenancy by the entireties. The Court recognized that in a tenancy by the entireties arrangement as between the spouses, the interest is non-severable by either spouse acting independently of the other.

The court noted that Florida case law has long recognized that real property acquired in the name of a husband and a wife is considered to be held as tenancy by the entireties by rule of construction. The Court acknowledged that with personal property, it had applied a different standard by requiring that "not only must the form of the estate be consistent with entireties requirements, but the intention of the parties must be proven."[15]

The court's primary holding was as follows:

> As between the debtor and a third-party creditor (other than the financial institution into which the deposits have been made), if the signature card of the account does not expressly disclaim the tenancy by the entireties form of ownership, a presumption arises that a bank account titled in the names of both spouses is held as tenancy by the entireties as long as the account is established by husband and wife in accordance with the unities of possession, interest, title, and time and with right of survivorship.[16]

Thus, the burden will be on the creditor to prove by a preponderance of evidence that a tenancy by the entireties is not created.

The court discussed the following examples of bank account titling:

(1) An express designation on the signature card that the account is held as tenancy by the entireties ends the inquiry as to the form of ownership. Thus, extrinsic evidence may not be brought up by a creditor in those circumstances. *Loumpos v. Bank One*, which is currently on appeal from the Second DCA to the Florida Supreme Court stated that the designation on a signature card applies only to intent, and that creditors may use extrinsic evidence to show that the unities have not been met which would preclude accounts being considered TBE.[17]

(2) Depositors may sign an express statement that tenancy by the entireties is not intended, coupled with an express designation of another form of legal ownership. In that circumstance, no presumption of a tenancy by the entireties arises and this express disclaimer would end the inquiry as to whether a tenancy by the entireties was intended. In one Florida case, the

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[13] *Beal Bank, SSB v. Almand and Associates,* 780 So. 2d 45, 62 (Fla. 2001).
[14] *Id.* at 63.
[15] *Id.* at 54.
[16] *Id.* at 58.
[17] *Loumpos v. Bank One*, 392 So. 3d 841 (Fla. App. 2 Dist. 2024).

court held that a bank's standard checking account agreement – explicitly excluding joint accounts from being held as tenancy by the entireties and incorporated by reference into the signature card – was sufficient to rebut the presumption of TBE.[18]

(3) If the signature card does not expressly disclaim tenancy by the entireties, there is a rebuttable presumption that a tenancy by the entireties exists where the other unities are established.

(4) If the financial institution does not offer a tenancy by the entireties form of account, and the signature card expressly states that the account is not held by tenants by the entireties, no presumption of tenancy by the entireties ownership arises, but the debtor and the spouse may prove by a preponderance of the evidence that there was an intent to own the account as tenants by the entireties.

(5) If the financial institution offered the option of tenancy by the entireties ownership, and the debtor and spouse affirmatively disclaimed tenancy by the entireties ownership and elected another form of joint ownership, then there would not be tenancy of entireties ownership, and the inquiry would end.

As a result of the factual scenarios described above, it seems that the only way to be absolutely sure of tenancy by the entirety status is for the lawyer to review all applicable paperwork relating to a subject account or other assets, if feasible.

The specific questions certified to the Florida Supreme Court in this case and the court's answers were as follows:

> In an action by the creditor of one spouse seeking to garnish a joint bank account titled in the name of both spouses, if the unities required to establish ownership as a tenancy by the entireties exist, should a presumption arise that shifts the burden to the creditor to prove that the subject account was not held as a tenancy by the entireties?
>
> **Florida Supreme Court Answer: Yes**
>
> In an action by the creditor of one spouse seeking to garnish a bank account jointly titled in the name of both spouses, if the unities required to establish ownership as a tenancy by the entireties exist, but the signature card expressly states that the account is owned as a joint tenancy with right of survivorship, does that statement alone constitute an express disclaimer that the account is not held as a tenancy by the entireties?
>
> **Florida Supreme Court Answer: No**
>
> In an action by the creditor of one spouse seeking to garnish a bank account jointly titled in the name of both spouses, if the unities required to establish ownership as a tenancy by the entireties exist, but the signature card expressly disclaims the tenancy by the entireties form of ownership, may the debtor resort to extrinsic evidence to prove that a tenancy by the entireties was intended if the debtor establishes that the financial institution did not offer a tenancy by the entireties form of account ownership?

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[18] **Error! Main Document Only.***Store Mountain, LLC v. George*, 357 So. 3d 709 (Fla. App. 4 Dist. 2023).

Florida Supreme Court Answer: Yes

Caution -- Notwithstanding the *Beal Bank* case, spouses should be careful to establish tenancy by the entireties accounts by labeling them as such. Spouses who open accounts with institutions that do not offer a checkbox for tenancy by the entireties should put the actual letters "TBE" in the title of the account [example -- Dr. John and Mary Smith, TBE account]. Spouses will continue to tell their lawyers that they have explicitly checked the tenancy by the entireties box or that such a box did not exist to be checked, in situations where they have inadvertently checked another box, didn't see the tenancy by the entireties box, or performed some other unexpected act that could destroy tenancy by the entireties status and surprise their advisors.

For example, suppose the account registration form provides the following option:

☐ Joint with Right of Survivorship

☐ Other __________________

In order to create a tenants by the entireties account in this situation, the clients should fill in the "Other" blank with "Dr. John and Mary Smith, as Tenants by the Entireties," but under the *Mathews* case[19], which is described in Section E below, it should also be sufficient to check the "joint with right of survivorship" box, although this could lead to challenge if the creditor believes that the Mathews case could be overturned.

After the *Beal Bank* decision, there was some difference in opinion between bankruptcy courts as to whether the "Beal Bank Presumption" applied to tangible personal property, stock certificates, automobiles, and other assets.[20] However, it appears that the presumption applies to all personal property.

In *In re Matthews,* the court found that a debtor and his wife owned their boat slip as tenants by the entireties, "regardless of whether [a boat slip] is considered real property or personal property."[21] The court in this case also found that the debtor and his wife owned their household goods and furniture as tenants by the entireties as well.

Will the Florida law of tenancy by the entireties apply to joint accounts held in Florida even though the owners live in another state? Case law and Florida Statutes seem to support the proposition that the law of the "situs" of the property would apply, which should entitle bank accounts in Florida to tenants by the entireties protection, regardless of whether the owners of the account live in Florida, but it is not clear whether courts will agree with this, and the result may vary from state to state, based upon conflict of law considerations.

In the 2019 Iowa Supreme Court case of *Wells Fargo Equipment Finance, Inc. v. Retterath*,[22] a married couple who resided in Florida owned an Iowa LLC and claimed that it was a tenancy by the entireties asset that the husband's creditors could not reach. The LLC "own[ed] and operate[d] ethanol production and by-product

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[19] See *In re Mathews,* 360 B.R. 732 (Bankr. M.D. Fla. 2007).
[20] *Id.*
[21] *Id.* at 744.
[22] 928 N.W.2d 1, 4 (Iowa 2019).

production facilities, and it also market[ed] and processe[d] ethanol and related by-products."[23] A creditor obtained a judgment against the husband and the Iowa Supreme Court ruled that Iowa law applied so that tenancy by the entireties protection was not available. The court further ruled that the Iowa charging order statute would apply, not the Florida charging order statute. The good news appears to be that married couples residing in any state or country may establish a Florida, Delaware or other tenancy by the entireties state LLC and have creditor protection, if the Iowa Supreme Court is correct.

Florida Statute Section 655.55 purports to control the treatment of tenancy by the entireties deposit accounts in Florida, and provides as follows:

> 1. The law of this state, excluding its law regarding comity and conflict of laws, governs all aspects, including, without limitation, the validity and effect of any deposit account in a branch or office in this state of a deposit or lending institution, including a deposit account otherwise covered by s. 671.105(1), regardless of the citizenship, residence, location, or domicile of any other party to the contract or agreement governing such deposit account, and regardless of any provision of any law of the jurisdiction of the residence, location, or domicile of such other party, whether or not such deposit account bears any other relation to this state, except that this section does not apply to any such deposit account:
>
>   a. To the extent provided to the contrary in s. 671.105(2)[24]; or
>
>   b. To the extent that all parties to the contract or agreement governing such deposit account have agreed in writing that the law of another jurisdiction will govern it. [Emphasis added.]

The statute defines "deposit account" as "any deposit account in one or more names" and includes a "joint account."

In the case of *Sanchez v. Sanchez*,[25] the 3rd District Court of Appeal cited Florida Statute Section 655.55, and found that Florida law, rather than Venezuela law, governed the rights of the beneficiaries to Totten trust bank accounts upon the trustee's death, even though the trustee was domiciled in Venezuela.

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[23] *Id.* at

[24] Florida Statute Section 671.105(2) reads as follows:

(2) When one of the following provisions of this code specifies the applicable law, that provision governs; and a contrary agreement is effective only to the extent permitted by the law (including the conflict-of-laws rules) so specified:

(a) Governing law in the chapter on funds transfers. (s. 670.507)

(b) Rights of sellers' creditors against sold goods. (s. 672.402)

(c) Applicability of the chapter on bank deposits and collections. (s. 674.102)

(d) Applicability of the chapter on letters of credit. (s. 675.116)

(e) Applicability of the chapter on investment securities. (s. 678.1101)

(f) Law governing perfection, the effect of perfection or nonperfection, and the priority of security interests and agricultural liens. (ss. 679.3011-679.3071)

(g) Applicability of the chapter on leases. (ss. 680.1051 and 680.1061)

[25] 547 So.2d 943 (Fla. 3rd DCA 1989).

The *Sanchez* court explicitly stated that "[i]t is well settled in Florida that the disposition of a joint bank account, including a Totten trust, is governed by the law of the situs of the account regardless of the domicile of any party to the account."

Further, the court stated that "[i]n the instant case, the subject Totten *trust bank accounts are located in a bank in Miami, Florida,* and accordingly, *Florida law must govern* their disposition-even though (a) *Venezuela is the domicile of the decedent* who created the trusts, and (b) Venezuelan law is *contrary to Florida law* on the disposition of the trusts when, as here, the creator of the trust dies."

Although this case does not explicitly deal with a tenants by the entireties account, it supports the position that Florida law will apply when Florida is the situs of the account.

In *McNeilly v. Geremia,*[26] a First Circuit Bankruptcy Appellate Panel held that the "applicable non-bankruptcy law" that determined whether the funds in a tenancy by the entireties account were exempt was the law of Vermont (where the bank account was located) not the law of Rhode Island (where the debtors lived and filed for bankruptcy). The court specifically stated that "the state law at play in Bankruptcy Code § 522(b)(2)(B) is not 'keyed into the situs of the debtor's pre-petition domicile,' here Rhode Island, but is determined by the 'situs of the asset that is held by a debtor in bankruptcy as a tenant by the entireties.'"

In the U.S. Bankruptcy Court Case of *In re Gillette,* now-retired Bankruptcy Court Judge Paul M. Glenn held that a mutual fund account based in the State of Wisconsin where the Strong Funds company was headquartered would not qualify as a tenancy by the entireties asset, even when owned by a Florida couple.[27]

STOCK CERTIFICATES – IS "JOHN AND MARY SMITH" SUFFICIENT VERBIAGE TO DENOTE TENANCY BY THE ENTIRETIES?

In the 2002 Florida's Fourth District Court of Appeals case, *Cacciatore v. Fisherman's Wharf Realty Ltd Partnership,*[28] held that the presumption of tenancy by the entireties extends to **shares of stock held in certificate form titled in the joint names of spouses**. However, it is best to title all stock certificates explicitly as tenants by the entireties.

What if, when purchasing the stock, the debtor had a choice between joint with right of survivorship or "other" with a blank line to fill in where he or she could have written in "tenants by the entireties", much like in the above example?

In 2009, the Eleventh Circuit Court of Appeals, in *In re Mathews*, found that a stock certificate titled "ROBERT L. MATHEWS & JOYCE M. MATHEWS JT TEN" was held as tenants by the entireties, despite the fact that they had the opportunity to check the "other" box and write in "tenants by the entireties," as demonstrated above.[29]

"The Debtor signed a document titled 'Stock Certificate Registration Instructions', which provide the Debtor with five ownership options – (1) Individual, (2) Tenants in Common, (3) Other, (4) Joint Tenants with Rights of Survivorship, and (5) Uniform Gift to Minor. The blank next to 'Joint Tenants with Rights of Survivorship' was checked."

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[26] 249 B.R. 576 (1st Cir. BAP 2000).

[27] 248 B.R. 845 (Bankr. M.D. Fla. 1999).

[28] 821 So.2d 1251 (Fla. 4th DCA 2002).

[29] *In re Mathews,* at 742.

The Eleventh Circuit found that "*Beal Bank* does not support the argument that the Debtor expressly disclaimed ownership of the stock as tenants by the entireties by checking the 'Joint Tenants with Rights of Survivorship' blank instead of checking the 'Other' blank and writing in 'Tenancy by the Entireties.'" The selection of another form of ownership "is not an express disclaimer *unless* the documentation *affirmatively* provides the debtor with an option to select tenancy by the entireties." The bankruptcy court decision that was overturned is described as follows:

> The bankruptcy court in the case *In re Mathews*[30] concluded that a bank officer who titled stock certificates as joint tenants with rights of survivorship with his wife should have known to title the certificates as tenants by the entireties and thus lost protection.
>
> Debtor claimed that he never filled out any forms associated with the stock. He said either "the people at Florida National" typed up the registration for him, that "somebody else" wrote "JT TEN" on the election form, or that he merely received the items in evidence as they were titled and took no actions to change them.
>
> The stock certificate for the stock of First National Bank of Orange Park was titled "Robert L. Mathews or Joyce M. Mathews (JTWROS)".
>
> The registration form was checked as "Joint Tenants with Right of Survivorship."
>
> The First National Bank stock certificate was titled the same as the first.
>
> Though Debtor was a director of the bank, he never took steps to change how the original stock certificate was titled.
>
> On the Ameris Bancorp merger Election form, Debtor wrote "Robert L. or Joyce M. Mathews" and the stock certificate issued is titled "Robert L. Mathews & Joyce M. Mathews JT TEN" and Debtor took no action to have it changed.
>
> Debtor testified of his intent to own all property jointly with his wife because if he died before her, the property would go straight to her without probate.
>
> The evidence supported the fact that Debtor did know about tenants by the entireties.
>
> Therefore, the bankruptcy court concluded that the Debtor, a sophisticated businessman, knew what he was doing and fully intended to own the stock as joint tenants with right of survivorship and expressly disclaimed ownership as TBE.

PROVISIONS IN LLC SHAREHOLDER OPERATING AGREEMENTS AND PARTNERSHIP AGREEMENTS CAN CAUSE LOSS OF TENANTS BY THE ENTIRETIES STATUS.

Often, entities are intended to be owned as tenants by the entireties, with organizational documents inconsistent with the law of tenancy by the entireties. An example would be a shareholder agreement where a company is owned partly by a husband and wife as tenancy by the entireties, but the agreement states that

[30] *Id.*

on the death of any shareholder, the company would buy out the stock of that shareholder. Florida case law does not provide a clear answer on whether the parties' intention and titling of the company to be owned as tenants by the entireties would override the contradicting language in the shareholder agreement. It seems clear, however, that the only way to guarantee that the ownership will be given tenancy by the entirety status is to ensure that the shareholder agreement is consistent with the law of tenancy by the entireties, thus, the agreement should provide that on the death of any shareholder, the spouse has an automatic right of survivorship to all stocks owned by that shareholder.

Savings clause language that the author uses for LLC Operating Agreements to help assure that tenancy by the entireties treatment is as follows:

> 16.17 <u>Tenants by the Entireties Ownership</u>. If and when any Membership Interest is owned by and between a husband and wife as tenants by the entireties, then the Florida Law of Tenants by the Entireties shall be controlling as between such husband and wife, in that upon the death of one spouse, the interest shall be automatically owned by the other spouse, and it shall require the joinder of both spouses to act with respect to a tenancy by the entireties ownership interest, notwithstanding any provision under this Operating Agreement to the contrary. Further, notwithstanding any provision under this Operating Agreement to the contrary, the Florida rules of tenancy by the entireties, and not the provisions under this Operating Agreement, shall apply with respect to any obligation herein imposed, such that any Florida resident married couple owning their Membership Interest as tenants by the entireties are considered as one entity until after the death of one of them. Therefore, such couple shall be considered one Member for all voting purposes, it shall require joint approval of married members owning their interests as tenants by the entireties to take any action with respect to such Membership Interest, and this Operating Agreement shall be construed accordingly. If one spouse is referred to as a Manager and the other spouse is not referred to as a Manager under this Agreement or by subsequent agreement or designation, then the spouse that is referred to as a Manager shall be considered a Manager, with the Manager designation being separate and apart from the tenancy by the entireties common membership status of both spouses.

JUDGMENTS ACQUIRED BY ONE SPOUSE ON TENANCY BY THE ENTIRETIES PROPERTY MAY BE PAYABLE UPON LOSS OF TENANCY BY THE ENTIRETIES STATUS.

Judgments or liens on one spouse and secured by property owned in tenancy by the entireties may attach after the property loses its status as tenancy by the entireties. In *Grossfield v. Security National Mortgage Company*, the District Court of Appeals held that a mortgage lien on property held as tenancy by the entireties, signed by only one spouse, was not void when signed.[31] After the foreclosure sale of the property, which terminated the common law unities, the lienholder was entitled to a portion of the proceeds from one spouse.

TAX REPORTING CONSISTENCY – IRS INSTRUCTIONS CAUSE CONFUSION.

[31] **Error! Main Document Only.***Grossfield v. Security National Mortgage Company, et. al.*, 389 So. 3d 726 (Fla. App. 3 Dist. 2024).

Federal and state taxes reflect the ownership of entities, and there are often inadvertent inconsistencies between the tax reporting documents and the intended ownership structure. For example, if ownership in an S corporation or a partnership is held as tenants by the entireties, the original S corporation Form 2553 and K-1 forms attached to S corporation or partnership tax returns should reflect such ownership.

The IRS instructions for the preparation of partnership tax returns (Form 1065), reads as follows:

> "Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year."

By this instruction, the IRS appears to indicate that a married couple owning a partnership interest as tenants by the entireties should be considered to be two separate owners and receive separate K-1 forms, which is what many CPA firms believe to be proper. The author sees no harm in issuing a single K-1 form to the spouses as tenants by the entireties and listing one of their social security numbers, particularly where the spouses file a joint return.

The IRS instructions for the S corporation returns (Form 1120S) do not provide any guidance on this.

Sometimes stock will be issued jointly to spouses as tenants by the entireties, but the initial IRS Form 2553 may show only one spouse as sole owner. An S election is not valid unless it is signed by each owner, so one spouse cannot sign for both spouses. Fortunately, the Treasury Regulations are somewhat lenient in allowing this mistake to be corrected.

If a shareholder is inadvertently not listed on Form 2553, this results in the shareholder not consenting to the S Election. However, the below referenced Treasury Regulations may allow a late filed S Election, even if this occurs many years after the original S Election was made.

The requirements under Treasury Regulation Section 1.1362-6(b) are as follows:

1. There was reasonable cause for the failure to file a consent;

2. The request for the extension of time to file the consent is made within a reasonable time under the circumstances; and

3. The interest of the government will not be jeopardized by treating the election as valid.

The Request for an Extension of Time to File the S Corporation Election Consents should be filed with the District Director or with the IRS Service Center that received the original Form 2553 Election for the Corporation.

CONTRACTS TO PURCHASE REAL ESTATE.

Oftentimes, spouses will simply put their names on real estate contracts with deposits, without clearly designating that they hold the contracts as tenants by the entireties. It is safest to have a contract to purchase real estate explicitly state that it is held by spouses as tenants by the entireties.

U.S. TREASURY BONDS.

Treasury Regulations indicate that United States Treasury Bonds cannot be placed in tenancy by the entireties. These treasury bonds may be owned by one individual or by the revocable trust of one individual, but it does not appear that they will qualify to be held directly as tenants by the entireties.

JOINT TAX REFUNDS.

The Bankruptcy Court case of *In re Kossow*[32] extended the holding in *Beal Bank* to conclude that a federal tax refund resulting from a joint tax return could be considered tenancy by the entireties property. The court stated that "a rebuttable presumption arises that all personal property, including a joint tax refund, is held as a tenancy by the entireties as long as the personal property is acquired by husband and wife in accordance with the unities of possession, interest, title, and time with right of survivorship."

In re Hinton[33] found that the tax refunds can be owned as tenants by the entireties, where the husband and wife filed joint returns, each refund check was jointly payable to husband and wife, and upon receipt of the refund check it was deposited into a joint account, expressly opened as a tenancy by the entireties account. *In re Freeman*[34] also found that tax refunds can be owned as tenants by the entireties.

However, *In re Morine*[35] is consistent with the holdings in *Kossow* and *Hinton.* In *Morine,* the debtor did not deposit the tax refund into a tenancy by the entireties account before filing his bankruptcy petition. Therefore, the Court found that "**the tax refund check was not deposited into a tenancy by the entireties bank account before the date of filing as in *Hinton,* so this Court declines to extend its holding.**" (Emphasis added.) Interestingly, the Court did not mention the *Freeman* case described above.

After *Morine*, another Middle District case, *In re Gorny*,[36] relied upon *In re Hinton* and *In re Freeman* and held that the tax refund qualified for ownership as tenancies by the entireties. However, in *Gorny* there were joint creditors, so the tax refund was not exempt.

Subsequently, *In re Rice*[37] followed the holding from *Morine* that the interest of each debtor in a joint refund is the amount attributable to his income. The court found that a debtor who had filed a joint income tax return with a non-debtor, income-earning spouse did not have an interest in entirety for the tax refunds.

In a December 2012 case *In re Newcomb*,[38] the Bankruptcy Court for the Middle District of Florida addressed the conflict concerning this issue in Florida courts. The court cited Gorny*, Freeman, Kossow,* and *Hinton* to support the proposition that joint tax refunds constitute tenancy by the entirety property. The court further cited to *Morine* and noted that "[n]ot every court, however, has agreed that joint tax refunds constitute tenancy by the entirety property. Indeed, a split of authority on this issue exists within the Middle District of Florida." Here, the court declined to follow *Morine* and held that the joint tax refund was exempt as tenants by the entireties property.

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[32] 325 B.R. 478 (Bankr. S.D. Fla. 2005).
[33] 378 B.R. 371 (Bankr. M.D. Fla. 2007).
[34] 387 B.R. 871 (Bankr. M.D. Fla. 2008).
[35] 391 B.R. 480 (Bankr. M.D. Fla. 2008).
[36] 2008 WL 5606583 (Bankr. M.D. Fla. 2008).
[37] 442 B.R. 140 (Bankr. M.D. Fla. 2010).
[38] 2012 WL 6043000 (Bankr. M.D. Fla. 2012).

It seems that tax refunds attributable in great part to one spouse as opposed to joint activities or investment losses will be considered to be tenancy by the entireties assets. The court, in *In re Garbett*,[39] held that a presumption exists that each debtor has equal interest in a joint tax refund, regardless of each debtor's respective contribution to the taxable income. The presumption is rebuttable, based on facts and circumstances.

DATE	CASE NAME	JUDGE & DISTRICT	AMOUNT OF TAX REFUND IN QUESTION	DID ONE SPOUSE HAVE MORE INCOME THAN THE OTHER IN THE YEAR IN QUESTION?	WAS THE UNEVENNESS DISCUSSED	ANY OTHER NOTES
4/28/2005	*In re Kossow*	Hyman, S.D., Fla.	$3,670	Not mentioned	N/A	Remanded the Court found that the Prenuptial Agreement caused "genuine issues of material fact as to whether the 2003 income tax return is exempt as a tenancy by the entireties"
4/12/2006	*In re Kant [unreported case]*	Glenn, M.D., Fla.	$6,117	Yes, the debtor was the only spouse with income and withholding for the year	Yes	

[39] 410 B.R. 280 (Bankr. E.D. Tenn. 2009).

DATE	CASE NAME	JUDGE & DISTRICT	AMOUNT OF TAX REFUND IN QUESTION	DID ONE SPOUSE HAVE MORE INCOME THAN THE OTHER IN THE YEAR IN QUESTION?	WAS THE UNEVENNESS DISCUSSED	ANY OTHER NOTES
10/1/2007	*In re Hinton*	Jennemann, M.D., Fla.	Total $483,292. The IRS issued a check for 1997 & 1998 totaling $304,383. The IRS issued two checks for 2001, $116,518 and $62,391	Yes	The Court did not state the difference in income	
4/30/2008	*In re Freeman*	Jennemann, M.D., Fla.	$1,339	Not mentioned	N/A	
5/6/2008	*In re Morine*	Paskay, M.D., Fla.	Not mentioned	Yes. "The refund is attributable solely to the debtor's income."	Yes	Does not mention *In re Freeman*
8/20/2008	*In re Gorny*	Briskman, M.D., Fla.	$6,397	Not mentioned	N/A	Does not mention *In re Morine*
12/4/2012	*In re Newcomb*	McEwem, M.D., Fla.	$6,235	Not mentioned	N/A	Noted the conflict in the Middle District regarding whether joint tax refunds can be held as tenants by the entireties. Declined to follow *In re Morine*

NOTE: This issue was also addressed by the Tennessee bankruptcy court case of *In re Garbett* in 2009, which concluded that refunds attributable to one spouse's losses are nevertheless tenancy by the entireties property.

TANGIBLE PERSONAL PROPERTY (PHYSICAL NON-REAL ESTATE ASSETS).

The Supreme Court in the *Beal Bank* case did not discuss whether tangible personal property "would be held" as tenants by the entireties without proof of that form of ownership. The Bankruptcy Court *In re Kossow*[40] and *In re Caliri*[41] have concluded that the *Beal Bank* decision applies to tangible personal property acquired jointly by a married couple, unless an express disclaimer of entireties ownership occurs.

In *Kossow*, a grill and patio furniture was found to be transferred by the debtor to tenancy by the entireties, although there was no bill of sale or other formal document confirming this. *In re Mathews,* discussed previously, the court found that there is a trend towards recognizing a presumption of tenancy by the entireties for all personal property, not merely real estate. The court held that if all the unities are present, a presumption should arise that a married couple owns personal property as tenants by the entireties.

In 2015, *In re Nazael Dumay* confirmed that one spouse can transfer an exempt asset, such as an automobile, to tenancy by the entireties.[42] Under Florida law, a spouse holding title to property may convey that property to both spouses and create a tenancy by the entireties.[43] However, the exemption is only applicable up to $5,000.

Will Florida law apply where tangible or intangible property is owned outside of Florida? The case law is not consistent, but it appears from a number of cases that tangible personal property (physical assets) will not be protected as tenancy by the entireties assets if physically located in a state or jurisdiction that does not recognize tenancy by the entireties. On the other hand, intangible assets, such as stock, partnership interests, and promissory notes should qualify as tenancy by the entireties assets, notwithstanding where they, or the underlying entity involved, are located.[44]

AUTOMOBILES AND OTHER REGISTERED VEHICLES.

In Florida, an automobile title can be held by multiple parties with the designation of "AND" or "OR." Pursuant to Florida Statutes § 319.22(2)(a)(1)(b), "AND" means that both signatures are required to effectuate a transfer, therefore, tenancy by the entireties should apply. However, "OR" means that either spouse can sign, so tenancy by the entireties should not apply. Practically speaking, the Florida DMV will not permit titling between spouses in a way that would explicitly mention tenancy by the entireties or "TBE."

Florida Statutes § 319.22 will affect the ability of a vehicle titled in Florida to qualify as tenants by the entireties property. In *AmSouth Bank of Florida v. Hepner,*[45] a judgment creditor was permitted to levy on a jointly owned vehicle because the title stated "OR," which the court found to mean that the vehicle was owned as joint tenants and not tenants by the entireties. If the title had stated "AND," then the court would have

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[40] *Kossow,* at 478.
[41] *Caliri,* at 788.
[42] No. 15-10472-BKC-RAM-WL 3505233 (S.D. Fla. 2015).
[43] Fla. Stat. § 222.25(1).
[44] *In re Koesling,* 210 B.R. 487 (Bankr. N.D. Fla. 1997); *In re Siegel,* 350 So 2d. 89 (Fla. 4th DCA 1977).
[45] 647 So.2d 907 (Fla. 1st DCA 1994).

found that tenancy by the entireties existed. The court also indicated that the parties would not be permitted to use extrinsic evidence, unlike with other personalty, to establish that despite checking the "OR" box, that they really intended to own the vehicles as tenants by the entirety.

In 2001, the Supreme Court of Florida extended the presumption of tenancy by the entireties to include joint financial accounts and other personal property.[46] The *Beal Bank* case does not specifically address motor vehicles and the *Caliri* case mentioned above found that vehicles (in this case, jet skis) titled by use of the word "OR" will not be considered as tenants by the entireties property.[47]

Three years later, in *Xayavong v. Sunny Gifts, Inc.,*[48] the court concluded that the presumption of tenancy by the entireties in *Beal Bank* did not apply to automobiles because of the provisions outlined in Florida Statutes § 319.22(2), as explained above.

Race cars and other vehicles that are only driven "off of the road" and on private tracks generally do not have a title, therefore these vehicles need to be titled as tenancy by the entireties by a formal bill of sale, perhaps by intent.

Federally documented vessels can also be held as tenants by the entireties. In *Caliri*, the debtor and her husband acquired a catamaran under a bill of sale from the dealer setting forth their names as joint tenants with right of survivorship, and the catamaran was federally documented and thus not titled by the State of Florida. The Certificate of Documentation showed the owners simply as the husband and wife, and showed the husband as the managing owner. The bankruptcy court concluded that the catamaran was held as tenancy by the entireties because the husband and wife did not expressly disclaim entireties ownership.

Florida's sales tax is generally imposed upon any transfer of a registered vehicle, boat, or airplane to a limited liability company or other entity. Floridians are therefore well advised to establish an LLC or other entity to own any such item from inception.

JOINT DEBT AND BANKRUPTCY.

While the general rule that a creditor owed money by only one spouse ("a sole creditor") may not reach tenancy by the entireties assets, this may be challenged in bankruptcy if there is joint debt, because the joint creditor or creditors can force a sale of the tenancy by the entireties assets, and then single creditors may claim that half of any excess value will not be protected as tenancy by the entireties property. To illustrate, in *Grossfield v. Security National Mortgage Company*, the court allowed a single lienholder to recover a portion of the home's equity from one spouse after a joint lienholder foreclosed on property held as tenants by the entirety and sold it at a surplus.[49]

It is clear "that an unsecured joint creditor" in bankruptcy can "have the automatic stay lifted in order to reduce its claim to judgment in state court and to enforce that judgment against property owned as tenants by the entireties by the debtor and his non-filing wife."[50]

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[46] *Beal Bank, SSB v. Almand and Associates,* 780 So. 2d 45 (Fla. 2001).
[47] 347 B.R. 788 (M.D. Fla. 2006).
[48] 891 So. 2d 1075, 1076 (Fla. 5th Dist. App. 2004).
[49] *Grossfield v. Security National Mortgage Company, et. al*., 389 So. 3d 726 (Fla. 3d DCA 2024).
[50] *Chippenham Hosp., Inc. v. Bondurant,* 716 F.2d 1057 (4th Circ. 1983).

The 1988 Middle District of Florida Bankruptcy Decision *In re Pepenella*[51] cited the Fourth Circuit Court of Appeals 1985 opinion *Sumy v. Schlossberg*[52] for the proposition that "[a]lthough there is a split between courts as to whether the presence of a joint creditor eliminates the [tenancy by the entireties] exemption entirely, . . . the most appropriate rule, and seemingly the majority rule [is that] the equity in the property may be used to satisfy the joint creditors, but the remainder of the equity is exempt as to the sole creditors of one of the tenants."[53]

This issue has not been addressed by any other Circuit Court of Appeals, or by any decision known of by the authors in recent years.

> **STRATEGY I –** maintain sufficient liquidity or access to liquidity to eliminate debt on joint non-exempt assets or have the debt owed by an entity other than that of the spouse's, although the spouse may guarantee the debt.
>
> **STRATEGY II –** investment assets other than homestead to be secured by debt may be purchased under an LLC or family limited partnership that is owned by the married couple as TBE, and the couple can guarantee the debt. Then there is not "individual joint debt" for purposes of bankruptcy planning.
>
> **STRATEGY III –** before one spouse files bankruptcy, transfer tenancy by the entireties assets to the other spouse so that the debt is not "joint debt" at the time of filing.

RULES APPLICABLE FOR TRANSFERRED PROPERTY TO AVOID JUDGMENT

The judge and the case that awards the judgment can ignore the 4 year fraudulent transfer statute according to some cases.

Section 56.29, Florida Statutes describes the procedure by which a person holding an unsatisfied judgment can initiate the proceedings supplementary (post judgment litigation in the same court that awards the judgment) to such execution.[54] Based on Florida Statute, 55.10(1), the judgment becomes a lien when a certified copy of the judgment is recorded with the County Public Records.[55] A judgment lien may be extended for up to 20 years, and therefore the passage of 4 years will not stop a judgment creditor from initiating the supplementary proceedings.[56] The 4 year rule may not apply as this is not a bankruptcy proceeding with a look back period. The statute of limitations is likely 20 years.

According to 11 U.S.C. Section 544, the appointed judgment creditor can utilize the state's fraudulent transfer statutes to reach back to property transfers that occurred more than 4 years before the proceeding supplementary occurs.[57] However, this rule applies in bankruptcy proceedings, not in supplemental proceedings for judgments. The Court in *Biel Reo* held that the shorter UFTA bankruptcy statute of limitations

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[51] 103 B.R. 299, 302(M.D. Fla. 1988).
[52] 777 F.2d 921, 928 (4th Cir. 1985).
[53] *In re Pepenella*, 103 B.R. 299, 302 (M.D. Fla. 1988).
[54] *Zureikat v. Shaibani*, 44 So.2d 1019, 1022 (2006)
[55] Fla. Stat. 55.10(1)
[56] *Salina Mfg. Co. v. Diner's Club, Inc.*, 382 So.2d 1309, 1310 (Fla. 3d DCA 1980)
[57] 11 U.S.C. Section 511

(4 years in FL) does not apply to supplementary proceedings on a judgment.[58] The court found that the "claims asserted pursuant to Florida Statute § 56.29 could be brought during the life of the judgment".[59] Based on this, it would appear that the expanded case law pushes the statute of limitations upwards to 20 years for collection in Florida.

In *McGregor v. Fowler White Burnett, P.A.*, the creditors were not able to pursue a money judgment because of the limitations of Fla. Stat. 56.29. [60] The law has changed since, shown in the next case. In *Rosenberg v. United States Bank, N.A.*, creditors were able to obtain a money judgment after a fraudulent transfer occurred and they proved this transfer was in fact fraudulent.[61] The court reasoned Fla. Stat. 56.29 was meant to give the courts the authority to grant the most complete relief possible, and a money judgment to remedy a fraudulent transfer constituted this power.[62]

In addition, Fla. Stat. 56.29(6)(a) shifts the burden of proof to the defendant to establish that the transfer of the property was not to defraud, delay, or hinder creditors.[63] In *Zureikat v. Shaibani*, the creditors were able to convince the court that the debtors had made a fraudulent transfer into their homestead.[64] This shifted the burden onto the debtors and they were not able to proof that this conduct was in fact not fraudulent.[65]

REAL ESTATE OWNED OUTSIDE OF FLORIDA.

Does the state of location recognize tenancy by the entireties? If not, then the ownership of the real property may be converted to an intangible asset so that Florida law will apply. Many states, including Georgia, Colorado, and Washington, do not recognize tenancy by the entireties. Conversion can also be done by transferring the property to a separate entity in a tenancy by the entireties protective state, such as a limited liability partnership or an LLC, the interests of which will be held as tenants by the entireties between the spouses.

Some states recognize tenancy by the entireties, but do not provide "full protection" for those assets. For example, under Alaska law, the creditor of one spouse can attach the survivorship right that the debtor spouse owns in the share of the non-debtor spouse in the event of the death of the non-debtor spouse, so creditors routinely receive nominal payments in lieu of nothing from a tenancy by the entireties debtor.

A non-resident of Florida may be able to exempt non-homestead Florida real property, so long as the property is owned by the debtor and his or her spouse as tenants by the entireties. In *In re Cauley*,[66] the Bankruptcy Court for the Middle District of Florida acknowledged that tenancy by the entireties protection can apply to individuals who reside in non-tenancy by the entireties states and own real estate in a tenancy by the entireties state, like Florida, pursuant to Bankruptcy Code Section 522(b)(3)(B). In this case, the court ruled that the debtor's interest in a Florida property was exempt in bankruptcy, even though the debtor did not live in Florida. Debtor and his wife purchased a home in Florida, which they lived in for approximately four months.

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[58] *Biel Reo, LLC v. Barefoot Cottages Development Co. LLC*, 156 So.3d 506, 511 (2014)
[59] *Id.*
[60] *McGregor v. Fowler White Burnett, P.A.*, 332 So. 3d 481 (Fla. Dist. Ct. App. 2021)
[61] *Rosenberg v. United States Bank, N.A.*, 360 So. 3d 795 (Fla. Dist. Ct. App. 2023)
[62] *Id.*
[63] Fla. Stat. Section 56.29 (6)(a)
[64] *Zureikat v. Shaibani*, 944 So. 2d 1019 (Fla. Dist. Ct. App. 2006)
[65] *Id.*
[66] 374 B.R. 311 (Bankr. M.D. Fla. 2007).

In 2006, the debtor filed for Chapter 7 Bankruptcy in Delaware, claiming that the Florida property was exempt because it was held as tenancy by the entireties. AmSouth bank objected, arguing that tenancy by the entirety protection was only available if the debtor was a Florida resident. The court applied Florida law because the property was located in Florida, and the sole determinant of whether Section 522(b)(2)(B) of the Bankruptcy Code protects an asset from the claims of the bankruptcy estate is the asset's situs. The court noted that "tenancy by the entirety is a creature of Florida common law, not an exemption which is given to a resident of Florida by the Florida Constitution or the Florida Statutes." Thus, the court found that there was no requirement to be a resident of Florida in order to exempt the Florida property under tenancy by the entireties.

Other courts have followed *Cauley*, allowing non-residents to exempt Florida property held as tenants by the entireties. In the case of *In re Holland*,[67] the court allowed an Illinois debtor who owned property in Florida as tenants by the entireties to exempt such property in her bankruptcy. Citing *Cauley,* the court noted that there is no requirement for the property owner to be a resident of Florida. The court specifically stated, "[i]t is therefore clear from Florida case law that, at least with respect to creditors who are not joint creditors of the husband and wife, Florida common law concept of tenancy in the entireties fits within the exemption provided by 11 U.S.C. § 522(b)(3)(B) [of the Bankruptcy Code]."

FUNDING A BY-PASS TRUST WITH TENANCY BY THE ENTIRETIES PROPERTY.

Many estate tax planners will want to provide that a first dying spouse is able to fund assets to a By-Pass Trust that can benefit the surviving spouse without being subject to federal estate tax on the estate. For those that die in 2017, the applicable exclusion amount is $5,490,000. When an affluent couple owns most of their assets as tenants by the entireties, how can a By-Pass Trust be funded?

Can the surviving spouse disclaim a portion of the tenancy by the entireties property to facilitate the funding of a By-Pass Trust under the Will of the first dying spouse? Treasury Regulation Section 25.2518-1, effective December 30, 1997, permits a surviving joint tenant to disclaim the survivorship interest in joint tenancy property if certain technical steps are followed to comply with state and tax rules.

CAN A JOINT TRUST QUALIFY FOR TENANCY BY THE ENTIRETIES OWNERSHIP?

There are only four known cases discussing whether a married couple in Florida can maintain tenancy by the entireties protection with respect to assets held in a "joint revocable trust", and it seems clear, at least to the author, that a properly drafted and administered trust can qualify.

A controversial case on point is the 2020 Bankruptcy Court decision of *In re Givans* and the apparent view of bankruptcy court Judge Jennemann that assets held by a married couple which are held as tenants by the entireties lose such joint status if the assets are moved into a joint trust.[68] In *Givans* the joint trust provided that on the death of the surviving spouse the trust estate would be devised equally to their children, this provision along with other trust provisions that were inconsistent with tenancy by the entireties ownership contributed to the Judge's decision. Therefore, it is important to provide that the entire beneficial ownership interest in the trust and all trust assets is a tenancy by the entireties asset, and to keep the trust provisions consistent therewith. An alternative would be to attempt to use a Delaware statutory tenancy by the entireties trust, but the authors are not absolutely sure that a Florida court will apply Delaware law, even if the situs of the trust assets were in Delaware, if both spouses reside in Florida. Other states that have tenancy by the entireties trust laws include Virginia, Illinois, and Missouri.

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[67] 2009 WL 2971087 (Bankr. N.D. Ill. 2009).

[68] *In re Givans*, No. 6:19-bk-01928-KSJ, 2020 Bankr. LEXIS 2912, at *2 (Bankr. M.D. Fla. Sep. 28, 2020)

In *Passalino v. Protective Group Securities, Inc.,*[69] Florida's Fourth District Court of Appeals held that the proceeds from a sale of property held as tenants by the entireties did not lose tenants by the entireties status when transferred to their attorney's trust account. Specifically, the court stated that "[t]ransferring the proceeds of the sale of entireties property to a trustee for the benefit of the husband and wife does not terminate the unities of title or possession, where the parties clearly intended their property to be held as a tenancy by the entireties by exercising beneficial ownership of the property and controlling the property's disposition."

The *Passalino* court discussed *Rollins v. Alvarez*,[70] in which the Fifth District made the following comment in a footnote regarding the transfer of entireties property to a trust controlled by the husband: "There is no dispute that the effect of this transfer to the trustee destroyed any tenants by the entireties that may have existed in the property pre-transfer." The *Passalino* court noted that the *Rollins* case does not stand for the proposition that a transfer to a trustee of entireties property in and of itself terminates entireties status. Rather, the court indicated that entireties status is destroyed when the property is transferred to a trust controlled by only one spouse. The *Passalino* court further asserted that the intent of the property owners is relevant in determining whether entireties property retains entireties status after being transferred to a trust. The court noted that tenancy by the entireties ownership can be terminated by divorce, death of one of the owners, or by agreement between the owners. The court further noted that such agreement does not need to be explicit and can be inferred from the conduct of the parties. Thus, the intent of the parties is considered in determining whether an agreement to terminate entireties status was reached. In the case at issue, the court stated that "[t]he evidence in this case established that Mr. and Mrs. Molinari did not intend to terminate the tenancy by the entireties when they deposited the proceeds of the sale from their entireties property in the trust account. The money was held for their use and benefit, and only they could direct its disposition."

In the case of *In re Quaid*,[71] the United States District Court for the Middle District of Florida found that "[w]hen assets held as TBE are transferred to a trust in which only one party maintains control, the terms of the trust eliminate any TBE protection." In this case, a couple transferred funds held in a tenants by the entireties bank account to a trust solely controlled by the wife. The court determined that these funds lost tenants by the entireties protection because the trust was solely controlled by the wife. However, the court did not allow the husband's creditors to reach the property held in trust because he was not a "settlor" under the Florida Trust Code because the husband did not have the power to revoke or withdraw the trust assets. Specifically, the court stated that "[b]ecause [the husband] was not a settlor of the Trust, his beneficial interest in the Trust is protected from his bankruptcy creditors by the spendthrift provision."

In the case of *In re Romagnoli*,[72] the Bankruptcy Court for the Southern District of Florida ruled that TBE property held in a joint revocable trust is not subject to creditor claims, regardless of whether a trust can hold TBE property. The trust at issue in this case was a joint revocable living trust that the debtor had established for estate planning purposes. The disputed properties transferred to the trust were the Debtor's homestead property that was purchased prior to marrying his wife, a condominium in Miami that the wife owned prior to the marriage, and a home in Orlando that the couple purchased as tenants by the entireties.

The debtor argued that the trust explicitly provided that all property in the trust was held by the debtor and his wife as tenants by the entireties and therefore the property could not be considered a part of the

[69] 886 So.2d 295 (Fla. 4th DCA 2004).

[70] 792 So.2d 695 (Fla. 5th DCA 2001).

[71] 2011 WL 5572605 (M.D. Fla. Nov. 16, 2011).

[72] 19-26521-BKC-LMI, 2021 WL 2762812 (Bankr. S.D. Fla. June 30, 2021)

bankruptcy estate. The debtor also argued that even if the properties had not been placed in trust, they would not be considered assets of the debtor's bankruptcy estate because the first property was the debtor's homestead, the second was purchased and owned by his wife prior to the marriage, and the third property was purchased by the couple as tenants by the entireties.

In the Order Granting Debtor's Motion for Summary Judgement as to Trustee's Objection to Debtor's Claimed Exemptions, the court noted that the Trustee's reliance on *In re Givans* was misplaced. In *Givans*, the debtor and his spouse claimed property in their trust as exempt TBE property. The *Givans* court, as noted above, held that a trust cannot hold property as TBE because a trust is an entity, not a married couple. In *In re Romagnoli*, the debtor did not seek to separately exempt the property in the trust (other than the Homestead property) and therefore the reasoning in *Givans* was not properly analogous.

The *Romagnoli* decision seems to limit the scope of the ruling made in *Givans*. The *Givans* case held that the trust was not held as tenants by the entireties and made the Givans' children co-beneficiaries of the trust could not hold property as tenancy by the entireties. By contrast, the joint revocable living trust at issue in *Romagnoli*, explicitly stated that the Romagnoli's held all property in the trust as tenancy by the entireties as co-trustees, Because the trust was properly drafted, the debtor's claimed exemptions were permitted. Advisors should note the crucial difference in trust language in *Givans* and *Romagnoli.*

Attorneys Richard O. Jacobs and Tye Klooster shared our view in their 2005 article entitled *Asset Protection Tools for Florida Professionals: Strategies to Pursue and Avoid,* which was published in Florida State University Business Review. They concluded as follows:

> In such a trust, the legal title is vested in the trustees, and the husband and wife have beneficial title. The TBE trust differs from the joint trust in that both husband and wife must agree to alter, amend, modify, or revoke the trust, or to withdraw assets from the Trust Estate. If there are disbursements, the disbursements must benefit both spouses. The TBE trust can be utilized when assets cannot otherwise be titled as TBE property. For example, some banks refuse to recognize TBE bank account titles, but will recognize account titles in a trustee. Similarly, a TBE trust is an option, as would an LLC or other entity, to hold title to property located in another state that does not recognize TBE property as a form of ownership. As Florida residents, the interests of husband and wife in the entity is a beneficial interest. As such, it is personal property, subject to the laws of Florida, and can be titled as TBE property. While there is some disagreement among practitioners as to whether or not TBE status can be protected by use of such a trust, we believe TBE trusts should withstand creditor attack.[73]

The above conclusion is further supported by an article entitled *Trusts: TBE or Not TBE* by R. Craig Harrison, which was first published in The Florida Bar Journal, May 2013. Our summary of this article is as follows:

> Attorney R. Craig Harrison's real property, probate and trust law sponsored article in the May 2013 Florida Bar Journal entitled – Trusts: TBE or Not TBE – provides an excellent discussion of the advantages and factors to consider in establishing and implementing a tenancy by the entireties trust. The article concludes that a married couple can transfer tenancy by the entireties property to a trust that will provide the couple with both the benefits of a trust and also creditor protection. The article further points out that a surviving spouse can be provided

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[73] Richard O. Jacobs & Tye J. Klooster, *Asset Protection Tools for Florida Professionals: Strategies to Pursue and Avoid*, 4 Fla. St. U. Bus. Rev. 1 (2004-2005).

with the right to disclaim his or her interest into the TBE trust to be allocated to a credit shelter trust that can be provided for under the trust document.

Florida favors married couples holding their property as tenants by the entireties (TBE). Probate is avoided as the property passes to the surviving spouse by operation of law. Further, the tenancy provides creditor protection. In essence, the TBE property belongs to neither individual spouse, but both are collectively seized in the whole property. This indivisible interest cannot be severed by the actions of just one spouse. Because of this legal concept, the creditor of one spouse cannot sever the TBE property to satisfy the debt.1 To avoid probate and to take advantage of estate tax exemptions, estate planners have traditionally split the TBE property to fund separate trusts for each spouse, which usually provide tax credit shelter and marital trusts upon the death of the grantor spouse. The division of the TBE property between the spouses (held in trust or otherwise) subjects the property held by a spouse to the reach of that spouse's creditors. With the increase of the federal exemption and portability, single-share joint trusts are becoming more popular; however, a creditor of one spouse may be able to reach the entire corpus of a single-share joint trust.

A tenancy by the entirety trust (TBE trust) can provide the married couple with both creditor protection and the various nontax benefits of a trust. The TBE trust with disclaimer provisions can provide the same estate tax benefits as a complex joint trust or the typical separate trust formats. A review of the TBE concept, historically and to the present day, together with an analysis of a beneficiary's interest in a trust supports the use of a TBE trust.

The below is an excerpt from R. Craig Harrison's article, *Trusts: TBE or not TBE*:

The TBE Property Roots

• *The Beginnings of Jointly Held Property* — The holding of property as joint tenants dates back to at least the 13th century. It was a mechanism to avoid the incidents of feudalism. The joint tenants were seized "per my et per tout." In other words, the tenants held simultaneous ownership of an equal undivided fractional share ("per my") of the entire estate ("per tout"). In the 14th century, partition actions developed to sever the joint tenancy and the concept of tenancy in common was born. Persons who hold property as tenants in common hold their respective interests as a separate and distinct estate, *i.e.*, an undivided one-half.

• *The Development of TBE Property: Married Women Could Not Hold Property Individually* — Tenancy by the entirety took form in the 14th century and the feudal system also played a role in its development as a married woman could not hold property in her individual name. However, it was not until the 18th century that tenancy by the entirety was described as a property interest in the ninth edition of William Blackstone's *Commentaries on the Laws of England*, in which he states:

> If an estate in fee be given to a man and his wife, they are neither property joint-tenants, nor tenants in common; for husband and wife being considered as one in law, they cannot take the estate by moieties, but are seized of the entirety, per tout et non per my; the consequences of which is that neither the husband nor wife can dispose of any part without the assent of the other, but the whole must remain to the survivor.[2] Although a married woman held title to the TBE property, her husband had the right to exclusively control the estate and his creditors had the ability to reach the TBE property subject only to the wife's right of survivorship.

• *The Modern Concept of TBE: The Rule of Construction and Presumption of Intention* — By statutory and constitutional enactments, married women gained the right to own property in their individual names. In Florida, the right of a married woman to hold separate property slowly progressed. Finally, in 1968, Florida adopted Fla. Const. art. 10, §5, which abolished all distinctions between married men and women in the holding, control, disposition, or encumbering of property.

Because married women could own property in their individual name, the original reason for the development of tenancy by the entireties, that the wife lacked capacity to hold title, no longer existed. Many jurisdictions faced the issue as to whether the tenancy by entirety concept should still apply. The Florida Supreme Court, in a series of cases, held that the ancient reason for the establishment of estates by the entirety (*i.e.,* the incapacity of the wife to hold property) was no longer the common law basis of the estate by entirety concept. Rather, the common law evolved into a rule of construction based on the presumption of an intent to create TBE property and ownership of the TBE property as a single unit (per tout et non per my).[3]

First Nat'l Bank v. Hector Supply Co., 254 So. 2d 777 (Fla. 1971), addressing a bank account, held that a TBE interest was created in the account so long as the signature card was drafted in a manner consistent with the essential six unities of the TBE estate. This standard was reaffirmed in *Beal Bank, SSB v. Almand and Associates,* 780 So. 2d 45 (Fla. 2001), which pronounced that strong public policy considerations favored the finding of a TBE interest in property — at least with respect to creditors.

Based on these common law standards, the TBE property interest is created by 1) the intention of the husband and wife to create the tenancy, and 2) the establishment of the six essential characteristics associated with TBE property.

The Creation of a TBE Trust

A trust can be drafted to meet the requirements set forth in *Hector Supply* and *Beal Bank.*

• *The Statement of Intent to Create TBE Property — Hector Supply*; *In re Lyons' Estate,* 90 So. 2d 39 (Fla. 1956); *Bailey v. Smith,* 103 So. 833 (Fla. 1925); and *Hagerty v. Hagerty,* 52 So. 2d 432 (Fla. 1957), all involved bank accounts and state that if the intent to create a TBE interest was set forth in the account signature card, the intent to create the TBE interest would be conclusive.

Beal Bank re-affirmed *Hector Supply* and concluded that if the signature card states the intent to create a TBE interest in the account, this "ends the inquiry as to the form of ownership" as to the tenancy.[4]

Beal Bank also cites the Fourth DCA holdings in *Sheeler v. United States Bank of Seminole,* 283 So. 2d 566 (Fla 4th DCA 1973), and *Morse v. Kohl, Metzger, Spotts, P.A.,* 725 So. 2d 436 (Fla. 4th DCA 1999), that the signature card designating the account as TBE property was conclusive and could not be challenged by extrinsic evidence.

Therefore, a simple statement in the trust agreement that the settlors intend to create a TBE interest for all property transferred to the trust provides the required intent to create a TBE interest in the trust property.

The TBE trust must also be consistent with the six essential unities of the TBE estate.

The Essential Unities of the TBE Estate — Tenancy by entirety must have the following six characteristics:

1) Unity of Possession — Both spouses must have joint ownership and control.
2) Unity of Interest — Each spouse must have the same interest in the property.
3) Unity of Title — The interest must have originated in the same instrument.
4) Unity of Time — The interest must have commenced simultaneously in the same instrument.
5) Survivorship — On the death of one spouse, the other spouse becomes the sole owner of the entireties property.
6) Unity of Marriage — The parties must be married. The unities of interest and survivorship can easily be incorporated into the trust agreement. The unity of marriage is simply an issue of fact. The unities of title, possession, and time also can be properly addressed in the trust agreement.

The Unity of Title: The Property Interest of Equitable Title — Some practitioners assert that the division of the TBE property into a legal interest (held by the trustee) and an equitable interest (held by the husband and wife) terminates the tenancy. They argue that the husband and wife no longer hold a unified title to the estate as a whole, and the tenancy by the entirety is destroyed.

"An estate by the entireties can be created in property capable of being held as an estate by the entireties where a conveyance of transfer is made to husband and wife without expressly specifying how they are to take."[5] It is the unity of title in the property interest that is relevant, not the quantity of the property interest. As discussed below, equitable title to trust property is a property interest and, therefore, is subject to TBE ownership.

In *In re McEwen's Estate,* 33 A.2d 14 (Pa. 1943), a Pennsylvania trust was established by a married couple with a bank as the trustee. The husband and wife made unequal contributions to the trust of securities. The trust provided for the distribution of the net income to the husband and wife during their joint lives and to the survivor during his or her life. After the death of the surviving spouse, the trustee was required to liquidate the trust and distribute the corpus to the remainder beneficiaries. The spouses held the right to revoke the trust during their joint lives, but upon the death of one spouse, the trust became irrevocable.

The Supreme Court of Pennsylvania held that the McEwens created a TBE interest in the corpus of the trust when they transferred the securities to the trust upon two separate grounds. First, the McEwens reserved the right to control the disposition of the trust corpus by revocation, termination, or modification of the trust during their lifetimes. Upon the revocation of the trust, the trust assets would have vested in the McEwens as tenants by the entirety. Although the trustee held the legal title to the trust property, the trustee held no beneficial interest therein. Second, the court reasoned that the McEwens held an actual property interest in the trust — an equitable ownership in the trust corpus — which was subject to the TBE interest. The Pennsylvania court noted that the early judicial concept considered a beneficiary as merely holding an in personam right in the trust — a right of action only against the trustee. The beneficiary did not own a property interest in the trust. The modern trend recognizes that the beneficiary has both the right of action against the trustee and an actual property interest in the trust — an equitable ownership in the trust corpus. The McEwens owned this equitable ownership interest as tenants by the entirety.

As in *McEwen,* Florida recognizes that a beneficiary of a trust owns equitable title in the trust property. *Barnett Nat. Bank of Jacksonville, et al. v. Murrey,* 49 So. 2d 535 (Fla. 1950), involved a challenge to a trust by the son of the settlor. One issue on appeal was whether the beneficiary son had to renounce his interest in the trust before filing his lawsuit. The trust corpus consisted of corporate stock. The son claimed that he was not required to renounce his interest in the trust because he had no legal title in the trust property (the corporate stock), but only an equity therein.

The Florida Supreme Court held that the trust vested legal title in the stock to the trustee, but the beneficiary held equitable title in the stock. The court found that the vested equitable title was property that could be alienated and subject to the claims of the beneficiary's creditors. Based on this property right, the beneficiary was required to renounce his interest in the trust, prior to filing the action challenging the trust.[6]

Like *McEwen,* Florida also recognizes the TBE property interest in a trust when the husband and wife retain the right to control the disposition of TBE property held by a trust. In *Passalino v. Protective Group Securities, Inc.,* 886 So. 2d 295 (Fla. 4th DCA 2004), the husband and wife sold property they held as tenants by the entirety and transferred the sale proceeds to their attorney's trust account. The creditor of the husband filed a writ of garnishment against the attorney's trust account claiming that the transfer of the sale proceeds to the trust account terminated the TBE interest because the couple no longer held the unity of title or possession. The creditor argued that the attorney was in possession of the funds and that he was the only person with the authority to sign on the trust account.

The Fourth District Court of Appeals disagreed and specifically held that the transfer of the TBE property to the trust account did not terminate the unities of title or possession:

> Transferring the proceeds of the sale of an entireties property to a trustee for the benefit of the husband and wife does not terminate the unities of title or possession, where the parties clearly intended their property to be held as tenancy by the entireties by exercising beneficial ownership of the property and controlling the property's disposition.[7]
>
> Therefore, the transfer of TBE property to a trust does not terminate the unity of title, especially when the husband and wife retain the power to amend, revoke, or terminate the trust.

• *The Unity of Possession* — Even though the TBE property interest is nonseverable and indivisible, a trust may provide a power in the trustee to remove assets from the trust as agent for the husband and wife without jeopardizing the TBE interest held by the trust.[8]

The transfer of TBE property to a trust in which one spouse is given the sole power to control the trust property may destroy the unity of possession and terminate the TBE character of the property.[9]

Nevertheless, *Passalino* makes it clear that *Rollins v. Alvarez,* 792 So. 2d 695 (Fla. 5th DCA 2001) (and therefore, *Quaid v. Baybook Home of Polk County, LLC et al.,* 2011 WL 5572605 (M.D. Fla. 2011)), is limited to trusts in which only one spouse has the power to control the trust.

In *Rollins*, a husband and wife funded an inter vivos trust with marital property. The wife transferred her interest in the property to the trust, on which her husband had sole control over the funds and had authority to amend, modify, or revoke the trust. The husband executed amendments changing the beneficiaries...

Although not in issue, in a footnote the district court stated, "There is no dispute that the effect of this transfer to the trustee destroyed any tenancy by the entireties that may have existed in the property pre-transfer. See *Hunt v. Covington,* 145 Fla. 706, 200 So. 76 (1941); 12 Fla. Jur. 2d Cotenancy and Partition 29 (1998)." 792 So. 2d at 696 n. 2.

Appellants suggested that *Rollins* stands for the proposition that a transfer to a trustee of entireties property in and of itself terminates the entireties. We disagree with this interpretation. *Rollins* ['] citation to *Hunt* is instructive. In *Hunt*, a husband's conveyance of properties to his wife terminated his interest in the property and, thus, the entireties character of the property. Likewise, in *Rollins* the wife's transfer of marital property to the trust in which her husband maintained sole control and could direct the disposition of property terminated the entireties character of property. In other words, the unities of possession and interest were terminated, because the wife no longer exercised control over the property.[10]

Thus, when the married couple retains the power to control the trust by direction, revocation, or modification, the unity of possession is not terminated by the transfer of the TBE property to the trust. In order to maintain the unity of possession, the trust should require the consent of both spouses to amend, terminate, or revoke the trust. Therefore, the trust agreement and any power of attorney relating to the trust should authorize the agent to consent to a trust amendment, termination, or revocation.[11]

• *The Unity of Time* — The unity of time can be easily met as well. The amendment of a separate trust to a TBE trust may not meet the unity of time. Instead, a new trust should be formed. Furthermore, it may be prudent to establish the TBE interest prior to transferring the asset into the trust. However, conceptually, this should not be necessary as the transfers of separate property to a TBE trust by a spouse is governed by the instrument and intent to create the TBE interest.[12]

Therefore, if the TBE trust provides that it is the intent for all property transferred to the trust be held as TBE property, it is the trust instrument and transfer that creates the tenancy interest, satisfying the unity of time.

Does the Florida Trust Code Prevent a Trust from Holding TBE Property?

Having established that under common law, TBE interests can be created in trusts, does the trust code abrogate this common law doctrine?

• *The Florida Trust Code is Silent as to the Treatment of TBE Property — Hector Supply* and the other Supreme Court cases addressing continued viability of TBE property in the wake of the statutory and constitutional provisions granting married women the right to own property individually looked to whether the legislation intended to abate or modify the common law TBE doctrine.

The Florida trust code does not specifically address tenancy by the entirety property interests in trusts, nor does it appear that the Florida trust code intended to modify the common law relating to the ownership of TBE property by a trust. In fact, F.S. §736.0106 states that "[t]he common law of trusts and principles of equity supplement this code, except to the extent modified by this code or another law of this state."

With that in mind, a few of the other Florida trust code provisions must be examined.

F.S. §736.05053(1) and the Duty of a Trustee to Pay the Expenses of the Estate — F.S. §736.05053(1) provides that a trustee of a trust described in F.S. §733.707(3) shall pay to the personal representative of a settlor's estate the amounts that the personal representative certifies in writing are required to pay the expenses of administration and obligations of the settlor's estate.

F.S. §733.707(3) states that any portion of a trust to which a grantor decedent, at the time of the decedent's death, has a right to amend, revoke, withdraw, or appoint, either alone or in conjunction with any other person, is liable for the expenses of the administration and obligations of the decedent's estate to the extent the decedent's estate is insufficient to pay them as provided in F.S. §733.607(2).

These provisions seem to expose the entire trust corpus of a TBE trust to a deceased spouse's estate administrative expenses and creditor claims. However, F.S. §733.707(3)(d) precludes exempt property from the reach of the probate estate. Therefore, it does not appear that the statute is intended to turn an exempt asset, such as a TBE property, into a nonexempt asset.

Nevertheless, the trust drafter should avoid language directing the trustee to pay the estate administrative expenses or creditors of the first spouse to die. This could be deemed a waiver of the statutory exception or assent by both spouses for the payment of such claims.[13]

• *F.S. §736.0505(1): The Liability of a Settlor to His or Her Creditors* — Florida does not exempt self-settled trusts from the reach of the settlor's creditors. F.S. §736.0505(1)(a) provides that assets of a self-settled trust are subject to the claims of creditors to the extent the property would not be otherwise exempt by law if owned directly by the settlor.

F.S. §736.0103(16) defines a settlor to mean a person who creates or contributes property to a trust. If more than one person creates or contributes property to a trust, each person is a settlor of the proportion attributable to that person's contribution except to the extent another person has the power to revoke or withdraw that portion. This definition is simply a restatement of the generally accepted common law of trusts.[14] Because the husband and wife are considered "one in law" and hold the property as a single moiety, together they are the "settlor" of the TBE trust. Since the TBE property held by the trust would be exempt if owned by them directly, the TBE trust property remains exempt from the creditors of either the husband or the wife. Based on the above, the Florida trust code does not expressly or by implication abrogate the common law to prevent a trust from holding TBE property with its creditor claim protection.

Surviving Spouse of a TBE Trust Can Disclaim TBE Interest to a Tax Credit Shelter Trust

Based on the current federal estate tax exemption of $11.7 million (plus indexing) for each spouse and portability, a married couple can transfer more than $23 million of TBE property first to the surviving spouse, then their children free of federal estate tax consequences. No separate trust is needed. Nevertheless, the estate tax picture is always unpredictable. To protect the married couple from future estate tax changes, the TBE trust can provide the surviving spouse with the right to disclaim all or part of the deceased spouse's estate tax imputed one-half interest in the TBE trust property. The TBE trust could provide that the disclaimed interest be allocated to a tax credit shelter trust so that the disclaimed interest will not be part of the surviving spouse's estate and continue creditor protection on the disclaimed portion. Further, probate continues to be avoided.

Conclusion

A married couple can transfer TBE property to a trust that provides the couple with both the benefits of a trust and creditor protection. If federal (or other) estate taxes need to be addressed, the surviving spouse can be provided with a right to disclaim his or her interest in the TBE trust to be allocated to a tax credit shelter trust. With the estate tax exemption of $11.7 million (plus indexing) and the portability option, the TBE trust is certainly a viable estate planning tool for a married couple.

Endnotes:

[1] *Winters v. Park,* 91 So. 2d 651 (Fla. 1956); *Beal Bank, SSB v. Almand and Associates,* 780 So. 2d 45 (Fla. 2001); *First Nat'l Bank v. Hector Supply Co.,* 254 So. 2d 777 (Fla. 1971).
[2] William Blackstone, 2 Commentaries on the Laws of England 179 (9th ed. 1783).
[3] *English v. English,* 63 So. 822 (Fla. 1913); *Hagerty v. Hagerty,* 52 So. 2d 432 (Fla. 1957); *Bailey v. Smith,* 103 So. 833 (Fla. 1925); *In re Lyons' Estate,* 90 So. 2d 39 (Fla. 1956); *Hector Supply,* 254 So. 2d 777.
[4] *Beal Bank,* 780 So. 2d at 60.
[5] *Matthews v. McCain,* 170 So. 323, 325 (Fla. 1936).
[6] See also *Miller v. Kresser,* 34 So. 3d 172 (Fla. 4th DCA 2010) (the trustee holds legal title in the trust and the beneficiary the equitable title).
[7] *Passalino,* 886 So. 2d at 297.
[8] See *Haggerty,* 52 So. 2d 432; *Hector Supply,* 254 So. 2d 777; and *Beal Bank,* 780 So. 2d 45.
[9] *Rollins v. Alvarez,* 792 So. 2d 695 (Fla. 5th DCA 2001); *Quaid v. Baybook Home of Polk County, LLC et al.,* 2011 WL 5572605 (M.D. Fla. 2011).
[10] *Passalino v. Protective Group Securities, Inc.,* 886 So. 2d 295, 297-8 (Fla. 4th DCA 2004).
[11] Fla. Stat. §702.2202(1)(b); Fla. Stat. §736.0602(5).
[**12**] See *Haggerty,* 52 So. 2d 432.
[13] *Morey v. Everbank,* 93 So. 3d 482 (Fla. 1st DCA 2012).
[14] *Rollins*, 792 So. 2d at 696.

Notwithstanding that there appears to be over a 99% confidence level that a Joint Revocable Trust can be a tenancy by the entireties asset, would it not be safer to have assets held under a limited liability company owned as tenants by the entireties, with a pay on death provision in the limited liability company Operating Agreement to provide that unless the surviving spouse otherwise designates, the LLC will be owned by the Revocable Trust on the second death? This avoids probate and also gives a higher level of assurance as to exemption.

MORE ABOUT JOINT TRUSTS.

The following discussion focuses primarily upon joint trusts that will not qualify as tenancy by the entireties. Clients and advisors must weigh the advantages and disadvantages of tax and inheritance protection against creditor protection considerations. Oftentimes, a non-TBE trust or trusts will be used in conjunction with other creditor protection planning mechanisms, such as by having a non-TBE joint revocable trust own a percentage of a limited liability company that would qualify for charging order protection.

The Internal Revenue Service has promulgated Private Letter Rulings which generally confirm that a joint trust held by a non-community property couple can be structured to have all of the assets held under such a joint trust used to fund the By-Pass Trust on the first death to the extent necessary to fully use the first dying spouse's full estate tax exemption. The authors believe that it is possible for the ownership of a joint trust interest to qualify as a tenants by the entireties asset, as described above and below, but special drafting and implementation is necessary, and most joint trusts will not qualify.[74]

[74] See *Leimberg Services Archive Message #243 – JOINT TRUSTS: A SECOND (AND CLOSER) LOOK*, January 31, 2001.

Advisors interested in the use of joint and single revocable trusts for estate planning purposes should realize that they typically do not provide creditor protection during the lifetime of the grantors, as further described below.[75]

Important Note: The following article was written *before* the literature on the "JEST" (joint exempt step-up trust), which fits under category 5) below, but provides greater income tax benefits, as described in the subsequent article:

SELECTING REVOCABLE TRUST SYSTEMS FOR CLIENTS

By Alan S. Gassman, Christopher J. Denicolo, and Kristen O. Sweeney

Reprinted with permission from Leimberg Information Services 02-Apr-09

Steve Leimberg's Estate Planning Newsletter – Archive Message #1439

NOTE – The below article was drafted before the "invention" of the Joint Exempt Step-Up Trust ("JEST" Trust), which is discussed in the next article, and will not qualify as a tenancy by the entireties trust

EXECUTIVE SUMMARY:

Advisors have a wide variety of revocable trusts at their disposal, and there are a number of important factors that must be carefully considered. This commentary will review:

(1) "Protective Beneficiary" Trusts,
(2) "All to Survivor" Joint Trusts,
(3) "First Death Lock-Up" Trusts,
(4) "Separate Trust for Each Spouse" Trusts,
(5) "Joint 100% Lock-Up" Trusts, and
(6) "Joint 50% Lock-Up" Trusts

FACTS:

Many estate plans involve revocable trusts, and selection and implementation of an appropriate plan is more of an art than a science.

Factors that should be considered when selecting a revocable trust system include:

1) Whether a surviving spouse or beneficiary should have total control or protective advantages that may be available;
2) Whether income tax savings for a surviving spouse may be desirable, and
3) What assets and beneficiary designation situations the client may have.

NOTE: Revocable trusts can be used to avoid probate and guardianship, but during the lifetime of the grantor, who establishes and owns the trust, there is no creditor protection, Medicaid protection, or income or estate tax savings. After death, such protections and savings may apply, depending on the revocable trust system selected.

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[75] For more information on joint trusts, see *Leimberg Information Services Newsletter #1439*, published April 2, 2009; *Leimberg Information Services Newsletter #2086*, published April 3, 2013, both of which are reproduced here.

COMMENT:

CONSIDERATIONS FOR A SINGLE INDIVIDUAL

Many unmarried individuals establish and maintain revocable trusts primarily to avoid probate and guardianship of their estate. Probate is the process whereby assets owned in individual names must be processed through the Probate Court System, in order to ensure that:

1) The proper Will has been identified and approved,
2) Accountings are received by the beneficiaries,
3) Creditors are paid, and
4) A fiduciary is appointed as personal representative to execute and monitor all of the above.

Many clients choose to bypass the "red tape" and expenses associated with the probate system by placing their assets under a revocable trust. Immediately upon its formation, the trust is controlled and administered by a non-court appointed relative, friend, professional or trust company.

Life insurance, annuities, and even pension benefits can be paid to the revocable trust upon death to facilitate the uniform distribution of assets. For pension plan purposes, it may be advantageous to instead name individuals who are able to withdraw the pension benefits out of an inherited IRA ratably over their life expectancy. Such ratable withdrawals may also apply under an appropriately drafted revocable trust agreement, but special technical language and planning is required to effectuate this.

Some clients choose to place their homestead under a revocable trust, which does have certain advantages. For instance, in Florida, as long as the client is alive, the homestead can qualify for the Florida $50,000 homestead exemption and the 3% cap on increases in value.

However, placing the homestead under a revocable trust also presents a potential *danger* from creditors. There is one bankruptcy court decision which has indicated that *the constitutional protection of homestead from creditors will not apply when the homestead is owned under a revocable trust.*

While other bankruptcy court decisions have not found this to be the case, our office generally suggests the more conservative approach of leaving the homestead *outside of* the revocable trust.

Clients who still wish to avoid probate of their homestead may be able to use a "Lady Bird Deed," which maintains creditor protection while still avoiding probate.

PROTECTIVE BENEFICIARY TRUSTS

A revocable trust will commonly provide that upon the death of the client, the trust assets will divide into separate protective trusts for any children or other beneficiaries. Each child or other beneficiary may serve as sole or co-trustee for his or her benefit, and receive amounts deemed reasonably appropriate to maintain his or her standard of living as well as to benefit his or her children.

The advantages of such a continuing trust include protection from:

1) Estate tax at the child's level,
2) Creditor and divorce claims that the child might have in the future, and

3) Inappropriate or risky spending and investments, which may be curtailed by mandating that the child serve with a co-trustee; i.e., a trusted relative, family friend, professional, or trust company.

REVOCABLE TRUST SYSTEMS FOR MARRIED COUPLES

Revocable trusts for married couples incorporate the above principles, but married couples have a number of configurations to choose from:

"ALL TO SURVIVOR" JOINT TRUST

The simple "All to Survivor" joint revocable trust. A married couple who would typically own their assets jointly with right of survivorship may prefer to use a revocable trust in order to facilitate avoiding probate upon the second death, and avoiding guardianship over trust assets if a spouse is declared by a court to be competent.

Although most couples who would use right of survivorship as their primary estate plan can simply have assets pass by Will on second death, using an All to Survivor Joint Trust assures that there would be a revocable trust in place after the first death. The All to Survivor Joint Trust eliminates the surviving spouse's need to engage in estate planning and decision-making regarding the use of a revocable trust after the first death.

NOTE: Clients should be careful to confirm that the joint revocable trust with survivorship can be considered to be a tenancy by the entireties ownership vehicle for the married couple.

Under Florida law joint assets held as tenants by the entireties between a husband and wife are not subject to the creditor claims of an *individual* spouse, unless *both* spouses owe the creditor. This is a very good reason to keep assets jointly as tenants by the entireties where spouses are creditor exposed.

Most joint revocable trust forms used by lawyers will not qualify the trust assets to be considered as held by tenancy by the entireties, but with proper drafting this can be accomplished.

"FIRST DEATH LOCK-UP TRUSTS"

There are several good reasons that a married couple might wish to have some or all of their assets "locked up" in a protective trust upon the first death, including:

1) Avoidance of federal estate tax upon the second death.
2) Creditor protection for the surviving spouse upon the first death.
3) Securing a Co-Trustee for the surviving spouse to help prevent loss of assets to undue influence, poor investments, or unwise distributions or loans to friends or family members. The surviving spouse can serve as Co-Trustee with the power to select and replace the other Co-Trustee, and can receive benefits as needed for the spouse and descendants.

The "All to Survivor" Joint Trust described above will not provide these protections. Therefore, the married couple wishing to have the protections provided by a "Lock-Up Trust" may choose one of the following three revocable trust systems:

1) "SEPARATE TRUST FOR EACH SPOUSE" TRUST SYSTEM
2) COMPLEX JOINT TRUST: "JOINT 100% LOCK-UP" TRUST SYSTEM
3) COMPLEX JOINT TRUST: "JOINT 50% LOCK-UP" TRUST SYSTEM

These three trust systems are described in more detail below:

"SEPARATE TRUST FOR EACH SPOUSE" TRUST SYSTEM

Each spouse will have a separate trust that "locks up" upon the first death to benefit the surviving spouse with those assets held by such trust and those assets made payable to the trust by beneficiary designation.

The "Separate Trust for Each Spouse" system is the most popular, and traditionally has been the only revocable trust system used by most estate planning lawyers. In this system, a "bypass trust" or "family trust" can be established upon the first death to be held for the surviving spouse without the assets under such trust being subject to federal estate tax, creditor claims of the surviving spouse, or claims of the future spouses and the descendants of future spouses.

Most of the married couple trust work that our office performs uses the Separate Trust for Each Spouse trust system with separate trusts for each spouse, but there are other alternatives.

"COMPLEX JOINT LOCK-UP" ALL ASSETS

Clients who may instead be better suited for a "Complex Joint Trust" would typically have one or more of the following characteristics:

1) Clients who prefer a simpler plan with assets under one trust as opposed to two.

2) Clients who wish to "lock up" more than the assets of the first dying spouse upon the first death (which is the case under the Separate Trust for Each Spouse trust system). The surviving spouse would become Co-Trustee of the trust holding these assets. Similar to the Separate Trust for Each Spouse trust system, these assets are held without being subject to federal estate tax, creditor claims of the surviving spouse, or claims of future spouses and the descendants of future spouses.

3) Clients who have had an All to Survivor Joint Trust in the past and do not wish to retitle to separate revocable trusts when updating their planning.

As stated above, clients who elect to have a Complex Joint Trust may choose between a "JOINT 100% LOCK-UP" trust system and a "JOINT 50% LOCK-UP" trust system.

Most wealthy clients who use a revocable trust system choose a "JOINT 100% LOCK-UP" trust system in order to achieve the following:

1) The ability to claim a "stepped up" basis for income tax planning purposes on all assets held under the joint revocable trust. For example, a stock purchased for $200 that's worth $1,100 with capital gains tax only owed on $100 worth. With a typical joint revocable (ATS) trust there is only a "step up" for half of the value upon death,

so the capital gains tax would be based upon the excess of $1,100 over $100, plus $500.

2) The ability to "lock up" as much in assets as possible to avoid estate tax upon the second death. For example, a married couple with good earnings may have $4,000,000 worth of assets and may wish to lock up a full $3,500,000 worth of assets in a bypass trust upon the first death, with the expectation that the surviving spouse will have future earnings and the possibility that the estate tax exemption will be reduced in the future.

The Joint 100% Lock-Up Trust has special design features that allow the trust assets to be considered for federal income and estate tax purposes to have passed from the first dying spouse into the surviving spouse's trust upon the first death.

This is done by giving each spouse the right to execute a separate document directly how the trust assets would pass if that spouse was to die first. To ensure that the first dying spouse does not appoint assets to somebody other than the surviving spouse or the Joint 100% Lock-Up Trust, the tax law permits the appointment of "Trust Protectors," who have the power to disapprove any exercise of such "power of appointment" by the first dying spouse.

For example, a husband and wife could appoint one or two close family friends or advisors as Trust Protectors under the trust. Their sole function would be to have the power to disapprove either spouse's decision to direct assets anywhere besides the Joint 100% Lock-Up Trust or the surviving spouse, unless the surviving spouse also approves of such direction of assets.

The tax law does permit the entire Joint 100% Lock-Up trust to be held upon the first death for the surviving spouse, without being subject to federal estate tax upon the surviving spouse's death. The tax law is not clear on whether all the assets of the trust receive a "stepped up" basis upon the first death.

Many tax commentators, myself included, believe that *all* assets inside a revocable trust should receive the "stepped up" basis. But the IRS has disagreed.

"JOINT 50% LOCK-UP" TRUST SYSTEM

The other Complex Joint Trust that can be used for estate tax and/or protective trust planning would be the "JOINT 50% LOCK-UP TRUST." This is a simpler document than the Joint 100% Lock-Up Trust, but only allows the lock-up of 50% of the assets of the couple upon the first death.

The Joint 50% Lock-Up Trust does provide a "stepped up" income tax basis for the 50% of the assets that are locked up, but there is no stepped up basis for the other 50% of the assets. Under the Joint 50% Lock-Up Trust, the spouse who dies first cannot override the mutually agreed trust document, as he or she could under the Joint 100% Lock-Up Trust system, and therefore the language used in the trust document is not as complicated.

BE SURE TO CONSIDER MEDICAID ISSUES:

Medicaid planning for a married couple adds one more twist to revocable trust structuring. Unfortunately, the Medicaid regulations provide that assets passing by revocable trust into a protective trust for a surviving spouse can qualify, unless such assets have passed through the probate estate of the first dying spouse.

We may therefore suggest that clients who wish to help ensure that their spouse will qualify for Medicaid without using trust assets place the assets in their personal names, to pass into a revocable trust system by a "Pour Over Will" upon the first death.

PLANNING TIPS:

Obviously, revocable trust planning is varied and complex. We hope that this commentary will open up planning opportunities, as well as common configurations, to clients and advisors.

As with most estate planning techniques, "one size does not fit all." It is best to structure a joint trust (or any trust for that matter) that is appropriate for the client's needs and circumstances.

An article on the Joint Exempt Step-Up Trust ("JEST") is as follows:

IT'S JUST A JEST, THE JOINT EXEMPT STEP-UP TRUST
By: Alan Gassman, Thomas Ellwanger & Kacie Hohnadell
Reprinted with permission from Leimberg Information Services 03-Apr-13
Steve Leimberg's Estate Planning Newsletter – Archive Message #086

"There are two primary concerns that arise when dealing with joint trusts in non-community property states: 1) whether, upon the first dying spouse's death, all joint trust assets (including those contributed by the surviving spouse) can be used to fund a credit shelter trust for the benefit of the surviving spouse without later being included in the surviving spouse's estate, and 2) whether, upon the first dying spouse's death, it is possible to obtain a step-up in basis for all trust assets, no matter which spouse contributed them to the trust.

After extensively researching these issues and reviewing alternative structures, we have designed a joint trust planning technique, entitled the 'Joint Exempt Step-Up Trust (JEST).' The JEST should allow a married couple in a common law state to make maximum use of the first dying spouse's unused estate tax exemption by fully funding a credit shelter trust upon the first dying spouse's death, even if this requires using assets contributed by the surviving spouse. We also believe that with proper structuring, the joint trust can provide a full step-up in basis for all of the trust assets.

Although not without risk or some uncertainties, clients who want a stepped up basis for all 'joint' assets, and to maximize use of credit shelter trust funding on the first death should have the opportunity to consider this strategy. While the risks herein described do exist, there is also the risk that the family will ask the planner why these techniques were not used to avoid capital gains taxes and facilitate making full use of the first dying spouse's estate tax exemption amount. *Practitioners will have to invest significant time to understand issues, to develop trust documents that take the above and many other considerations into account, and make sure that clients understand the risks and possible advantages of the system."*

Now, Alan Gassman, Tom Ellwanger and Kacie Hohnadell provide members with their commentary on the Joint Exempt Step-Up Trust. The authors sincerely thank Howard Zaritsky, Michael Mulligan, John Meier, Christopher J. Denicolo and Kenneth J. Crotty for words of wisdom and contributions made in prior literature, and for their input on previous editions of this article.

EXECUTIVE SUMMARY:

Many legal scholars and practitioners have considered whether a married couple living in a non-community property state can contribute assets to a joint trust, which upon the first spouse's death would be used to fund a credit shelter trust and to facilitate a full step-up in basis. LISI commentators Alan Gassman, Tom Ellwanger and Kacie Hohnadell analyze the many issues that arise with respect to joint trusts, and present an innovative joint trust design strategy that can be used to avoid or reduce issues at hand. In addition to letting members in on this new innovative technique, this letter describes a number of interesting concepts that relate to joint trust planning and also concepts that related to joint trust planning and its impact upon estate tax, gift tax, and creditor protection objectives.

FACTS:

There are two primary concerns that arise when dealing with joint trusts in non-community property states: 1) whether, upon the first dying spouse's death, all joint trust assets (including those contributed by the surviving spouse) can be used to fund a credit shelter trust for the benefit of the surviving spouse without later being included in the surviving spouse's estate, and 2) whether, upon the first dying spouse's death, it is possible to obtain a step-up in basis for all trust assets, no matter which spouse contributed them to the trust.

After extensively researching these issues and reviewing alternative structures, we have designed a joint trust planning technique, entitled the "Joint Exempt Step-Up Trust (JEST)." The JEST should allow a married couple in a common law state to make maximum use of the first dying spouse's unused estate tax exemption by fully funding a credit shelter trust upon the first dying spouse's death, even if this requires using assets contributed by the surviving spouse. We also believe that with proper structuring, the joint trust can provide a full step-up in basis for all of the trust assets. This technique is clearly explained in our JEST chart that can be found at www.gassmanlaw.com/articles-symposiums.

The basic structure of the JEST is as follows: a married couple funds a jointly established revocable trust, with each spouse owning a separate equal share in the trust. Either spouse may terminate the trust while both are living, in which case the trustee distributes 50% of the assets back to each spouse. If there is no termination, the joint trust becomes irrevocable when the first spouse dies.

Upon that first death, the assets of the first dying spouse's share will be applied this way:

1) First, assets equal in value to the first dying spouse's unused estate tax exemption will be used to fund **Credit Shelter Trust A** for the benefit of the surviving spouse and descendants. These assets will receive a stepped-up basis and will escape estate tax liability upon the surviving spouse's death.

2) Second, if the first dying spouse's share exceeds his or her unused exemption, then the excess amount of that share will be used to fund **Q-TIP Trust A** for the benefit of the surviving spouse and descendants. The assets will avoid estate tax because of the marital deduction. They will receive a stepped-up basis on the first dying spouse's death, and again on the surviving spouse's death, at which time they will be potentially subjected to estate tax.

If the first dying spouse's share is less than his or her exemption amount, then the surviving spouse's share will be used to fund **Credit Shelter Trust B** with assets equal to the excess exemption amount. We believe that the assets of Credit Shelter Trust B should avoid estate taxation at the surviving spouse's death, although the surviving spouse originally contributed these assets to the JEST.

We also believe that the assets of **Credit Shelter Trust B** should receive a full stepped-up basis at the first death. IRS opposition on this issue can be expected, at least for the time being, but how this trust is structured may help obtain a favorable result.

Finally, the remainder of the surviving spouse's share (if any) will be used to fund **Q-TIP Trust B**, under which the surviving spouse will be at least an income beneficiary. We believe that there is a good chance that these assets will also get a basis step-up if the surviving spouse retains only the right to receive income; again we think more rights for the surviving spouse will somewhat lessen the chance of that result.

The tax and other issues raised by this technique are further discussed below.

COMMENT:

Over the last 20 years, the IRS has issued five significant rulings touching on joint trust arrangements, three private letter rulings and a TAM.[76]

The first was TAM 9308002, which was issued in 1992. The facts indicated that both spouses funded a joint revocable trust, which granted each spouse a general power of appointment over the entire trust in the form of a right to direct payment of his or her debts and taxes from any of the trust assets. The IRS determined that all trust assets were included in the first dying spouse's estate under IRC Section 2041. However, the IRS ruled that assets contributed by the surviving spouse were in effect gifted to the first dying spouse upon the spouse's death; since those assets passed back to the surviving

[76] See PLRs 200101021, 200210051, 200403094, and TAM 9308002.

spouse within one year, those assets could not receive a basis step-up because of IRC Section 1014(e).

PLRs 200101021 and 200210051 addressed the same issues. In both PLRs, married couples formed joint revocable trusts. In one ruling, each spouse had a lifetime power to withdraw the income and principal; in the other, the first-to-die spouse was given a testamentary general power of appointment over the entire trust. In both rulings, upon the first spouse's death, the assets of the joint trust were used first to fund a credit shelter trust (in the amount of the first dying spouse's unused exemption) for the surviving spouse's benefit. Both PLRs made the following determinations:

- All of the joint trust assets were included in the first dying spouse's estate. The assets contributed by the first dying spouse were included under IRC Section 2038; the assets contributed by the surviving spouse were included under IRC Section 2041.

- Upon the death of the first dying spouse, the surviving spouse made a completed gift to the first dying spouse of the assets contributed by the surviving spouse. The gift qualified for the gift tax marital deduction.

- Because of Section 1014(e), only the assets contributed by the first dying spouse could receive a step-up in basis.

PLR 200403094 addressed similar issues in a slightly different context. Rather than a joint trust, the ruling dealt with a revocable trust to be created and funded by a husband. If the wife died first, the trust agreement provided her with a testamentary general power of appointment over trust assets equal in value to her remaining exemption, less her own assets. In that case, the wife will exercise the power by appointing assets to set up a credit shelter trust for the husband's benefit. The IRS ruled as follows:

1) The husband's creation of the power of appointment would constitute a gift to the wife which would be considered completed at her death if she died before him. The gift from him would qualify for the gift tax marital deduction.

2) If the wife died first, assets contributed by the husband to the trust but appointed by the wife to a credit shelter trust for the husband would not be included in the husband's estate for estate tax purposes at his later death.

No basis issue was discussed.

PLR 201429009, released on July 18, 2014, addresses a husband and wife who created a joint revocable trust and who contributed their joint property to the trust. The trust instrument, however, provided that each of them held their interests in the trust as "tenants in common" and not as joint tenants. After the wife's death, the trustee was to divide the joint trust into a Family Trust and a Survivor's Trust and the husband was to retain the power to withdraw the greater of $5,000 or 5% of the value of the Family Trust per year (commonly referred to as a "5 or 5" power). When the husband died sometime later, the executors of his estate requested that the Family Trust not be included in the estate. The IRS determined "that the value of the assets of [the] Family Trust [were] not includible in the gross estate of [the husband], with the exception of the value of the 5 or 5 Power held by [the husband] at his death."

These rulings sparked renewed interest in using joint trusts as a way to make sure that both estate tax exemptions of a married couple would be fully used, without having to split up assets and set up a living trust for each spouse. Although no ruling allowed a total basis step-up for the marital property at the first death, there was speculation about weaknesses in the IRS arguments on that point and potential ways to rebut those arguments.

However, some commentators have expressed concern about the favorable results of the rulings, none of which has any value as precedent. The estate tax laws at the time of the rulings did not give a surviving spouse the benefit of any exemption not used by the first spouse to die – i.e., there was no portability. Thus, the commentators pointed out, the IRS was being lenient in these rulings so as to permit a simpler way to achieve basic estate tax savings. But the IRS was not giving the comfort of a Revenue Ruling, which practitioners could rely upon, meaning that it could change its position on some or all of the favorable decisions in the rulings.

After extensively reviewing these issues, we believe that our JEST technique can be used to maximize the use of both spouse's estate tax exemptions, as well as setting up a situation to provide the best possible arguments in favor of getting a total basis step-up on all assets at first death. Nevertheless, because it is an area without binding precedent, any practitioner should carefully consider the concerns that commentators have raised. Where practitioners (or clients) are particularly risk-averse, thought might be given to getting an IRS ruling.

Using a joint trust arrangement can complicate creditor protection aspects of trusts. Throughout this article we touch on that issue.

Below, we provide an in-depth explanation of the "mechanics" of the JEST and discuss the various issues surrounding this technique.

JEST Creation

In implementing the JEST, the married couple first establishes a joint revocable trust. Each spouse will have a separate share consisting of any assets contributed to the trust by that spouse. To avoid having to retitle assets, pre-existing revocable trusts can become separate shares of the joint revocable trust by amendment and restatement.

The trust agreement will give each spouse an equal share of the trust assets. While both spouses are living, either spouse can revoke the agreement and terminate the trust, in which case the trustee will transfer the trust assets back to the spouses in equal shares.

Unequal funding of the trust raises the possibility of a gift on funding. A spouse who contributes more than 50% of the assets but only has the power to get back 50% in a unilateral termination has presumably made a completed gift of the difference. Transferring property held in a tenancy by the entireties would result in such a gift if, as is generally the case, the tenancy can only be severed by joint action of the parties. The severance occurring when entireties property is added to the trust would be a gift by the younger spouse, who has a greater actuarial interest in the property.[77]

Estate planning attorney, Michael Mulligan, has suggested that any gift on funding is incomplete until the first death, whether or not a spouse can terminate the trust and take back assets. He states that "[u]nder the laws of most states, the retained right to distributions of income and principal would cause any contribution by a beneficiary to the trust to remain subject to claims of the beneficiary's creditors. If applicable state law permits a settlor's creditors to reach property conveyed to a trust, such conveyance does not constitute a gift for Federal gift tax purposes."[78]

If a gift on funding does occur, so long as both spouses are U.S. citizens, one might assume that the gift tax marital deduction should eliminate tax concerns (unless a spouse is a non-citizen, where the marital deduction does not apply). This is the position the IRS has taken in the rulings. However, as discussed below, questions have

[77] See IRS Reg. Section 25.2511-2(c). In PLR 200101021, the IRS held that the contribution of tenants by the entireties assets to a joint trust did not constitute a gift by either spouse under this regulation, because each spouse retained the right, acting unilaterally, to revoke his or her transfer and revest title in himself or herself, rendering the gift incomplete. Much as we like the result, we think it ignores the actuarial difference between the interests of the spouses.

[78] Michael D. Mulligan, *Is It Safe to Use a Power of Appointment in Predeceasing Spouse to Avoid Wasting Applicable Exclusion Amount?* 23 Tax Mgmt. Fin. Plan. J (Sept. 18, 2007).

been raised by commentators as to whether the IRS is correct in applying the marital deduction in this situation.

Mr. Mulligan's comment as to funding touches on another issue. Holding properties in tenancy by the entireties usually provides creditor protection because the properties can only be reached by creditors with a claim against both spouses. Tenancy by the entireties property transferred into a joint trust will lose the entireties status and this creditor protection unless (1) the joint trust satisfies all unities required by tenancy by the entireties law (which will not be the case with a JEST), or (2) the governing law explicitly provides that trust assets can be designated by a married couple to be treated as tenancy by the entireties property, even if the unities are not satisfied. Delaware, Virginia, Hawaii and Illinois are examples of jurisdictions having such statutes.

When the First Death Occurs

Upon the first dying spouse's death, the joint trust becomes irrevocable. The trust assets are still in two equal shares – one attributable to the first dying spouse, and one attributable to the surviving spouse. We will assume that the first dying spouse has not exercised his or her general power of appointment.

Assets of the first dying spouse's share equal in value to the first dying spouse's unused estate tax exemption will be used to fund **Credit Shelter Trust A** for the benefit of the surviving spouse and descendants (or surviving spouse, then descendants). If the first dying spouse's share exceeds his or her unused exemption, then the excess amount can be used to fund **Q-TIP Trust A** for the lifetime benefit of the surviving spouse, and later for the couple's descendants.

All of these assets receive a stepped-up basis at the first death, unless they were gifted to the first dying spouse by the surviving spouse within a year before the first dying spouse's death, when IRC Section 1014(e) denies the step-up.

Turning to the surviving spouse's share, if the first dying spouse's share is less than the first dying spouse's exemption amount, then the surviving spouse's share is used in **Credit Shelter Trust B**. Like **Credit Shelter Trust A**, this can be for the benefit of the surviving spouse and descendants (or the surviving spouse, then descendants), although including the spouse as a beneficiary may imperil getting a basis step-up for these assets at the first death.

If there are assets remaining in the surviving spouse's share after fully funding **Credit Shelter Trust B**, the remainder of the surviving spouse's assets will be used to fund **Q-TIP Trust B**, with the surviving spouse as lifetime beneficiary and the descendants as remainder beneficiaries. Again, the extent of the surviving spouse's interest may affect the basis argument.

The results of this technique are as follows:

Credit Shelter Trust A.

The assets of **Credit Shelter Trust A** will be treated as coming from the first dying spouse. They will be included in the first dying spouse's gross estate for estate tax purposes pursuant to IRC Section 2038, because of the first dying spouse's lifetime right to revoke the trust and receive back these assets. These assets are sheltered from estate tax liability at the first death by the first dying spouse's estate tax exemption. Unless the Section 1014(e) one-year rule applies, the inclusion of these assets in the first dying spouse's gross estate will provide a stepped-up basis.[79]

A spendthrift provision in **Credit Shelter Trust A** will provide creditor protection to the surviving spouse because the first dying spouse (rather than the surviving spouse) will be deemed the grantor/transferor of the trust. Increased creditor protection could be provided by limiting the surviving spouse to distributions in the discretion of the trustee according to an "ascertainable standard," such as distributions for health, support, maintenance, and education. In most jurisdictions, limiting discretionary distributions to the surviving spouse by such a standard prevents creditors of the surviving spouse from being able to reach the trust assets or demand trust distributions.

Q-TIP Trust A.

Similarly, the assets of **Q-TIP Trust A** will also be included in the first dying spouse's estate under IRC Section 2038. They will avoid estate tax at that time because of the estate tax marital deduction. These assets will receive a stepped-up basis on the first dying spouse's death unless Section 1014(e) applies. Since the assets remaining at the surviving spouse's death will be includable in the surviving spouse's estate under Section 2044, those assets will receive another basis step-up then.

Even with a spendthrift provision, **Q-TIP Trust A** cannot provide total creditor protection for the surviving spouse because qualifying for the marital deduction requires that all trust income be paid to that spouse. Creditors will be able to reach the income distributions after

[79] PLRs 20010102 & 200210051; See also Mulligan, supra n. iii (stating that "[p]roperty which is contributed by the predeceasing spouse and included in such spouse's estate under §§ 2036 and 2038 rather than § 2041 is unaffected by § 1014(e), and acquires a new income tax basis under § 1014(a)"). Of course, Section 1014(e) could apply if the first dying spouse receives the property from the surviving spouse and dies within a year after contributing it to the trust.

they are received by the spouse. However, the principal can be further protected by making principal distributions discretionary and limited by an ascertainable standard.

The trustee can potentially minimize or eliminate the surviving spouse's income exposure by investing in low or zero dividend stocks or other cash neutral investments. Of course, this will require implicit consent of the surviving spouse because of the surviving spouse's right to have marital trust assets be productive.[80]

Credit Shelter Trust B and **Q-TIP Trust B.**

Let's look at how the first death affects the surviving spouse's share of the JEST.

Issue 1: Estate Tax on Credit Shelter Trust B

Credit Shelter Trust B is designed to use up the first dying spouse's estate tax exemption if the first dying spouse's share of the trust is smaller than that exemption amount. This requires having assets from the surviving spouse's share go into **Credit Shelter Trust B** after having been includable in the estate of the first dying spouse for estate tax purposes, even though these assets are from the surviving spouse's share of the JEST.

By providing the first dying spouse with a testamentary general power of appointment over all of the trust assets, we make the assets of **Credit Shelter Trust B** includable in the first dying spouse's estate under IRC Section 2041, as was the case in most of the rulings.[81]

The rulings to date made clear the IRS's view that with proper drafting, **Credit Shelter Trust B** would not be considered as funded by the first dying spouse and would not be includable in the gross estate of the surviving spouse, even if the surviving spouse is a beneficiary of that trust.

Risks: Taxable Gift Treatment on Funding of Credit Shelter Trust B and Inclusion in Surviving Spouse's Estate

[80] Treas. Reg. 20.2056(b)-5(f)(5).

[81] The same conclusion was reached in PLR 200210051, where each spouse had the power to withdraw all of the trust assets while both were living. We do not recommend that approach because it would most likely subject all of the trust assets to creditor claims against either spouse prior to the first death. Otherwise, claims against one spouse should only imperil that spouse's share of the trust.

The IRS rulings are promising, but they are not binding on the Service and cannot be cited as precedent. It is certainly possible for the IRS to come to different conclusions in the future.

One concern expressed by Mr. Mulligan is that Section 2041 may not apply to the joint trust assets because the first dying spouse's power of appointment is effectively contingent upon the surviving spouse's failure to withdraw his or her share of the trust assets before the first death. His fear is that the contingency may turn the testamentary power of appointment into a power only exercisable in conjunction with the creator of the power – something which is not considered a general power of appointment under IRC Section 2041(b)(1)(C)(i).[82]

That would mean that assets of the surviving spouse's share could not be applied to use up the first dying spouse's exemption if the first dying spouse's share is insufficient. It opens the door to an argument that the assets in **Credit Shelter Trust B** are includable in the gross estate of the surviving spouse under IRC Sections 2036 and 2038.

According to Mr. Mulligan, the Service could reach the same result by a "conduit" or "step transaction" argument by looking at the entire transaction as one in which the surviving spouse is viewed as the actual contributor of the assets of **Credit Shelter Trust B**, again triggering Sections 2036 and 2038 rather than Section 2041. He cites several cases in which, for example, one party who transferred assets to a second party is deemed to be the actual grantor of a trust created by the second party with those assets.[83]

In the end, however, Mr. Mulligan points out that the lifetime Q-TIP rules justify ignoring these arguments where spouses are involved. Spouse A can set up a lifetime Q-TIP for Spouse B with Spouse A's assets; the trust can benefit Spouse A after the death of Spouse B; but

[82] Mulligan, supra n. 3.

[83] Footnote 14 of Mr. Mulligan's article supports this concept by citing the cases of *Mahoney v. U.S.*, 831 F. 2d 641 (6th Cir. 1987); *Marshall Estate v. Commissioner*, 51 T.C. 696 (1969); *Sinclaire Estate v. Commissioner*, 13 T.C. 742 (1949); and *Schwartz Estate v. Commissioner*, 9 T.C. 229 (1947). In each of these cases, the IRS successfully showed that trust assets were included in the beneficiary's estate, even though the beneficiary did not directly contribute the assets to the trust. In *Mahoney*, a father created a trust for his son's benefit and funded it with stock. The son then executed a promissory note to his father in an amount equal to the stock's value. The son died and the IRS concluded that the trust assets were included in the son's estate because he was the party who in substance transferred assets to the trust by paying consideration to his father at the time the stock was transferred to the trust. Citing to *Marshall, Sinclaire*, and *Schwartz*, the court concluded "that although [the father] nominally created the Trust, the decedent must be considered the effective grantor of the Trust to the extent of his contribution." a trust created by the second party with those assets. In *Sinclaire*, the decedent transferred assets to her father, and her father funded a trust for the decedent using those assets before her death. The Tax Court found that the trust assets were included in the decedent's estate, noting that "in substance and reality decedent was the settlor of the trust and that her father acted only as her agent in its creation."

Sections 2036 and 2038 do not bring the assets back into Spouse A's estate.

Apparently inclusion in the estate of Spouse B under Section 2044 "cleanses" the trust assets, so that Spouse B is considered to be the source of them. Mr. Mulligan sees no reason why the same concept should not apply in the joint trust arena.

In their 2008 article, Mitchell Gans, Jonathan Blattmachr and Austin Bramwell share Mr. Mulligan's concern about the step transaction doctrine. They fear that the IRS could determine that the surviving spouse is the transferor of the Credit Shelter Trust B assets, causing inclusion under Sections 2036 (if the surviving spouse had the right to receive income from **Credit Shelter Trust B**) or 2038 (if the surviving spouse has a special power of appointment over the trust). They note that even if the surviving spouse has neither an income interest nor a power of appointment over the trust assets, being merely a discretionary beneficiary, Section 2036 could apply for one of two reasons: (i) the Service could find an "implied understanding" that the surviving spouse would receive distributions from the trust or (ii) the Service could decide that the ability of creditors of the surviving spouse, under state law, to reach assets of the trust because it is considered to be self-settled.[84]

Some planning may be possible to minimize the risk of estate tax inclusion. Perhaps careful drafting can negate an "implied understanding." Drafting to avoid creditors (such as by setting up **Credit Shelter Trust B** in a jurisdiction which protects self-settled trusts) can be helpful both for tax and non-tax reasons (the non-tax reasons being discussed below).

One could always try to structure the funding of the joint trust to minimize the need for a **Credit Shelter Trust B** created with assets from the surviving spouse. Of course, this eliminates one advantage of joint trust planning, the ability to ensure full use of both spouses' exemptions without having to split assets up or move them around.

In the end, the PLRs and TAM are a weak bulwark against a later IRS attack on these issues unless there are strong reasons for the IRS to continue to support the same reasoning. Messrs. Gans, Blattmachr and Bramwell fear that the reasoning in the rulings could invite abuse by taxpayers seeking to overcome the step transaction doctrine in other contexts. Mr. Mulligan seems to feel that the Q-TIP analogy will continue to support the rulings. Planners forced to confront this issue and seeking certainty may consider getting rulings of their own.

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[84] Mitchell M. Gans, Jonathan G. Blattmachr & Austin Bramwell, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?* 42 Real Prop. Prob. & Tr. J. 413, 422 et. Seq. (2007-2008).

Two alternative questions can be asked:

1) Does inclusion of **Credit Shelter Trust B** in the surviving spouse's estate cause a significant problem? If the alternative to a joint trust arrangement would not result in full use of both exemptions anyway, then what is the harm if that aspect of the joint trust arrangement doesn't work?

2) Is there a way to minimize the harm caused by inclusion?

On the second point, consider the result if **Credit Shelter Trust B** is structured as a defective grantor trust with the surviving spouse as grantor. This might be done by giving the surviving spouse the power to replace Credit Shelter Trust B assets with assets of equal value. The surviving spouse would owe income taxes for trust income left in the trust or distributed to other beneficiaries, and the tax payments would reduce her taxable estate without being considered gifts.

For example, if **Credit Shelter Trust B** is funded with $2 million worth of assets and the surviving spouse has a $5.25 million estate tax exemption, it would seem that, at worst, the surviving spouse would have been deemed to have made a $2 million gift to the trust. If the trust is moved to an asset protection jurisdiction and the spouse does not have a power of appointment over trust assets, all growth in the trust that occurs during the surviving spouse's remaining lifetime can escape federal estate tax, notwithstanding that the trustee may have discretion to make distributions to the surviving spouse.

Issue 2: Creditor Protection

Risk: No Creditor Protection from the Surviving Spouse's Creditors

Where an individual transfers assets to a trust for his or her own benefit, the British common law (and most states which follow it) allows the individual's creditors to reach those assets. Just as there is a risk that the surviving spouse may be considered to have transferred assets to the trust for estate tax purposes, there is a risk that the surviving spouse could be considered the transferor of the assets for creditor purposes. This could allow creditors of the surviving spouse to reach the assets of **Credit Shelter Trust B** if the surviving spouse is the beneficiary.

Note that the two issues would arise in different contexts, probably in different legal jurisdictions, and the decisions might not be consistent. Depending on the outcome, the estate tax could take part of **Credit Shelter Trust B** on the surviving spouse's death, but even worse, creditors could take all of the assets.

The best way to minimize the risk of actual creditors would be to situate **the Credit Shelter Trust B** in an "asset protection trust jurisdiction" such as Nevada, Alaska, Delaware, or Nevis, where creditor protection is available for self-settled trusts.

An alternative that could help for creditor protection purposes, but not federal estate tax purposes, would be to have the trustee invest in a family LLC or limited partnership to obtain charging order protection so that creditors of the surviving spouse would have a more difficult time obtaining assets from **Credit Shelter Trust B**. But, just as an IRS determination does not apply to creditors, taking actions which as a practical matter deter creditors by using LLC and limited partnership structures does not prevent the IRS from concluding that creditors of the surviving spouse can reach into Credit Shelter Trust B, and thereby cause its assets to be considered as owned by the surviving spouse for estate tax purposes.

Issue 3: Marital Deduction

Risk: The Gift May Not Qualify for the Marital Deduction.
Under our proposed JEST, gift tax consequences may arise at two points in the life of the trust.

First, because each spouse will have individual rights, while both spouses are alive, to terminate the trust and receive back half of the assets, a gift would occur upon funding the trust if the spouses do not contribute equal amounts or, in most cases, if the spouses contribute property held as tenants by the entireties. Unless the recipient spouse is not a citizen, the gift tax marital deduction should eliminate any gift tax consequences.

Second, in the rulings, the IRS concluded that upon the first spouse's death, the surviving spouse would make a completed gift to the deceased spouse of the assets that the surviving spouse contributed to the joint trust.[85] This is because as of the first death, the surviving spouse relinquishes dominion and control over those assets, either by losing the power to revoke those assets or because the assets are subject to the first dying spouse's testamentary general power of appointment (or, under our suggested arrangement, for both reasons). The rulings go on to conclude that this completed gift by the surviving spouse would qualify for the estate tax marital deduction (assuming the first deceased spouse was a citizen).

Common sense suggests that the IRS is correct on the marital deduction issue. Of course, common sense is not always a reliable guide to the workings of the tax laws. While the IRS rulings don't go

[85] See PLRs 200101021, 200210051 & 200403094.

into detail on the marital deduction question, the Service must have reach two conclusions:

1) That the gift occurred at a time when the spouses were married, and

2) That the gift did not involve a nondeductible terminable interest.

Reminding us again that this determination has been made in non-binding rulings, the commentators have suggested that these are conclusions the IRS may later abandon.[86]

They point out that whether the gift was made when the spouses were married turns on exactly when it was made. If it was considered made after the moment of death, the parties were not then married, and the marital deduction would not apply. If it was considered made before or at the moment of death, then the first requirement of the deduction is met.

Messrs. Blattmachr, Gans and Bramwell take comfort from the authorities dealing with the death of spouses in common disasters.[87] There it has been held that a gift occurs at the moment of death, rather than after death. These commentators opine that "no policy justification exists for refusing to extend this rationale to the [joint trust] strategy."[88]

Blattmachr, Gans and Bramwell also bring up the Ninth Circuit Court of Appeal's 1935 decision in *Johnstone v. Commissioner*,[89] in which the court suggested that a transfer occurs the moment before death rather than after death. However, their discussion reveals that later cases have cited Johnstone, with the result not always being consistent. On the other hand, Johnstone did not involve spouses, while the simultaneous death authorities do. We believe that practitioners can be fairly confident that the gift at death will be deemed to be made during the marriage.

The terminable interest issue is more problematic. The facts in the rulings show no outright gifts or Q-TIP election. The question is whether the surviving spouse receives enough rights in the gifted property to satisfy IRC Section 2523(e): a right to receive lifetime income and a general power of appointment over the applicable interest.

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[86] Mulligan at 9 et seq.; Mitchell M. Gans, Jonathan G. Blattmachr & Austin Bramwell, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?* 42 Real Prop. Prob. & Tr. J. 413, 422 et seq. (2007-2008).
[87] *Id*. at 422-430.
[88] *Id.* at 424.
[89] 76 F.2d 55 (9th Cir. 1935).

In PLR 200210051, each spouse had the right to demand distributions of income and principal while both were living, effectively having a lifetime general power of appointment. In the others, the first spouse to die received only a testamentary general power of appointment with no particular income rights. Under the rulings, the IRS allows a marital deduction, but there is no discussion of the terminable interest issue.

To Blattmachr, Gans and Bramwell, getting the marital deduction would seem to require relying on case law allowing a marital deduction where a spouse may elect whether to accept a gift and does accept it.[90] Finding acceptance here would seem to require that the surviving spouse exercise a testamentary power of appointment. One ruling did involve the exercise of the power; the rest did not. And, these commentators feel that even exercise may not be enough, since the relevant cases all involve spouses who personally accept outright gifts, not just spouses who receive a power of appointment.

Clearly, we hope that the IRS will not change its position on the marital deduction issue and will eventually issue a definitive ruling. In the meantime, short of requesting a ruling for each joint trust we prepare, how can we increase our chances of avoiding a marital deduction problem on **Q-TIP TRUST B**?

Certainly, there is no harm in using language so closely identified with the marital deduction that the Service may grant the deduction without giving the subject much thought. As an example, one of the rulings made the first deceased spouse's testamentary general power of appointment "exercisable alone and in all events." This language added nothing, but it does scream out, "marital deduction"!

More substantively useful may be the inclusion of a joint trust provision allowing both spouses to withdraw principal from the trust while both are living, as found in PLR 200210051, which could help bring the gift within the statutory requirements of Section 2523(e).[91] Having **Credit Shelter Trust B** set up and funded by exercise of the testamentary power of appointment should improve the odds of coming within the case law on gifts made by election.

If all else fails, a savings clause in the trust agreement could provide that should the gift tax marital deduction not apply, **Credit Shelter Trust B** would be funded only to the extent of the surviving spouse's estate tax exemption (or to an amount slightly less than the surviving spouse's exemption to permit future gifting and a cushion

[90] Gans, Blattmachr & Bramwell at 429.

[91] Each spouse would seem to have a lifetime general power of appointment, which eliminates the need for income payments to qualify for the marital deduction. *See* Treas. Reg. Section 25.2523(e)-1(f)(6). (Whether each spouse is comfortable with the other spouse having such a power is another question.)

for valuation issues that could apply in later years). That way the surviving spouse could avoid a gift tax on assets going into that trust at the first death. So long as the terms of **Credit Shelter Trust B** don't subject the remaining assets to estate tax at the second death, the parties should be no worse off than if they had not tried to use a joint trust to protect both exemptions. Of course, description of the contingency could alert the Service to the marital deduction issue if it is not otherwise aware of it.

Stepped-Up Basis

In its rulings, the IRS has denied that the assets of the surviving spouse's share of the joint trust will get an IRC Section 1014(a) basis step-up in non-community property jurisdictions at the first death, even though the assets are includable in the gross estate of the first dying spouse.

We believe the IRS is wrong. We believe that a basis step-up should be available. The risk to practitioners would seem minimal, since it is confined to not getting a step-up which would not have been otherwise available for clients not living in community property states. Although we expect the Service to continue to contest the issue, we also think there are ways to significantly increase the chances of a successful outcome.

In the rulings, the IRS denied a step-up to assets which, prior to the first death, were in the surviving spouse's share of the trust. The IRS asserted that the step-up was prohibited by IRC Section 1014(e).

Section 1014 generally provides that the basis of property in the hands of a person acquiring the property from a decedent, or to whom the property passed from a decedent, is the fair market value of the property at the date of the decedent's death. However, Section 1014(e) provides the following exception to this rule:

If appreciated property was acquired by the decedent by gift during the one-year period ending on the date of the decedent's death, and the property is acquired from the decedent by, or passes from the decedent to, the donor of such property, the basis of such property in the hands of the donor is the adjusted basis of the property in the hands of the decedent immediately before the death of the decedent.[92] [Emphasis added.]

For Section 1014(e) to apply, the property must be "acquired by" or "pass to" the original contributor of such property – in this case the surviving spouse. How does this language apply when the property does not pass directly to the surviving spouse, but instead passes to a

[92] PLR 200101021 (p. 4), PLR 200210051 (p. 4).

trust for the benefit of the surviving spouse? The Service thinks it does, but does not have an explanation. We share the belief of many others that the Service has stretched the literal language of the law in so concluding. To us, "acquired by" or "pass to" should apply only if full ownership is transferred back to the surviving spouse.

Assets originating with the surviving spouse will wind up in Credit Shelter Trust B or Q-TIP Trust B. The less interest the surviving spouse has in these trusts, the easier it is to argue that Section 1014(3) should not bar a step-up.

For example, we think it is clear that a step-up should be allowed if the surviving spouse is not a beneficiary of the Credit Shelter Trust B. Of course, economic considerations may require that the surviving spouse be a beneficiary. Some planners have asserted that Section 1014(e) should not apply if the surviving spouse is only a discretionary beneficiary. There have not been any ruling or cases that explicitly confirm this conclusion, but it's difficult to say that property "passed to" or was "acquired by" a discretionary beneficiary, who by definition has no certain rights to the property.

The requirements of the estate tax marital deduction require that the surviving spouse be an income beneficiary of Q-TIP Trust B. Again, we and others feel that should not bar a step-up; nor should the right to receive principal in the discretion of the trustee, or a special power of appointment. But, the fewer rights the surviving spouse has, the better the argument for a step-up may be.

Conclusion:

The JEST technique eliminates many of the concerns that have prevented estate planners in non-community property states from using joint trusts in the manner approved by the IRS in PLR's 200101021 and 200210051. Although not without risk or some uncertainties, clients who want a stepped up basis for all "joint" assets, and to maximize use of credit shelter trust funding on the first death, should be offered this strategy. While the risks herein described do exist, there is also the risk that the family will ask the planner why these techniques were not used to avoid capital gains taxes and facilitate making full use of the first dying spouse's estate tax exemption amount.

Practitioners will have to invest significant time to understand issues, to develop trust documents that take the above and many other considerations into account, and make sure that clients understand the risks and possible advantages of the system. We hope that every law firm reading this article implements at least 23.8 JESTs this year, and we are not jesting!

CAN A THREE-WAY ACCOUNT BE TENANTS BY THE ENTIRETIES AS TO MARRIED PARTIES?

No, according to *In re Planas,*[93] where putting the mother-in-law on a joint account with a married couple, among other things, caused the loss of assets otherwise asserted to be protected as tenants by the entireties. The court stated that the mother-in-law's power to "individually alienate the assets" of the account "is inconsistent with the essential unity of possession, or control."

Deeds are commonly used to transfer property to a surviving spouse and one or more other individuals with "right of survivorship." In such circumstances, it may not be clear whether the spouses inherit only from each other, or whether they also inherit from the third person. It is also unclear whether the third person will inherit a share from a spouse.

TENANCY BY THE ENTIRETIES PROPERTY CAN BE FREELY TRANSFERRED TO A NON-DEBTOR SPOUSE.

In *In re Blatstein,*[94] the Third Circuit Court of Appeals held that a transfer from tenants by the entireties to the non-debtor spouse will not be considered a fraudulent transfer as to the creditors of the debtor spouse. **NOTE –** Transfers of homestead between spouses may implicate the 1,215-day waiting period under the Bankruptcy Code.

TRANSFERS TO NON-RESIDENT ALIEN SPOUSES.

A U.S. citizen/resident may incur gift tax liability if transfers to tenancy by the entireties with a non-citizen spouse exceed a total gift transfer value of $328,000 per year. (For 2022, the annual gift limit is $164,000, unless the account is of such a nature that the donor has the right to withdraw all assets without permission of the non-citizen spouse, even if the spouse is a green card holder!) Because only a half interest in property is deemed to be transferred where a spouse transfers solely owned property to tenants by the entireties with his or her spouse, a transfer of property worth $328,000 corresponds to a taxable gift of $164,000. However, not needing permission to withdraw the assets would vitiate tenancy by the entireties status, so basically only $328,000 per year in wealth generated by or owned by one spouse can be transferred without U.S. gift tax implications under tenancy by the entireties. The above amounts apply in 2022 and are adjusted annually for inflation.

Under Treasury Regulation Section 25.2511-1(h)(4), the creation and funding of a joint bank account is generally treated as an incomplete gift for gift tax purposes when both spouses retain the right to unilaterally withdraw funds without the consent of the other spouse.

FRAUDULENT TRANSFERS AND USING MONEY BORROWED ON TENANCY BY THE ENTIRETIES PROPERTY TO PURCHASE OR PAY DOWN DEBT ON OTHER TENANCY BY THE ENTIRETIES PROPERTY.

In the case of *In re Mathews,*[95] Judge Funk found that borrowing monies on tenancy by the entireties property and using such funds to purchase other tenancy by the entireties property is not a fraudulent transfer. In this case, the actual loan documents and closing statement showed the husband-debtor as the sole borrower, but the wife did sign the mortgage document, and the husband and wife owned the mortgaged

[93] 199 B.R. 211 (Bankr. S.D. Fla. 1996).
[94] 192 F.3d 88 (3rd Cir. 1999).
[95] 360 B.R. 732 (Bankr. M.D. Fla. 2007) (reversed on other grounds).

property as tenants by the entireties. The debtor used the money to buy two properties as tenants by the entireties with his wife. The properties purchased were owned by BMC, the corporation that the debtor was president of since the inception of the business. The Trustee argued that if the debtor had not transferred the properties, then they would have been subject to execution by the creditors of BMC and the debtor. The Trustee argued that the transfer was fraudulent and sought to avoid it.

The court found that irrespective of the statutes at hand, the properties involved were mortgaged by exempt tenants by the entireties property. A transfer of exempt property (or the loan proceeds thereof) to other exempt property is not a fraudulent transfer. Additionally, even if the transfers were not from exempt to exempt, the Trustee failed to prove that the transfers were fraudulent by a preponderance of the evidence. The court found that the Trustee did not establish that BMC was insolvent at the time of the transfer, that the purchase price was inadequate, or that the monies paid to BMC for the properties ended up in the debtor's pocket. Therefore, the two properties were not acquired via fraudulent transfer and were exempt as tenants by the entireties.

In addition to using the loan proceeds to purchase the two properties, the debtor also used the proceeds to pay off the mortgage on homestead property. The Trustee attempted to argue that the loan proceeds were not held as tenants by the entireties because only the debtor signed the promissory note and loan statement, and the checks were made payable to the debtor only. The court disagreed and found that the property pledged as collateral was owned as tenants by the entireties, and the fact that the debtor alone signed the documents did not make the loan proceeds non-exempt. The loan proceeds were deposited into a joint checking account and used to pay off or acquire other tenants by the entireties property and the transactions did not trigger Bankruptcy Code § 522(o).

While exempt assets may be used to purchase other exempt assets or pay down the indebtedness associated therewith, the use of exempt assets to pay a creditor within 90 days of filing bankruptcy will be considered a preferential payment that may be avoided by the Trustee in bankruptcy.[96]

It is also important to note that the Florida Supreme Court has found that proceeds from the sale of a homestead will only be protected if they are invested in another homestead.[97] Therefore, there is a risk that a Floridian who sells his or her protected homestead and places the proceeds into an exempt asset could be considered to have made a fraudulent transfer into the exempt asset if it can be shown that he or she had the requisite intent to avoid creditors.

WAIT A MINUTE – IS THIS COMMUNITY PROPERTY?

In states that recognize community property, such as California, the normal rule is that all property acquired during the marriage is community property.[98] The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Unlike property held as tenants by the entireties, community property is subject to liability for the debts of either spouse. Couples who move to Florida with community property assets may be surprised to later find that those assets were not successfully converted into tenancy by the entireties property pursuant to the law of the community property state where the ownership originated.

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[96] See *Tavenner v. Smoot,* 257 F.3d 401, 406 (5th Cir. 2001).

[97] *Orange Brevard Plumbing & Heating Co. v. La Croix,* 137 So. 2d 201 (Fla. 1962).

[98] See e.g., Cal. Family Code § 760.

CALIFORNIA RULES:

There are two ways to overcome the classification of community property. According to a 2002 bankruptcy case applying California law, *In re Summers,*[99] spouses can indicate their intent with respect to the character of the property (a) initially by specifying the form of title in which it is held or (b) later by "transmuting" the character of the property by taking appropriate steps.

Therefore, in order to overcome the presumption of community property and take advantage of the creditor protection of tenancy by the entireties property, spouses should be sure to title bank accounts and other property initially as tenancy by the entireties. If spouses did not do this initially, in California at least, this can be remedied by executing a postnuptial transmutation agreement.[100] Notwithstanding the above, transmutations can be subject to fraudulent transfer rules.[101]

California case law indicates that any transmutation must be clearly expressed in writing for most categories of assets, and must apply across the board for all purposes. For example, a transmutation agreement which indicates that all community property assets owned by one spouse will be considered non-community property.

NEVADA RULES:

In order to effectively transmute property in Nevada, spouses must do so explicitly in a properly recorded and memorialized writing which contains clear language indicating a right of survivorship.

When initially acquiring property, spouses may "opt out" of Nevada's statutory community property scheme by written agreement to create a joint tenancy or a tenancy in common in that property.[102] Pursuant to Nevada Statutes 123.280, 123.290, and 123.300, such an agreement is not effective against third-party creditors unless the agreement is properly recorded.[103] For example, a valid deed showing that a title to real property is held in joint tenancy is a properly recorded memorialized agreement sufficient to overcome the presumption of community property.[104]

Nevada Revised Statutes § 100.085(4) provides that an account labeled as a joint account is presumed to be held in joint tenancy:

> For the purposes of this section, unless a depositor specifically provides otherwise, the use by the depositor of any of the following words or terms in designating the ownership of an account indicates the intent of the depositor that the account be held in joint tenancy:
>
> (a) Joint;
>
> (b) Joint account;

[99] E.g., Cal. Family Code § 910(a).
[100] See Cal. Family Code § 850-853 and Fla. Stat. § 732.225.
[101] Cal. Family Code § 851.
[102] *Hardy v. U.S.,* 918 F. Supp. 312, 317 (D. Nev. 1996) (*citing* Nev. Rev. Stat. § 123.220 (1997)).
[103] *Jansen v. U.S.,* CV-S-90-253-RDF (RJJ), 1992 WL 121368 at *2 (D. Nev. Feb. 4, 1992).
[104] *Forrest v. Forrest,* 668 P.3d 275, 277 (Nev. 1983).

(c) Jointly held;

(d) Joint tenants;

(e) Joint tenancy; or

(f) Joint tenants with right of survivorship.

Pursuant to Nevada Statutes 111.064 and 111.065, spouses may transmute community property into a tenancy in common or joint tenancy at any time. In order to properly reclassify the character of that property, spouses must do so in writing, and that writing must contain language creating a right of survivorship.[105] The Nevada Supreme Court in *McKissick* found that a bank deposit issued in the name of "husband and/or wife" did not create a joint tenancy in the bank deposit between the spouses because there was no writing that contained a right of survivorship.[106] Parol evidence is not admissible to prove the existence of a joint tenancy, although it may be admissible to prove the non-existence of one.[107]

Spouses can also transmute community property into separate property by gift inter vivos as long as that property is not subject to creditors.[108] In other words, a spouse can just give the other spouse his or her half of the community property, but such a transmutation must be of a clear and convincing character to stand up in court.[109] The Nevada Supreme Court in *Milisich* ruled that there was sufficient evidence showing that an effective transmutation when a husband gave his wife community funds that she placed in bank accounts that were under her exclusive dominion and control.[110] Another way that spouses can transmute community property into separate property via gifts is by agreeing in writing to retain their respective earnings as separate property.[111]

Spouses can constructively transmute community property into separate property by naming the other spouse as a *sole* beneficiary of a life insurance policy.[112] In *Peters,* the Supreme Court of Nevada held that "[w]hen one spouse is named the beneficiary in the life insurance policy of the other spouse, and remains so at the time of the insured's death, all proceeds vest at that moment in the surviving spouse as separate property, even though the premiums had been paid with community funds."[113]

TEXAS RULES:

In Texas, it is accepted that when a husband and wife explicitly demonstrate their desire to create a joint tenancy with right of survivorship (or tenancy by the entireties), and do so in writing, that desire will be upheld, as stated in *Shroff v. Deaton.*[114] In *Shroff*, the husband and wife held a joint bank account comprised primarily of community funds. However, because they made a clear and explicit contract creating a joint

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[105] *McKissick v. McKissick,* 93 Nev. 139, 146 (Nev. 1977).
[106] *Id.* at 145-146.
[107] *Starr v. Rousselet*, 110 Nev. 706, 710-11 (Nev. 1994).
[108] *Stockgrowers' & Ranchers' Bank of Reno v. Milisich,* 283 P. 913 (Nev. 1930).
[109] *Id.* at 914.
[110] *Id.* at 915.
[111] *Hardy,* 918 F. Supp. At 317 (*citing* Nev. Rev. Stat §§ 123.220, 123.190).
[112] *Peters v. Peters* 557 P.2d 713, 716-717 (Nev. 1976).
[113] *Id.*
[114] 220 S.W. 2d 489 (Tex. Civ. App. 1949).

tenancy with right of survivorship and there was no evidence of fraud or undue influence, the court upheld the principle that this contract should take effect notwithstanding a Texas statute stating that where a joint owner of property dies, his interest descends to his lawful heirs.

It is important to note that in Texas unlike in California, there is significant debate over whether parol evidence may be used to determine the intent of a husband and wife to create a tenancy by the entireties.[115] Thus, if a couple intends to create a joint tenancy with right of survivorship or tenancy by the entireties, they should ensure the effectiveness of their transmutation with a clear and explicit contract stating their intent.

Furthermore, a husband and wife's agreement to convert community property into separate property is ineffective when dealing with property that has not yet come into existence, or which has not yet been acquired.[116] As a result, transmutations of property from community property into joint tenancies with right of survivorship or tenancies by the entireties are allowed and valid in Texas, provided two requirements are met: (1) the property being transmuted is in existence and possessed by the spouses at the time of the conversion; and (2) there is clear evidence of the spouses' intent to transmute the property preferably in an explicit written contract.

In other community property states, however, it may be even more difficult to overcome the classification of community property. For example, in Louisiana, spouses may enter into a matrimonial agreement which modifies or terminates their community property interest. But after the first year of moving to Louisiana, this may be done "only upon joint petition and a finding by the court that this serves their best interests and that they understand the governing principles and rules."[117]

WISCONSIN RULES:

Wisconsin also allows creditors to pursue community property where only one spouse owes the creditor if the obligation arose during the marriage. Wisconsin Statute Section 766.31 provides for classification of property as follows:

> **(10) Reclassification.** Spouses may reclassify their property by gift, conveyance, as defined in s. 706.01(4), signed by both spouses, marital property agreement, written consent under s. 766.61(3)(e) or unilateral statement under s. 766.59 and, if the property is a security, as defined in s. 705.21(11), by an instrument, signed by both spouses, which conveys an interest in the security. If a spouse gives property to the other spouse and intends at the time the gift is made that the property be the individual property of the donee spouse, the income from the property is the individual property of the donee spouse unless a contrary intent of the donor spouse regarding the classification of income is established.
>
> **As a Gift or Conveyance:** 706.01(4) . . . satisfies requirements of 706.02:

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[115] *Belkin v. Ray*, 176 S.W. 2d 162 (Tex. 1943).

[116] *Chandler v. Alamo Mfg. Co.*, 140 S.W. 2d 918 (Tex. Civ. App. Austin 1940) (finding the agreement between spouses that all income from rental property would be separately held was invalid because they did not possess the income at the time the agreement was constructed); *Davis v. Davis*, 108 S.W. 2d 681 (Tex. Civ. App. Fort Worth 1937) (holding that a husband and wife's agreement to place wife's personal earnings in a separate account was ineffective for removing community property status).

[117] *See* Louisiana Civil Code Article 2329.

1) Transactions under s. 706.001(1) shall not be valid unless evidenced by a conveyance that satisfies all of the following:

    a. Identifies the parties; and

    b. Identifies the land; and

    c. Identifies the interest conveyed, and any material term, condition, reservation, exception or contingency upon which the interest is to arise, continue or be extinguished, limited or encumbered; and

    d. Is signed by or on behalf of each of the grantors; and

    e. Is signed by or on behalf of all parties, if a lease or contract to convey; and

    f. Is signed, or joined in by separate conveyance, by or on behalf of each spouse, if the conveyance alienates any interest of a married person in a homestead under s. 706.01(7) except conveyances between spouses, but on a purchase money mortgage pledging that property as security only the purchaser need sign the mortgage; and

    g. Is delivered. Except under s. 706.09, a conveyance delivered upon a parol limitation or condition shall be subject thereto only if the issue arises in an action or proceeding commenced within 5 years following the date of such conditional delivery; however, when death or survival of a grantor is made such a limiting or conditioning circumstance, the conveyance shall be subject thereto only if the issue arises in an action or proceeding commenced within such 5-year period and commenced prior to such death.

2) A conveyance may satisfy any of the foregoing requirements of this section:

    a. By specific reference, in a writing signed as required, to extrinsic writings in existence when the conveyance is executed; or
    b. By physical annexation of several writings to one another, with the mutual consent of the parties; or

    c. By several writings which show expressly on their faces that they refer to the same transaction, and which the parties have mutually acknowledged by conduct or agreement as evidence of the transaction.

TENANCY BY THE ENTIRETIES ASSET PROTECTION TRUSTS – THE DELAWARE, NEVIS AND TENNESSEE ALTERNATIVES.

Attorney Jonathan Gopman, who is a contributor to this book, led in the process of drafting statutes for Delaware and Nevis which provide that married couples can transfer tenancy by the entireties assets to trusts, and then receive the assets back as tenants by the entireties to provide protection for situations where there would be a creditor having a judgment against one, but not both, spouses.

For example, a married couple consisting of two OB-GYNS who practice together and might both be sued by the same patient would like to maintain tenancy by the entireties protection for the most likely scenario of one of them being sued by a patient, while also having asset protection trust ("APT") protection in case a common creditor sues both of them.

While we cannot predict what a Florida judge might do if a common creditor has a judgment against both spouses and they have funded an asset protection trust in advance of the problem occurring, it would be helpful to be able to claim tenancy by the entireties protection as to the asset protection trust assets if there is a creditor pursuing only one spouse. Time will tell whether Florida courts will recognize these statutes and the protection of "tenancy by the entireties" in situations where the six traditional unities discussed in Chapter 2, Section B of this book.[118]

A TAX ADVANTAGED ALTERNATIVE – CONSIDER THE ALASKA, TENNESSEE, OR FLORIDA COMMUNITY PROPERTY TRUST.

In 1998, Alaska implemented the Alaska Community Property Act, which allows both resident and non-resident married couples to create Alaska Community Property Trusts. The property transferred to the trust will be deemed community property under Alaska law so long as the statutory requirements are met.

There are significant benefits to using an Alaska Community Property Trust, namely that all community property assets will receive a stepped-up basis for federal income tax purposes on the first death, and that the assets should be protected from the spouses' creditors under Alaska Trust law, as is further discussed in the sections of this book that discuss domestic creditor protection trusts.

According to Jonathan Blattmachr, who helped draft this law, Alaska Community Property Trusts cannot qualify as tenants by the entireties property.[119] These trusts may, however, provide more significant creditor protection than tenants by the entireties assets because creditors of both spouses should not be able to reach the property under Alaska's asset protection trust law.

It is also important to note that the conversion of assets from separate to community property will be deemed a gift for tax purposes to the extent that the value of a spouse's separate property exceeds the value in the community property, subject to complex rules that should be carefully reviewed. However, if both spouses contribute equal amounts of separate property or if the spouses transfer joint property, then there will be no gift tax purposes upon contribution. Even if one spouse is deemed to have made a gift, this gift will likely qualify for the marital tax deduction. Beware of the step transaction doctrine, which can apply when one

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[118] Jonathan Gopman, Esquire, is the originator of the idea for the statutory tenancy by the entireties trust (commonly referred to as a "STET", a term he coined) that is set forth in § 3574(f) of Title 12 of Chapter 35 of the Delaware Statutes. This statute was enacted into law in Delaware in July of 2010 and became effective on August 1, 2010. Jonathan's articles, commentaries and presentations have also served as the impetus for changes to the trust laws of several states. In 2011 and 2012, Jonathan assisted the government of Nevis in revising its trust laws (including the Nevis Rule Against Perpetuities) set forth in the Nevis International Exempt Trust Ordinance by rewriting almost the entire Ordinance. He was the only attorney in the United States selected by the government of Nevis to work and consult on this project. SEE "Nevis Introduces New Asset Protection Trust for Tenancy by the Entirety Property", Co-Author, 270 Offshore Investment 24, (October. 2016) and LISI Asset Protection Planning Newsletter #297, Co-Author, "Safanda v. Castellano; District Court Tells Bankruptcy Court to Cast-away-no," (May 26, 2015).

[119] See Jonathan G. Blattmachr, Howard M. Zaritsky and Mark L. Ascher, *Tax Planning with Consensual Community Property: Alaska's New Community Property Law,* 33 REAL PROPERTY, PROBATE AND TRUST JOURNAL, 4 (1999).

spouse transfers assets to the other spouse or into joint names, followed by having the other spouse or the spouses jointly transfer those assets to another entity.

Tennessee passed its Community Property Trust Statute in 2010, which presently reads as follows:

§ 35-17-101. This chapter shall be known as the "Tennessee Community Property Trust Act of 2010".

§ 35-17-102. As used in this chapter:

(1) "Community property" means property owned by a community property trust during the marriage of the settlor spouses;

(2) "Community property trust" means an express trust that complies with § 35-17-103;

(3) "Decree" means a judgment or other order of a court;

(4) "Dissolution" means either:

(A) Termination of a marriage by a decree of dissolution, divorce, annulment or declaration of invalidity; or

(B) Entry of a decree of legal separation maintenance;

(5) "During marriage" means a period that begins at marriage and ends at dissolution or the death of a spouse;

(6) "Qualified trustee" means either: - 2 - 01326976

(A) A natural person who is a resident of this state; or

(B) A company authorized to act as a fiduciary in this state pursuant to § 45-2-1001; and

(7) "Settlor spouses" means a married couple that establishes a community property trust.

§ 35-17-103. An arrangement is a community property trust if one (1) or both spouses transfer property to a trust, that:

(1) Expressly declares that the trust is a Tennessee community property trust;

(2) Has at least one (1) trustee who is a qualified trustee whose powers include, or are limited to, maintaining records for the trust on an exclusive or a nonexclusive basis and preparing or arranging for the preparation of, on an exclusive or a nonexclusive basis, any income tax returns that must be filed by the trust. Both spouses, or either spouse, may be a trustee;

(3) Is signed by both spouses; and

(4) Contains the following language in capital letters at the beginning of the trust:

THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH YOUR SPOUSE BOTH DURING THE COURSE OF YOUR MARRIAGE AND AT THE TIME OF A DIVORCE. ACCORDINGLY, THIS AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS AGREEMENT, YOU SHOULD SEEK COMPETENT ADVICE.

§ 35-17-104.

(a) In the agreement establishing a community property trust, spouses may agree on:

(1) The rights and obligations in the property transferred to the trust, notwithstanding when and where the property is acquired or located;

(2) The management and control of the property transferred to the trust;

(3) The disposition of the property transferred to the trust on dissolution, death, or the occurrence or nonoccurrence of another event;

(4) The choice of law governing the interpretation of the trust; and

(5) Any other matter that affects the property transferred to the trust and does not violate public policy or a statute imposing a criminal penalty.

(b) …

(1) Either spouse may amend a community property trust regarding the disposition of that spouse's one-half (1/2) share of the community property in the occurrence of such spouse's death.

(2) Except as provided in subdivision (b)(1), a community property trust may not be amended or revoked unless the agreement itself provides for amendment or revocation.

§ 35-17-105.

(a) Whether or not both, one (1), or neither is domiciled in this state, spouses may classify any or all of their property as community property by - 4 - 01326976 transferring property to a community property trust and providing in the trust that the property is community property.

(b) A community property trust is enforceable without consideration.

(c) All property owned by a community property trust will be community property during marriage.

(d) The right to manage and control property that is transferred to a community property trust is determined by the terms of the trust.

(e) When property is distributed from a community property trust, it shall no longer constitute community property.

§ 35-17-106.

(a) An obligation incurred by only one (1) spouse before or during marriage may be satisfied from that spouse's one-half (1/2) share of a community property trust.

(b) An obligation incurred by both spouses during marriage may be satisfied from a community property trust of the spouses.

§ 35-17-107. Upon the death of a spouse, one-half (1/2) of the aggregate value of the property owned by a community property trust established by the spouses reflects the share of the surviving spouse and the other one-half (1/2) reflects the share of the decedent. Unless provided otherwise in the trust agreement, the trustee has the power to distribute assets of the trust in divided or undivided interests and to adjust resulting differences in valuation. A distribution in kind may be made on the basis of a non pro rata division of the aggregate value of the trust assets, on the basis of a pro rata division of each individual asset, or by using both methods.

§ 35-17-108. Upon the dissolution of the marriage of the settlor spouses, the community property trust shall terminate and the trustee shall distribute one-half (1/2) of the trust assets to each spouse, with each spouse receiving one-half (1/2) of each asset, unless otherwise agreed to in writing by both spouses. SECTION 2. This act shall take effect on July 1, 2010, the public welfare requiring it.

THE FLORIDA COMMUNITY PROPERTY TRUST ACT

The Florida Community Property Trust Act ("FCPTA"), which became effective on July 1, 2021, was written to allow married couples living in or outside of Florida to form a trust and to "opt-in" to cause the assets held in the trust to qualify as community property in order to have a new fair market value income tax basis under Internal Revenue Code Section 1014(b)(6) on the death of the first dying spouse.

Code Section 1014(b)(6) provides the following language:

> (6) 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, 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 under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;

It is noteworthy that some experts, including Jonathan Blattmachr, believe that the FCPTA "may not work" for purposes of achieving the double step-up in basis under 1014(b)(6) because the community property laws that the FCPTA provides for are not in-line with the most common traditional community property rules. For example, in most community property jurisdictions all of the community property is subject to the creditor claims of either spouse. Under the Florida Act, only one-half of the assets under the Community Property Trust are subject to the creditor claims of one spouse. This concern is addressed in more detail below.

The FCPTA is enumerated in Florida Statutes Sections 736.1501 to 736.1512 and is somewhat similar to the Alaska, Tennessee, South Dakota and Kentucky Acts. The Act provides that "Community Property" means the property, and the appreciation of and income from the property, owned by a qualified trustee of a community property trust during the marriage of the settlor spouses. The Act applies to both revocable and irrevocable trusts and provides that the surviving spouse can have the power to amend the trust with respect to his or her half of the property.

In community property jurisdictions, each spouse in a marriage is considered to own a one-half undivided share of marital assets, including any financial or real assets acquired during the marriage. As opposed to traditional community property states, where assets acquired from earnings during the marriage are treated as community property under the law, married couples in Florida must "opt-in" to community property treatment by placing those assets in a community property trust for which they wish to receive community property treatment.

CREATING A FLORIDA COMMUNITY PROPERTY TRUST

A community property trust is a trust that complies with Florida Statute Section 736.1503 and is created on or after July 1, 2021. Therefore, it appears that a pre-existing trust cannot be converted into a community property trust, but trust assets existing on or before July 1, 2021, can be "decanted" or transferred into a new community property trust.

"Community Property" is defined under 732.1502(1) as "the property and the appreciation of and income from the property owned by a qualified trustee of a community property trust during the marriage of the settlor spouses. The property owned by a community property trust pursuant to this part and the appreciation of and income from such property shall be deemed to be community property for purposes of general law." Readers should be aware that there is no definition of "general law" provided by the statutes. It seems, in any case, that it is not necessarily community property under the law of an American state or territory or of a foreign jurisdiction which is necessary for Section 1014(b)(6) to apply.

A "qualified trustee" is defined under Florida Statute Section 736.1502 to be either (a) a natural person who is a resident of Florida, or (b) a company authorized to act as a trustee in Florida.

736.1502 defines "settlor spouses" to mean a married couple who establish a community property trust pursuant to the statute.

In order for a married couple to form and maintain a Florida community property trust, the Act requires that one or both settlor spouses transfer property to a trust that meets the following four requirements:

1. Expressly declares that the trust is a community property trust "within the meaning of this [statute]"

2. Has at least one trustee who is a qualified trustee "provided that both spouses or either spouse also may be a trustee."

3. Is signed by both settlor spouses consistent with the formalities required for the execution of a trust [under this chapter].[120]

4. Contains substantially the following language in capital letters at the beginning of the community property trust agreement:

"THE CONSEQUENCES OF THIS COMMUNITY PROPERTY TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH RESPECT TO CREDITORS AND OTHER THIRD PARTIES, AND YOUR RIGHTS WITH YOUR SPOUSE DURING THE COURSE OF YOUR MARRIAGE, AT THE TIME OF A DIVORCE, AND UPON THE DEATH OF YOU OR YOUR SPOUSE. ACCORDINGLY, THIS TRUST AGREEMENT SHOULD BE SIGNED ONLY AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY

[120] *Revocable Trust Execution Requirements: A Notary is Not Needed*, Jeff Baskies and Mary Karr. The Real Property, Probate & Trust Law Section of the Florida Bar. April 29, 2020.

QUESTIONS ABOUT THIS TRUST AGREEMENT, YOU SHOULD SEEK COMPETENT AND INDEPENDENT LEGAL ADVICE."

Florida Statute Section 736.1504 provides that the trust agreement that establishes the community property trust may include agreement by the settlor spouses upon the following:

a. The rights and obligations in the property transferred to the trust, notwithstanding when and where the property is acquired or located.

b. The management and control of the property transferred into the trust.

c. The disposition of the property transferred into the trust on dissolution, death, or the occurrence or nonoccurrence of another event, but subject to both of the following limitations:

Limitation 1 - Under Florida Statute Section 736.1507, upon "the death of a spouse, one-half of the aggregate value of the property held in a community property trust …is not subject to testamentary disposition by the decedent spouse or distribution under the laws of succession…the other one-half…reflects the share of the decedent spouse and is subject to testamentary disposition or distribution under the laws of succession of the state.”

Limitation 2 - Florida Statute 736.1508 states that, upon dissolution of the marriage of the couple, the community property trust will terminate, and the trustee will distribute one-half of the trust assets to each spouse.

It is important to note that Florida Statute Section 736.1508 appears to provide that the married couple can contractually agree to share the assets of the community property trust other than equally in the event of the dissolution of marriage, but does not seem clear to the authors.

The authors are not sure whether the spouses can have a prenuptial or postnuptial agreement that would require the equal ownership of assets received from the community property trust to be adjusted after receipt, such as upon the event of a divorce filing, after the literal language of the statute has been satisfied by facilitating an equal distribution.

It seems that once the assets are distributed from a Florida community property trust to the spouses while living they will be considered to be the couple's separate property. Unlike Alaska law, which provides that assets contributed to an Alaska community property trust and declared to be as community property under Alaska law remain community property under Alaska law if and when distributed out, Florida law does not continue to treat the assets as community property (as Florida has no community property law outside of a Florida community property trust).

d. Whether the trust is revocable or irrevocable. The presumption is that the trust is revocable unless stated otherwise.

There are advantages to having an irrevocable community property trust. This includes the reduction of risk that one or more individuals may unduly influence the married couple to change the trust and to lose access to the assets thereof.

e. Any other matter that affects the property transferred to the trust "and does not violate public policy or general law…or result in the property not being treated as community property under the laws of any jurisdiction."

The statute further provides that in the event of the death of a settlor spouse, the surviving spouse may amend the trust with reference to the disposition of the surviving spouse's one-half share of the trust "regardless of whether the agreement provides that the community property trust is irrevocable," or regardless of what the trust agreement says to the contrary. This (and Limitation 1 described above) underscores the principle that the surviving spouse's one-half of the community property trust is the surviving spouse's property that vests in the surviving spouse upon the first dying spouse's death. Moreover, this prevents distributions from being made to descendants, charities, or others from a community property trust, and causes loss of flexibility, but enhances the protection of the married couple themselves.

With regard to homestead property, Florida Statute 736.151, contained within the FCPTA, provides the following:

> Property that is transferred to or acquired subject to a community property trust may continue to qualify or may initially qualify as

> the settlor spouses' homestead within the meaning of s. 4(a)(1), Art. X of the State Constitution and for all purposes of general law, provided that the property would qualify as the settlor spouses' homestead if title was held in one or both of the settlor spouses' individual names.

However, with no existing case law on transferring homestead property to a Florida community property trust, it is still unknown what nuances might arise with regard to creditor protection, forced inheritance rules, and property taxes, and it would seem that the $250,000 per spouse exemption from capital gains tax that applies under IRC Section 121 if and when a home that has been owned under a Community Property Trust is sold.

NO GUARANTEE OF A 1014(B): USING AN OPT-IN COMMUNITY PROPERTY TRUST FOR ACHIEVING THE DOUBLE STEP-UP IN BASIS UNDER IRC SECTION 1014(B)(6)

While the Alaska, Tennessee, Florida, and Kentucky Community Property Trust Acts seek to provide non-residents with the ability to "opt-in" to the advantages of community property, commentators have pointed out concerns about whether the trusts will be afforded such tax treatment, and that creating such trusts can potentially forfeit valuable creditor protection benefits.

There is a question as to whether an elective community property arrangement like the Florida Community Property Trust Act will be recognized by the IRS as a legitimate community property arrangement to qualify all trust assets for a fair market value date of death basis step-up under Internal Revenue Code Section 1014(b)(6) on the death of the first dying spouse. The IRS has not formally commented on the efficacy of community property trust arrangements, although well respected commentators have concluded that it "should qualify." With the warning that this tax treatment is "not absolutely certain," Jonathan Blattmachr, Howard Zaritsky and Mark Ascher in "Tax Planning with Consensual Community Property: Alaska's New Community Property Law" provide extensive discussion of the *Harmon* case and statutory law that exists in this area.[121]

Since Blattmachr, Zaritsky, and Ascher published their article in 1998, the IRS updated its Publication 555 on community property to specifically provide that "[t]his publication does not address the federal tax treatment of income or property subject to the 'community property' election." It is unknown whether the IRS will take a closer look at whether an "opt-in" community property trust will be afforded a step-up in basis to all trust assets in light of the advent of elective community property trust systems, and that Florida has implemented an elective community property trust regime which will open this planning tool to many more married couples who may have family, friends, or advisors in Florida who can serve as trustees so as to avoid paying trust company fees for a community property trust.

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[121] Jonathan G. Blattmachr, Howard M. Zaritsky, and Mark L. Ascher, *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 Real Prop. Prob. & TR. J. 615 (1998) Page 631.

Commentators who urge caution point to the 1944 U.S. Supreme Court decision of *Commissioner v. Harmon*,[122] which involved a married couple who opted into community property treatment under an Oklahoma law that was passed to allow married couples living there to elect whether to have community property characterization apply to their assets.

Before 1948, married couples could not file joint federal income returns, so each spouse would file a separate return and the spouse with more income would be in a higher tax bracket. Married couples living in community property states were nevertheless able to divide their income from community property equally on income tax returns, giving them an advantage over married couples living outside of community property states.

The U.S. Supreme Court held in *Harmon* that the act of electing into the community property regime constituted an "assignment of income" and quoted the 1930 United States Supreme Court case of *Lucas v. Earl*. *Lucas v. Earl* is one of the most famous United States Supreme Court tax cases and provides that a taxpayer cannot avoid taxation on income by assigning in advance of receipt.[123]

While some read this case to indicate that it may not be possible to elect into community property status to receive tax advantages, the *Harmon* decision is somewhat vague and seems to base its conclusion on the fact that the Oklahoma statute "permits voluntary action which effects a transfer of rights of the husband and wife, and that the situation is governed by *Lucas v. Earl* and other decisions of like import."[124] In essence, the majority opinion distinguished community property treatment applicable by operation of law upon marriage from community property treatment that applies "by contract" such as where an election is made by the married couple.

The 1958 United States District Court decision of *McCollum v. United States* seems to support the proposition that the 1014(b)(6) step-up in basis will apply to community property created as a result of an election made by the spouses. In *McCollum*, a married couple elected under the then-applicable 1943 Oklahoma law to treat their assets as community property, and in 1945 Oklahoma changed its law to require that all of a married couple's assets had to be considered to be community property.[125] Mr. McCollum died after the community property status became mandatory and Mrs. McCollum took a full step-up in basis for the full value of the community property that existed on Mr. McCollum's date of death. The court allowed the full step-up in basis.

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[122] *Commr. of Internal Revenue v. Harmon*, 323 U.S. 44 (1944).

[123] *Id*. at 46. "Under Lucas v. Earl an assignment of income to be earned or to accrue in the future, even though authorized by state law and irrevocable in character, is ineffective to render the income immune from taxation as that of the assignor. On the other hand, in those states which, by inheritance of Spanish law, have always had a legal community property system, which vests in each spouse one half of the community income as it accrues, each is entitled to return one half of the income as the basis of federal income tax."

[124] Jonathan G. Blattmachr, Howard M. Zaritsky, and Mark L. Ascher, *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 Real Prop. Prob. & TR. J. 615 (1998) Pg. 626.

[125] 58-2 U.S.T.C. (N.D.Okla. 1958)

The *McCollum* decision seems consistent with the notion that Section 1014(b)(6) applies to elective community property as well as mandatory community property. Although Oklahoma had a mandatory community property system, by the time the decision was reached, and because the property at issue was acquired before the change of law in 1945, the property would not have been community property under the 1945 Oklahoma community property law, except by reason of the fact that the McCollum's had previously designated it as community property under the elective system.

Internal Revenue Code Section 1014 was enacted in 1948, only four (4) years after the Supreme Court decision in *Harmon*, and it is therefore possible that Congress recognized the issue by enacting Section 1014(b)(6). This is evidenced by the fact that Congress made no mention in the statutory language and provided no legislative history that would distinguish between elective and mandatory community property systems that existed when the statute was updated. Section 1014(b)(6) is very clear that the step-up in basis applies to the surviving spouses share of community property "held by the decedent and the surviving spouse under the community property laws of <u>any</u> State, or possession of the United States or any foreign country…" (emphasis added), without distinction for elective community property laws or without regard to unique characteristics that a State might have with respect to its community property laws (such as creditor protection features).

A 1977 Revenue Ruling discusses the differences between separate property and community property income, and references the *Harmon* case vis-a-vis the issue of whether income generated by separate property has become community property by agreement between the spouses.[126] "To the extent that the agreement affects the income from separate property and not the separate property itself, the Service will not permit the spouses to split that income for Federal income tax purposes where they file separate income tax returns." *Commissioner v. Harmon*, 323 U.S. 44 (1944), 1944 C.B. 166. The Ruling acknowledges that property converted from separate property to community property is community property for federal tax purposes, and makes no mention as to whether the Service will distinguish between elective and mandatory community property systems.

Blattmachr, Zaritsky, and Ascher conclude as follows on the step-up in basis tax issues:

> Because the Alaska Community Property law's treatment under Section 1014(b) remains untested, a couple seeking a full step-up in basis when the first spouse dies should preferably place all of their assets in the name of the spouse who is expected to die first. Unfortunately, crystal balls are scarce. Moreover, no change in

[126] Rev. Rul. 77-359, 1977-2 C.B. 24 (IRS RRU 1977). "Accordingly, where a husband and wife residing in the State of Washington agree in writing that all presently owned property and all property to be acquired thereafter, both real and personal, will be community property, such agreement changes the status of presently owned separate property and subsequently acquired separate property to community property."

basis occurs when a donor gives property to the decedent within a year of death and then acquires it directly or indirectly.[127]

There are no known cases or audits, so the risk of this being an issue as a practical matter may be quite small. Nevertheless, the issue will have a larger profile on the IRS's radar now that Florida and its citizenry will be entering into this arena.

For those looking for reassurance, in a June 29th Florida Bar Real Property, Probate, and Trust Law Section presentation entitled "An Examination of the New Florida Community Property Trust Act", Travis Hayes and Robert Lancaster stated that "The IRS is silent on the federal tax treatment of property subject to the community property election . . . silence doesn't mean ineffective . . . as it stands to date, Alaska established these in 1998, Tennessee in 2010, and there are no known cases where the IRS has challenged these opt-in community property trusts. And you know, I know from my personal discussions with trustees in those jurisdictions, that they've not had any situation where they did not get the basis adjustment either.

As mentioned above, an additional concern with respect to Florida's Community Property Trust Act is whether it is possible to have community property when the assets are not 100% accessible to the creditors of one spouse. Because Alaska and South Dakota allow creditors of one spouse to access 100% of the assets held in a community property trust, assets held in community property trusts in those states are treated more like traditional community property than with a Tennessee, Kentucky, or Florida community property trust. Few articles have been written on this subject, and no definitive authority on this issue exists, but it is a possible argument that the IRS could use to support the proposition that Florida's "elective community property" statute does not result in the assets held under the trust being "real community property." Therefore, in the abundance of caution, it may be safer to use an Alaska or South Dakota community property trust for purposes of receiving the Section 1014(b)(6) double stepped-up basis, although the authors do not believe that any such IRS argument would have any merit due to Section 1014(b)(6) not making any distinction between the types of community property laws of the States.

CONCLUSION

In conclusion, the Florida Community Property Trust Act should be well understood by estate and tax planning professionals based in Florida, or who have Floridian clients or clients with Florida ties, as a potential tool that will benefit married couples who have substantially appreciated assets and would like to avoid federal income tax by being able to sell the assets after the death of the first dying spouse. In addition, estate and tax planners throughout the United States should be somewhat familiar with the various community property trust acts in order to determine which state will be most appropriate for clients for whom the community property trust would be a good fit.

Given that all five states have statutes which are probably effective to provide a full step-up in basis upon the first dying spouse's death, the main criteria may be what family members or advisors or trust companies would be preferable trustees. A secondary consideration

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[127] Jonathan G. Blattmachr, Howard M. Zaritsky, and Mark L. Ascher, *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*. Pg. 633.

might be whether all assets held under a Community Property Trust are accessible to creditors, such as using a state (Florida, Kentucky, or Tennessee) that does not expose 100% of the community property trust assets to creditors, versus using a state (Alaska or South Dakota) that exposes all of the Community Property Trust assets to creditors.

Alan Gassman & Jonathan G. Blattmachr: STEPPING UP EFFORTS TO STEP-UP BASIS FOR MARRIED COUPLES

EXECUTIVE SUMMARY:

The capital gains tax may be the most formidable tax challenge for surviving spouses who need to sell assets to support themselves. The increase in this tax from 15% to 20%, with the additional 3.8% Medicare tax for those with high income in the year of sale makes this a very important topic to cover with clients and their families.

The primary estate planning goal of most married couples is to provide as well as possible for the surviving spouse, but most of them do not recognize that 23.8% of the lifetime appreciation of family investments including in many cases on a large residence will have to be paid to the government in order to produce money for the surviving spouse.

For some survivors, this will be a devastating reality that must be faced when the cost of an adult congregate living facility and proper care is compared to the net proceeds that can be derived from the liquidation of assets. Even a modest investment portfolio owned by a retired married couple can be significantly impacted by these taxes, and the more modest the asset basis, the more crucial it is to protect against lost value due to capital gains taxes.

FACTS:

There are three primary ways that the typical non-community property state couple can attain a full step-up in basis for assets on the first death (understanding that some assets, such as those in pension plans or IRAs never receive a step up when the owner dies):

Have the assets owned by the first dying spouse more than one (1) year before he or she dies, or if the one (1) year period cannot be met, have the spouse leave the assets to a trust that may benefit the surviving spouse and not trigger the one (1) year rule under Internal Revenue Code Section 1014(e), which denies a step up in basis with respect to assets the spouse dying first received by gift from the survivor within a year of death and that are re-inherited back by the spouse who made the gift. Trying to guess who dies first and even having to talk about this can be a difficult and risky proposition.

The couple can amend their estate planning documents to either provide that each of them will have a testamentary power of appointment over assets held in on another=s separate revocable trusts or form one joint JEST (Joint Estate Step-up Trust), in which event Private Letter Rulings 200101021, 200210051, and 200403094 and TAM 9308002 support the proposition that assets owned jointly under a JEST Trust or under the revocable trust of a surviving spouse may be considered to have passed through the taxable estate of the first dying spouse, although there are Section 1014(e) one (1) year rule and fundamental issues associated with this (such as whether the private letter rulings and the technical advice memorandum are correct). These issues and possible drafting solutions are discussed at length in LISI Estate Planning Newsletter No. 2086 and the October and November 2013 issues of Estate Planning Magazine that were co-written by Alan S. Gassman, Tom Ellwanger, Christopher J. Denicolo, and Kacie Hohnadell.

This technique has its downsides, as described in the chart below but the JEST Trust itself has no annual cost associated with it unless there are changes in the client=s estate plan. Many clients prefer to have their assets under a single trust created by and for both of them, and preexisting separate trusts can be amended and restated to be considered a part of the single JEST Trust so that re-titling of assets is not required. It will take the planner a few hours to draft and thoroughly review their initial trust draft. See Estate Planning Newsletter No. 2086 for a discussion of some of the provisions Alan Gassman includes in his documents.

The most reliable way to achieve a full step up on the first death, with potential incidental asset protection features is to establish a conventional Alaska Community Property Trust with an Alaskan Co-Trustee. The Alaskan community property statute was enacted in 1998 to allow both Alaskan couples and non-Alaskan couples to form trusts there to comply with Internal Revenue Code Section 1014(b)(6), which provides that community property will receive a full step up on the death of one spouse. This technique has been endorsed by not only Jonathan Blattmachr, who originated the concept, but also by Howard Zaritsky and a number of other well respected experts. It is essentially a joint revocable trust which will be used as the principal estate planning document as the spouses die. The Alaska Trust Company provides the trust form to professionals who use these, and an Alaskan lawyer is available to review and approve the trust document for only about $1,000.

COMMENT:

Assume that a married couple in their late sixties has $500,000 of investments with a cost basis of $100,000, and their home=s worth is $100,000.

If one spouse dies owning one-half (2) of the assets or the assets are jointly owned in a non-community property state and one of them dies, his or her half of the assets will receive an automatic change in income tax basis to its estate tax value (even if no estate tax is due) and the inherent gain in those assets are forgiven. That result is known as the income tax free “step up in basis” at death. But the inherent gain in the survivor=s half of their wealth will not be stepped up. That means then that there is $200,000 worth of untaxed gain that will cost, depending upon several factors including whether the couple lives in a jurisdiction with state and local taxes of, perhaps, over $50,000 in capital gains tax in order to liquidate their wealth to provide cash to support the surviving spouse or to buy into a retirement center unit.

Contrast that couple’s situation with one if they live in a community property state, such as Texas or California. For that couple, all of the inherent gain is “forgiven” when the first spouse dies. Therefore, the survivor would face no capital gains tax in liquidating the couple’s wealth.

A couple with $2,000,000 of assets and a $500,000 home with the same ratios of growth face a much larger tax which could be $450,000 or more. The above assumes that tax rates will not rise and that there will be no state income tax to be paid.

Why do so many planners fail to discuss this with clients, much less put mechanisms in place to assure a complete step-up in basis of all of a couple’s assets on the first death? One reason is that the full impact of the large capital gains tax increase has not yet been felt by many clients. Another is the complexity of the recent estate tax changes, and especially the attention given to wealthy clients during 2012 to use their large gift and generation-skipping transfer tax exemptions. Now estate planners can get their eyes on the capital gains avoidance ball.

Conclusion:

Planners need to become accustomed to stepped-up basis planning being in the forefront of objectives and structuring. The Alaska community property trust is extremely under-utilized, and the JEST trust or stepped-up basis power of appointment arrangements can be considered for those clients who for whatever reason would not prefer to use an Alaska community property trust.

CITE AS:

QUESTIONING THE VALIDITY OF USING AN OPT-IN COMMUNITY PROPERTY TRUST FOR ACHIEVING THE DOUBLE STEP-UP IN BASIS UNDER IRC SECTION 1014(B)(6)

While the Alaska, Tennessee, Florida, and Kentucky Community Property Trust Acts seek to provide non-residents with the ability to "opt-in" to the advantages of community property, commentators have pointed out concerns about whether the trusts will be afforded such tax treatment, and that creating such trusts can potentially forfeit valuable creditor protection benefits.

PRACTICAL PROBLEMS WITH TENANTS BY THE ENTIRETIES AND WHY FAMILY LLCS AND LIMITED PARTNERSHIPS ARE COMMONLY USED.

(1) What if both spouses get sued?

(2) What if the non-debtor spouse dies while the debtor spouse is waiting for the jury to come in?

(3) What if the spouses are divorced and the debtor spouse receives an outright disposition?

(4) What if the law changes?

A common solution to these concerns is to establish a Family Limited Partnership or a Limited Liability Company to own the tenancy by the entireties assets, so that there would at least be charging order protection if the tenancy by the entireties protection was compromised.

Another common solution is to keep an expensive term life policy owned by a spouse who may die first, and make this payable to a trust that will be irrevocable that will benefit the surviving spouse, to hopefully replace assets that might be lost by reason of outright ownership by the surviving spouse.

SAME SEX COUPLE IMPLICATIONS.

A good number of same sex couples who are now married owned property jointly before marriage and now must re-convey the property to themselves as tenants by the entireties in order to have protection. Florida did not recognize the marriage of same sex couples until it was required to do so by the 2015 U.S. Supreme Court Case of *Obergefell v. Hodges*.[128] Nevertheless, same sex couples who were married in states that recognized their marriage before June 26, 2015, can be expected to argue that their marriages were considered to be effective, and that tenancy by the entireties should apply, notwithstanding that Florida did not recognize the marriage until June 26, 2015.

[128] 135 S. Ct. 2584 (2015); see also *Brenner v. Scott*, 2016 WL 3561754 (N.D. Fla. Mar. 30, 2016) (holding Florida Statutes Section 741.212, which prohibits the recognition of same sex marriage, as unconstitutional).

CHAPTER 3:
ANNUITY CONTRACTS

INTRODUCTION.

Florida and several other states offer unlimited protection of permanent life insurance and the cash values of annuity contracts. The life insurance and annuity industries have come to market with mutual fund wrapped products that provide income tax deferral and creditor protection for policyholders and their families. And while these protections are sweeping there are nuances that individuals have to be aware of regarding beneficiaries, declaring bankruptcy, income tax, guaranty fund rules, settlements, and lottery arrangements. This chapter will also explore the different instrumentalities that can be used to create annuities and best planning practices. Florida Statutes Section 222.14 provides as follows:

> The cash surrender values of life insurance policies issued upon the lives of citizens or residents of the state and the proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor of the person whose life is so insured or of any creditor of the person who is the beneficiary of such annuity contract, unless the insurance policy or annuity contract was effected for the benefit of such creditor.

BENEFICIARIES.

The statute only protects the proceeds of annuity contracts when the debtor is the beneficiary of the contract. It would be assumed that the owner of an annuity contract is its beneficiary, although by the terms of the contracts, the "beneficiary" is typically the party designated to receive the payout of the annuity upon the death of the initial owner. In the bankruptcy court case of *In Re Zeitz,*[129] the court found that while beneficiaries of life insurance policies are not accorded creditor protection for policy proceeds, the reference in Florida Statutes Section 222.14 to "any creditor of the person who is the beneficiary of such annuity contract" protects both a lifetime payee and remainder interest beneficiaries under a commercial annuity contract. The court quoted the 2nd Restatement of Trusts which defines beneficiary as "the person for whose benefit property is held in trust."[130]

The holding in *Zeitz* was clarified by *In re Turner*, stating that the determination of whether an individual is a beneficiary of an annuity contract or whether a settlement agreement constitutes an annuity contract is settled in Florida law.[131] As the law currently stands, individuals may receive

[129] 171 B.R. 903 (Bankr. S.D. Fla. 1994).
[130] *Id*. at 905.
[131] 332 B.R. 461, 463 (Bankr. N.D. Fla. 2005) (holding that a settlement agreement that did not specify beneficiaries was not sufficient to grant exempt proceeds under an annuity contract).

exempt proceeds under a settlement agreement if those individuals were named beneficiaries in an annuity contract.

The 2019 Bankruptcy Court decision of *In re Rensin* involved Cayman Islands-based annuity contracts that were purchased by the trustee of an offshore trust for the benefit of an insolvent debtor, who was given the ability to borrow money from the annuity contracts, but only with consent of the trustee of the asset protection trust. The trustee purchased two annuity contracts that were custom written, and apparently had errors in drafting. One contract was "annuitized" and paid a fixed monthly amount to Mr. Rensin. Further, the contract was found to be protected as an annuitized domestic annuity contract would be. The other contract was not yet making payments to Mr. Rensin, but the trustee had the right to require that payments be made.

Judge Kimball of the United States Bankruptcy Court found that Mr. Rensin was the beneficiary of an annuity contract that had been activated to pay him $15,000 per month for his lifetime, with the remainder of the contract to be held by the offshore asset protection trust on his death, and found that a second annuity contract that had not yet begun paying money to Mr. Rensin was also not available to his creditors even though the judge opined that Florida law should apply to allow creditors to reach trust assets. The trust apparently had no assets but the annuities, and the court found that the trustee's decision to invest the trust's assets in annuities after Mr. Rensin had a large judgment against him by the FTC was a decision and transfer made by the trustee, not by the debtor, and therefore not subject to the Florida or federal fraudulent transfer statutes. Specifically, the judge had the following to say about the annuity contracts:

APPLICABLE PROVISIONS OF THE ANNUITY CONTRACTS:

> Under the variable annuity, Mr. Rensin is the annuitant with the right to receive monthly payments during his life, commencing on the annuity starting date. Prior to the annuity starting date, the funds are invested. The Joren Trust is the owner of the variable annuity as well as the beneficiary entitled to receive payments after Mr. Rensin dies. The variable annuity contract becomes irrevocable on the annuity starting date. The variable annuity contract itself is silent on the annuity starting date. Based on Mr. Rensin's deposition testimony, the annuity starting date has not occurred. Because the annuity starting date has yet to occur, the Joren Trustee has the power to surrender the variable annuity, thereby canceling it, and also has the power to make withdrawals. In addition, prior to the annuity starting date, Mr. Rensin may borrow from the investment pool up to 90% of its value. But because the Joren Trustee can cancel the variable annuity at any time during the same period, the right to borrow is effectively subject to veto.
>
> As with the variable annuity, under the fixed annuity Mr. Rensin is the annuitant with the right to receive monthly payments during his life, commencing on the annuity starting date. Unlike the

variable annuity, the annuity starting date for the fixed annuity has occurred and the issuer makes regular monthly payments directly to Mr. Rensin. The Joren Trust is the owner of the fixed annuity as well as the beneficiary entitled to receive payments when Mr. Rensin dies. Unlike the variable annuity contract, the fixed annuity contract omits section 6.4, the operative provision for surrender of the contract or withdrawal of funds. The references to surrender and withdrawal in sections 6.1 and 6.2 are surplusage in light of the deletion of section 6.4 from the form of the fixed annuity contract. The fixed annuity contract includes section 6.3, permitting borrowing, but that right terminated upon the annuity starting date. Under section 4.3, the fixed annuity contract became irrevocable on the annuity starting date. The overall effect of these provisions is that the rights of the Joren Trust and Mr. Rensin are permanently established under the fixed annuity contract, subject to minor adjustments not relevant here.

Section 11.1 of each annuity contract states that if the annuitant is not also the owner, "all of the Annuitant's rights, title, interest and obligations under this policy vest in such Owner(s) and in such case the policy shall be read substituting 'Owner' in place of 'Annuitant' as respectively required." Reading just this provision, one might assume that the Joren Trust, as owner, is to be substituted in each instance where the annuity contract uses the word "annuitant." But the inclusion of the phrase "as respectively required" suggests that the substitution of terms is not universal. It is obvious from a review of the annuity contracts that substituting the owner for the annuitant in every instance does not make sense. Among other things, the Joren Trust has no "birthday" nor will it ever suffer "death" in the obvious meaning of that term in the annuity contracts.

Section 2.0 of each annuity contract provides for payments to the annuitant. If the owner is substituted for the annuitant under this provision, during Mr. Rensin's life the issuer would make payments to the Joren Trustee rather than to him. After receiving such payments, the Joren Trustee could exercise discretion whether to provide any of such funds to Mr. Rensin but would not be required to pay anything to him. On the other hand, if Mr. Rensin is entitled to receive direct payments from the issuer of the annuity contracts, neither the right to such annuity payments nor the funds themselves ever become part of the Joren Trust.

With regard to the fixed annuity, the issuer has been making and continues to make monthly payments directly to Mr. Rensin. This supports the conclusion that Mr. Rensin, as annuitant, has the right to receive such payments and retains that right until his death under the now irrevocable fixed annuity. Mr. Rensin's right to receive payments under the fixed annuity contract is not part of the Joren Trust but represents his personal right under the contract. The Joren Trust holds only the remainder interest under the fixed annuity contract, after Mr. Rensin's death.

With regard to the variable annuity, the annuity starting date has not occurred, and so no monthly payments are being made. The Joren Trustee may surrender the variable annuity or withdraw funds. Mr. Rensin may borrow up to 90% of the investment pool, but this right is constrained by the Joren Trustee's right to surrender. One might argue that Mr. Rensin's right to borrow under the variable annuity is property of the bankruptcy estate, but if the plaintiff attempted to exercise that right the Joren Trustee could simply terminate the contract.

MR. RENSIN'S ANNUITY PAYMENT RIGHTS ARE EXEMPT FROM ADMINISTRATION IN THIS CASE.

Mr. Rensin scheduled his rights to payment under the annuities as exempt, conceding that such rights are property of his bankruptcy estate if not exempt. Mr. Rensin holds irrevocable payment rights under the fixed annuity. He holds payment rights under the variable annuity, subject to the Joren Trustee's right to surrender that contract prior to the annuity starting date. Mr. Rensin claims all of these payment rights as exempt under Fla. Stat. § 222.14.

Florida Statutes § 222.14 provides, in relevant part: "The ... proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of ... any creditor of the person who is the beneficiary of such annuity contract, unless the ... annuity contract was effected for the benefit of such creditor." In this statute, the term "beneficiary" means a person who receives payments under an annuity contract. The creditors of such a payee may not execute on the annuity payments. Mr. Rensin is a "beneficiary" under this provision as he is entitled to payments under the annuities.

The Florida annuity exemption protects Florida citizens and residents who receive payments under annuity contracts. At least one court has ruled that section 222.14 requires that the annuity contract also be issued to, and thus owned by, a Florida citizen or resident, even if that person is not receiving the annuity payments. The issue is material here because the Joren Trust, a resident of Belize, owns the contracts.

The statutory phrase "issued to citizens or residents of the state" is the key to this question. One court, cited by Mr. Rensin, initially ruled that this phrase modifies the term "annuity contracts" and so the annuity contract must be issued to a citizen or resident of Florida. *In re Pizzi*, 153 B.R. 357 (Bankr. S.D. Fla. 1993). That same court later ruled that the phrase "issued to citizens or residents of the state" modifies the word "proceeds" and so the proceeds must be payable to a citizen or resident of Florida. *In re Belue*, 238 B.R. 218 (Bankr. S.D. Fla. 1999) (noting that the issue was not critical to the same court's prior decision in *Pizzi*); accord *In re Bennett*, 217 B.R. 654 (Bankr. M.D. Fla. 1998); *In re Benedict*, 88 B.R. 387 (Bankr. M.D. Fla. 1988). The latter view is the majority view and most closely reflects the obvious intent of the statute.

It does not matter that the Joren Trust is the owner of the annuity contracts. Mr. Rensin is a citizen and resident of Florida. Mr. Rensin's rights to payment under the annuities are exempt under Fla. Stat. § 222.14.

The plaintiff argues that to permit a debtor to exempt rights under an annuity contract that is owned by a non-Florida person or entity would only encourage fraudulent or inappropriate behavior. It is hard to see how this is the case. The statute protects payment rights under annuity contracts. The Florida legislature determined that, except when acquired with fraudulent intent in violation of Fla. Stat. § 222.30 or if the exemption results from a fraudulent transfer or conveyance in violation of Fla. Stat. § 222.29, all payment rights under an annuity contract are exempt from process. When an annuity contract provides for payments to a citizen or resident of Florida, it does not matter who owns the contract. There are a variety of valid reasons why an annuity contract may be owned by a person other than those entitled to payment. For example, an estate plan may include an annuity contract providing payments to the testator while alive with the remainder paid to a trust that is also designated the owner of the contract. If section 222.14 is interpreted to require the owner of the annuity contract to also be a Florida citizen or resident, this would greatly restrict the selection of a trustee, without any valid purpose. In any case, Fla. Stat. §§ 222.29 and 222.30 address the concerns raised by the plaintiff by limiting the effect of the exemption provisions where fraud is involved.

THANK YOU DR. GOLDENBERG.

In *Goldenberg v. Sawczak*,[132] Dr. Goldenberg filed for bankruptcy the same day a malpractice suit was to begin trial against him. The doctor filed bankruptcy schedules showing $3,751,678 out of $3,791,119 in assets as being exempt.

This included $355,894 in annuity contracts, which were single premium deferred annuities for which Dr. Goldenberg had paid a single premium for a contract that accumulated earnings until the maturity date.[133] Each of the contracts provided for a future date as to which sums owed would become payable to Dr. Goldenberg or his survivors, and each of them contained a provision for surrender of the contract in exchange for a specified lump sum payment.

The bankruptcy court held that the cash surrender value of a variable investment annuity contract was protected from creditor claims under Florida Statutes Section 222.14, but on appeal, the Court found that "Dr. Goldenberg did not have annuity contracts until the funds in the annuity account reached maturity." Instead, he had option contracts to buy annuities at a future date which could be revoked by him at any time prior to the maturity date. This sent shudders through the annuity and creditor protection community in 2000 and 2001.

The Eleventh Circuit Court of Appeals certified this case to the Florida Supreme Court and the Florida Supreme Court decided in a 7-0 decision that if the Florida legislature had wanted to limit what would qualify as an annuity, they would have so stated in the statute. The exact language of the holding was as follows:

> The terms of section 222.14 are clear. No reliance on legislative history is needed to determine intent where the statutory language is clear. The statutory addition in 1978 simply added "annuity contracts" to the existing statute. Sawczak would have us define the term "proceeds" to include only those payments that commence at the maturity date of Goldenberg's policies. In other words, Sawczak maintains that moneys received by surrendering an annuity contract are not proceeds. We do not find a basis for such a narrow definition of "proceeds" in the statute or in the commonly accepted definition of proceeds. The dictionary definition of proceeds is "the net amount received after deduction of any discount or charges." The only difference between receiving payment streams after maturity and a settlement payment before maturity is the surrender charge. Thus, we conclude that the "proceeds of annuity contracts" include moneys received from surrendering an annuity contract prior to maturity.

Although the Supreme Court decision made mention that the annuity contracts that were owned by Dr. Goldenberg were subject to substantial penalties for early withdrawal, this statement should not be read to mean that no load variable annuities would have any less protection than the typical commissioned loaded annuity arrangement. No-load annuity companies charge ongoing

[132] 791 So.2d 1078 (Fla. 2001).

[133] *In re Goldenberg,* 253 F.3d 1271, 1273 (11th Cir. 2001).

administrative, maintenance, and mortality fees that may cost significantly less than other comparable annuity products.

INCOME TAX ASPECTS.

Tax deferral offered by commercial annuity contracts may result in greater after-tax returns. But consider whether the client would be better off paying a 20% capital gains tax as opposed to ordinary rates if appreciated stocks are the primary underlying investment. Consider the penalty imposed upon taxable income withdrawn before age 59 1/2.

FLORIDA GUARANTY FUND RULES.

Florida has a Guaranty Fund that covers failed annuity contracts for up to a certain dollar amount per contract. This is generally based upon up to $100,000 per contract, and up to 3 contracts per carrier. This is why many Floridians purchase 3 separate $100,000 or less contracts with each applicable carrier and diversify among carriers for Guaranty Fund and practical purposes.

It is important to note that the protection provided by the Florida Guaranty Fund against the insurer's insolvency will not guarantee any portion of a variable annuity contract that is not guaranteed by the insurer. It is therefore important to understand any variable annuity contract that the client establishes with the expectation of qualifying under the Guaranty Fund. Section 631.713 provides:

> (1) This part shall apply to direct life insurance policies, health insurance policies, annuity contracts, and supplemental contracts with or without life contingencies issued by persons licensed to transact such insurance in this state.
> . . .
>
> (3) This part does not apply to:
>
> > (a) That portion or part of a variable life insurance contract or variable annuity contract not guaranteed by an insurer.

STRUCTURED SETTLEMENTS CAN QUALIFY IF PROPERLY STRUCTURED.

Structured settlements should be considered for any clients settling a personal injury claim because they are creditor-protected assets under Florida law.[134] Under a structured settlement, annual fixed payments received based upon a specified settlement will all be tax free, notwithstanding the interest income element inherent in such contracts.[135]

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[134] See *In re McCollum*, 986 F.2d 436 (11th Cir. 1993).

[135] See Alan S. Gassman & Randal E. Gassman, *Structured Annuities: What Every Plaintiffs Lawyer Should Know,* The Practical Litigator (May 1997).

In *In re McCollum*,[136] the Florida Supreme Court found that Section 222.14 exempted an annuity that was created in lieu of a defendant paying a lump sum settlement. This case stands for the proposition that the conversion of a cause of action in a personal injury suit to a structured settlement annuity will not be considered a fraudulent transfer. The Supreme Court noted that annuities have been defined as "the right to receive fixed, period payments for a term of years of life." The Court also looked at Florida Statutes Section 238.01(15), which is part of the State Teachers' Retirement System Law, which defines annuity as "annual payments for life . . . from the cumulated contributions of the member."

In *In re Solomon*,[137] the Eleventh Circuit found that where a structured settlement is arranged whereby the defendant insurance company has all legal and equitable interest in an annuity contract and agrees to make payments over time to the plaintiff/debtor, such arrangement was not exempt under Section 222.14. The Court stated, "the statute does not shield all debts or "accounts receivable" structured to resemble annuities from a debtor's bankruptcy estate."

In *In re Turner*,[138] the Court found that an annuity contract did not exist under Florida Statutes Section 222.14 where the litigant released her claims against the insurance company in order to receive a structured settlement. The agreement did not specify that settlement proceeds were to be paid under an annuity contract, and did not refer to the litigant as the beneficiary or payee.

In *Ministri Family LLC v. Bell*,[139] the United States District Court for the Middle District of Florida held, in an extremely thorough and well-written opinion, that a structured settlement annuity "owned" by the defendant insurance company that listed the plaintiff as the irrevocable payee was exempt from creditor claims under Section 222.14, based upon the premise that this was in substance an annuity contract that the debtor/former plaintiff was a beneficiary of. The Court confirmed that the actual technical "ownership" of the annuity contract for issuance purposes is irrelevant, and that the "beneficiary" for purposes of Section 222.14 is the person or people entitled to receive payments. For conventional annuity contracts, the owner, who has the right to withdraw and/or to receive payments during his or her lifetime would be considered the "beneficiary" under Florida law, while the "beneficiary designation" under the annuity contract might be in favor of a trust or other person as the "survivor owner or beneficiary." In this case, the "payee" was considered to be the beneficiary, even though the contract itself did not specifically list a "beneficiary."

Structured settlement agreements should still be reviewed carefully for creditor protection purposes before implementation. However, the *Ministri Family* case, which was denied appeal to the 11th Circuit of the United States Court of Appeals, and the Florida Supreme Court case of *In re McCollum* provide clarity that if the annuity contract is properly structured, it will be fully exempt from the claims of creditors.

LOTTERY ARRANGEMENTS.

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[136] 612 So.2d 572 (Fla. 1993).

[137] 95 F.3d 1076 (11th Cir. 1996).

[138] 332 B.R. 461 (Bankr. N.D. Fla. 2005).

[139] 2015 WL 6445954, (M.D. Fla. 2015), appeal dismissed (Apr. 27, 2016).

As presently structured, Florida Lottery payments will not be considered as exempt assets for the reasons described below. In *In re Pizzi*,[140] the Bankruptcy Court of the Southern District of Florida held that a lottery contract made payable to the State of Connecticut, which in turn makes payments to the lottery winner, is not creditor protected as an annuity under Section 222.14.

Similarly, in *In re Bruce*,[141] the Bankruptcy Court for the Middle District of Florida found that lottery winnings were not exempt under Florida Statutes Section 222.14, even though the debtor received his lottery payments in installments. The court emphasized that in order to qualify for this exemption, there must be an actual annuity contract, and the Florida lottery does not purchase annuity contracts. Instead, the Florida Department of Lottery invests sales proceeds in "zero coupon bonds" and pays the winners from the funds it receives from these bonds.

However, in *Ruff v. Dixson*,[142] the Bankruptcy Court for the Middle District of Florida allowed the debtor's Arizona lottery winnings, which were paid by annuity contract, to be exempt under Florida law. To pay the debtor, the State of Arizona purchased an annuity contract, under which the debtor would receive proceeds for seventeen years. In determining that the annuity qualified for the Florida exemption, the court focused on the "broad application" of Section 222.14 and held that "the annuity at issue is properly included within the purview of such exemption." The Eleventh Circuit later reversed and remanded the *Dixson* decision without publishing an opinion.[143]

Therefore, it seems that lottery winnings in some states may be exempt under Florida law, so long as the state where the distributions are being made actually purchases an annuity. According to the December 2016 Florida Lottery website, the Florida Lottery still purchases zero-coupon bonds, and therefore Florida Lottery winnings will not normally be protected.

PRIVATE ANNUITY AND GRANTOR RETAINED ANNUITY TRUST ("GRAT") PLANNING.

Private Annuities can be used as an Estate Tax savings device, especially when an older client has adverse health conditions, but is reasonably expected to live more than one year. Standard life expectancy tables can be used as long as the Seller/Payee has a better than 50% chance of living at least one year at the time the transaction is entered into. There will be an irrefutable presumption that the good health requirement is satisfied if the person lives at least eighteen months.[144]

Consider having a client receive a life annuity or other annuity payment rights from a Defective Grantor Trust in exchange for a joint and survivor annuity. Not only is the joint and survivor annuity protected from creditors, but there are significant estate tax savings results that

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[140] 153 B.R. 357 (Bankr. S.D. Fla. 1993).
[141] 224 B.R. 505 (Bankr. M.D. Fla. 1998).
[142] 153 B.R. 594 (Bankr. M.D. Fla. 1993), *rev'd in part and vacated in part*, 116 F.3d 491 (11th Cir. 1997).
[143] *Ruff v. Dixson*, 116 F.3d 491 (11th Cir. 1997).
[144] Treasury Regulation Section 25.7520-3(b)(3), issued in 1995, has more information and examples regarding sales for private annuities and self-canceling installment notes.

will occur, particularly if the rate of return on the installment obligation and subsequent reinvestment thereof exceeds the Section 7520 rate assumptions implicit in the second-to-die annuity tables.

The 1988 Bankruptcy Court Case of *In re Mart*[145] held that a private annuity agreement whereby the debtor established an Irrevocable Trust for children, nieces, and nephews and made a $2,000 gift, followed by an annuity agreement funded by a $350,000 transfer by the Debtor and his spouse to the Trust in exchange for a return stream of annuity payments, was exempt from the claims of creditors under Florida Statutes Section 222.14. In this case, the annuity was established thirteen months before the debtor filed bankruptcy. The court found that the statutory exemption is not restricted to annuities provided by unrelated entities and that there was no intent to defraud creditors found in the circumstances. The case is further discussed in the article that follows at the end of Section I below.

A Grantor Retained Annuity Trust (“GRAT”) is a trust that pays its grantor a set amount each year for a term of years. Lawyers drafting GRATs should use language to confirm that the payments to be received should qualify as a contractual annuity right, and might consider having the GRATs used in asset protection trust jurisdictions that would enable the Trustee to make the GRAT payments to other trusts for the benefit of the grantor to satisfy the requirements of Internal Revenue Code Section 2702 and the Treasury Regulations thereunder.

Estate tax planning specialists know how effective a Grantor Retained Annuity Trust (GRAT) is for estate tax planning purposes. In *Audrey J. Walton v. Commissioner of Internal Revenue*,[146] the Tax Court held that a two-year GRAT could be zeroed out for estate and gift tax purposes. In this case, Sam Walton’s widow (the founder of Wal-Mart) transferred approximately $100,000,000 of Wal-Mart stock to a GRAT for the right to receive 49.35% of the initial value 12 months after inception, and 59.22% for the second 12-month term.

A 2009 Florida Bar Journal article entitled “Unraveling the Mysteries of the Florida Exemptions for Life Insurance and Annuity Contracts, Part Two” concluded that a private annuity arrangement will not be protected from creditors and that the creditors of the grantor of a GRAT would be able to reach into the trust to the extent of payments owed to the grantor. The authors, and many others, disagree with these conclusions, as explained in the article “Creditor’s Rights Under Private Annuities and Grantor-Retained Annuity Trusts in Florida” 83 Fla. B.J. 49 (July/August 2009) by Alan S. Gassman, David L. Koche & Michael C. Markham.

An excerpt from a 2009 article explains what the authors consider the primary issues and our conclusion, which to our knowledge has not changed or been supported or distinguished by any case or significant commentary since 2009:

Creditor’s Rights Under Private Annuities and Grantor-Retained Annuity Trusts in Florida
By: Alan S. Gassman, David L. Koche and Michael C. Markham

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[145] B.R. 436 (Bankr. S.D. Fla. 1988).
[146] 115 T.C. 589 (2000).

The second part of a recent two-part Florida Bar Journal article titled "Unraveling the Mysteries of the Florida Exemptions for Life Insurance and Annuity Contracts, Part Two" discusses the creditor protection elements of annuity contracts.[147] The article discusses inter alia the exemption granted by F.S. §222.14. Under this statute, the proceeds of an annuity contract issued to a Florida resident are statutorily exempt from the beneficiary's creditors.[148]

The article reaches the conclusion that a private annuity arrangement *should* not qualify for protection under the Florida Statute as an exempt asset because the legislature did not intend to protect private contracts.[149] The authors respectfully disagree with this perspective in light of the analysis and authority cited below, which includes general rules of statutory construction and the bankruptcy decision in *In re Mart*, 88 B.R. 436 (S.D. Fla. 1988), which specifically held that a private annuity contract entered into between a debtor and a trust established by the debtor was a protected annuity under F.S. §222.14.

Statutory Construction

The article refers to legislative history and concludes that the legislature intended only to provide protection for commercial annuities, because commercial annuities were apparently mentioned in the legislative history. If the legislature considered private annuities during its legislative sessions but did not address them in the statute, then the failure to omit them from the final versions of the statute that was enacted would be a clear acknowledgment that they fall within the purview of the statute. A reference to commercial annuities in the legislative history, without more, is hardly sufficient to change the clear meaning of a statute.

On the other hand, if the legislature did not contemplate private annuities when passing this legislation, then one could posit that they would still be protected, because the statute provides protection for *all* annuities without limiting the types of annuities protected. Put another way, it would take a legislative clarification to modify the clear language of the statute, which is quite expensive in its literal scope, as it refers to annuity contracts "upon whatever form."'

This statutory construction argument is supported by established concepts of judicial construction. In the 1989 case of *U.S. v. Ron Pair Enterprises, Inc.*, 489 U.S. 235 (U.S. 1989), the U.S. Supreme Court found that the interpretation of a statute should be based upon the wording thereof,

[147] Jonathan E. Gopman, Mathew N. Turko & Howard M. Hujsa, *Unraveling the Mysteries of the Florida Exemptions for Life Insurance and Annuity Contracts, Part 1*, 82 Fla. B.J. 52 (Dec. 2008); *Part 2*, 83 Fla. B.J. 55 (Jan. 2009).

[148] Fla. Stat. §222.14 states in relevant part: "the proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor of the person…who is the beneficiary of such annuity contract, unless the…annuity contract was effected for the benefit of such creditor."

[149] We have purposely italicized the word "should" given that the authors did not necessarily conclude that such arrangements "did" not qualify, but rather suggest that they "should" not qualify for the statutory exemption.

unless the clear intent of the legislature is other than as set forth in the statute.[150] If the language of a statute is plain, courts must enforce the statute according to its clear and unambiguous terms.[151]

Furthermore, the law is well settled that creditor exemptions are to be construed liberally in favor of providing the benefits of the exemptions to debtors.[152] In *In re Mart*, the court stated that , "there is no basis in this statute to restrict the exemption to annuities provided by completely unrelated, public entities."[153] In *LeCroy v. McCollum*, 612 So. 2d 572 (Fla. 1993), the Florida Supreme Court noted that the statute does not limit the exemption to any particular type of annuity contract. "This holding suggests that even 'private' arrangements not involving 'commercial' annuities will qualify for the exemption."[154]

To limit F.S. §222.14 so that it does not apply to private annuities is to create a distinction that does not exist in the statute, and would be tantamount to rewording the statute by changing the references to "annuity contracts" to "commercial annuity contracts" as shown below:

The cash surrender values of life insurance policies issued upon the lives of citizens or residents of the state and the proceeds of *commercial* annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor of the person whose life is so insured or of any creditor of the person who is the beneficiary of such *commercial* annuity contract, unless the insurance policy or *commercial* annuity contract was effected for the benefit of such creditor. (Additional, hypothetical verbiage italicized.)

It is not appropriate to add words to a statute that were not placed there by the legislature (to do so would be an impermissible abrogation of legislative power). Such an interpretation of the statute not only would be strained, but also seems illogical in light of the last phrase, which clearly interposes a limitation on the exemption for proceeds of annuity contracts when they were "effected for the benefit of such creditor."[155] Certainly, the concept of a private annuity existed and the legislature could have expressly excluded such an annuity if it so chose (in the same way it excluded annuity contracts effected for the benefit of creditors).

The article refers to the verbiage of the statute that indicates "annuity contracts *issued* to citizens or residents" are protected and makes the case that, because commercial carriers "issue" annuity contracts, and because the definition of "issuer" under the Florida securities statutes refers

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[150] *U.S. v. Ron Pair Enterprises, Inc.*, 489 U.S. 235 (U.S. 1989); *see also U.S. v. Northrop Corp.*, 811 F. Supp. 333 (S.D. Ohio 1992).
[151] *In re Griffith*, 206 F.3d 1389, 1393 (11th Cir. 2000) (citing *U.S. v. Ron Pair Enter.*, 489 U.S. 235, 241 (1989)).
[152] *Havoco of Am., Ltd V. Hill*, 790 So. 2d 1018, 1021 (Fla. 2001) (quoting, *Milton v. Milton*, 58 So. 718, 719 (1912)). *See also In re Solomon*, 95 F. 3d 1076 (1996) (special Florida exemption for proceeds of debtor's annuity contracts is to be broadly construed to reach *all* annuity contracts).
[153] *In re Mart*, 88 B.R. 436, 438 (S.D. Fla. 1988).
[154] RIA, Asset Protection and Tax Aspects of Annuities §13.06.
[155] As the authors of the article point out, Fla. Stat. §222.30 (the fraudulent asset conversion statute) also limits the applicability of the exemption under §222.14.

to arm's-length parties issuing securities, the use of the word "issued" in the statute supports the position that the exemption for proceeds of annuity contracts should *not* include private annuity arrangements. The authors of this article believe that this reads more in the verb "issue" than should be the case, and would again suggest that the cardinal rule of statutory construction is to give words their plain meaning.[156]

In this vein, the common meaning of "issue" (*i.e.*, its ordinary dictionary definition), when used as a verb is "to give or come out" or to "circulate or to distribute in an official capacity." In common parlance, there is no restriction on what type of person the issuer can be. Accordingly, whether the annuity contract is issued by a commercial carrier or a private individual is less important than whether an annuity contract is properly issued in the first instance. Moreover, if one looks at the use of the word "issued" in other legal contexts, it is clear that a person or entity may properly issue something to himself or herself (notwithstanding the absence of an arm's-length relationship). Indeed, garden-variety transactions routinely involve a non-arm's-length party issuing a certificate of ownership or an employment agreement to another person. There is no reason why a private party cannot issue a contract such as an annuity contract in the same form and fashion as an institutional carrier. In fact, the very securities statute referenced in the article, F.S. §517.021, contemplates that a person can be an issuer of its own securities.[157] Frankly, the article disregards the fact that the Internal Revenue Code recognizes that a self-settled trust can, indeed, be a separate and distinct legal entity.[158]

The article then discusses self-settled trusts, which enter into annuity contracts to the grantors thereof. The article concludes that an annuity contract payable to the grantor of an irrevocable trust should not protect the grantor or the trust assets from creditor claims despite the holding in *In re Mart*. The article discusses grantor-retained annuity trusts (GRATs) in this context.[159]

The article quotes F.S. §736.0505, which was enacted in July 2007, for the proposition that creditors can freely reach into a self-settled irrevocable trust where the grantor has contracted for the right to receive payments from the trust. F.S. §736.0505(1)(b) states that a creditor may reach assets held under a self-settled irrevocable Florida trust to the extent of "the maximum amount that can be distributed to or for the settlor's benefit." The scrivener's summary to the statute indicates that the provision was intended to simply codify the Florida common law, which has allowed creditors of a self-settled irrevocable trust to reach payments to the extent that a trustee has the discretion to pay monies to the grantor.[160]

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[156] *Southwest Florida Water Management District v. Save the Manatee Club, Inc.*, 773 So. 2d 594 (Fla. 1st D.C.A. 2000).

[157] *Umbel v. Foodtrader.com, Inc.*, 820 So. 2d 372, 374 (Fla. 3d D.C.A. 2002).

[158] The article specifically states, "in context of self-settled trusts, there is no act whereby one party issues anything of value to another party."

[159] GRATs are a popular estate tax planning tool whereby a grantor contributes assets to a trust in exchange for the right to a stream of payments defined by the Internal Revenue Code as a "qualified interest." The term "qualified interest" in Code §2702(b)(1) means any interest, which consists of the right to receive fixed amounts payable not less frequently than annually.

[160] Florida Trust Code Scrivener's Summary 28-29.

The article then cites the case of *In re Brown*, 303 F.3d 1261 (11th Cir. 2002), which is a 2002 11th Circuit Court of Appeals bankruptcy decision that held that the creditors of a self-settled charitable remainder unitrust, which paid seven percent of the value of trust assets to the grantor each year for life (with the remainder passing to charity), could attach the unitrust payments as they came due each year, but could not attach the remainder interest.

The court in *Brown* found that petitioners had not timely asserted that the unitrust payments could be protected as proceeds of an annuity contract under F.S. §222.14.[161] The court held that the creditors could not reach the trust corpus, but could attach the income stream. The court held that the remainder interest, as well as future payments not yet due, was protected from the creditors under Florida law. Based on the authors' review, this result is consistent with the common law in most other states.

The *Brown* decision cites a number of consistent cases, which state that an income interest reserved to a settlor entitles the creditor to receive the income from the trust, on an annual basis, but not the remainder interest.

The authors are unaware of any well-publicized, reported decision in the United States, which indicates that a creditor can reach assets held in a self-settled irrevocable trust, except to the extent actually payable to the grantor at the time of levy.[162]

Even trusts established by grantors who retain the right to income and additionally retain the power to appoint how trust assets would be devised could not have trust principal seized by creditors where the power of appointment was limited to not being exercisable in favor of the grantor/power holder or his or her estate, creditors, or creditors of the estate.[163]

When a grantor establishes an irrevocable trust and enters into a private annuity contract with the trust, there is an arm's-length arrangement between the grantor and the trustee of the trust, and the annuity payments made to the grantor should not be regarded as "benefits" payable to the grantor as a beneficiary of the trust. Similarly, with a GRAT, the Internal Revenue Code requires that the payments made back to the grantor be set at the time of establishing the trust based upon appropriate actuarial calculations or a fixed dollar amount, which, by definition cannot exceed the value of assets placed in the trust at the time that the GRAT is established.

Based upon the above, the authors believe that a self-settled trust that enters into a private annuity contract or is a GRAT theoretically should have its assets exempt from claims of creditors of the grantor, and that the annuity payment rights held by the grantor should as a normative matter, be exempt from creditor claims under F.S. §222.14. Obviously, an exception to the above would apply if the funding of the trust were considered a fraudulent transfer under this interpretation, in

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[161] *In re Brown*, 303 F.3d 1261 at n. 4.
[162] See also Robert T. Danforth, *Rethinking the Law of Creditors' Rights in Trusts*, 53 Hastings L. J. 287 (2002).
[163] See *U.S. v. Baldwin*, 283 MD. 586 (MD 1978).

what would be a case of first impression, or that the legislature could rewrite the statute to restrict the scope of the statutory exemption.[164]

If the above-referenced article is correct and a court were to find that the proceeds of an annuity contract were not exempt from creditor claims, then the most a creditor could attach or garnish would the annuity payments then due to the extent that the trustee has not applied the annuity payment "for the benefit of" the grantor as permitted under Treasury Regulation §25.2702-3(b)(i).

The bottom line is that private annuity contracts and GRATs are legitimate estate planning tools (particularly in a low interest rate environment)[165] that might also have secondary asset protection benefits if a court were to construe Florida law in accordance with the plain meaning of the statute as written.

A QUALIFIED PERSONAL RESIDENCE TRUST (QPRT) MAY BE CONVERTED TO AN ANNUITY TRUST.

A Qualified Personal Residence Trust is an Internal Revenue Code specific entity that enables a homeowner to place a primary or vacation home residence under a trust that allowed the grantor/contributor to have access and control for a term of years, after which the trust is held solely for a spouse and/or descendants, and not subject to federal estate tax in the estate of the grantor. Under the estate and gift tax law, the contribution of the home to the trust is considered to be a gift, but the value of the gift is reduced pursuant to IRS provided actuarial tables which take into account the limited value of the right to only have use for a term of years.

There is much concern that a creditor could take over the right to occupy a home held under a QPRT for the term of years that the grantor retained use for, but under Treasury Regulation Section 25.2702-5(c)(8)(i), if the home is sold while in the QPRT, the trust ceases to be a QPRT and the trustee must either: (1) distribute the proceeds outright to the grantor; or (2) the interest of the grantor should be converted into an annuity interest.

Although the QPRT regulations provide that the Trustee can be given the choice of distributing the proceeds to the grantor or converting the grantor's interest into an annuity, the authors strongly recommend that QPRT Trust documents should be drafted to require a conversion to an annuity interest, and to not offer the choice of an outright distribution to the grantor. The authors recommend that the Trust document require conversion to an annuity interest, and do not offer the conversion option. Under the annuity option, the trust will make an annual annuity payment to the grantor, which if properly drafted, should qualify as an exempt asset under Florida Statutes Section 222.14. Sample language that has been used in QPRTs to facilitate this process for those who reside in states that protect annuity payments from creditors is as follows:

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[164] A court decision would likely be retroactive, *i.e.*, it would unwind the challenged transaction – whereas legislation is typically prospective.

[165] Certain techniques, like grantor-retained annuity trusts (GRATs), charitable lead annuity trusts (CLATs), and private annuities do better in low interest rate environments, whereas others, most notably, qualified personal residence trusts (QPRTs) and charitable remainder annuity trusts (CRATs) fare worse.

> If the Trust ceases to be a Qualified Personal Residence Trust with respect to certain property, such property shall, within thirty days, be held in a separate share and the interest of the grantor shall be converted into a qualified annuity interest (as defined by Tres. Reg. § 25.2702-3 and the requirements for such interest shall be deemed incorporated into this Article) with the smallest fixed annuity payments permitted by Treas. Reg. § 25.2702-5(c)(8)(ii)(C) to be made to the grantor each calendar month for the balance of the Retained Possession Term, provided that the Trustee is authorized to make the conversion at an earlier time. The commencement date of the qualified annuity interest shall be determined in accordance with Treas. Reg. § 25.2702-5(c)(8)(ii)(B), and the Trustee may defer and determine the payment of any annuity amount as provided in that Regulation. If the Trust ceases to be a Qualified Personal Residence Trust with respect to certain property, the intent of the grantor is to provide for issuance of an annuity contract to the grantor based on the terms of this Agreement.

Federal Regulation Section 25.2702-5(c)(8)(i) reads as follows:

> (8) Disposition of trust assets on cessation as personal residence trust – (i) In general. The governing instrument must provide that, within 30 days after the date on which the trust has ceased to be a qualified personal residence trust with respect to certain assets, either-
>
> (1) The assets be distributed outright to the term holder;
>
> (B) The assets be converted to and held for the balance of the term holder's term in a separate share of the trust meeting the requirements of a qualified annuity interest; or
>
> (C) In the trustee's sole discretion, the trustee may elect to comply with either paragraph (c)(8)(i)(A) or (B) of this section pursuant to their terms.

In *Nolte v. White*,[166] the Florida Fourth District Court of Appeals affirmed the trial court's decision granting final summary judgment in favor of the debtor, who claimed a homestead tax exemption in property that she conveyed to a qualified personal residence trust (QPRT) and in which she retained a right to reside for a term of eight years.

It is important to note that by definition, a QPRT will end a certain number of years after formation, and at that time, the grantor will no longer have a possessory interest for property tax purposes. The grantor, however, may wish to lease the property from the QPRT, and if a 99-year lease is put into place at the time the possessory interest term ends, then the Florida homestead property exemption and 3% cap may continue to apply. A 99-year lease may be considered a sale for income tax purposes, but possibly not if the lease contains provisions which allow termination upon certain events (such as upon the death of an elderly tenant) and rent amount readjustment clauses so that the economics of the 99-year lease are not substantially equivalent to that of a sale.

[166] 784 So.2d 493 (Fla. 4th DCA 2001).

THE PRIVATE ANNUITY TRUST.

The "private annuity trust" was heavily marketed before the issuance of a 2006 Revenue Ruling that invalidated the ability to convert ordinary income to capital gains treatment using what was considered by many to be a highly aggressive and unproven strategy. Trusts that employed that strategy prior to the issuance of the ruling may be grandfathered if the technique was valid.

CONSIDER GOING OFFSHORE.

Life insurance and annuity products offered by offshore jurisdictions may allow the underlying investments to be managed by selected money managers or a broad range of mutual funds, and many offshore jurisdictions have creditor protection statutes which may requires that a creditor obtain a judgment in the offshore jurisdiction before such an annuity contract would be susceptible to creditor claims.

Offshore annuity policies are very similar to offshore life insurance policies, which are discussed extensively in Leimberg Information Services Newsletter No. 485 entitled "Offshore Life Insurance: A Potent Wrapper for Ordinary Income Investments," which is provided below in Chapter 4, Section E.

Reputable offshore trust and insurance companies can provide customized annuities, modified endowment contracts, and traditional life contracts that may qualify for tax deferral or complete income tax avoidance under applicable income tax law, with the client having the ability to choose a money manager or possibly even the client's broker to oversee investment of the product. This helps to bring new meaning to the word variable. However, the Treasury Regulations make deferral on offshore annuity products somewhat doubtful in many situations.

Foreign bank account disclosure requirements do not apply to investments in offshore life insurance and annuity products.

Since such policies can qualify under the tax and state law without fulfilling expensive and strenuous requirements imposed by state insurance commissioners, clients investing large sums may be able to save money in large policies and have more flexibility as to investments by going offshore.

DOES THE 10-YEAR BANKRUPTCY TRANSFER AVOIDANCE RULE APPLY TO ANNUITIES AND LIFE INSURANCE?

The 2005 revisions to the Bankruptcy Code make transfers to self-settled trusts "or similar devices" subject to avoidance or set aside in bankruptcy when made within ten years of filing. Are annuities and life insurance products considered to be "similar devices" that would be protected in bankruptcy? The answer is probably no, given that no court case has extended the ten-year rule to any self-settled asset protection trusts, such as life insurance policies, multiple corporations, LLCs, and partnership structures. At one point in the legislative process, this asset protection trust 10-year set aside provision was to specifically exclude qualified retirement plans, but this exclusion language was taken out of the legislation when enacted.

The only known case discussing this is favorable to the debtor. In the Southern District of Illinois bankruptcy court case of *In re Porco*,[167] a company was entitled to receive real estate from a third party, and instead allowed the real estate to go to a separate company owned by the same shareholder, thereby creating a resulting or constructive trust. The creditors that were owed money by the first company attempted to set aside the transfer of rights under the ten-year fraudulent transfer statute, claiming that the arrangement was to "a self-settled trust or similar device." The court determined that the **"similar device"** language "require[d] an express trust." The court stated that the purpose of Bankruptcy Code Section 548(e) was to thwart the protection of "the domestic asset protection trusts" enacted in some jurisdictions.

ABUSIVE SALES AND COMMUNICATIONS TACTICS.

The life insurance industry has been harshly criticized by many for lack of disclosure and truthfulness in how it describes certain annuity products. A good example of this can be found in the YouTube video entitled "Alan Gassman's Presentation to the 2014 Notre Dame Tax & Estate Planning Institute on Annuities." In addition, letters sent by Senator Elizabeth Warren to several life insurance carriers in 2015 point out that using incentives such as lavish vacations and gifts could cause agents to put their own interests before that of their clients. These letters can be found on the Internet at https://www.warren.senate.gov/files/documents/AnnuitiesLetters.pdf.

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[167] 447 B.R. 590 (Bankr. S.D. Ill. 2011) (finding that resulting or consecutive trusts were remedial in nature and arose by operation of law, rather than by the settlor's express grant).

CHAPTER 4:
LIFE INSURANCE

INTRODUCTION.

The statutory language exempting life insurance is contained in Florida Statutes Section 222.14, which reads:

> The cash surrender values of life insurance policies issued upon the lives of citizens or residents of the state and the proceeds of annuity contracts issued to citizens or residents of the state, upon whatever form, shall not in any case be liable to attachment, garnishment or legal process in favor of any creditor of the person whose life is so insured or of any creditor of the person who is the beneficiary of such annuity contract, unless the insurance policy or annuity contract was effected for the benefit of such creditor.

This is a shield against the insured creditors. However, the statute does not protect a debtor who is the beneficiary of another's life insurance policy, and neither does it protect the beneficiaries of the debtor's life insurance policy.[168] Thus, it is better to have the policy payable to protective trusts than individuals or other entities.

The statute makes no mention of term insurance policies, which have values to the extent of pre-payment, and may also be marketable for sale purposes.

Many of the same considerations that apply to annuities, discussed in Chapter 3, apply equally to life insurance products, including the ten-year Bankruptcy Code look back provision. Clients with large investment portfolios can get custom designed private placement policies, including customizable offshore life insurance programs.

A life insurance policy that meets the minimum corridor requirements can qualify both for tax free loans that can be made during the life of the policy and income tax free payments of cash and loan forgiveness upon death to policy beneficiaries.

When purchasing a "permanent value life insurance," individuals should consider that life insurance products oftentimes include significant sales and administrative charges in their premiums.

MODIFIED ENDOWMENT CONTRACT.

A Modified Endowment Contract (MEC) is a special type of cash value life insurance policy that fails to meet the seven-pay test which distinguishes between policies purchased primarily for

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[168] See *In re Zesbaugh*, 190 B.R. 951 (Bankr. M.D. Fla. 1995) (holding that the debtor, as beneficiary, was not entitled to the exemption for proceeds of life insurance policies).

tax advantages and policies purchased for death protection. While most life insurance policies are appropriately designed to qualify under the "TEFRA guidelines" to permit tax-free borrowing, it is easier to satisfy the "Modified Endowment Contract" guidelines, which involve having less mortality risk component in a policy, and still allow for the policy proceeds to be received income tax free on death. For example, where the insured is age 80 or over, the death risk portion of a life insurance policy needs to be only 5% of the principal amount invested to qualify the policy for income tax proceeds received upon death. An 80-year-old investor who holds assets that may quickly increase in value might consider paying an offshore life insurance carrier a reasonable fee to "wrap" the investment into a life insurance policy so that all growth under the fund would pass as income tax free to the descendants upon the death of "insured." However, for your average person, a MEC is not the recommended form of life insurance.

LOAN PROCEEDS.

In the Fourth District Court of Appeals case of *Technical Chemicals and Products, Inc. v. Porchester Holdings, Inc.*,[169] the court determined that the protection provided by Florida Statutes Section 222.14 is not lost simply because an insured requests the cash surrender value of the policy in the form of loan proceeds. The appellate court agreed with the trial court's determination that the cash surrender value of life insurance policies is protected both in the hands of the insurer and insured. However, the court declined to decide whether the creditor would be able to proceed against the funds once the debtor received them. Subsequent cases have not resolved this issue, therefore, it is unclear whether a creditor can reach loan proceeds after the debtor has received them. Only time will tell whether this issue will ever be brought before the Florida Supreme Court.

CASH SURRENDER VALUE CONVERTED TO ANOTHER FORM.

In *Faro v. Porchester Holdings, Inc.*,[170] the 4th District Court of Appeals held in 2001 that the cash surrender value of a life insurance policy continued to be statutorily exempt from garnishment even after the debtor took possession of a portion of the proceeds and converted it into another form by purchasing a certificate of deposit (CD) with the proceeds. In this case, the creditor received a judgment against the debtor in 1994. In 1997, the debtor requested a withdrawal of part of the cash surrender value of two life insurance policies. He then used the proceeds to purchase a CD from a bank, and used the CD as collateral for a loan. Relying on *Goldenberg,*[171] the court held that the proceeds were still exempt from garnishment even though part of the cash surrender value had been converted into a CD.

The court reiterated that "Florida has a long-standing policy that favors liberally construing exemption statutes so as to prevent debtors from becoming public charges" and explained how the language "upon whatever form" contained in the statute must be broadly construed. Specifically, the court stated that "the clarity of these words indicate[s] that the form of payment is not relevant for purposes of having the exemption apply."

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[169] 785 So.2d 636 (Fla. 4th DCA 2001).
[170] 792 So.2d 1262 (Fla. 4th DCA 2001).
[171] 791 So.2d 1078. (Fla. 2001).

Notably, in this case, as well as many others construing this statute, the court does not focus its analysis on what type of life insurance policy is at issue. The broad language of the statute, combined with the lack of detail paid to this issue in the case law, indicates that all types of life insurance will likely be covered by this statute.

OFFSHORE PRIVATE PLACEMENT LIFE INSURANCE POLICIES.

OFFSHORE LIFE INSURANCE: A POTENT WRAPPER FOR ORDINARY INCOME INVESTMENTS

By: Alan S. Gassman, Esq., Steven Holub, CPA, and Jeffrey M. Gad, Esq. Reprinted with Permission from Leimberg Information Services 04-Dec-02 Steve Leimberg's Estate Planning Newsletter – Archive Message #485

INTRODUCTION

Although offshore policies have been around for many years, more and more individuals and businesses are utilizing them for several good reasons. Offshore life insurance has become an effective way of structuring personal and financial planning investments based on a number of factors:

BENEFITS TO USING OFFSHORE INSURANCE CARRIERS:

One important factor is a competitive offshore industry that is willing to be cost effective and flexible in its planning in operation and parameters.

A second factor is the flexibility made possible by not having to comply with regulatory requirements which are imposed by the fifty states and the District of Columbia domestically. This assures that the structure will cover death claims.

Most carriers use recognized and respected United States actuarial and legal firms to assure that the policies offered comply with United States tax law rules, and in particular, the minimum corridor rules and modified endowment contract ("MEC") criteria. (The minimum corridor rules control how much life insurance element must be present with reference to the investment value of the policy, and the modified endowment contract rules provide stricter standards of minimum death benefit element which must be provided for the policy holder to be able to take interest free loans from the policy. The MEC standard used to be the "Four out of Seven" rule).

No client should invest in an offshore life policy unless there are solid opinions letters from A-V rated U.S. legal counsel and reputable United States actuarial firms confirming that the policy meets applicable corridor and MEC requirements.

Offshore life insurance carriers will typically charge an administrative expense based upon a percentage of the "cash value" of the policy. Additionally, the policy issuer will contract with a re-insurance company to provide the death benefit element, and this premium will typically be passed on as a direct cost to the policy without markup by the offshore carrier. (It has been reported that there may be a commission "kicked back" from the reinsurance carrier to the offshore carrier, and this is something that may need to be investigated when the policy is negotiated.)

Administrative expenses can run from 1% to 2% of value but may be negotiable depending on the company and the particular circumstances. Commissions paid to individuals who refer or coordinate these arrangements as between the client and the carrier usually do not exceed 3% of premiums. Any commission should be disclosed to the client and may be paid out of the policy contributions.

Offshore policies can only be sold outside of the United States. Consequently, most insurance carriers will insist that the application for the policy and preferably the medical examination necessary for underwriting purposes take place outside of the United States. Few, if any, reputable offshore carriers will meet directly with, or talk directly to, a client in the United States. The carrier will, however, meet with a client's advisors in the United States, provided the client is not present at the meetings. One role of the lawyer is to facilitate United States communications with the insurance carrier and the applicable professional, without the client interacting in the United States with the insurance carrier.

Virtually, all of the offshore carriers also offer annuity products which may provide tax deferral, although the Treasury Regulations make deferral with offshore annuity products both complicated and uncertain. Such annuities do not typically require significant life insurance or mortality cost elements within the policy.

SOME VERY BASIC LIFE INSURANCE TERMINOLOGY

Most advisors are aware of variable life insurance products, where there are investments held by the insurance company which can be accessible to the owner of the policy, and which grow in a tax-free manner assuming that the policy remains intact until the death of the insured. For example, an individual might invest $100,000 in a life insurance policy that would provide a $250,000 death benefit. The individual may borrow from the policy tax free, and the policy investments may grow to be worth $300,000 by the time the individual dies. No tax would be paid on the growth within the policy or on the loan that would be forgiven on death if the insured dies with the policy intact. If the insured terminates the policy while alive, then the growth becomes taxable income in the year of termination. It may be possible to withdraw up to $100,000 from the policy tax free during the insured's lifetime without paying income tax.

A traditional "seven pay policy," which really doesn't take seven annual payments to qualify, must meet certain tests in order to qualify as a life insurance policy under the Internal Revenue Code so that loans can be taken on a tax free basis. A MEC is a life insurance policy that does not meet the "seven pay test." Although the growth and proceeds from the policy on death will generally be tax free if the policy is kept intact for the lifetime of the insured, loans or any other withdrawals from the policy will be taxable to the extent of income within the policy if they occur during the lifetime of the insured.

For the sake of terminology, we will refer to the underlying value of investments within the policy as the "asset value" and the mortality element, which is generally furnished by a third-party re-insurance company or guaranty of additional benefit by the insurance company issuing the policy will be referred to as the "mortality coverage". Most of the offshore insurance companies accept very little of the risk. For example, Mass Mutual's Bermuda subsidiary would hold the cash value, have a re-insurance company agree to pay money into the policy if the insured dies based upon agreed tables, and will add $5,000 to the policy on the death of the insured and otherwise not be at risk.

YOU HEARD IT HERE FIRST – REDUCING MORTALITY COSTS – THE "DEDICATED MORTALITY ACCOUNT"

The mortality risk element is an expense that becomes greater as the insured becomes older. Typically, offshore insurance products pass the cost of the re-insurance on to the policyholder by withdrawing this from the policy values, and the re-insurance for offshore policies is apparently significantly more expensive than typical domestic re-insurance.

The significant advantage that can be enjoyed by offshore policies with respect to mortality charges, however, is related to something which may be referred to as a "Dedicated Mortality Account." The concept is that growth in cash value can be earmarked to a separate account under the policy that will be held for mortality risk purposes only, thus significantly reducing the re-insurance mortality element.

For example, assume a 77-year-old man wishes to invest $1,000,000 in a variable life policy to be treated as an MEC. Satisfying what is known as the 105% test which applies under IRS Tables, there would need to be mortality risk insurance based upon no less than 5% of the cash value of the policy until the insured reaches age 90, and then this would be reduced to 4% at age 91, 3% at age 92, 2% at age 94, and no mortality element would be needed at age 95.

Therefore, if the policy were to grow to $3,000,000 in cash value, there would need to be at least $150,000 of mortality re-insurance available, which would not be inexpensive to procure at the time the policy is first purchased. If the policy values might grow to $10,000,000, then insurance commitments for $500,000 would have to be procured upon inception, which is expensive. If the policy values grow beyond the required re-insurance, then a "force out" occurs, meaning that monies would have to be paid out. The "forced out" money would be taxed at ordinary incomes rates during the life of the insured.

Using a Dedicated Mortality Account, however, once the increase in value to $1,150,000 has occurred, instead of additional insurance, the policy can provide that excess value from growth, or a specific percentage thereof, will be designed to be held under a separate account in lieu of the additional insurance element. Thus, the 77-year-old may only need to wait until the investments under the policy grow by at least 5% before mortality charges substantially decrease or vanish, although some level of re-insurance is going to be necessary in case the investments go back down below 105% of original cost.

While the Dedicated Mortality Account concept may sound somewhat aggressive, a number of reputable law firms with expertise in this area believe it is in absolute conformance with the Internal Revenue Code and are willing to opine on its viability, based upon the tax law as it is now written. The fact that the client does not have direct access to policy values allocated to the Dedicated Mortality Account may help to support this position.

Where there is concern as to constructive receipt and control issues, which are described briefly below, the use of a Dedicated Mortality Account should alleviate the risk to the extent that the policy owner could not access policy growth as a matter of contract.

DIVERSIFICATION AND CONTROL ISSUES

Prior to December 31, 1983, the IRS generally required that the life insurance policy owner not have control over the investments and general conduct of investing with respect to the cash values under the life policy. To address this concern, Congress added a diversification requirement by enacting Code Section 817(h) effective January 1, 1984. Section 817(h) generally requires specific levels of diversification to occur within the first year of policy funding.

Diversification Tests: Section 1.817-5(b)(1)(i) of the Treasury Regulations, a contract will only be considered adequately diversified if the following conditions are satisfied:

> First, no one investment constitutes more than 55% if the value of the total assets of the account;
>
> Second, no two investments constitute more than 70% of the value of the total assets of the account;
>
> Third, no three investments constitute more than 80% of the value of the total assets of the account; and
>
> Fourth, no four investments constitute more than 90% of the value of the total assets of the account.

The fact that the diversification requirements do not have to be met during the first year provides a significant planning opportunity in the case of an initial potential investment with prospective substantial increase in value during the first year, as long as the diversification requirements can be met by the end of that first year.

The Section 817 test must be met every calendar quarter after the first year. Once this test is met for a particular period, however, the arrangement will be considered to meet the diversification requirements if investments are unchanged based upon a "frozen allocation." Notwithstanding the percentage of investment tests, these rules will not be violated by reason of value growth in existing policy investments. The rules will only be violated where additional investments or withdrawals of investments cause the percentages to become unaligned.

The Control issue: A big question in the tax law is whether the policy owner can now control policy investments to such an extent that the income derived therefrom would be subject to income as if directly received. While, as a practical matter, policyholders under United States variable life policies have absolute control to the extent that they choose between various mutual funds and control timing with respect thereto, can the policyholder or their family direct the insurance company to invest in specific stocks, businesses, or to even form offshore banks and loan monies or actually operate active business endeavors?

The tax law on this is not completely settled, and the IRS was successful in one case *Christoffersen v. U.S.*, 749 F.2d 513 (8th Cir. 1984), where a taxpayer bought an annuity contract that allowed him to change the underlying funds at any time within the policy, and had the right to withdraw all of the investments on seven (7) days' notice. In this case the taxpayer erroneously reported the income from the investment on his personal return, but later filed an amended return requesting a refund. There is some support, however, for the proposition that policy owners should not be considered the owners of the underlying account assets, particularly where they can only receive cash back from liquidation of the policy and do not have contractual rights to control the investments outside of being able to suggest investments to the insurance carrier. See *Investment Annuity, Inc. v. Blumenthal*, 442 F. Supp. 681 (D. DC), which was reversed on other grounds at 609 F.2d 1 (D.C. Cir. 1979).

In Revenue Ruling 81-225 the IRS found a program whereby a Savings and Loan directed its customers to a variable annuity company where the money the customer invested would buy a CD from the Savings and Loan itself was found to be the equivalent of direct ownership of the CDs by the contract holders under an alter ego theory.

It is the position of the ABA section of taxation, Committee on Insurance Companies that the legislation passed to amend Section 72 in enacting Section 817(h) on diversification supersedes the IRS/*Christoffersen* theory, and there is some support for this in the Blue Book issued by the Treasury Department after the passage of the Deficit Reduction Act of 1984. This topic is very well covered by BNA in portfolio #546, Chapter VI.

MORE POLICY STRUCTURE CONSIDERATIONS

With reference to the structure of holding investments, insurance companies licensed in Caymans or Bermuda operate under the separate account legislation which clearly earmarks the investments held under the policy to not be subject to creditor claims of the insurance company. The insurance company will generally have the policy owner appoint a custodian and an investment manager. The custodian can hold the investment assets, and the investment manager can direct how the assets will be invested.

While the actual insurance policy language used by the offshore carriers prevents control over investments by the policyholder, in actuality the insurance carrier may be able to accommodate the investment goals of the owner of the policy, if the investments are handled by a reputable trust company. The trust company may form an International Business Corporation ("IBC"), where the family of the policyholder might have significant input or even a partial interest in the IBC. The life insurance tax law provisions do not have prohibited transaction or related party restrictions that would explicitly prevent an insured or policy owner from working for, lending money to, or borrowing money from a business owned by a life insurance policy.

Where the insurance contract is an MEC and the owner is unable to make withdrawals from the policy itself without triggering tax, an IBC may under certain circumstances be able to loan money to the policyholder without triggering tax.

MARVELOUS THINGS THAT CAN BE DONE SINCE THERE ARE NOT PROHIBITED TRANSACTION RULES IN THE INTERNAL REVENUE CODE CONCERNING LIFE INSURANCE.

Leverage can also be used in two major ways:

A. First, to help reduce mortality costs and re-insurance needs, the client may loan money to the IBC and then withdraw the money later as a repayment of the loan, with interest that may be charged at the applicable federal rate. Then if the investments in the IBC do poorly, the client may have a bad debt deduction. A loss on investment in a life insurance policy itself is generally not income tax deductible. This also keeps a lot of the ultimate investment out of the hands of the insurance company and can help reduce administrative charges with respect to insurance carriers who would charge a percentage of all assets under management, since the amount owed to the insured or their affiliate would reduce the ultimate net cash value.

Clients who would like to receive payments from the IBC exceeding simple interest and principal loaned might consider selling property to it in return for a private annuity. If the annuity payments end when the client dies and the client outlives his or her life expectancy, the ultimate payments to be received will generally be greater than would apply with principal and interest under a promissory note. Also, payments received on a loan are considered to be interest to the extent then earned and then principal, while payments received under an annuity arrangement are characterized as interest and principal in a more advantageous manner. Conversely, if the client does not live beyond his or her life expectancy, the amount that would otherwise be included in his or her estate has the obligation been in the form of a promissory note may, if properly structured, pass outside of his or her estate.

B. Finally, clients with appreciated assets that they would like to have held under a life policy to avoid tax on further appreciation may sell much assets to the IBC in exchange for a private annuity. While there will be some income tax recognized as annuity payments are received by the contributor, a good part of each payment will be considered a return of principal, and future growth of the assets may be shielded from the income tax system.

These loan techniques and “control” over policy investments by individuals or entities designated by the policyholder may be considered aggressive from an income tax standpoint. But they are not uncommon and have some probability of withstanding IRS scrutiny and even litigation that might ensue as a result of the use of these techniques.

OTHER OPPORTUNITIES

In addition to the use of offshore life insurance as referenced above, offshore life insurance may also be particularly well suited for a non-United States citizen or resident who is planning on moving to the United States so that wealth accumulated prior to entering the United States may remain offshore and nontaxable. Similarly, in the case of a non-United States client who has intended United States beneficiaries, it may be feasible to structure an offshore life insurance policy which could be used in conjunction with offshore trusts that would keep this wealth offshore without subjecting it to United States taxes. Such trusts often provide both wealth preservation and asset protection (and give you just one more reason to visit the tropics once a year during winter!)

RISK OF TAX DISALLOWANCE: IF IT SOUNDS TOO GOOD TO BE TRUE

As discussed above, are several potential issues that arise when offshore life insurance is used. Failure to satisfy the diversification test or a violation of the control test (if it is a viable test), could make the owner of a policy currently taxable on investment growth.

Also, the life insurance rules will not neutralize and eliminate income tax on certain types of income, such as unrelated business taxable income, income from U.S. sources effectively connected with a U.S. trade or business, and income from certain fixed or determinable annual or periodic U.S. sources, such as rent, royalties and certain dividends derived from the U.S.

It does appear, however, that U.S. source gains emanating from real property sale activities will be subject to the U.S. tax regime, whether short term or long term. Interest paid on loans to real estate development entities, however, should escape taxation if the payee is an offshore policy that is properly structured.

Another issue that could be asserted by the IRS would be that contracts issued by offshore insurers cannot qualify as "variable contracts" in the most technical sense. An issuer must allocate amounts received with respect to a variable contract pursuant to State law or regulation [to a segregated asset account]. Code Subsections 7701(a)(9) and (10) define the terms "State" as the States of the United States and District of Columbia. Thus, a contract based on a segregated asset account under the laws of a non-U.S. jurisdiction may not constitute a "variable contract." One defense to this position is that the diversification requirements of Section 817 may not apply to such contracts.

There will also doubtlessly be practical abuses of life insurance policies by aggressive and/or uneducated life insurance companies, clients, and unscrupulous business people, as can apply with any vehicle.

The offshore industries have had more than their share of Ponzi schemes and misled or intentionally errant taxpayers who are looking to be aggressive or are somehow convinced that something too good to be true could be true.

There are obviously a number of potential issues that arise when offshore life insurance is being placed. While a plain vanilla wrapper with standard and appropriate amounts of reinsurance for a hedge fund investment will probably not be considered controversial, the fact that the industry will still typically recommend opinion letters and confidentiality with respect to the arrangement demonstrates that there is less than complete certainty as to tax results.

Where the policy has dedicated business, international business companies controlled by entities other than the life insurance carrier, loan arrangements with the insured or family members of the insured, and/or private annuity arrangements, potential challenges by the IRS seem more likely, but whether the Service can be successful in dismantling these arrangements when they are based upon law written in favor of an insurance industry without related party rules or prohibited transaction restrictions is highly questionable. For instance, if the control test described above is not satisfied, then the owner of the policy can be taxable.

Finally, as offshore planning becomes increasingly popular, it is likely to receive even more scrutiny by the Treasury Department and will not have the lobby that the domestic insurance industry keeps at its disposal to protect specific arrangements they promote.

The authors believe that it is likely that there will eventually be legislation specifically limiting offshore insurance activities, but hopefully any such legislation will leave a place for the use of offshore life insurance in tax planning and preexisting activities will be grandfathered or allowed to continue under limited parameters.

The authors' conclusion is that the sophisticated client who may save taxes and achieve non-tax planning objectives by using offshore life insurance should be made familiar with the concept and educated sufficiently in order to determine whether the client believes that this is something worth pursuing.

JEFFREY T. WEBBER'S TAX VICTORY WITH OFFSHORE PRIVATE PLACEMENT LIFE INSURANCE

While the case of *Jeffrey T. Webber versus the Commissioner of Internal Revenue* is commonly referred to as an example of a situation where courts will disregard a trusteeship or other fiduciary relationship where the fiduciary simply follows the exact instructions of a grantor, the end result of the situation was that a $735,046 investment grew to become worth $12,300,000 as the cash value of an offshore private life insurance policy, with an income tax cost of only $536,948, plus attorneys fees. [172]

Webber is a U.S. based venture-capital investor and private-equity fund manager. He has a bachelor's degree from Yale and also took some courses at the Stanford University MBA School before joining a technology consulting firm and a series of private equity partnerships that provided seed capital to startup companies. Because of his continuing success and accumulating wealth, Mr. Webber was referred to William Lipkind, a partner in the law firm of Lampf, Lipkind, Prupis and Petigrow, in order to establish a wealth and estate plan. Mr. Lipkind, is a well-respected tax and estate planning lawyer who introduced Mr. Webber and a handful of other clients to offshore private placement life policies.

Private-placement life insurance is usually sold through a private-placement offering to high net-worth individuals who qualify as accredited investors under the Securities Act of 1933. By making these products variable, both the premiums and death benefit may fluctuate. The assets held for the death benefit of the policy are held in separate accounts that are separate from the general assets of the insurance company. The policy does not earn a fixed rate of return, but instead a rate of return that is dictated by the actual performance of the investments in the account. Therefore, if the assets held in the separate account perform extremely well, as they did in this case, the value of the policy may substantially exceed the minimum death benefit.

In 1999, by the recommendation of Mr. Lipkind, Webber used $700,000 from his Alaska Trust to purchase two private placement variable life insurance policies from a Cayman life insurance carrier, Lighthouse Insurance. Lighthouse was established in 1996 and issued seventy to one

[172] 144 T.C. No. 17.

hundred policies in 1999 with a total outstanding face value of $250,000,000 to $300,000,000. The carrier had no direct or indirect ownership relationship with Mr. Webber, and is managed by a major London-based insurance company.

Webber's Alaska trust owned the policies from October 28, 1999 until October 8, 2003, at which time he formed an irrevocable trust in the Bahamas. The Alaska trust then assigned all of its assets, including the private placement variable life insurance policies, to the offshore trust. The purpose of the trust was intended to produce tax benefits with no income tax on dividends, as well as interest and capital gains and federal estate tax avoidance. The Bahamas trust owned the policies from October 9, 2003 to March 6, 2008.

While the separate account assets were worth $12,300,000 by 2007, the amount of cash that Webber was able to receive by surrender or policy loan was capped at the $735,046 in premiums paid, which was presumably the result of a provision under the life insurance policy that allowed growth in assets to be used to replace mortality arrangements and thus reduce or eliminate annual mortality expenses.

For the majority of 2006 and 2007, a Bahamian bank was the investment manager for the policies. The policies stated that no one but the investment manager may direct investments for a separate account. Under the policies, the policyholder was allowed to propose investment objectives and guidance to the investment manager, who in turn would comply within that framework. The Trusts specified that 100% of the assets in the separate accounts should consist of high-risk investments, which included private-equity and venture capitalist assets. The majority of the investments in Webber's policies' separate accounts consisted of non-publicly traded securities, and there was no indication of due diligence research with respect to Webber's investment directives by the investment manager.

Nevertheless, Webber sold shares of three start-up companies to the policy in exchange for $2,240,000, had one of his companies borrow $450,000, and had the policy purchase a promissory note for money owed to him for $50,000. Then another six other promissory notes were purchased from him for $186,600, among other transactions.

1999	$700,000 used to purchase two PPLI policies	Petition filed Form 709 – US Gift Tax Return
2003	Alaska Trust assigns assets to Bahamas Trust	Petition filed Form 3520 – Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts

Mr. Lipkind explained to Webber that it was essential that Webber did not appear to exercise any control over the investments purchased for the separate accounts for tax reasons and avoidance of the Investment Control Doctrine. Mr. Lipkind had reviewed opinion letters from several law firms, in which three specifically addressed the Investor Control Doctrine. These opinion letters were provided from reputable law firms that concluded that the policies' investments would comply with U.S. tax law and avoid application of the Investment Control Doctrine for tax purposes. Therefore, Webber never communicated directly with Lighthouse or the investment manager.

However, over 70,000 emails were sent to or from Mr. Lipkind, the investment manager, and/or Lighthouse regarding Webber's recommendations for investments by the separate accounts. Mr. Lipkind charged time at the traditional hourly rates and did not receive any bonus or special compensation of any kind from Lighthouse or the investment manager.

Due to the reasons mentioned above, the court held that Webber was the owner of the assets in the separate account, and was taxable on the income earned on those assets during the taxable years at issue, though no additional penalties would be imposed.

The court found that Webber had the unfettered ability to select investments for the separate accounts by directing the Investment Manager to buy, sell and exchange securities and other assets that he wanted the carrier to hold for him. Mr. Lipkind came up with what he thought was a clever protocol to place a buffer between Webber and the investments so that it would appear that Webber did not exercise any control over the investments. However, the court found that there was no documentation to establish that the carrier or the investment manager engaged in independent research or meaningful due diligence, and found that the carrier exercised "bare bones know your customer" review and occasionally requested organizational documents."[173] The court did find, however, that Webber reasonably relied upon his tax lawyer, Mr. Lipkind, who was a competent tax advisor and an expert in income and estate tax who had diligently researched the relevant legal issues and received accurate and complete information about the arrangements in setting up Mr. Webber's estate plan. Therefore, the Court did not impose the accuracy-related penalty for any of the years in question. The court also found that the tax lawyer was not a "promoter upon whom petitioner could not reasonably rely."[174]

The court found that within a period of twelve months he was able to indirectly extract more than $1,000,000 in cash for personal use and therefore had no need to surrender the policies or to use policy loans to obtain cash.

While the income tax part of Webber and Mr. Lipkind's plan was not successful, Webber was able to get a large amount of growth out of his own estate. The income tax penalties assessed by the court will instead come out of his other assets. There were no additional penalties, as it was clear to the court that Mr. Webber did not attempt to hide his estate plan from the IRS.

DECEPTIVE INDUSTRY PRACTICES.

It is believed by many that the life insurance industry employs deceptive marketing and disclosure practices with respect to many products that are sold on a commission basis. Alan Gassman's materials prepared for the 2014 Notre Dame Tax Institute can be received upon request, and provide significant discussion on the issues.

The following are considered to be "essential definitions" that each reader should be at least somewhat familiar with in regards to life insurance.

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[173] *Id.*
[174] *Id.*

TERM	DEFINITION
1035 Exchange	A tax-free exchange of an existing insurance or annuity contract for a new one on the same insured/annuity.
Accelerated Death Benefit Rider	A rider which allows the terminally ill insured to receive the death benefit during their lifetime.
Accidental Death Benefit Rider	This rider increases the death benefit if death is caused by an accident. The increase is usually double or triple the face amount.
Account Value	The value of the cash value account before deduction of early termination penalties.
Agent of Record	The life insurance agent assigned to a contract who will receive commissions and be able to provide information and advice.
Benchmark	An independent point of reference (i.e., the S&P 500) that may be used for comparison or as a formula in communications for policy terms. The most common Benchmarks are the S&P 500, the NASDAQ and the Dow Jones Industrial Average.
Bureau	The Medical Information Bureau (M.I.B.) defined below
Cash Surrender Value/Cash Value	The cash amount available to the policyholder if the policy is surrendered, less any loans outstanding.
Cash-value-based "wrap fees"	Charges that are calculated as a percentage of either the policy account value or the policy cash surrender value. While a set percentage is typically disclosed in either the policy prospectus, product guide and/or in the footnotes of the illustration, these percentages can and often do vary from year-to-year.
Commissioned Target Premium	Used in universal life products, target premiums are equal to the annual premium amount needed to endow policy cash values in an amount equal to the policy face (death) amount, and thus make policy death benefits permanent based on the insurer's current actuarial expectations as to mortality experience and operating expenses and based on the historical performance for the asset classes underlying policy cash values. This is significant, because commissions are commonly a larger percentage of the commissioned target premium than upon premiums contributed in excess thereof.
Convertibility Option	A rider that enables the owner of the term life policy to convert to a permanent policy, notwithstanding the health of the insured.
Cost of Insurance Charges (COI)	Charges to cover the insurer's "cost" of providing death benefits. Current or expected COI charges are based on current or expected mortality experience, often including a margin for expenses or adverse deviations and profits.
Cost of Living Rider	A contractual term that allows the death benefit under a policy to increase by a specified annual percentage in order to plan for inflation.

TERM	DEFINITION
Death Benefit	The total amount payable to the beneficiary upon the death of the insured.
Dialed Down Commission	A less than maximum commission that can be selected by the selling agent to reduce policy costs.
Dividend	A defining characteristic of whole life products. Dividends may (1) be paid to the policyholder; (2) applied against the premium to reduce premiums paid in cash to the policyholder; (3) left on deposit with the insurer and credited with some rate of interest; or (4) used to purchase paid-up additional amounts of insurance.
Expense Charges	Charges against accumulation-type policies to compensate the insurer for issuing and maintaining the policy (in addition to COI, Fixed Administration, M&E, and other expenses).
Extended Maturity Rider	Allows the owner to extend the time at which the policy would otherwise mature.
Equity Index Universal Life Insurance	Permanent life insurance where the return on investment is geared to complicated formulas designed to emulate specified indexes.
Face Amount	The death benefit provided by a life insurance policy. This term most often applies to the amount of insurance specified on the "face" of the policy at the time of issue and may not include post-issue changes in total death benefits, such as those arising from paid-up additions or death benefit increases caused by growth in account values. However, some illustrations use "face amount" to apply to the total policy death benefit at any given time.
FINRA	The Financial Industry Regulatory Authority is a quasi-governmental organization that enables the life insurance industry to be somewhat self-regulating.
FINRA Illustration Requirements	Defined in Rule 2210, which must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service.
Fixed Administration Expenses	Fixed administration expenses are generally calculated as either a fixed rate per period (e.g., $100 per month) or a fixed rate per $1,000 of policy face amount (e.g., $1.00 per $1,000 of policy face amount), or some combination of the two. These rates are generally disclosed as a fixed formula in either the policy prospectus, product guide and/or in the footnotes of the illustration, but may vary with either the policy face amount and/or the amount of total death benefit if different.
Fixed premiums	Payments of a fixed, equal amount paid to an insurance company for insurance or an annuity.

TERM	DEFINITION
Flexible premiums	Non-fixed (Flexible) payments permitted under universal policies which are designed to adapt premiums to the policyholder's changing needs and financial conditions.
General Account	All the assets of a life insurance company other than those held in separate accounts. Separate accounts, or subaccounts, are typically used for variable products, which pass actual investment experience including all capital gains and losses through to policy cash values. The assets backing all other products are held in the General Account.
Guaranteed Performance	Policy illustrations show guaranteed figures, which will be honored by the insurance company regardless of the carrier's future financial experience. What is guaranteed will depend on the type of life insurance policy.
Guaranteed Universal Life Insurance	A Guaranteed Universal Life insurance policy where the death benefit is guaranteed if specified premiums are timely made for a given period of years (age 121).
In-force Ledger	A computer-generated illustration of a cash value life insurance policy's current, projected, and guaranteed values.
Informal Application	An application for coverage that is not signed nor officially finalized so as not to be reported to the Medical Information Bureau (MIB).
Interpolated Terminal Reserve Value	The estimated fair market value of a life insurance policy, which is determined by the carrier upon request based upon what it would charge to replicate the given policy, assuming that the insured(s) is of average health for the population that the specific policy was issued for.
Investment in the Contract (Income Tax cost base with adjustments)	The aggregate amount of premiums paid into the contract, less any amount received under the contract (and less amounts of income from the contract that are spent to provide benefits under riders for extra death benefit in the event of accidental death, waivers of premium upon disability, or policy loans), to the extent that the amount was not included in the gross income (i.e. dividends). See Internal Revenue Code Section 72E.
Life Expectancy	An actuarially projected period of time a person is expected to live. Life expectancies are averages based on factors such as the gender and current age of an individual. Although illustrations may sometimes be provided for durations only up to "life expectancy," roughly half the population would be expected to live beyond life expectancy.
Medical Information Bureau (M.I.B.)	An organization that enables life insurance carriers to share application information.

TERM	DEFINITION
Minimum Corridor 7-Pay Test	The 7-pay test limits the cumulative amount of premium that may be paid into the policy for each of the first seven years but may permit payments over fewer than seven years. The dollar amount is required to be clearly identified in life insurance contracts issued on or after June 21, 1988. Any policy that exceeds the cumulative premium guidelines (the 7-pay test rules) becomes a modified endowment contract.
Modified Endowment Contract	A contract between a life insurance company and a policyholder that will typically not qualify as life insurance for tax purposes but will meet the requirements of Internal Revenue Code Section 72 to allow for deferral of income tax and the requirement of paying income tax at ordinary rates upon eventual withdrawals and/or payments of profits within the contract.
Mortality and Expense risk charges (M&E)	A separate charge made on variable products, which is normally based upon a percentage of the account balance. This transparency does not apply to General Accounts policies.
Mortality Cost	The cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk. With term insurance, the insurance company is generally exposed to risk of loss for the entire face amount of the policy; with permanent insurance, the net amount at risk for the insurance company is the difference between the policy's death benefit and the cash value.
Non-Guaranteed Performance	An estimate of future results of the policy's cash value and death benefit, (and surrender values are estimated as well). The non-guaranteed performance reflects changes in the interest credits <u>that can be halfway between the guaranteed and nonguaranteed assumptions</u>, but it is a random point for the hypothetical and solely based on the insurer's current practices. The mortality charges do not change for either guaranteed or non-guaranteed.
Option A Death Benefit	A universal life policy where the death benefit remains stable.
Option B Death Benefit	A universal policy where the death benefit may increase over time if certain requirements are met with each premium payment.
Option C Death Benefit	The death benefit will increase with each premium so that the initial death benefit plus an amount sufficient to repay all premiums will be received upon death.
Ordinary Life Insurance	A type of whole life insurance contract that provides for premiums to be payable until the earlier of age 100 or the death of the insured.

TERM	DEFINITION
Permanent life Insurance	Insurance intended to provide life insurance protection for the entire life of the insured. Permanent insurance differs from term insurance in that its premium structure includes a savings component. Permanent insurance policy premiums have two components, the insurance cost (mortality cost, administrative fees, sales loads, etc.) and the savings component.
Prudent Delegatee	An individual who accepts the duty of acting in a fiduciary manner to evaluate and opine that a life insurance contract is a prudent investment for a trustee or other owner having a fiduciary relationship, as authorized under the Uniform Prudent Investor Act in Section 9.
Return of Premium Rider	A rider which assures that the death benefit will at least be equal to the cumulative premiums paid**.**
Spousal or Children's Death Protection Rider	This rider provides life insurance for the insured's spouse or children. It occurs in group life insurance, and proof of insurability is not required.
Surrender Charge	An amount deducted from the accumulation value to yield its cash surrender value. These charges, typically found in the first 10 to 20 policy years, enable the insurer to cover a portion of unrecouped issue costs on policies that surrender early.
Tabular Cash Value	The guaranteed value of a whole life policy that can never be withdrawn except by borrowing or cashing the policy in.
Tax Free Access	Monies received as a return of basis (investment on the contract) and from borrowing will not be subject to income tax as long as a qualifying policy is maintained until death, unless the Transfer For Value Rules have been violated.
Term Blend Universal Life Contract	To reduce commissions and cost of insurance charges, some carriers permit a portion of a life policy to consist of term insurance that is expected to be supported by the increasing cash value. While these blend policies were widely criticized in the 1980s for being less reliable than a pure universal policy, present industry standards require that a term blend universal policy have the same actuarial durability as a non-term blend universal policy, with the result being better for the policyholder, and a lower commission than traditional whole life.
Term Life Insurance	Provides coverage at a fixed rate of payments for a limited period of time.
Traditional Whole Life	A whole life policy with a level guaranteed premium and death benefit.
Transfer for Value Rules	Internal Revenue Code Section 101 provides that the death benefit of life insurance will not be tax free if the policy has been "transferred for value" and no exceptions apply.

TERM	DEFINITION
Two Year Contestability	State laws require policies to prevent the carrier from denying benefits after the insured has lived 2 years from when the policy was issued.
Universal Life Insurance	A type of flexible permanent life insurance designed to offer competitive death benefit protection as well as a savings element which is invested to provide cash value buildup. The primary varieties of Universal Life are variable Universal Life, equity index Universal Life, and conventional Universal Life.
Variable Universal Life Insurance	A type of permanent life insurance with no endowment age in which the cash value can be invested in a wide variety of separate accounts, similar to mutual funds, and the choice of which of the available separate accounts to use is entirely up to the contract owner. FINRA will allow carriers to illustrate rates of return as high as 12% before reduction for fund costs, but most carriers require their agents to illustrate it at no more than a 10% gross rate of return.
Viatical Settlement	An arrangement whereby a person with a terminal illness sells their life insurance policy to a third party for less than its death benefit amount.
Waiver of Premium Rider	This rider provides economic benefits if the insured becomes disabled by waiver of certain expenses within the policy or considering premiums to be paid in lieu of requiring actual premium payments.
Whole Life Insurance	A life insurance policy which is guaranteed to remain in force for the insured's entire lifetime, provided required premiums are paid, or to the maturity date. Premiums are fixed, based on the age of issue, and usually do not increase with age.

CHAPTER 5:
HOMESTEAD PROTECTION

INTRODUCTION AND WAIVER.

The Florida Constitution provides an almost supernatural protection for homeowners against creditors, which has been found to trump the Florida Fraudulent Transfer Statute but is subject to The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which prevents the use of the homestead exemption under certain circumstances if the homeowner is in bankruptcy. The Florida Constitution protects up to one half of an acre if within city limits, or up to 160 acres if outside of the municipality, provided that the owner is an individual (or perhaps a revocable trust) who resides on the property and is a U.S. citizen or "permanent" green card holder.[175] The person must be a permanent resident of Florida and intend to make the property his or her permanent residence.

Besides real estate, it is possible for recreational vehicles, mobile homes, houseboats, co-ops, and long-term leases to qualify for the homestead protection, as indicated in Section S of this Chapter, and it may also be possible to allow seasonal rentals of the homestead as long as the homestead owner who moves out occasionally to facilitate this maintains her homestead status most of the time.

As noted in Chapter 1, the Florida Supreme Court held that an individual could not waive Florida's homestead protection via a general waiver in a loan agreement.[176] While the court noted that case law had not prohibited a waiver of the homestead protection, the Florida Constitution mandates that any waiver must be accomplished by mortgage, sale, or gift. The Court's analysis commenced with a statement that "the homestead exemption has been enshrined in our state constitution for over 100 years."[177] The Court noted that many decisions by Florida courts have acknowledged that the public policy behind not upholding waivers of creditor rights is to promote both the stability and welfare of the state for a homeowner and his or her heirs. The Court stated that while it has permitted a surviving spouse to waive homestead inheritance rights, "we have repeatedly refused to find an exception to the protection from forced sale. . ."[178]

Clients and advisors should not forget that Florida also recognizes tenancy by the entireties, so that creditors having a judgment against only one spouse may not be able to penetrate the homestead, even if one spouse files bankruptcy and the bankruptcy law exceptions to homestead protection apply.

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[175] See *In re Fodor*, 339 B.R. 519 (Bankr. M.D. Fla. 2006) (holding that "an alien can satisfy this residency requirement only if he has obtained permanent resident status or a 'green card' as of the petition date"); *see also In re Charania*, 2015 WL 12086, at *3 (finding that a nonresident alien could not formulate the legal intent necessary to claim homestead exemption without a permanent visa).

[176] 972 So.2d 850, 862 (Fla. 2007).

[177] *Id*. at 852.

[178] *Id*. at 854.

Caution should be exercised, however, with respect to exceptions provided for under this chapter, which include "super creditors", divorce situations, and under certain other circumstances.

In addition, planners must be aware that a homestead will be less protected than many other categories of exempt assets in bankruptcy if there has been a "fraudulent transfer" into the homestead, it has not been owned a prerequisite period of time, or a white collar crime or grossly negligent conduct exceptions apply.

There is often confusion with respect to when the rules relating to property tax exemptions disallow homestead characterization, notwithstanding that the creditor protection rules are completely separate and apart from the *ad valorem* tax rules.

BROAD INTERPRETATION – TRUMPING THE FRAUDULENT TRANSFER STATUTE.

Article X, Section 4 of the Florida Constitution establishes the right of Floridians to homestead their property. This right provides that homesteaded property is exempt from any type of forced sale or creditor proceeding. The Florida Supreme Court has been very liberal in interpreting this protection. In the Florida Supreme Court case *Havoco of America, Ltd. v. Hill,*[179] the Court confirmed the broad interpretation of Florida's homestead exemption. The Court held that even a homestead acquired by the debtor with specific intent to hinder, delay, or defraud creditors qualifies for homestead protection.

In this case, Havoco obtained a $15,000,000 judgment against Hill, which became enforceable on January 2, 1991. Just three days before the enforcement date, Hill purchased a $650,000 property, claiming that he intended to make this property his homestead. His creditors argued that the property should not fall under the Florida homestead exemption because Hill converted nonexempt assets into the homestead with the intent to defraud his creditors. Despite Hill's obvious intent to defraud, the Court found that the homestead exemption protected Hill's property from creditors.

The Court reasoned that the "plain and unambiguous" language of Florida Constitution Article X, Section 4 provides that a homestead is *only* subject to forced sale for: 1) the payment of taxes and assessments thereon; 2) obligations contracted for the purchase, improvement or repair thereof; or 3) obligations contracted for house, field or other labor performed on the realty.

Additionally, the court held that the Florida homestead exemption trumps and preempts the fraudulent transfer statute. Here, the bankruptcy court found that the creditor did not satisfy its burden of showing "by the preponderance of the evidence" that Mr. Hill purchased the home with the intention of hindering, delaying, or defrauding the creditor.

EXCEPTION FOR JUDGMENT RECORDED BEFORE PROPERTY BECOMES THE DEBTOR'S HOMESTEAD AND THE "TIE GOES TO THE DEBTOR" RULE.

[179] 790 So. 2d 1018 (Fla. 2001).

A judgment recorded in the county where the debtor has property that is not yet homestead will prevail over homestead protection, but what if the homestead is acquired by inheritance or purchase and will qualify as homestead under the Constitution at the moment of acquisition?[180]

In Florida, courts have held that "the rule accords priority to the homestead right, where the homestead right and the lien attach simultaneously, as in the case of purchase of inheritance of land by a judgment debtor." [181] This rule is also referred to as the "tie goes to the debtor". *In re Bowers* is the first case which applied the "tie goes to the debtor" rule. Here, the debtor's parents owned the property in question as homestead. The debtor's father became ill and passed away, leaving the property to his mother and children. Upon hearing this news, the debtor sold his business in March of 1963 and moved back home with his mother. Before the mother transferred the property to herself and the son in 1964, the appellee, a creditor, obtained and recorded her judgment lien against the debtor. The court held that a lien cannot attach to property until the debtor obtains ownership, which in this case was after the lien against the debtor was recorded. Essentially, the lien and homestead right attached at the same time and the "tie goes to the debtor" rule applied.

More recently in the September 2016 decision of *In re Cole*[182], a mother died leaving her homestead to her son, who was a debtor who lived in the home before she died. The creditor claimed that its judgment attached to the home at the moment of death, before the debtor owned it as "homestead," but Judge Michael Williamson of the Middle District of Florida found to the contrary and summed up the "tie goes to the debtor" rule beautifully, as he often does, as follows:

> Where, like here, a judgment lien and homestead status attach to property at the same time, the homestead exemption defeats the hypothetical judgment lien.[183]
>
> > To be sure, the Florida Supreme Court has previously held that the homestead exemption must give way to a judgment lien where the judgment lien went into effect before the homeowner became eligible to claim the homestead as exempt.[21] In *Pasco v. Harley,* for instance, Pasco (a bank receiver) obtained a judgment against Harley and recorded the judgment in the county where Harley owned property.[22] Because Harley was not married at the time, he could not claim the homestead exemption under then Florida law.[23] Shortly after the judgment lien was recorded, however, Harley married and became eligible for the homestead exemption.[24] Ultimately, the Florida Supreme Court held that Harley acquired the homestead exemption subject to Pasco's lien since he was not eligible for the homestead exemption at the time Pasco's judgment lien was recorded.[25]

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[180] 381 So.2d 1344, 1348 (Fla. 1980).

[181] *Bowers v. Mozingo*, 399 So. 2d 492, 494 (Fla. Dist. Ct. App. 1981); see also *Perez,* 391 B.R. 190, 190 (Bankr. S.D. Fla. 2008).

[182] *In re Cole*, 559 B.R. 920 (Bankr. M.D. Fla. 2016).

[183] *Id.* at 919.

Similarly, in *First National Bank of Chipley v. Peel,* the Florida Supreme Court rejected a homestead claim where a bank filed suit and obtained a judgment against the judgment debtor before the judgment debtor and his wife occupied — or took any steps toward occupying — the property at issue as their homestead.[26] There, the Florida Supreme Court observed that the final judgment would establish the rights of the parties as of the date the lawsuit was filed.[27] So if the judgment debtor did not move into the property until after the lawsuit was filed, it could not have the effect of making the property homestead with respect to the bank's judgment lien. According to the Florida Supreme Court, the homestead exemption may not be established to the exclusion of preexisting liens or conveyances.[28]

There is one fatal flaw with that argument as applied to this case. In *Harley* and *Peel,* the creditor's judgment lien attached to the property at issue before the judgment debtor was eligible to claim the homestead. That is not so here. While the Trustee's hypothetical judgment lien existed as of the petition date, it could not attach to the Brookhaven Drive property until the Debtor acquired an interest in it — i.e., when her mother passed away two weeks after the petition date. So the Trustee's hypothetical lien on the Brookhaven Drive property is not a preexisting lien. Here, the Trustee's hypothetical lien and the Debtor's homestead exemption attached to the property at the same time.

Those were the facts in *Milton v. Milton* — albeit not in the bankruptcy context — where the Florida Supreme Court held that an heir who took title to property upon his mother's death was able to assert the homestead exemption as to judgments entered against *him* before his mother's death.[29] The issue in *Milton* was whether the heir could claim the homestead exemption even though he did not occupy the property at the time of his mother's death. The Florida Supreme Court held he could because he did occupy it within a reasonable time afterward. The significance of *Milton* to this case is that there was no question in *Milton* that the homestead exemption applied to the heir's preexisting debts:

An occupancy of land as a homestead by an heir within a reasonable time, under all the circumstances, will prevent the forced sale under a judgment against the occupying heir of his interest in the land that is lawfully and in good faith occupied and claimed by him as his homestead.[30]

In short, *Milton* stands for the proposition that the usual rule that the homestead exemption cannot be used to extinguish preexisting liens does not apply where an heir, who has existing judgment creditors, inherits homestead property.[31]

Conclusion

> By virtue of Bankruptcy Code § 544(a), the Trustee had all of the rights of a hypothetical judgment lien creditor as of the petition date. When the Debtor acquired the Brookhaven Drive property under her mother's living trust, the Trustee's hypothetical judgment lien attached to the property. But the homestead exemption also attached at the same time. In essence, it was a tie. Under the Florida Supreme Court's decision in *Milton,* a tie goes to the heir. Accordingly, the Court will enter a separate order overruling the Trustee's objection to the Debtor's homestead exemption as a matter of law.
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> **<u>Cited</u>**:
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> 21. *Pasco v. Harley,* 73 Fla. 819, 75 So. 30, 33 (1917); *First Nat'l Bank of Chipley v. Peel,* 107 Fla. 413, 145 So. 177, 178 (1932).
> 22. 75 So. at 31.
> 23. *Id.*
> 24. *Id.* at 31-32.
> 25. *Id.* at 33-34.
> 26. 107 Fla. 413, 145 So. 177, 178-79 (1932).
> 27. *Id.* at 178.
> 28. *Id.*
> 29. 63 Fla. 533, 58 So. 718, 719 (1912).
> 30. *Id.*
> 31. Even the Florida Bar Journal article the Trustee relies on in support of her argument acknowledges that a decedent's heir can use the homestead exemption to protect against a forced sale by the heir's preexisting creditors. Doc. No. 46 (citing Rohan Kelley, Homestead Made Easy, Fla. Bar J. at 17 (March 1991)).

Notwithstanding the above, title companies cannot be expected to write title insurance for a homestead owner who wants to sell or finance the property where there is a judgment in place that should not attach by reason of being recorded after the property became homestead, or by reason of the property being homestead from the moment of purchase.

Florida Statutes Section 222.01 enables a homestead owner to give specific notice of homestead status to a creditor. The creditor will then have forty-five days to file an action in the county circuit court where the property is located. If the creditor does not file the action, then the title company can safely write an owner's or lender's policy, and typically will. The Statute and notice form can be found at Section 222.01.

WHAT IF YOU EXCEED ONE-HALF OF AN ACRE WITHIN CITY LIMITS?

A key fact for individuals that own homestead property within city limits is that the property must be one-half acre or less to be eligible for homestead protections. For example, in *Englander v. Mills,*[184] a debtor took the position that a center circle of his property, which had no outside access, was not used as homestead and that a donut shaped piece of property that fit within the one-half

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[184] 95 F. 3d 1028 (11th Cir. 1996).

acre exemption was his homestead. The judge disagreed and ordered the whole property sold and the proceeds apportioned between exempt and non-exempt assets.

In the 2002 appeal of a Bankruptcy Court decision, *In Re Quraeshi*,[185] the debtor owned more than half an acre in the municipality of Wellington, Florida, and the Court allowed for the sale of the entire parcel and allocation of the proceeds based upon 50/269ths going to the debtor as exempt homestead and 219/269ths going to the creditors.

The court noted that there was no controlling 11th Circuit case or Florida case law dealing explicitly with whether the homestead exempt funds would be calculated based on the net proceeds of the sale, after the payment of liens and mortgages, or the gross sales price.

The court concluded that the debtor's homestead exemption portion would be based upon a pro rata share of the net proceeds. The court made mention of the 1983 8th Circuit Court of Appeals case of *O'Brien v. Heggen*, which yielded a similar result for a Minnesota homestead case.

In the December 21, 2017 Bankruptcy Court decision of *In re Gamboa*,[186] a 73 year old debtor living alone in a trailer located on 14 acres outside of city limits was permitted to keep the trailer and the property as his homestead, notwithstanding that he was violating a county ordinance by living there.

Under the county ordinance, Mr. Gamboa would have been allowed to live in the trailer if he had a building permit to show that he was building a house, which he could not afford to do so. The court noted that he had made efforts to obtain the approval of several necessary county departments, but still needed approval from other departments to begin construction of a house that he was not able to afford to build.

The court noted that the property was zoned as agricultural, and that the county would require him to reclassify a portion of the property to be residential if he wished to legally live there. In this case, the lawyer for the creditor "tipped off" Miami-Dade County as to the situation, and the county issued a citation against the debtor.

The court found that notwithstanding the county law violation, the debtor had an actual intention to make the property his permanent residence and actually lived there. The court recognized that several courts in the past have allowed the homestead exemption to apply where the debtor occupied the property in violation of city, county or state law, or local zoning ordinances, and cited the case of *In re Kain*, where a debtor lived in a portion of property that was zoned commercial and housed his medical practice. The court also cited other cases that have occurred outside of Florida that led to similar results, including the 1994 case of *In re Heard*, where a Connecticut debtor lived on his boat even after the creditor apparently caused the government to require the boat to be dry-docked, and the debtor continued to live there with no certificate of occupancy and in violation of state statutes, the public health code, and zoning regulations. The

[185] *In re Quraeshi*, 289 B.R. 240 (S.D. Fla. 2002).
[186] *In re Gamboa*, 578 B.R. 661 (Bankr. S.D. Fla. 2017).

decision implies that creditors who "turn in a debtor" for living illegally on a property will not be rewarded.

The court in *In re Gamboa* pointed out that the only facts that ultimately matter are that "debtor has made the property his permanent residence since he moved into the trailer in 2013, <u>and</u> he intends to stay on the property as his permanent residence."[187] Ultimately, the court held that the fact that the debtor was living in a trailer in violation of a county ordinance did not preclude him from claiming the Florida homestead exemption.

In *In re Kellogg*, the court held that it can order the sale of a homestead when such property exceeds the acreage limitations and cannot be practically or legally subdivided.[188] However, if the property can be properly subdivided, then the court cannot order a sale of the homestead. In the *Kellogg* case, the debtor owned a 1.3-acre piece of property within the city limits of Palm Beach. The debtor argued that his home should not be sold, but rather, he should be able to remain in his residence with one half of an acre of the 1.3-acre tract being protected, so that the creditor would only be able to take the 8/10ths of an acre that did not include the house itself. Unfortunately for the debtor, the Palm Beach zoning regulations did not allow the debtor to subdivide his property, so the court ordered a sale of the homestead property.

The judge apportioned the net proceeds, after payment of the mortgage, pro-rata to land size.

The judge also found that the mortgage debt would not be apportioned to the protected or unprotected property. For example, a debtor with a two-acre lot inside the city limits with a $1,000,000 house on half an acre and landscaping on an acre-and-a-half would have the net proceeds from a forced sale allocated 25% to exempt and protected proceeds that the debtor could keep, and 75% to proceeds available to satisfy the obligations of creditors.

However, if the property is annexed into the city while the client owns it, the property may be over a half acre and retain its homestead character. See Part R of this chapter for a more detailed explanation.

It is better to only have the half acre with the most valuable building and/or waterfront included in the name of the debtor, and to have the surrounding property that would not be protected in a separate entity in order to avoid a division based upon acreage, which can be very disadvantageous to the debtor.

EQUITABLE LIENS, CONSTRUCTIVE TRUSTS AND ILL-GOTTEN GAINS.

Florida law is developing quickly with respect to identifying what "ill-gotten gains" or "tainted funds" may have been used to purchase, improve, or pay down a mortgage on homestead, with the result being that the applicable creditor from whom these ill-gotten gains were taken may impose an equitable lien, a constructive trust finding, or both upon the homestead, with the result

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[187] *Id.* at 669.

[188] 197 F.3d 1116 (11th Cir. 1999).

being that a court of equity can decide whether to force a sale of the home to satisfy the equitable lien or constructive trust, or whether it is more equitable to wait until the home is sold, or someone other than the debtor who may reside in the home and own an interest will no longer need protection

The following chart summarizes the elements of and differences between a constructive trust and an equitable lien:

<u>Constructive Trust vs. Equitable Lien</u>

Constructive Trust	Equitable Lien
Imposed when defendant: Is reaping benefit from property that he acquired unfairly. ONLY APPLIES WHEN DEFENDANT OWNS THE PROPERTY AT ISSUE **Plaintiff must establish that:** A. The defendant wrongfully obtained legal title to property which, as an equitable matter, properly belongs to the plaintiff; B. That retention of the property would result in unjust enrichment; and C. There is no adequate remedy at law **Effect:** Turns the defendant into a trustee, charged with holding and managing the property, but unable to reap any benefit from it. Equity intervenes to declare the defendant's apparent title to the property invalid, and instead orders the defendant to make restitution of both	**Imposed when defendant either:** 1. Wrongfully acquired someone else's property; *OR* 2. Has made improvements to a piece of property using funds he obtained unfairly. **Plaintiff must establish that:** • The defendant wrongfully obtained property or services from the plaintiff which, as an equitable matter, the defendant should either return or pay for; • The defendant used the plaintiff's property or services to invest in another piece of property; and • There is no adequate remedy at law. **Effect:** Uses the property to secure the debt.

possession and any other title interest of the property.	Equity intervenes to declare that the defendant's property is subject to a lien in the plaintiff's favor.

While the Supreme Court's decision in *Havoco of America Ltd. v. Hill* confirmed that a debtor can use funds to acquire a creditor exempt homestead with the specific intent of avoiding the creditor, the Court noted that an equitable lien can be imposed "where the funds obtained through fraud or egregious conduct were used to invest in, purchase or improve the homestead."

Certainly stolen funds, or funds received as the result of a crime perpetrated by the homeowner, will not be protected just because the debtor used those funds to pay down a mortgage loan or to buy a homestead, but what about situations where the debtor received the funds from a criminal activity that the debtor was not aware of, or as the transferee of a conveyance that was intended by the transferor to avoid a creditor?

Discussion of what happens when "ill-gotten gains" are mixed with non-tainted monies that find their way into a homestead or elsewhere can be found after the below discussion in the subsection entitled **WHEN ILL-GOTTEN GAINS ARE CO-MINGLED WITH NON-TAINTED MONIES BEFORE BEING PAID INTO HOMESTEAD -- THE "LOWEST INTERMEDIATE BALANCE RULE" APPLIES**.

The following is a 2017 Leimberg Information Services write up on a well-written Florida Bankruptcy Court decision that does a good job of summarizing this area, and a chart and "white paper" on the cases that have developed since the Florida Supreme Court's *Havoco* decision, notwithstanding that the authors disagree with the conclusion that monies received by a debtor who does not know that they are "ill-gotten gains" will be tracked and considered to establish an equitable lien against the unknowing debtor's homestead under the circumstances described below:

EXECUTIVE SUMMARY

On June 22, 2017, the Bankruptcy Court for the Middle District of Florida, Tampa Division, in *Wiand v. Lee*[189] (herein referred to as the "*Lee*" case), held that the innocent victim of a Ponzi scheme who used monies received from the bankrupt Ponzi entity to purchase a homestead, lost the homestead exemption to the extent of fraudulently transferred funds, even though he had no knowledge whatsoever that the funds came from a Ponzi scheme, he was not accused of any

[189] *Wiand v. Lee*, No.: 8:15-bk-01038-KR, slip op. (Bankr. M.D. Fla. June 22, 2017) *affirmed by (Lee v. Wiand*, 603 B.R. 161 (Bankr. M.D. Fla. 2018).

wrongdoing in connection with the scheme, and it was admitted that he did not engage in any fraud or egregious conduct. The authors believe that this decision was in error because the Florida Supreme Court case of *Havoco of America, Ltd. v. Hill,* discussed below, provides a limited exception to homestead protection which only applies if the funds used to buy a homestead or pay down a homestead mortgage were "obtained through fraud or egregious conduct."

The *Lee* court imposed an equitable lien on the home, and also imposed a "constructive trust" so that the home could be sold to satisfy the equitable lien. In doing so, the Florida bankruptcy court relied on four decisions.

First, the court cited the Florida Supreme Court's decision in *Havoco of America, Ltd. v. Hill*, which held that even if a debtor used funds to acquire a homestead with the specific intent to defraud a creditor, the Florida homestead exemption still prevailed and protected the home. In *Havoco*, the Florida Supreme Court noted the narrow exception that an equitable lien may be imposed "where the funds obtained through fraud or egregious conduct were used to invest in, purchase, or improve the homestead." However, the *Lee* court's discussion of *Havoco* ended there. Moreover, the *Lee* court made no mention of its earlier decision in *In re McClung* which noted that the equitable lien remedy has been "narrowly construed" and subject to a "high standard."

Second, the *Lee* court cited *Palm Beach Savings & Loan Association, F.S.A. v. Fishbein*, to support the imposition of an equitable lien. In *Fishbein*, the co-owner of the subject homestead fraudulently obtained funds through a forged mortgage, and used those funds to satisfy three existing mortgages. While the other co-owner of the home was innocent, she no doubt benefited from the fraud of her spouse and the satisfaction of three mortgages for which she was responsible. In *Fishbein*, unlike *Lee*, the subject funds were fraudulently obtained by the spouse and used to satisfy mortgages on the homestead.

Third, the *Lee* court cited the bankruptcy case of *In re Fin. Fed. Title & Trust, Inc*. to support the imposition of an equitable lien and constructive trust. In *FinFed*, like in *Fishbein*, the co-owner of the home fraudulently obtained funds from a Ponzi scheme that *he* was directly operating, and such funds were used to acquire a homestead. Again, while the co-owner spouse was innocent, the court focused on the "fraudulent nature of the funds which is of utmost importance." In *FinFed*, unlike *Lee*, the subject funds were fraudulently obtained by the spouse.

Lastly, the *Lee* court cited the Fifth Circuit Court of Appeals decision in *Crawford v. Silette* to support the imposition of an equitable lien. In *Crawford*, the funds were fraudulently obtained by the homeowner's boyfriend, who was actively involved in a Ponzi scheme, and he then "gifted" the funds to the homeowner. Contrary to the bankruptcy court's statement in its decision in *Lee*, the subject funds in *Crawford* were not "false profits" received by an innocent investor in the Ponzi scheme. Instead, the funds were "obtained" through the boyfriend's active defrauding of investors. The facts in *Crawford* are substantially different from the facts in *Lee*.

In *Lee*, the spouse is really irrelevant to the fact pattern as she did not come onto the scene until *after* Mr. Lee had innocently received the funds as an investor, and *after* he used them to buy a homestead. Neither Mr. Lee nor his after-the-fact spouse had any involvement in any fraud, and neither engaged in any "fraud or egregious conduct" as required by *Havoco*. The holding and result in *Lee* are directly contrary to the Florida Supreme Court's decision in *Havoco*. The proper question should have been whether the homeowner, Mr. Lee, an innocent inventor in the Ponzi scheme, "obtained" funds "through fraud or egregious conduct." Clearly, he did not. Mr. Lee obtained the funds through a return on his investment in the scheme of which he had no knowledge or involvement. Moreover, the funds representing his false profits were not obtained, directly or indirectly, through fraud or egregious conduct by anyone connected to Mr. Lee.

In *Fishbein*, the funds were fraudulently obtained by the spouse and used to pay existing mortgages thereby creating an issue of subrogation not present in *Lee*. In *FinFed* and *Crawford*, the funds were fraudulently obtained through direct, active involvement in a Ponzi scheme. In *Lee*, the funds were "passively" obtained through an investment. Passive conduct cannot satisfy the "fraud or egregious conduct" requirement in *Havoco*.

In support of its imposition of a constructive trust, the *Lee* court noted that the "rightful owner of misappropriated trust property may trace whatever has been bought." However, Mr. Lee did not misappropriate anything, particularly any trust property. If anyone did any misappropriation, it was the operator of the Ponzi scheme – just like the bad actors in *Fishbein, FinFed* and *Crawford*. But neither Mr. Lee nor anyone connected to his homestead had any involvement whatsoever in the scheme. In further support of its constructive trust remedy, the *Lee* court stated, without citation of authority, that Mr. Lee "did not have rightful ownership of those funds, which must be considered as being held in trust for the benefit of the receivership." This statement fails to recognize the distinction between a void and voidable transaction. *See O'Halloran v. First Union National Bank*, 350 F.3d 1197 (11th Cir. 2003) (noting distinction between void and voidable title). The transfer to Mr. Lee by the Ponzi scheme operator was not void; it was merely voidable. Without question, Mr. Lee had rightful ownership of those funds upon receipt and at the time he used those funds to acquire a homestead.

A troubling aspect of the Lee court's conclusions is that narrowly construed equitable remedies were imposed against a Florida homestead in favor of a fictional entity (a receiver) that is acting for the benefit of other innocent victims of the same Ponzi scheme who could not have obtained the same remedies. Innocent victims of Ponzi schemes often try to assert an equitable lien or constructive trust against assets of a Ponzi scheme entity, but are unsuccessful because the victim's funds were commingled with the funds of other innocent investors. Why should a receiver acting for a group of creditors who voluntarily invested in a Ponzi scheme have greater rights than the creditors themselves? In essence, the *Lee* court created a "Ponzi scheme exception" to the Florida homestead exemption.

It is important to note that *Lee* is not a case of stolen property. The other innocent victim-investors in the Ponzi scheme voluntarily parted with their funds in hopes of receiving the same return that Mr. Lee received. Under Florida law, where an owner has voluntarily parted with property, even though induced by a criminal act, a bona fide purchaser can acquire good title to the property, under the theory that where one of two innocent parties must suffer because of the wrongdoing of a third person, the loss must fall on the party who voluntarily, but unwittingly, participated in the criminal scheme. *Anderson Contracting Company v. Zurich Insurance Company*, 448 So.2d 37, 38 (Fla. 1st DCA 1984). For example, what if it were a simple three person scheme where innocent Investor A voluntarily gives money to the criminal actor, and then the criminal actor repays innocent Investor B with what was essentially Investor A's money. If Investor B used those funds to acquire a homestead, could Investor A get an equitable lien or constructive trust against

Investor B's homestead? We think not. There is simply no public policy reason to grant a receiver greater rights than those possessed by his constituent investor group.

The *Lee* decision is on appeal to the District Court and may ultimately reach the Eleventh Circuit Court of Appeals or the Florida Supreme Court.

CONCLUSION

The *Lee* decision should be reversed because the false profits paid to the innocent homeowner were not obtained, directly or indirectly, through fraud or egregious conduct as required by *Havoco*. In the meantime, individuals who buy homes or pay down homestead mortgages should be careful if they have received large distributions or gifts from sources that might be considered to be inappropriate, whether as fraudulent transfers or profits or other distributions received from otherwise insolvent or fraudulent sources. Any such funds should be held separate and apart from legitimate monies, and should not be commingled. It may be preferable to pay normal living expenses from potentially questionable funds, and to use earnings and other legitimate funds to purchase homestead and other exempt assets.

High risk investors who are not able or willing to determine whether their "hedge fund profit" may consist of "ill-gotten gains" will be well advised to carefully plan what they do with these monies, and how they handle other income and funds from an investment, debt reduction, and living expense standpoint.

The following pages include a chart that summarizes the case law in this area, and the *Bifani* case, which is described in detail after the chart.

The Florida Constitution states that a homestead may not be used to satisfy court judgments except in the following instances:

3. Unpaid property taxes for the homestead itself;
4. Mortgages for the purchase or improvement of the homestead itself; or
5. Mechanics' liens for work performed on the homestead

However, equitable liens and constructive trusts may also be "invoked to reach beyond the literal language of the above exceptions, <u>[but] only where the funds used to invest in, purchase, or improve the homestead were obtained through fraud or egregious conduct, or in order to prevent unjust enrichment</u>.

This distinction can be difficult to spot. An equitable lien and constructive trust will be imposed where fraudulent or otherwise egregious conduct was used to obtain monies that were used to purchase, payoff or improve an otherwise protected homestead. [*Havoco; In re Thiel*].

The Florida Constitution will continue to "exempt Florida homestead, even where the debtor acquired the homestead using non-exempt funds with the specific intent of hindering, delaying, or defrauding creditors." [*Havoco*] However, when it comes to imposing an equitable lien or constructive trust on a homestead, such relief "is limited to [only those] cases in which the homestead was purchased with the fruits of fraudulent activity." [Palm Beach Savings and Loan Ass'n].

Case	Interpretation of FL Homestead Protection	Case Description	FL Court Analysis
FL Homestead Exception Involving No Fraudulent Transfers			
Havoco of Am. v. Hill, 790 So. 2d 1018, 1027 (Fla. 2001)	Homestead property is exempt from any type of forced sale or creditor proceeding. However, an equitable lien can be imposed "where the funds obtained through fraud or egregious conduct were used to invest in, purchase or improve the homestead."	Debtor's creditors argue that disputed property should not fall under the Florida homestead exemption because the debtor converted nonexempt assets into the homestead with the intent to defraud his creditors.	Despite a debtor's intent to defraud, the funds obtained were not used to invest in, purchase or improve the homestead, therefore the Florida homestead exemption will protect the debtor's property from creditors. The "plain and ambiguous" language of Florida Constitution X Section 4 provides that a homestead exemption is only subject to forced sale for: 1) the payment of taxes and assessments thereon; 2) obligations contracted for the purchase, improvement or repair thereof; or 3) obligations contracted for house, field or other labor performed on the realty.
Distinguished by the Following Three Cases:			
Callava v. Feinberg, 864 So. 2d 429, (Fla. Dist. Ct. App. 2003)	A Debtor's conduct does not amount to "fraudulent or egregious conduct" when acting consistently with the main intent of a court order.	In an underlying divorce action, the trial court ordered the transfer of a home to the Debtor that was to be used to satisfy child support, alimony, and legal expenses. Debtor used the proceeds to purchase a new home and failed to pay legal expenses. Debtor's attorney sought an	The primary intent of the dissolution court order transferring the original property was to provide the Debtor with the means to support herself and her children. Payment of legal fees was deemed a "secondary purpose" for the transfer. Therefore, Debtor's conduct in selling the transferred property and moving into a more affordable

Case	Interpretation of FL Homestead Protection	Case Description	FL Court Analysis
		equitable lien against Debtor's homestead.	residence, but not paying her legal fees, was not viewed as "fraudulent or egregious."
In re Adell, 321 B.R. 562, (M.D. Fla. 2005)	If it can be proven that a Debtor "claiming Florida homestead exemption acquired [the] homestead by fraudulently obtained funds or embezzlement" then it is appropriate to impose an equitable lien or constructive trust on the Debtor's homestead.	Debtor was found liable in Michigan bankruptcy court 11 U.S.C.S. §303(i) for money damages for filing a bankruptcy petition against a creditor in bad faith. Two weeks after the judgment was entered, the Debtor moved to Florida, purchased the homestead, and took various steps to establish Florida residency with the intent to claim the Florida homestead exemption. Debtor's creditor argued that 11 U.S.C.S. §303(i) trumped Florida's constitutional homestead protection.	11 U.S.C.S. §303(i) does not trump the constitutional protection of the Florida homestead of a Debtor. The Florida Constitution clearly outlines three limited exceptions, these include: "(1) taxes owed by the homesteader; (2) obligation incurred by the owner which created the lien on the property by consent, i.e. by contact; and (3) claims on laborer and material men who contributed to the repair and improvement of the homestead …" The court held that the Debtor did not meet any of the exceptions, nor was it proven that the Debtor purchased the homestead with "embezzled funds or funds obtained through fraud," therefore the homestead was protected.
Willis v. Red Reef Inc., 921 So. 2d 681 (Fla. Dist. Ct. App. 2006)	The imposition of equitable liens on homesteads is limited to cases in which the homestead was purchased with the "fruits of fraudulent activity."	Debtor and Red Reef Inc. entered into a lease agreement. Later, a third party plaintiff sued the debtor for breach of lease and was awarded damages. During the lawsuit, Debtor sold the commercial property and used the proceeds from	Even though the Debtor fraudulently transferred the proceeds from the sale of commercial property to their personal accounts, and used such proceeds to pay down a mortgage on their homestead, the conduct did not give rise to an equitable lien.

Case	Interpretation of FL Homestead Protection	Case Description	FL Court Analysis
		the company to pay off his homestead mortgage.	
FL Homestead Exception Involving Fraudulent Transfers			
LaMarca v. Jansen (***In re Bifani***) 580 F. App'x 740, (11th Cir. 2014)	An equitable lien may be imposed on a homestead property acquired with proceeds of a fraudulent transfer. Although the Florida homestead exemption is liberally construed, it should not be used as "an instrument of fraud or imposition on creditors."	Debtor transferred property to his girlfriend who then sold the property and used the proceeds to purchase a home in Florida. These steps were taken by the Debtor with the actual intent to hinder, delay, or defraud creditors under Florida Statutes Sections 726.105(1)(a) and 726.106(1).	The purpose of the lien is to prevent unjust enrichment. The court held that it was unjust to allow the Debtor to use the proceeds from a fraudulently transferred property to purchase a home to avoid creditors.
FL Homestead Exception and Fraudulent Asset Conversion			
Dowling v. Davis, 295 F. App'x 322, 323 (11th Cir. 2008)	Transfer of nonexempt assets into an exempt homestead with the intent to hinder or defraud creditors is not one of the three exceptions to the homestead exemptions affirmed in *Havoco*, and are protected under the Florida homestead exemption.	Debtor had a judgment against him in the amount of $535,550.29. To avoid liability, the Debtor purchased a home in Florida with his wife as tenants by the entirety and transferred other funds to his wife with the intent to hinder, delay and defraud his creditor.	The three Florida homestead protections were affirmed and include: 1) the payment of taxes and assessments thereon; 2) obligations contracted for the purchase, improvement or repair thereof; or 3) obligations contracted for house, field or other labor performed on the realty. These exceptions are strictly construed and do not contain an expressed exception for real property that is acquired in Florida for the sole purpose of defeating the claims of out-of-state creditors.
FL Homestead Exception and Construction Fraud			

Case	Interpretation of FL Homestead Protection	Case Description	FL Court Analysis
Hirchert Family Trust v. Hirchert, 65 So. 3d 548, 2011 Fla. App LEXIS 8979, 36 Fla. L. Weekly D 1290.	Where a trustee breaches fiduciary duty by conveying Florida real property to an undeserving third party, constructive fraud may be the basis of a constructive trust, resulting in an equitable lien being placed on a homestead.	Appeal involving a Debtor's residential Florida property. The property was subject to a constructive trust because the trustee committed constructive fraud emanating from his breach of fiduciary duty.	Breach of fiduciary duty was the equivalent of fraud resulting in an exception to the homestead protection afforded by the Florida Constitution.
FL Homestead Exception- Recent Treatment			
Fed. Trade Comm'n. v. Am. Precious Metals LLC, 726 Fed. Appx. 729 (11th Cir. 2018)	An equitable lien is appropriate "where fraudulently obtained funds are used to invest in, purchase, or improve the homestead." However, it is not required that a plaintiff prove that fraudulently obtained funds were used for both "improvement" and "purchase" of a homestead.	The Federal Trade Commission (FTC) brought an action against a Debtor for operating a deceptive investment scheme, where money from the scheme went into the homestead. The FTC was granted its motion to have an equitable lien placed on the Debtor's home.	To obtain an equitable lien on the homestead, the FTC was required to show the following by a preponderance of the evidence: (1) the Debtor "engaged in conduct"; and (2) that the "funds from the conduct [could] be directly traced to the purchase of, investment in, or improvement of, the homestead." The court held that the FTC met both of these elements.
In re Lee, 574 B.R. 286 (Bankr., M.D. Fla. 2017)	The Florida homestead exception does not require that the fraud or egregious conduct be committed by the homeowner who is claiming the exception.	An individual unknowingly received false profits from a Ponzi scheme, and used the money to purchase a home. At no point did this individual and his spouse engage in any fraud or egregious conduct.	An equitable lien can be imposed on a Florida homestead to prevent the homeowner from being unjustly enriched as the recipients of fraudulent transfers made in furtherance of a deceptive investment scheme, even though there was no knowledge of any wrongdoing by the homeowner or his wife.

Case	Interpretation of FL Homestead Protection	Case Description	FL Court Analysis
			The court held that a constructive trust could be imposed on the Florida homestead to the extent of profits paid to the homeowners that could be traced to their home.

The Bankruptcy Code prohibits the discharge of debts that have been "obtained by… false pretenses, a false representation, or actual fraud." 11 U.S.C. Section 523(a)(2)(A). There is an existing split among circuits of "whether 'actual fraud' requires a false representation or whether it encompasses other traditional forms of fraud … such as a fraudulent conveyance of property made to evade payment to creditors." *Husky* at 1585.

In order for a debt to be non-dischargeable under Section 523(a)(2)(A), the debt must <u>be obtained by fraud</u>. Thus, when a transferee receives a fraudulent transfer and meets the requisite intent, the debt will be incurred by actual fraud. (Fraud + wrongful intent = actual fraud). This applies when a debtor is seeking to discharge a specific debt.

Case	**Does "actual fraud" encompass a fraudulent transfer?** Was debt <u>**obtained by**</u> fraud?	Case Description	Court Analysis
Husky Int'l Elecs., Inc. v. Ritz (In re Ritz), 832 F.3d 560, 562 (5th Cir. 2016).	A debt is obtained by actual fraud "only if the debtor's fraud involves a false representation to a creditor." The ruling in *Husky* added to the existing split among Circuits of "whether 'actual fraud' requires a false representation or whether it encompasses other traditional forms of fraud, such as a fraudulent	A company owed Husky money for electronic components. Instead of paying Husky, the Debtor who was director and part owner at the time, drained the company's assets and transferred the money to other entities the Debtor controlled. Husky filed a complaint against the Debtor claiming that debt was non-	The Florida Supreme Court held that "the term 'actual fraud' in Section 523(a)(2)(A) encompasses forms of fraud, like fraudulent conveyance schemes that can be effected without a false representation." "Transferor does not 'obtain' debts in a fraudulent conveyance. But the recipient of the

Case	Does "actual fraud" encompass a fraudulent transfer? Was debt **obtained by** fraud?	Case Description	Court Analysis
	conveyance of property made to evade payment to creditors."	dischargeable because Ritz's "intercompany-transfer scheme constituted 'actual fraud' under 11 U.S.C. Section 523(a)(2)(A)."	transfer—who, with the requisite intent also commits fraud—can obtain assets by his or her participation in the fraud." The transferee who later files for bankruptcy will not receive a discharge under Section 523(a)(2)(A). It is important to note that in *Husky,* the Plaintiff moved to hold the Debtor personally liable for the debt under Texas law, which allows creditors to hold shareholders responsible for corporate debt. Tex. Bus. Orgs. Code Ann. §21.223(b).
Supported by the Following Case:			
Siverio v. Rodriguez (In re Siverio), 253 F. Supp. 3d 418 (D.P.R. 2017)	Yes – "actual fraud" as a dischargeability exception, "includes fraudulent conveyance schemes, even when those schemes don't involve false representation."	Plaintiff's grandmother loaned him $30,000. Plaintiff's wife agreed to transfer title of property she owned to her grandmother-in-law to serve as a form of security for the loan. To do so, Plaintiff's wife executed a deed of sale" purporting to sell the property for $12,000. When Plaintiff failed to pay the full $30,000 owed, his grandmother sold the property to her	The debt owed to the Plaintiff was found to be non-dischargeable as money obtained through actual fraud. The Supreme Court further held that Defendant-Debtor and her husband were not bona fide purchasers of the real property because they were aware of the nature of the agreement between Plaintiff and Defendant Debtor's grandmother, and

Case	Does "actual fraud" encompass a fraudulent transfer? Was debt **obtained by** fraud?	Case Description	Court Analysis
		other granddaughter (Debtor) for the remaining debts. The granddaughter obtained the property knowing that the title was invalid and participated in the fraudulent transactions.	that Plaintiff remained the true owner of the property.
Sauer Inc. v. Lawson (In re Lawson), 791 F.3d 214, 220 (1st Cir. 2015)	Yes – The continued inclusion of actual fraudulent conveyance within § 523(a)(2) is consistent with Congress's "conclu[sion] that preventing fraud is more important than letting defrauders start over with a clean slate."	Debtor received a fraudulent conveyance from her father with the intent to prevent creditor from receiving judgment against him (the father).	The transferee must be "guilty of intent to defraud not merely be the passive recipient of a fraudulent conveyance." The requisite intent can be met from the acceptance of a transfer that transferee knew was made with intent to hinder creditors.
Reed v. Zak (In re Zak), 573 B.R. 13, 43 (Bankr. D. Mass. 2017)	Yes – The recipient of a transfer "who, with the requisite intent, also commits fraud – can obtain assets by his or her participation in the fraud." If the recipient later files for bankruptcy, debts "traceable to" the fraudulent conveyance are nondischargeable.	Debtor breached fiduciary duty and duty of loyalty to Loan Modification Group, Inc. (LMG) by taking revenues and transferring them into an entity Debtor controlled.	The court held that Debtor's actions "constituted fraudulent conveyances and actual fraud when the [Debtor]…transferred all the revenues, assets, and business of LMG to an entity he controlled for no consideration, enabling him to reap considerable financial benefit he was not

Case	Does "actual fraud" encompass a fraudulent transfer? Was debt **<u>obtained by</u>** fraud?	Case Description	Court Analysis
			entitled to in light of the partnership agreement."
In re Korn, 567 B.R. 280 (2017).	Yes – The court established that *Husky* did not change the law with regard to what is needed for fraud; rather it clarified that the element of justifiable reliance does not need to be met in a fraudulent conveyance.	A judgment creditor and former business associate of a Chapter 7 Debtor filed a complaint seeking determination that his debt of over $1.9 million arising out of a Michigan state-court action was nondischargeable.	To establish actual fraud Plaintiff must show the following: (1) a course of conduct intended to deceive; (2) justifiable reliance; AND (3) proximate causation.
Browne v. Lombard (*In re Lombard*), 2016 Bankr. LEXIS 998, at *1 (Bankr. D.N.H. Mar. 30, 2016)	Yes – *Husky* allows a claim of "actual fraud" to hold a debt non-dischargeable; however, the plaintiff must include a **<u>legal claim,</u>** either under state or federal law, to recover the fraudulently transferred debt.	Debtor's husband was the sole owner of a café through which he obtained loans. Rather than using the loans for the café, the husband transferred money to the Debtor, which the Debtor used with fraudulent intent to fund her new business. The transfers were so that the Debtor could fund her new business. The Debtor filed for bankruptcy. The Plaintiffs included factual detail about the fraudulent transfer and sought to have the	The Court agrees that because this is a fraudulent conveyance there is no need to show that there was a misrepresentation for "actual fraud" to apply. The Court distinguished from <u>*Husky*</u> and found that "Section 523(a)(2)(A) does not provide a cause of action that simultaneously creates a debt and renders it non-dischargeable." See below, *Zacharakis v. Melo (In Re Melo*), 558 B.R. 521, 561 (Bankr. Mass 2016).

Case	Does “actual fraud” encompass a fraudulent transfer? Was debt **obtained by** fraud?	Case Description	Court Analysis
		debt’s dischargeability determined. The plaintiffs did not include **a legal claim** that would allow them to recover from the alleged fraudulent transfer.	
United Supply Co. v. Crivaro (*In re Crivaro*), Nos. 15-23020 (JNP), 15-2262, 2017 Bankr. LEXIS 1133, at *2 (Bankr. D.N.J. Apr. 24, 2017)	Yes –- The Court agreed that in order to have actual fraud the element of fraud must be met as well as the element of wrongful intent.	Debtor sold and installed heating and air conditioning equipment that he purchased from numerous vendors, including United Supply Co. Debtor executed a credit application and personal guarantee to United Supply Co. Debtor later filed bankruptcy after failing to make any payments to the company. As a result, the company filed a complaint alleging that its claim for reimbursement should be non-dischargeable.	The court distinguished this case from *Husky* by highlighting that United Supply was unable to show that the debtor took part in a scheme to fraudulently transfer assets. More specifically, the “element of fraud – assets transfers intended to impair the creditor’s ability to collect a debt – was not proven.”
World Bus. Lenders, LLC v. Barry (In re Barry), 559 B.R. 654, 663 (Bankr. M.D. Pa. 2016)	Yes – “…a transfer alone is not enough to show actual fraud.”	Plaintiff, World Business Lenders, LLC (WBL), filed a complaint requesting that its debts with Debtor be non-dischargeable. WBL claimed that the transfer itself was proof of	The Court applied *Husky* and found that Plaintiff failed to show that the transfer constituted actual fraud. Plaintiff also failed to allege that the conduct was actual fraud or that the daughter

Case	Does "actual fraud" encompass a fraudulent transfer? Was debt **obtained by** fraud?	Case Description	Court Analysis
		fraudulent intent. The Plaintiff alleged that the false statements made by Debtor were actual fraud.	accepted the transfer of the car with intent to commit fraud.
Prado v. Erickson (In re Erickson), 2017 Bankr. LEXIS 3343	Yes – Connection between the pre-existing debt and the transfer must be shown.	Plaintiffs sold their company assets to Debtor, which included a promissory note guaranteed by Debtor. Plaintiff and Debtor later agreed to reduce the debt and a note was signed granting a lien on Debtor's vacation home. Debtors filed bankruptcy and Plaintiffs allege their claim should be non-dischargeable "on the basis of certain allegedly fraudulent transfers."	Similar to *Husky,* the debtors obtained the property through a fraudulent transfer scheme. However, the Plaintiff did not allege there was a connection between the pre-existing debt and the transfers, thus the dischargeability of the debt must be determined by a bankruptcy court proceeding.
Argyle v. Harkin (In re Harkin), 2017 Bankr. LEXIS 916	Yes – If wrongful intent cannot be shown, then the debt was not obtained by actual fraud.	A loan was secured by mortgages on properties owned by the Debtor. In 2014, the Debtor defaulted on the loan and the two parties reached a settlement agreement. Subsequently, Plaintiff filed a complaint alleging unaccounted debts. Debtor filed bankruptcy and Plaintiff requested	Court follows *Husky* analysis of the term "actual fraud." However, the Plaintiff did not succeed in having the debt non-dischargeable because they failed to prove by the preponderance of the evidence that the Debtor acted with **wrongful intent**.

Case	Does “actual fraud” encompass a fraudulent transfer? Was debt **obtained by** fraud?	Case Description	Court Analysis
		the claim be deemed non-dischargeable.	

Way Down Upon the Bifani River 1: Setting Aside Fraudulent Transfer Into Florida Homesteads (Debtor's Transferee Who Received Pre-Bankruptcy Fraudulent Transfer Ends Up All Wet)

By Alan S. Gassman, Esq., Travis Arango and Dena Daniels

The Florida Supreme Court, in *Havoco of Am., Ltd. v. Hill*, 790 So.2d 1018 (Fla. 2001), held that the homestead protection afforded under the Florida Constitution trumps the Florida Fraudulent Transfer Statute, and therefore a debtor subject to an impending or actual judgment can use monies to purchase or pay down the mortgage on a homestead owned by the transferor, with the creditor having no remedy against the homestead unless or until the debtor files for bankruptcy by reason of the provisions of the 2005 revisions to the Bankruptcy Code “Mansion Law.”[3]

But what if the debtor, knowing that he or she may be going into bankruptcy, gives the monies to a close friend who puts them into a homestead and then intends to hunker down and remain judgment proof, and outside of bankruptcy, so that the creditor is not able to recover the funds? And the debtor is able to live with the close friend and enjoy the benefit of the home. Will this boat float?

This exact factual pattern has occurred more than once, leading the courts to look for a way to reach the home equity and prevent this type of conduct, as opposed to waiting for Congress to endorse an appropriate remedy by amending the Bankruptcy Code.

Judge Michael Williamson, a very well-respected bankruptcy judge of the Middle District Bankruptcy Court sitting in Tampa, came to the conclusion in 2013 that a fraudulent transfer, directly or indirectly, to the debtor's cohabiting and apparent significant other before filing bankruptcy rose to the level of being considered a secretion of “ill-gotten gains” under the Florida case law, saying specifically that: Here, LaMarca's Sarasota house was acquired with ill-gotten proceeds. LaMarca used the nearly $670,000 from the sale of the Golden Eagle Road property to purchase her Sarasota house. It would be inequitable and unjust to allow the Debtor [Bifani] to fraudulently transfer property to LaMarca to keep it from his creditors.[4]

The Federal District Court sitting in Tampa found that the decision did not hold water, and overturned it,[5] but the Eleventh Circuit Court of Appeals agreed with the judge, finding that: Under

Florida law, homestead property purchased with funds obtained by fraud is not exempted from equitable liens. *See Havoco*, 790 So.2d at 1028. The facts of this case do not fall within *Havoco*'s exception because the funds used to purchase the Sarasota property were obtained through Bifani's fraudulent transfers….That the fraud occurred in a bankruptcy proceeding rather than a criminal offense is irrelevant.[6]

It is almost certain that the U.S. Supreme Court will have no interest in hearing this case, and the Florida Supreme Court will not have jurisdiction because bankruptcy court cases pass through the federal system, and not the state system.

The Eleventh Circuit Court of Appeals could have requested guidance from the Florida Supreme Court by certifying the issue as a question of importance but apparently chose not to do so.

Floridians and their advisors will now most likely need to wait for a number of years before similar factual patterns occur in circuit courts and become subject to circuit court decisions that are appealed to District Courts of Appeals, and then eventually to the Florida Supreme Court.

A prominent bankruptcy attorney has had this to say about the case: If you think it through, the whole idea of getting around the federal Bankruptcy law by doing something through an apparent straw man that you cannot do directly, you can certainly conclude that at least the spirit of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (closing the so-called mansion loophole via new sections 522(o) and (p)) was violated. That doesn't really shock me. If you're going to try to take advantage of the Florida homestead law, you need to follow the centuries old method of buying your own house, and if this is a fraudulent transfer you also have to stay out of bankruptcy for 10 years thereafter. It's not escaping taxes or domestic relations liability, it's not money you stole from somebody else, but a well-respected bankruptcy judge, with affirmation from the highest federal court overseeing Florida federal courts, has found that it is the equivalent of transferring ill-gotten gains into homestead. Debtors and advisors are going to have to stick with the patterns that worked, at least for the foreseeable future. It could be a decade or more before the Florida Supreme Court or the US Supreme Court ever look at this.

Judge Williamson had this to say after the 11th Circuit Court of Appeals opinion was published: While *Havoco* attracts the most attention in allowing a fraudulent conversion of non-exempt property into a homestead, what is often overlooked is that *Havoco* itself recognizes the *Fishbein* exception, 619 So.2d 267 (Fla. 1993), which allows the imposition of an equitable lien where there are two frauds: (1) the permitted fraudulent conversion into the homestead, and (2) the initial wrongful conduct that taints the proceeds as being ill-gotten, e.g. the funds were stolen or obtained through fraud. The 11th in *Bifani* simply confirms what has long been the law in this area.[7]

While this case will be rightly criticized as judicial legislation, and seems to also add to the longstanding confusion among some courts and advisors that a fraudulent transfer somehow constitutes fraud, it also shows that conventional knowledge will sometimes be turned on its ear, without warning, and that clients and advisors should not rely upon any one creditor protection technique when multiple techniques are available.

For more information, in the Tax Management Portfolios, see Rothschild and Rubin, 810 T.M., Asset Protection Planning, *and in Tax Practice Series, see ¶6350, Estate Planning.*

Cited:

[1]The Suwannee River is a 246-mile black water river that can take you much of the way from the Bankruptcy Court in Tampa to the 11th Circuit Court of Appeals in New Orleans, which is where this case went before the debtor's raft sank. Made famous by Stephen Foster's song, The Old Folks at Home (Foster never saw the river but read about it). Mr. Gassman owns two lots on this river that he bought in 2007 and would gladly sell for half of what he paid, and no extra charge for the alligators who live there. *See* Way Down Upon the Suwannee River Far Far Away, LLC on the Sunbiz Website, *and also* Hey Hey Santa Fey (river), LLC, and Withlacoochiecoochicoo, LLC, which own his other failed river investments.

This article is dedicated to the memory of Joan Rivers, who performed in Tampa Bay shortly before her death at age 81 with great energy and physical strength.

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[3]*See*11 U.S.C. §522(o), §522(p).

[4]*In re Bifani*, 493 B.R. 866, 871 (Bankr. M.D. Fla. 2013).

[5]*In re Bifani*, No. 8:13-cv-02197-JDW, Order of Feb. 13, 2014 (M.D. Fla. 2014).

[6]*In re Bifani*, 580 F. Appx. 740, 747 (11th Cir. 2014).

[7] In *Havoco*, the Florida Supreme Court held that an intentionally fraudulent transfer into homestead would not be set aside because the protection of homestead under the Florida Constitution trumps the Florida Fraudulent Transfer Statute. In *Fishbein*, however, the Florida Supreme Court held that when ill-gotten monies are transferred into homestead, the transfer can be set aside. In *Bifani*, the 11th Circuit agreed with Judge Williamson that a fraudulent transfer made by someone contemplating bankruptcy will be considered as ill-gotten gains for purposes of recapturing the transfer from the homestead of the transferee that was funded thereby.

WHEN ILL-GOTTEN GAINS ARE COMMINGLED WITH NON-TAINTED MONIES BEFORE BEING PAID INTO HOMESTEAD --- THE "LOWEST INTERMEDIATE BALANCE RULE" APPLIES:

What if "ill-gotten gains" are commingled with non-tainted funds? How do the courts determine what portion will be tainted? These questions were addressed by the *Wiand v. Lee* decision discussed above. In short, the intermediate balance rule is applied. The courts want to preserve the ill-gotten gains in any account where they exist so that if a person receives ill-gotten gains and puts them in an account with other monies, the other monies come out first. That way, the ill-gotten gains sink to the bottom and the legitimate gains float to the top so that the legitimate funds are used first. Therefore, recovery of the ill-gotten gains stays available to the creditor, if any funds remain. This approach backfires on creditors when the first monies held under an account that contains both ill-gotten gains and legitimate funds are used to buy a homestead or pay down a mortgage thereon.

The *Wiand* Court analyzed these rules and concluded that all monies from an account that was used to buy an otherwise creditor protected homestead would be considered as tainted, as long as (1) the amount of tainted funds put into the account equaled or exceeded the amount of the purchase price; and (2) the account had a balance at the time of withdrawal no greater than the amount of tainted funds that were put into the house.

The court determined that "the lowest intermediate balance rule" should be applied to determine the amount of the equitable lien, which would be held in the constructive trust.[190] The court stated as follows:

> "[T]he lowest intermediate balance rule" is an acceptable method for treating trust proceeds that have been commingled with other funds: where trust funds are commingled in an account they are considered as undiminished so long as the total account balance is at least equal to the amount of the trust fund deposits. If the aggregate amount of trust deposits exceeds the lowest intermediate balance in the account, they are considered lost. Thus, "the lowest intermediate balance" in a commingled account represents trust funds that have never been dissipated and which are reasonably identifiable.[191]

The court reasoned that since tracing only requires "that [the] tainted funds be identified and followed from the point of origin (i.e. the fraudulent act),"[192] there was no need for a "'dollar-for dollar' accounting."[193]

When a court applies the lowest intermediate balance test, it uses what is known as a legal fiction. A legal fiction is a "presumption of fact assumed by a court for convenience, consistency, or to achieve justice."[194] In cases involving tainted and untainted funds, when applying the lowest intermediate balance rule, courts use the fiction that the debtor will spend his or her own money first to preserve the fraudulently obtained money – presumably to pay back defrauded creditors. Whether or not that is actually the case does not matter to the courts when they apply the test. Thus, the rule is that a debtor's own money will be spent first, and then the tainted, commingled funds will be spent.

Below are three examples of how the application of this rule may work:

Example 1: A debtor has $100,000 of "untainted funds" in an account. The debtor then deposits $250,000 of tainted funds into that same account. If the debtor spends $200,000 on his or

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[190] *Wiand v. Lee*, No.: 8:15-bk-01038-KR, slip op. at 11 (Bankr. M.D. Fla. June 22, 2017).
[191] *Id.*
[192] *Id.* at 12.
[193] *Id.*
[194] Nolo's Plain English Legal Dictionary, https://www.nolo.com/dictionary/legal-fiction-term.html.

her homestead, the court will presume that the debtor used $100,000 of the untainted funds first, exhausting the untainted amount in the account, and used $100,000 of tainted funds to purchase the home. The remaining $150,000 in the account will be considered tainted funds, and $100,000 of tainted funds used to secure the house will be subject to equitable lien.

Example 2: If the numbers are the same as in the above example, except the house purchased is only $95,000 instead of $200,000, then the test would find that $95,000 of untainted funds were used to purchase the house. $5,000 of untainted funds remained in the account along with $250,000 of tainted funds. If the debtor then bought a $50,000 car, the court will consider the debtor to have paid $5,000 in untainted funds and $45,000 of tainted funds. As such, the creditor may have a $45,000 “equitable lien” on the automobile. Assuming no further contributions of untainted funds to the account, and that subsequent withdrawals are used to improve or repair the car or the house, they will be from the tainted funds remaining in the account and will be subject to lien as well.

Example 3: A debtor who puts $900,000 of “untainted funds” and $100,000 of tainted funds into an account, and spends $901,000 on legitimate expenses and then $99,000 paying down a homestead mortgage will be found to have contributed $99,000 of tainted funds into the homestead, and will thus be subject to an equitable lien of $99,000, and constructive trust treatment may also apply. See also the United States First Circuit Court of Appeals case of *Connecticut General Life Insurance Company v. Universal Insurance Company*, 838 F.2d 612, 619 (1st Cir. 1988).[195]

A DEBTOR CAN LOSE ALL OF HIS OR HER HOUSE IN BANKRUPTCY (EXCEEDING $189,050) AS THE RESULT OF A FRAUDULENT TRANSFER WITHIN ONE YEAR BEFORE FILING.

DON’T DO THIS WITHIN A YEAR OF FILING BANKRUPTCY, OR EVERYTHING MIGHT BE LOST! Paying one’s mortgage down with non-exempt monies less than one year before filing bankruptcy can be catastrophic where the payment causes the debtor to lose his or her bankruptcy discharge. In *In re Chauncey*, the Eleventh Circuit Court of Appeals determined that the debtor’s actions in not filing for bankruptcy until just a few days after she used her non-exempt personal injury action settlement proceeds to pay down the mortgage on her homestead (to protect those funds from creditors) did not warrant the imposition of an equitable lien on her homestead based on the principles set forth in *Havoco.*[196] However, the court affirmed the bankruptcy court’s decision to deny a discharge of her debt, stating that “[i]ts finding of fact in determining that [the debtor] transferred her property within one year before filing her petition with intent to defraud creditors and in failing to keep financial records without justification are not clearly erroneous.”

WHAT ELSE CAN YOU HAVE ON YOUR HOMESTEAD BESIDES YOUR HOME?

The Florida Constitution is not clearly written with reference to the question as to whether a debtor can use homestead property for functions other than the residence of the debtor and the debtor’s family. Specifically, Article X, Section 4 of the Florida Constitution reads as follows:

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[195] See, *In re Columbia Gas Sys. Inc.*, 997 F.2d 1039, 1063 (3rd Cir. 1993); *In re Dameron*, 155 F.3d 718, 724 (4th Cir. 1998); *First Fed. of Mich. v. Barrow*, 878 F.2d 912, 916 (6th Cir. 1989).
[196] *In re Chauncey*, 454 F.3d 1292 (11th Cir. 2006).

> (a) There shall be exempt from forced sale under process of any court, and no judgment, decree or execution shall be a lien thereon, except for the payment of taxes and assessments thereon, obligations contracted for the purchase, improvement or repair thereof, or obligations contracted for house, field or other labor performed on the realty, the following property owned by a natural person:
>
> (1) a homestead, if located outside a municipality, to the extent of 160 acres of contiguous land and improvements thereon, which shall not be reduced without the owner's consent by reason of subsequent inclusion in a municipality; or if located within a municipality, to the extent of one-half acre of contiguous land, <u>upon which the exemption shall be limited to the residence of the owner or the owner's family</u>.

The above underlined language may apply only to property within city limits, or might apply to property outside of city limits. The case law associated with this issue is summarized as follows:

OUTSIDE CITY LIMITS

Property located outside of the city limits can qualify for homestead exemption even when the property (up to 160 acres) is also used for substantial and independent business activities. This was confirmed by the First District Court of Appeals in *Davis v. Davis,* where the homestead property included the home and an independently operated mobile home park.[197]

Further, in *In re Oullette*,[198] the Middle District of Florida held that property located outside a municipality with two mobile homes located on it was exempt homestead property even though the debtors rented one of the mobile homes to a third party. However, in *Radtke,* a Bankruptcy Court Judge in the Southern District of Florida declined to follow the *Davis* case referred to above, and held that a debtor's 2.23-acre property located in an unincorporated area of Highlands County could only be considered homestead for the residential portion, and would not allow the mobile home park commercial space to be included in homestead property.[199]

Noting the difference in, and even "declining] to follow" the outcome in *Davis*, the *Radtke* court held that "when a debtor utilizes a portion of his or her land for commercial purposes, the debtor is not entitled to claim that portion as exempt by virtue of the Florida homestead exemption."

The *Radtke* court distinguished the two cases by noting that the debtor leased portions of his homestead property to third parties with mobile homes and RVs, who in turn would sublease those mobile homes and RVs for their own business enterprise.

In acknowledging the difference in *Davis*, *Radtke* noted that while "a decision of a court from an alternate state district is persuasive, this Court finds that the language contained in the

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[197] 864 So.2d 458 (Fla. 1st DCA 2003).
[198] 2009 WL 1936896 (Bankr. M.D. Fla. 2009).
[199] *In re Radtke,* 344 B.R. 690 (S.D. Fla. 2006).

Florida Constitution was not intended to extend homestead protection to those portions of property which its owner utilizes for commercial enterprise."

INSIDE CITY LIMITS

Recent cases in Florida have held that a "separate structure" on contiguous homestead property where the debtor's daughter lived did not qualify as the debtor's homestead, because the homestead exemption is limited to the "residence" of the debtor.

The law is flexible for debtors with dual purpose homestead properties within city limits, but there are limitations.

In the bankruptcy case of *In re Bornstein,*[200] a debtor who lived on one side of a duplex and rented out the other side was unable to claim the portion of the duplex occupied by the tenant as being exempt from creditors because it was within city limits on property smaller than one-half an acre. The court found that the debtor could claim exemption of the sales proceeds attributable to the portion of the duplex that she resided in, and that the amount attributable to the rental portion would be distributed to her creditors. The court divided the net equity available after satisfaction of the mortgage on the property between the debtor and the creditor.

The court distinguished this case from *In re Ballato,*[201] where the court allowed a full exemption, despite evidence that unrelated third persons were living in the home and paying rent. In *Ballato,* the home was a single-family residence with no "severable portions," and the debtor/owner had unlimited use of the entire home, presumably including the bedroom or bedrooms that the renter slept in. In *In re Makarewicz,*[202] the debtor, whose homestead was located **"within a municipality,"** was entitled to a full homestead exemption, notwithstanding the fact that a portion of the two-story garage attached to the home was rented to third parties, based upon the rationale that rented portions were not severable and that the property could not be partitioned and sold.

In *In re Ensenat*, a Southern District Bankruptcy Court judge found that two buildings located on a one-half acre parcel of land in incorporated Miami qualified as exempt homestead property, even though only one building was occupied by the debtors and the other building was a second dwelling consisting of two bedrooms and a bathroom that was connected to the "main house" by a covered patio and occupied by a half-niece and her family.[203] The second building had an independent living room, kitchen and separately gated entrance with separate electrical metering and its own water supply. The debtors never rented the second building, but allowed family members emigrating from Cuba to live there. At the time of the case, the building was occupied by the wife's half-niece, the half-niece's young son, and the half-niece's boyfriend. They did not pay rent, but the boyfriend paid the electric, phone and water bills.

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[200] 335 B.R. 462 (Bankr. M.D. Fla. 2005).

[201] 318 B.R. 205 (Bankr. M.D. Fla. 2004).

[202] 130 B.R. 620 (Bankr. S.D. Fla. 1991).

[203] *In re Ensenat,* 2007 WL 2029332 (Bankr. S.D. Fla. 2007).

The Trustee argued that the debtors were not entitled to exempt the second building because it was not part of the debtor's residence, and the half-niece was not a member of the debtor's family. The court found that a separate structure on what is otherwise homestead property is not disqualified from the same protection as the residential structure merely because it is separate from the primary residential structure. In support of this proposition, the court cited *Armour & Co., v. Hulvey,*[204] where the Florida Supreme Court noted in 1917 that outhouses, barns, wagon houses, garage, sheds, chicken houses and fences could all be appurtenant and subsidiary to and used in connection with a protected homestead resident.

Further, the court noted that abandonment or waiver of the exemption in a separate structure within city limits can occur when it is used to generate income. Here, the Trustee argued that because the property could be rented (even though it was not currently being rented and had not previously been rented), that homestead protection should not be given to the structure; however, the court rejected this argument. The court stated that "[t]he potential of a separate building for use for a business purpose, like a prior use of such building for a business purpose, is not adequate to compromise the Debtors' homestead rights in such building."

THE HOMEOWNER DOES NOT HAVE TO RESIDE IN A PROTECTED HOMESTEAD IF "FAMILY" LIVES THERE AND OTHER REQUIREMENTS ARE MET

While the Constitution protects the homestead, courts have limited that protection to the "residence of the owner <u>or</u> his family."[205] Therefore, the homeowner need not live in the homestead as long as a family member does. The test for what constitutes a family member has been extended beyond marital and blood relationships, and instead requires "either singly or in combination (1) a legal duty to maintain arising out of the relationship; and (2) a continuing communal living by at least two individuals under circumstances where one is regarded as the person in charge."[206]

The 1977 First District Court of Appeals decision in *In re Ensenat* found that a debtor's "half-niece" did not fit within the definition of "his family" because the debtor who owned the home that the niece lived in had no legal obligation to support either the niece or her family. Nonetheless, the court held that the debtors were entitled to claim the homestead exemption for the entire residence, including the second building, because the structure in which the half-niece's family resided was part of the property that fell within the protection of the constitutional homestead guidelines and was not used for a business purpose.

A relevant case discussing the extension of the homestead exemption protection to family members when the owner no longer lives in the house is *Beltran v. Kalb*.[207] In this case, the homeowner, Evaristo Beltran, owned a homesteaded property with his wife, Carmen. They divorced in 1990. Carmen and their daughter remained in the house. Evaristo was later sued and a final judgment was rendered against him. In 2007, Carmen passed away and Evaristo quit-claimed his interest in the property to his daughter. The judgment against Evaristo remained and in 2007 was

[204] 74 So. 212 (Fla. 1917).
[205] *In re Wierschem*, 152 B.R. 345, 347 (Bankr. M.D. Fla. 1993).
[206] *In re Ensenat,* 2007 WL 2029332 at *3 (*citing Heard v. Mathis*, 344 So.2d 651, 654 (Fla. 1st DCA 1977).
[207] *Beltran v. Kalb*, 63 So. 3d 783 (Fla. Dist. Ct. App. 2011).

re-recorded. In March 2007, a sheriff's levy was recorded on the property and a sheriff's sale was conducted in May of 2007. Evaristo filed a motion to vacate the sale that was denied by the trial court, but reversed on appeal.

The appellate court found that "the homestead exemption is 'limited to the residence of the owner or the owner's family.' Accordingly, 'the Florida Constitution does not require that the owner claiming homestead exemption reside on the property; it is sufficient that the owner's family reside on the property.'" *Nationwide,* 400 So. 2d at 561.[208] A concurring opinion found the following:

> Grisel, Evaristo's daughter, is a member of his family. *See Cain v. Cain*, 549 So. 2d 1161, 1163 (Fla. 4th DCA 1989). So long as Evaristo owned any interest in the former marital home and Grisel resided in it, the interest he owned was exempt from execution and levy (forced sale) to satisfy the judgment obtained.[209]

Evaristo left the house pursuant to the terms of a final judgment to his wife, and after the divorce, Carmen and Grisel continued to live on the property. Meanwhile, Evaristo continued to support his daughter financially as she aged into adulthood and by the time of this case, Grisel lived in the home with her son. Despite this, the court found that the daughter was an eligible family dependent residing in the home even though she was no longer a minor. It therefore appears that a "moral obligation" to support a family member as a "dependent" should be sufficient.

The court goes on to note that homestead status continues until the homestead is abandoned or alienated in the manner provided by law. In order to show abandonment, "it must be shown that both the owner and the owner's family abandoned the property."[210] Thus, because Carmen and Grisel continued to live on the property and there was no showing of abandonment, the property maintained its homestead character.

In *Nationwide*, referenced above, the court found that the extension of the homestead protection rested on a two part test. "First the property must be the residence of either the owner or the owner's family. Second, the owner of the property must be the 'head of a family'.[211] "We cannot assume . . . the 'head of the family.'" It is a factual question."[212] The court goes on to describe why the "head of family" test is somewhat less important today as it writes:

> Since the homestead exemption for the "head of a family" has been a part of the constitution, however, separate living arrangements, dissolutions and single parentage have become a much more frequent occurrence. It is common for more than one member of the family to provide family income. When the "family" is not a cohesive unit or when only one parent provides the income, it is no easy task to determine who is the "head" of the family, and the courts have been reluctant to adhere to any hard and fast rule in making that determination.[213]

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[208] *Nationwide*, 400 So. 2d at 559.
[209] *Beltran v. Kalb*, 63 So. 3d 788 (Fla. Dist. Ct. App. 2011).
[210] *Nationwide*, 400 So.2d at 561.
[211] *Nationwide*, 400 So. 2d at 559.
[212] *Id.* at 561.
[213] *Id.*

Courts can be expected to apply homestead law "liberally" in order to protect homestead property owners and their family. Footnote 3 of the decision provides as follows:

> [T]he trial judge faced with making a finding on who is the family head may take some solace in the knowledge that a common thread can be found running through each case: the homestead law should be construed liberally for the benefit of those whom it was designed to protect. See *Vandiver v. Vincent*, 139 So.2d 704, 707-708 (Fla. 2d DCA 1962).[214]

HOW MUCH OF THE HOMESTEAD IS REALLY HOMESTEAD?

The courts have repeatedly held that a homestead will not be exempted from creditor claims if it is within the city limits and used for business purposes, except for the portion of the property that functions solely as a residence.[215]

In 2009, the Bankruptcy Court addressed this issue in *In re Wilson.* In *Wilson,* the debtor attempted to claim homestead on a nightclub that he alleged that he lived in, but was not currently living in because he had moved out to have carpet installed. The court found that the debtor's residence was the apartment above the nightclub, but refused to say that the entire property constituted his homestead since it was undisputed that the debtor's living area constituted only a small portion of the building. In arguing that the portion of the building that his son lived in should be considered homestead, the debtor admitted that his son was an adult who was not physically or mentally disabled. The Court held that because the debtor had no legal duty to support his son for purposes of the debtor's homestead, his son could not be considered to be a family member and the room he lived in did not constitute as part of the debtor's homestead.[216]

Similarly, in *In re Fowler*, decided in 2016, the Bankruptcy Court stated:

> Just as Bankruptcy Judge Isicoff held in *Wilson* that an adult son living in a building also housing a nightclub and the debtor's apartment did not justify homestead status for the son's room, the residence of the debtor's adult daughter in a separate home with a separate address and driveway creates no homestead exemption to the Second Parcel for the debtor.[217]

In both of these cases, it seems like the courts would have extended homestead, to at least the portion of the property the child lived on, if the child of the debtor was actually dependent on

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[214] *Id.* at Footnote 3.
[215] *In re Wilson*, 393 B.R. 778, 783 (Bankr. S.D. Fla. 2008); The burden of proof falls on the party claiming the property is not exempt. *In re Ballato*, 318 B.R. 205, 209 (Bankr. M.D. Fla. 2004) (citing (In re Harrison, 236 B.R. 788, 790 (Bankr. M.D. Fla. 1999)).
[216] *Id*. at 781.
[217] *In re Wilson*, 393 B.R. 778, 783 (Bankr. S.D. Fla. 2008).

the debtor. In each case, the court could not because both "children" were above the age of maturity (18) and possessed no disability.

Perhaps the more important theme to gather from these cases, however, is that the homestead exemption does not extend to exempt property used for business purposes.

Additionally, an adjoining vacant lot may not be considered homestead where it has not been used or considered by logistics and fencing to be part of the homestead estate. This was the result in *In re Estate of Ritter,*[218] where the property in question was not jointly fenced with the residence and was "merely a separate, empty lot which served, at best, as an excess side yard to the residence."

Floridians owning adjoining houses will be well advised to make sure that there are no fences between the homes, and to build pathways, integrate uses, and coordinate appearance from the road and otherwise to promote the concept that the two separate houses are a single homestead. The second house may be referred to as a storage/exercise/guest house. If possible, the homeowner should request the Property Appraiser to merge both parcels under one parcel ID number.

Because homestead can be owned under a revocable trust, and a land trust is a revocable trust which may own multiple properties and even properties as defined in the trust agreement as portions of parcels in different manners, the authors believe that it is possible to place more than one-half acre of property in the name of a land trust, and to have the land trust agreement provide that a defined one-half acre portion of the property will be considered as owned directly by the individual beneficiary of the land trust, while the acreage surrounding the most valuable one-half acre is considered as owned by a limited liability company or other entity that may provide it with better creditor protection.

For example, the land trust agreement could define a parcel of real estate as being the "homesteaded one-half acre" and "excess property," and the grantor of the land trust would be able to assign all beneficial interests in the "excess property" to a separate family LLC.

If all of this is done in advance of a judgment being filed, then it would seem that the judgment against the debtor would not attach to the one-half acre homestead part of the property, and that the debtor would not own the excess acreage held under the family LLC.

This could occur without notification to third parties such as neighbors, homeowner's associations, or municipalities that the property was divided for beneficial ownership purposes.

IS A HOMESTEAD SAFE IF IT IS TITLED UNDER A REVOCABLE TRUST?

The 2001 case of *In re Bosonetto*,[219] surprised a great many Florida advisors when a well-respected bankruptcy judge in Jacksonville concluded that an 89-year-old widow's homestead was not protected when found by the court to be owned by her revocable trust. The widow's home was

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[218] 407 So.2d. 386 (Fla. 3rd DCA 1981).
[219] 271 B.R. 403 (Bankr. M.D. Fla. 2001).

titled by deed in her own personal name, but the revocable trust had a provision stating that the trust owned all real estate registered in her individual name.

Since the *Bosonetto* decision, however, there have been a number of cases holding that homestead is perfectly safe under a revocable trust, and the judge that presided over *Bosonetto* passed away in 2007.

In 2006, in *In re Edwards,*[220] the Bankruptcy Court for the Middle District of Florida explicitly rejected *Bosonetto*, and held that debtors can claim the homestead exemption for residences held under revocable trusts. The court stated that "[t]he great weight of the relevant case law holds to the contrary. Fee simple title of the property is not required, and an equitable or legal interest should afford protection pursuant to the provision."

Notably, Judge Michael G. Williamson of the Tampa Bankruptcy Court has held that debtors can claim residences as exempt under the Florida homestead exemption, even though title to the subject property is held by a revocable trust at the time that a petition is filed.[221] In 2003, a similar result was reached by the Third District Court of Appeals in *Callava v. Feinberg,*[222] and, in 2006, the Fourth District Court of Appeals came to the same conclusion in *Engelke v. Estate of Engelke.*[223]

In *Callava v. Feinberg,* the Third District Court of Appeals held that the debtor's homestead held under a trust was protected from an attorney who was a creditor. The court held that the Florida Constitution "does not designate how title to the property is to be held, and it does not limit the estate that must be owned . . ."[224] The beneficial interest the client owned in the home from the trust was enough to enjoy homestead protection.

Also, Florida's Third District Court of Appeals confirmed that property held in a revocable trust qualifies for the homestead creditor protection.[225] In this case, a husband placed his homestead in a revocable trust, and the court found that it was protected, specifically stating that "it is undisputable [sic] the Key Biscayne condominium was the decedent's homestead." In footnote two, the court clarified that "the estate owned need not be fee simple, but may be any type of interest in the property, legal or equitable, so long as the interest is a possessory interest."

In the 2009 Bankruptcy Court case of *Steffen v. United States*, the court held that even though the debtor was the sole beneficiary of a revocable trust, she did not have a legal or equitable interest in the property to support her homestead claim. Therefore, "even though she resided on the property, she failed to show that she had a legal right to use and possess it as of her bankruptcy filing date."

The court distinguished other cases in which the trustee and beneficiary of a revocable trust claimed property titled in the name of the trust as exempt homestead property. However, In *Steffen*,

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[220] 356 B.R. 807 (Bankr. M.D. Fla. 2006).
[221] *In re Alexander,* 346 B.R. 546 (Bankr. M.D. Fla. 2006).
[222] 864 So.2d 429 (Fla. 3rd DCA 2003).
[223] 921 So.2d 693 (Fla. 4th DCA 2006).
[224] *Id.* at 431 (*citing Southern Walls, Inc. v. Stilwell Corp.,* 810 So.2d 566, 569 (Fla. 5th DCA 2002).
[225] *Aronson v. Aronson*, 81 So. 3d 515 (Fla. 3rd DCA 2012).

several more layers of ownership were involved that the court was not willing to extend homestead protection towards. Here, she was sole beneficiary of a trust that was a limited partner of a limited partnership; she also owned 100% of the stock in the limited partnership's general partner holding corporation. The limited partnership, however, was the entity that the supposed homestead property was titled in.

The court reasoned that when property is held by a revocable trust, the debtor could revoke the trust thereby causing the property to revert back to the debtor. Here, even if she revoked the trust she would not have had a beneficial ownership interest in the property.

INHERITANCE OF HOMESTEAD – IS IT PROTECTED WHEN IT ENDS UP IN AN ESTATE OR TRUST?

One trap for the unwary is that the former homestead of the decedent that is left by Will, trust or intestacy to the "heirs" of a decedent will not be subject to the decedent's creditor claims, but there is authority for the proposition that if the Will or trust requires that the homestead be sold, or that it pass in trust instead of outright to one or more "heirs," then it may lose its homestead creditor protection status.[226]

The 2010 4th District Court of Appeals decision of *Pajares v. Donahue* involved language under a Will which was read by the Court to require the sale of the deceased debtor's homestead, and distribution of the proceeds to the heirs of the debtor.

The Appellate Court concluded that where a decedent has no surviving spouse or minor children, and specifies under his or her Will that the homestead will be sold and the proceeds will be divided, then the homestead will no longer be protected from creditors of the deceased debtor. The court did not accept the appellant's argument that the Will "should be strictly construed in favor of retaining the homestead exemption," and reiterated that the intent of the testator is the polestar to the interpretation of a will.[227]

The Court in *Pajares* relied on the 2010 Florida Supreme Court case of *McKean v. Warburton* which held that "where a decedent is not survived by a spouse or minor children, the decedent's homestead property passes to the residuary devisees, not the general devisees, unless there is a specific testamentary disposition ordering the property to be sold and the proceeds made a part of the general estate."[228]

In *Pajares*, there was a specific clause in the Will requiring that Mrs. Pajares's homestead be sold, with the proceeds to be paid equally to the beneficiaries listed after all estate taxes and debts were satisfied. Therefore, her homestead was no longer protected from creditors because her

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[226] See *Elmowitz v. Estate of Zimmerman* (where Mr. Zimmerman provided for his homestead to go to a trust for the benefit of his sister, in lieu of outright, when he had no spouse or minor child. A contrary determination was made in the case of *HCA Gulf Coast Hospital v. Estate of Downing* by the First District Court of Appeals in 1991).

[227] *Pajares v. Donahue*, 33 So. 3d 700, 702 (Fla. 4th Dist. App. 2010).

[228] *McKean v. Warburton*, 919 So. 2d 341, 347 (Fla. 2005).

Will explicitly indicated a testamentary intent to dispose of the property by sale and to distribute the proceeds.

Homestead creditor protection has also been found to inure to the beneficiary of a spendthrift trust who would otherwise be entitled to claim homestead protection if title passed directly to him or her by devise or intestacy. Florida's 1991 Third District Court of Appeal's decision in *HGA Gulf Coast Hospital v. Estate of Phyllis Downing* indicated that the homestead of the decedent, which was left to a spendthrift trust for her daughter, continued to be homestead property after the death of the homeowner, and was therefore exempt from the hospital creditor of the decedent.[229]

Homestead protection can also transfer from a trust to a person intact. *In Cutler v. Cutler,* a woman created a land trust for estate planning purposes, naming herself and her two children as trustees.[230] The grantor was the sole beneficiary during her life, but the trust provided that upon her death, the remainder interest in the trust property was to be distributed to her estate. In her Will, however, she specifically devised the homestead property to her daughter. The court held that the property was constitutionally protected homestead, stating that "property held in trust may be impressed, legally speaking, with the character of the homestead." The homestead protection required that the decedent's debts be paid from the estate. The court held that the homestead was part of the estate.

Do the proceeds from a sale of a homestead qualify for the same protection as giving the homestead outright when the property in question is owned by a trust at the time of death?

The homestead protected property was directed to be sold under the will rather than devised. Because the proceeds go to the devisees/beneficiaries after the sale and the testatrix took the decision of what was to be done with the property at her death rather than devising it and letting the devisees choose its destiny, it lost its homestead exemption and protection from creditors in that moment. This unfortunate set of circumstances comes from one word: "sale".

The issue with our client's will is that it directs the sale of the homestead instead of merely devising it.

> Here, the provisions of the revocable trust effective upon Paul's death provided generally that the trustee would pay any expenses that the estate could not pay. Yet the trust also specifically directed that the homestead be available to Judy during her lifetime with Paul's children to receive it following the termination of Judy's interest. The trust cannot be read as requiring the sale of the homestead. In fact, the opposite conclusion must be drawn.

Engelke v. Estate of Engelke, 921 So. 2d 693, 697 (2006).

Here is more to support that a directed sale in the language of a will makes the property lose its homestead exemption.

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[229] 594 So.2d 774 (Fla. 1st DCA 1991).

[230] 994 So.2d 341 (Fla. 3rd DCA 2008).

> It has long been recognized that the owner of homestead property may devise that property in a manner that terminates the protections accorded by article X, section 4. In *Estate of Price v. West Florida Hospital.*, Inc., 513 So.2d 767, 767 (Fla. 1st DCA 1987), the court confirmed that where a testator directs the sale of homestead property and distribution of the proceeds, the proceeds lose their homestead character and become part of the estate subject to administrative costs and creditors' claims. As the court explained, this is because the same result would have obtained had the testator sold the property and either gifted or used the proceeds while alive. Id. ("[I]f Mrs. Price had sold her house during her lifetime and distributed the proceeds to her two children, those proceeds would unquestionably lose their homestead character and would be subject to the claims of her creditors."); see *Knadle v. Estate of Knadle*, 686 So.2d 631, 632 (Fla. 1st DCA 1997) (holding that because a will specifically directed that homestead property be sold and the proceeds placed in the residue for distribution along with other assets, it lost its homestead character); see also *Thompson v. Laney*, 766 So.2d 1087, 1088 (Fla. 3d DCA 2000) (confirming that where a will directs that homestead property be sold and the proceeds distributed, the proceeds lose their homestead protection). Although Edith did not direct that her home be sold, she did direct, in a specific manner, that it be used to satisfy her debts. This was the equivalent of ordering it sold and the proceeds distributed to pay debts, actions which Price and its progeny confirm results in loss of homestead protections.

Cutler v. Cutler, 994 So. 2d 341, 345 (2008).

When the testator makes a direct request or command to sell the property and then divide the proceeds amongst beneficiaries that may or may not be heirs, the homestead exemption is lost and those proceeds are susceptible to creditor claims.

A more recent statute seems to abandon *Cutler*, instead stating that a general direction to pay debts from the trust does not remove the forced sale exemption for homestead property. Effective July 1, 2021, Fla. Stat. § 736.1109 reads as follows:

> (1) If a devise of homestead under a trust violates the limitations on the devise of homestead in s. 4(c), Art. X of the State Constitution, title shall pass as provided in s. 732.401 at the moment of death.
>
> (2) A power of sale or general direction to pay debts, expenses, and claims within the trust instrument does not subject an interest in the protected homestead to the claims of decedent's creditors, expenses of administration, and obligations of the decedent's estate as provided in s. 736.05053.
>
> (3) If a trust directs the sale of property that would otherwise qualify as protected homestead, and the property is not subject to the constitutional limitations on the devise of homestead under the State Constitution, title shall remain vested in the trustee and subject to the provisions of the trust.

> (4) This section applies only to trusts described in s. 733.707(3) and to testamentary trusts.
>
> (5) This section is intended to clarify existing law and applies to the administration of trusts and estates of decedents who die before, on, or after July 1, 2021.

Contrary to *Cutler's* holding, this recent statute requires explicit language, rather than a "general direction to pay debts" to force a sale of homestead property.

Further, Fla. Stat. § 733.608 outlines the general power and authority of a personal representative in managing and administering the decedent's real and personal property, with a focus on the protected homestead.

The homestead protection provision reads in pertinent part as follows:

> (1) All real and personal property of the decedent, except the protected homestead, within this state and the rents, income, issues, and profits from it shall be assets in the hands of the personal representative:
>
> > (a) For the payment of devises, family allowance, elective share, estate and inheritance taxes, claims, charges, and expenses of the administration and obligations of the decedent's estate.
> > (b) To enforce contribution and equalize advancement.
> > (c) For distribution.

The language "except the protected homestead" creates a carve-out wherein the homestead property may not be used to pay the obligations of the estate.

On the other hand, the rest of the statute grants the personal representative the authority to take possession of the decedent's protected homestead for preservation purposes, specifies circumstances under which the personal representative may be relieved of the duty to enforce collection of the debt, and establishes a lien mechanism for the personal representative to recover expenses they have incurred in maintaining the homestead. It also provides procedures for foreclosure of the personal representative lien on the homestead property, according to "the manner of a foreclosing of a mortgage under the provisions of chapter 702." The statute also allows a court to transfer the lien from the homestead property to the proceeds of its sale to accommodate a sale or encumbrance, provided the proceeds are deposited into a restricted account subject to the court's jurisdiction.

This statute therefore supports that the homestead may not be used as an asset to pay the obligations of the estate without explicit direction by the testator, however, it does recognize certain conditions under which a personal representative's lien against the homestead property may lead to foreclosure.

LEASEHOLD INTERESTS, REMAINDER INTERESTS, LIFE ESTATES, LADY BIRD DEEDS, AND CO-OPs.

If a client wants to avoid probate and still retain homestead creditor protection, he or she may consider transferring the remainder interest in the homestead to a revocable trust by use of a "life estate deed" or a "lady bird deed." Under the classic life estate deed, the grantor gives away the remainder interest in a property, but keeps the lifetime right to use, enjoyment, and control of the property. The grantor also retains the right to any rental profits, as well as the right to sell, lease, mortgage or otherwise dispose of the property. The transfer of the remainder interest in an established homestead should not be considered a fraudulent transfer if the entire property was protected at the time of the transfer and there was no intent to defraud. The retained life estate should also qualify for homestead creditor protection and tax advantages under the Florida Constitution and Florida Statutes Section 196.031.

The operative language for a typical lady bird deed is as follows:

WITNESSETH, that the Grantor, for and in consideration of the sum of ten dollars ($10.00) and other good and valuable consideration, receipt whereof is hereby acknowledged, hereby grants, bargains, sells, aliens, remises, releases and conveys and confirms unto the Grantee all that certain land situate in __________ County, State of Florida, and more fully described as follows:

Grantor reserves unto Grantor for and during Grantor's lifetime, the exclusive possession and enjoyment of the rents and profits of the property described herein. Grantor further reserves unto Grantor, for and during Grantor's lifetime, the right to sell, lease, encumber by mortgage, pledge, lien, or otherwise manage and dispose, in whole or in part, or grant any interest therein, of the aforesaid premises, by gift, sale, or otherwise so as to terminate the interests of the Grantee, as Grantor in Grantor's sole discretion shall decide, except to dispose of said property, if any, by devise upon Grantor's death. Grantor further reserves unto Grantor the right to cancel this deed by further conveyance which may destroy any and all rights which the Grantee may possess under this deed. Grantee shall hold a remainder interest in the property described herein and upon the death of the Grantor, if the property described herein has not been previously disposed of prior to Grantor's death, all right and title to the property remaining shall fully vest in Grantee subject to such liens and encumbrances existing at that time.

The Grantor hereby represents and warrants that the above-referenced property **IS NOT** the homestead property of the Grantor.

This deed was prepared without the benefit of a title search of the subject property and the preparer of this conveyance does not guarantee merchantability or marketability of title.

Together, with all the tenements, hereditaments, and appurtenances thereto belonging or in anywise appertaining.

AND the Grantor hereby covenants with said Grantee that the Grantor is lawfully seized of said land in fee simple; that the Grantor has good right and lawful authority to sell and convey said land, and hereby warrants the title to said land and will defend the same against the lawful claims of all persons whomsoever; and that said land is free of all encumbrances, except covenants, conditions, easements and restrictions of record; and subject to taxes for the year ____________ and subsequent years.

TO HAVE AND TO HOLD, the same in fee simple forever.

A remainder interest holder living in a homestead has protection. In the 2010 Bankruptcy case of *In re Williams*, a son lived in a home with his wife and mother. The mother had transferred her ownership to hold a life estate, with the remainder interest owned by her son. The court determined that the property was held by a debtor who constituted a natural person and that the homestead exemption applied. A second case, *In re Hildebrandt*, came to the same conclusion.

MOVING OUT OF THE HOMESTEAD FOR A FEW MONTHS AT A TIME SO THAT IT CAN BE A SEASONAL RENTAL TO PRODUCE INCOME FOR THE HOMESTEAD OWNER.

The case law is clear that homestead status continues to apply if the owner of the homestead is not physically present there, but intends to continue to make it his or her homestead and to return there.[231] It should be safe for the homestead owner to rent out his or her house occasionally for a few weeks at a time during the prime season while maintaining homestead exemption status for both property tax and creditor exemption purposes. An individual can maintain their homestead status even when they are "temporarily removed from the homestead but the homestead remains the permanent abode to which the family unit intends to return."[232]

A LEASEHOLD INTEREST CAN QUALIFY FOR HOMESTEAD CREDITOR PROTECTION

Can a debtor prepay a lease and then live rent-free on a leased property for a period of time without the Florida Fraudulent Transfer Statute to apply? In the 2012 Second District Court of Appeals case of *Geraci v. Sunstar EMS,* it was determined that a long-term lease constituted "property owned by a natural person" under the Florida Constitution, Article X, Section 4, and thus qualified for homestead creditor protection.[233] The court also specifically found that fee simple ownership is not necessarily to claim this type of homestead protection.

In *Geraci*, the court considered whether a long-term lease of a condominium qualified for homestead creditor protection under Article X, Section 4 of the Florida Constitution. The property at issue was a Pinellas County condominium that was the subject of a 100-year lease agreement from 1976. The decedent, Mary J. Geraci, owned the leasehold interest, which had approximately 64 years remaining, and upon her death, creditors filed claims against her estate. Lawrence Geraci, Jr., as personal representative of Mary Geraci's estate, filed a petition with the court to determine whether the condominium qualified as homestead and thus was exempt from creditor's claims.

Judge Lauren C. Laughlin of the Circuit Court for Pinellas County concluded that the condominium did not qualify for homestead creditor protection because it was subject to a lease

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[231] See *Novoa v. Amerisource Corp.*, 860 So. 2d 506, 507 (Fla. Dist. Ct. App. 2003) (noting that "continuous uninterrupted physical presence is not required to create a homestead.")
[232] *Id.*
[233] 93 So.3d 384, 385 (Fla. 2nd DCA 2012).

agreement rather than being owned in fee simple. The Second District reversed, finding that fee simple ownership is not necessary to qualify for homestead creditor protection.

Applying Article X, Section 4(a) of the Florida Constitution, which grants homestead creditor protection, the 2nd District Court of Appeals found that the condominium qualified as a homestead, despite the fact that it was not owned in fee simple. Specifically, the court stated that "Article X, section 4(a) does not distinguish between the different kinds of ownership interests that are entitled to the homestead exemption against forced sale."[234] The Florida Supreme Court has long held that a fee simple estate is not necessary to qualify for the homestead exemption.

The court also noted that "'any beneficial interest in land' may entitle its owner to the exemption." Significantly, the court stated that the proper inquiry in determining whether a property qualifies for homestead creditor protection is whether: 1) the debtor intended to make the property his or her homestead; and 2) whether the debtor used the property as his or her principal and primary residence.

CO-OPS QUALIFY.

Similarly, in *Southern Walls, Inc. v. Stilwell Corp.,* the Fifth District Court of Appeals held that a co-operative interest qualified for homestead creditor protection.[235] Specifically, the court stated that "a co-op must be a dwelling that an individual has an ownership interest in that gives him or her the right to use and occupy it as his or her place of abode." The Fifth District further noted that the Florida Constitution does not define the term "owned" and that it "does not designate how title to the property must be held and it does not limit the estate that must be owned."

In *Phillips v. Hirshon,* the Third District Court of Appeals discussed the divergence in court opinions regarding whether ownership is required to claim homestead creditor protection and specifically stated, "[W]e respectfully submit that the courts may not diverge when interpreting the same subsection of the Florida Constitution, even if it seems to make good policy."[236] The court attempted to resolve the confusion among courts by certifying a question to the Florida Supreme Court, but the Supreme Court declined jurisdiction, leaving this issue unresolved.

Although the Second District in *Geraci* is not the first court to hold that a long-term leasehold interest may qualify for homestead creditor protection, this decision is significant because it strengthens the body of case law allowing homestead creditor protection absent an ownership interest. However, other Florida decisions have declined to extend this form of homestead protection to interests other than fee simple ownership.

It is also important to note that extending constitutional creditor protection to long-term leasehold interests may result in these interests being subject to the constitutional restrictions on

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[234] *Id.* at 385; (citing *In re Alexander,* 346 B.R. 546, 549-50 (Bankr. M.D. Fla. 2006); *Cutler v. Cutler*, 994 So. 2d 341, 344 (Fla. 3d DCA 2008); *S. Walls, Inc. v. Stillwell Corp.,* 810 So. 2d 566, 571 (Fla. 5th DCA 2002)).
[235] 810 So.2d 566 (Fla. 5th DCA 2002).
[236] 958 So.2d 425 (Fla. 3rd DCA 2007).

descent and devise. It is also noteworthy that New York Law was modified in 1996 to permit married couples to directly own Co-Op's as Tenants by the Entireties where certain requirements are met.[237]

	Constitutional Homestead Creditor Protection	**Tenancy by the Entireties**
1	Florida Constitution.	Florida Common Law (and Statutes in some ways)
2	Immune from Florida Statute 726 Fraudulent Transfer Set Asides.	Not immune from Florida Statute 726.
3	Transfers can qualify for four years plus one year lookback?	Transfers can qualify for four years plus one year lookback?
4	Ten year rule applies under bankruptcy code.	Four year Fraudulent Transfer Statute will apply in bankruptcy – with one year lookback.
5	White collar crime exception in bankruptcy.	No white collar crime exception in bankruptcy.
6	Cannot reinvest proceeds – may borrow and reinvest borrowings and sell later.	Can reinvest in other exempt assets, including a homestead.

PROCEEDS FROM SALE.

Proceeds from the sale of an exempt homestead can be used to purchase a creditor exempt replacement homestead, and will be protected during the transition if the following four requirements are met: The owner (1) has a good faith intent to reinvest the proceeds in a new homestead, (2) does not comingle the proceeds, (3) the proceeds are both identifiable and kept separate from other monies, and (4) reinvests the proceeds in a new homestead within a reasonable time. However, Florida courts have held that the proceeds from the sale of a homestead cannot be used by a debtor to reinvest in other exempt assets if the transfer would otherwise be set aside under the Florida Fraudulent Transfer Act. This section will first look at the 3 restrictions on using homestead sale proceeds to purchase a new homestead, and will then turn to the limitations on using homestead funds in other exempt asset scenarios.

USING HOMESTEAD PROCEEDS TO PURCHASE A NEW HOMESTEAD.

Florida law will allow the proceeds of a sale of homestead to be reinvested in a new homestead within a reasonable period of time with continued protection. To qualify for this protection, the Florida Supreme Court, in *Orange Brevard Plumbing & Heating Co. v. La Croix,* held that the homeowner must show a good faith intention at the time of sale of the homestead to reinvest the proceeds within a reasonable period of time.[238]

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[237] N.Y. Est. Powers & Trusts Law § 6-2.2 (McKinney).

[238] 137 So.2d 201 (Fla. 1962).

The Florida Supreme Court declined to define a reasonable period of time and stated that "whether funds received from the sale of a homestead are invested in another homestead within a reasonable time must be determined from the facts and circumstances of each case."

Subsequently, court cases have found that the monies held to purchase a homestead would be protected for a short period of time. For example, in *Rossano v. Britesmile, Inc.,*[239] the court found that a fourth month period was reasonable, but in *In re Delson*[240] and *Sun First National Bank of Orlando v. Gieger,*[241] the court found that four years and ten years, respectively, were not reasonable.

The 2016 Florida Supreme Court decision of *JBK Assocs. v. Sill Bros.* approved a four month holding period, and affirmed the decision in *Orange Brevard Plumbing & Heating Co. v. LaCroix* without discussion of how long the proceeds can be held in an account.

Two Bankruptcy Court cases have ruled on what is considered a reasonable time frame for proceeds to stay in a bank account (while still making a good faith effort to purchase a new homestead property.) In the 2006 case *In re Castro,* the United States Bankruptcy Court for the Southern District of Florida, Miami Division, approved two years as being a reasonable time frame for proceeds to stay in a bank account. In the 2011 case, *In re Fling,* the United States Bankruptcy Court for the Northern District of Florida, Tallahassee Division, approved a thirteen month period as reasonable.

As long as the individual has a "good faith intention" to reinvest the proceeds from the sale of one homestead into another within a year, a court will likely rule in that individual's favor. The shorter the timeframe, though, the safer.

INVESTING HOMESTEAD SALE PROCEEDS INTO OTHER EXEMPT ASSETS – THIS DOESN'T WORK, AND FUNDS MUST BE KEPT SEPARATE – NOT CO-MINGLED.

Because the funds from a homestead can be reinvested in a new homestead, one would assume that monies received from the sale of a protected homestead could be reinvested in another creditor exempt asset, given the general rule that one exempt asset can be converted to another exempt asset.[242] In *Sneed*, the Florida Supreme Court in 1938 cited the original Corpus Juris legal encyclopedia (which is now in C.J.S.) to confirm this:

> According to the weight of authority a debtor in disposing of property can only commit fraud on creditors only by disposing of such property as the creditor has a legal right to look to for satisfaction of his claim, and hence <u>a sale, gift or other disposition of property which is by law absolutely exempt from the payment of the owner's debts cannot be impeached by creditors as in fraud of</u>

239 919 So.2d 551 (Fla. 3rd DCA 2005).
240 247 B.R. 873 (Bankr. S.D. Fla. 2000).
241 402 So.2d 428 (Fla. 5th DCA 1981).
242 *In re Kimmel,* 131 B.R. 223 (Bankr. S.D. Fla. 1991) (holding that transfer of funds from one form of exempt assets to another was not a fraudulent conveyance).

> their rights. Creditors have no right to complain of dealings with property which the law does not allow them to apply on their claims, even though such dealings are with a purpose to hinder, delay or defraud them.[243]

Unfortunately, in 1962, the Florida Supreme Court did not agree with this general rule as it related to homestead proceeds in *Orange Brevard Plumbing & Heating Co. v. La Croix.*[244] In this case, the Florida Supreme Court stated the following:

> [W]e hold the proceeds of a voluntary sale of a homestead to be exempt from the claims of creditors just as the homestead itself is exempt if, and only if, the vendor shows, by a preponderance of the evidence an abiding good faith intention prior to and at the time of the sale of the homestead to reinvest the proceeds thereof in another homestead within a reasonable time. Moreover, only so much of the proceeds of the sale as are intended to be reinvested in another homestead may be exempt under this holding. Any surplus over and above that amount should be treated as general assets of the debtor. We further hold that in order to satisfy the requirements of the exemption the funds must not be commingled with other monies of the vendor but must be kept separate and apart and held for the sole purpose of acquiring another home. The proceeds of the sale are not exempt if they are not reinvested in another homestead in a reasonable time or if they are held for the general purposes of the vendor.[245]

This issue arose again in the 2000 Bankruptcy Court case of *In re Simms,*[246] where the homestead owners took the check from the sale of their house and endorsed it directly to purchase an annuity. The Court followed the decision of the Florida Supreme Court in *Orange Brevard Plumbing & Heating Co. v. La Croix* and found that homestead proceeds only retain their exempt status when rolled over into another homestead, and therefore the proceeds were non-exempt when they were rolled into the annuity. Specifically, the court stated:

> The voluntary liquidation of an exempt asset and subsequent reinvestment in another exempt asset should be considered permissible per se because such a maneuver neither harms creditors nor changes their position vis-a-vis the debtor. However, as directed by the Eleventh Circuit Court of Appeals, "[T]he bankruptcy court must interpret and apply the Florida exemption law in the same manner as a Florida state court."

In dicta, the court cited two non-Florida cases for the general proposition that exempt assets may be rolled over into another exempt asset, and noted that these cases were persuasive.[247] Thus, it seems that the court was convinced that the proceeds should be exempt, but was required to follow the Florida Supreme Court's ruling in *La Croix*.

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[243] 184 So. 865 (Fla. 1938).
[244] 137 So.2d 201 (Fla. 1962).
[245] *Id.*
[246] 243 B.R. 156 (S.D. Fla. 2000).
[247] *Love v. Menick,* 341 F.2d 680 (9th Cir. 1965) (subsequently overruled).

A separate question is whether money borrowed on a homestead can be directly transferred into an exempt asset, such as a variable annuity, a life insurance policy, or tenancy by the entireties.

In *In re Goldberg*, the debtor refinanced his house and transferred $80,000 directly to his fiancée from the loan proceeds.[248] He then took out a second mortgage and transferred another $50,000 directly to his fiancée. The Court distinguished this case from *La Croix*, and held the following:

> [T]he Debtor retained no interest in the funds generated by the loans against his homestead and never had possession of the funds since they were delivered directly to [his fiancée]. Moreover, the Debtor did not sell his homestead. The Debtor merely mortgaged and refinanced his homestead, encumbering the Real Property with liens that must be satisfied upon its sale. Mortgage and refinance proceeds are not the functional equivalent of sale proceeds. Thus, the fact that the Debtor did not reinvest the proceeds or have the requisite intent to reinvest the proceeds into another homestead within a reasonable period of time is irrelevant. The Court finds that no creditor could have forced the Debtor to mortgage his homestead to satisfy its claims. Thus, the Debtor's creditors were not harmed and there was not, nor could there be, any fraudulent intent on the part of the Debtor.

The court did not specifically address what would happen if the debtor had transferred the refinance and second mortgage proceeds into an exempt annuity; however, because he was able to transfer these proceeds to his fiancée without triggering a fraudulent transfer, it could be argued that a debtor should also be able to borrow against his homestead and purchase an exempt annuity.

SALE OF HOMESTEAD PROCEEDS CASES			
	CASE	**DESCRIPTION**	**HOLDING/REASON**
1	*Orange Brevard Plumbing & Heating Co. v. La Croix,* 137 so. 2d 201 (Fla. 1962).	The debtor voluntarily sold his homestead and was living in a rental home, with no evidence on when he intended on buying a new homestead.	Established the rule that proceeds from the sale of homestead can be reinvested in another homestead. IF there is a good faith intention prior to and at the time of the sale of the homestead to reinvest the proceeds thereof in another homestead within a reasonable time. Did not provide a definition of reasonable time, but noted that the facts and circumstances of each case should be considered.

[248] 229 B.R. 877 (Bankr. S.D. Fla. 1998).

SALE OF HOMESTEAD PROCEEDS CASES			
	CASE	**DESCRIPTION**	**HOLDING/REASON**
2	*In re Simms,* 243 B.R.156 S.D. Fla. 2000).	Debtors sold homestead and transferred proceeds directly into an annuity by endorsing check in favor of annuity company.	The court considered non-Florida cases and found it persuasive that the voluntary liquidation of an exempt homestead and subsequent reinvestment in another exempt asset should be permissive. BUT the court was required to follow the Florida Supreme Court's decision in *La Croix*. Pursuant to *La Croix* the $65,467.57 net sale proceeds of the homestead constituted a non-exempt asset because the Debtors had no intention of reinvesting the proceeds in another homestead. However, the transaction was not considered a fraudulent transfer because there was not enough evidence to establish that the debtors intended to hinder, delay or defraud creditors.
3	*In re Delson,* 247 B.R. 873 (Bankr. S.D. Fla 2000).	Husband has $4 million in debt. Husband & wife sold homestead and proceeds were transferred to bank account owned solely by wife. Wife then transfers proceeds into mutual fund investment accounts.	Homestead sale did not retain homestead exemption status. The proceeds were used by the debtor's wife to purchase collateral for a business loan; and, nearly four years after the homestead sale, neither the debtor nor his wife has purchased a new homestead. This subsequent action and inaction belies any purported intent at the time of the sale to reinvest in another homestead within a reasonable time.
4	*In re Vick,* 2008 WL 2444526 (Bankr. S.D. Fla. 2008).	Debtor filed a bankruptcy petition. On the petition date, the debtor occupied the home and held title to the homestead but sold the homestead after filing. Trustee argued that Debtor was required to reinvest the proceeds of the post-petition sale of her homestead into another homestead within a period of time or suffer the loss of the exemption.	The debtor retained the homestead protection for the proceeds. The court held that the sales contract did not constitute an abandonment of the property. The Trustee's attempt to reach into the future, to recover post-petition assets for the payment of pre-petition debts or administrative expenses, is unauthorized and against the policies upon which the Bankruptcy Code is premised.

SALE OF HOMESTEAD PROCEEDS CASES			
	CASE	**DESCRIPTION**	**HOLDING/REASON**
5	*In re Goldberg,* 229 B.R. 877 (Bankr. D. Fla 1998).	Debtor refinanced his house and transferred $80,000 directly to his fiancée from the loan proceeds. He then took out a second mortgage and transferred another $50,000 directly to his fiancée. The Trustee cited *La Croix* for the proposition that once homestead property is converted into another form, it loses its exempt status unless reinvested into another homestead within a reasonable period of time.	The Court held that this is distinguishable from *Orange Brevard* because the debtor did not sell his home and he retained no interest in the funds since. Thus, the fact that the debtor did not reinvest the proceeds or have the requisite intent to reinvest the proceeds into another homestead within a reasonable period of time was irrelevant. Not a fraudulent transfer.
6	*In re Dozonia,* 347 B.R. 920 (Bankr. M.D. Fla. 2006).	Debtor's homestead was sold in a foreclosure sale. There were surplus proceeds from the sale. The surplus funds were being held in a trust account pending the Court's decision.	Debtor was entitled to Florida homestead exemption in surplus proceeds, notwithstanding that he did not know, prior to mortgage foreclosure sale, that there would be any surplus proceeds.

SALE OF HOMESTEAD PROCEEDS CASES			
	CASE	**DESCRIPTION**	**HOLDING/REASON**
7	*In re Cottrill,* 118 B.R. 535 (Bankr. S.D. Ohio 1990). Exempt to Exempt Case.	Debtor husband withdrew money from his deferred compensation program, deposited $9,700 into a joint account with his wife, and shortly thereafter transferred $8,287.36 into the Public Employee's Retirement System.	"Because Mr. Cottrill essentially 'rolled-over' money from one exempt retirement fund into another, the transfer cannot be considered fraudulent." To the extent that transfer of funds to purchase pension plan benefitted not only debtor, but debtor's wife, transfer was not voidable as fraudulent. Death of debtor husband after commencement of bankruptcy case, leaving benefits from debtor's husband's pension plan payable to debtor's wife, did not render transfer of assets to pension plan fraudulent. Temporary placement of money in debtor husband's personal checking account for specific purpose of transferring funds from one exempt fund into another exempt fund did not cause asset to lose its exempt status, nor render transfer fraudulent.
8	*In re Kimmel*, 131 B.R. 223 (Bankr. M.D. Fla. 1991). Exempt to Exempt Case.	Debtor made 4 transfers: 1) IRA to IRA 2) Pension to Pension 3) Two Life Insurance Policies 4) Proceeds from Automobile to Annuity.	1) Exempt to Exempt transfer, not a fraudulent conveyance. 2) Exempt to Exempt transfer, not a fraudulent conveyance. 3) Not a fraudulent conveyance, life insurance policies were not purchased with intent to defraud creditors. 4) Not a fraudulent conveyance, because transfer was not done with intent to defraud creditors.

SALE OF HOMESTEAD PROCEEDS CASES			
	CASE	DESCRIPTION	HOLDING/REASON
9	*Sneed v. Davis,* 184 So. 865 (Fla. 1938).	Debtor owned stock in a corporation, then transferred it back to the company, which re-issued the stock to the debtor's family. At the time of the transfer, the debtor was the head of a family residing within the state, and the stock, together with all other personalty owned at such time by debtor, was worth less than $1,000.	The stock was exempt under the personal property exemptions, thus, transferring the exempt stock did not result in a fraudulent transfer.

ONE ADVANTAGE OF BEING MARRIED AND LIVING SEPARATELY.

In *In re Colwall,* the Eleventh Circuit Court of Appeals held that married couples legitimately living apart can occupy two protected homesteads.[249] It is noteworthy, however, that under Florida law, the local County Property Appraiser has discretion to deny a homestead tax exemption to married individuals who live separately, based upon criteria, including whether they actually have separate finances, file separate income tax returns, and constitute true independent separate households. This, as well as the process to appeal a homestead tax exemption denial, are enumerated in Florida Statute Section 194.011.

For property tax purposes, however, the law is clear that a married couple cannot claim two separate homesteads unless they truly live separately, and file separate federal income tax returns. Fortunately, the property tax status of separately owned and occupied houses will not be determinative as to creditor protection but is often persuasive.

SOMETIMES THE BEST STRATEGY IS TO BUY ANOTHER HOUSE.

When spouses own a home as tenants by the entireties and only one spouse is liable to a creditor, it may make sense to have the debtor spouse purchase a new home and use the old home as an income property. This is the best available strategy if the debtor spouse will not be forced into bankruptcy.

OCCUPANCY MUST BE LEGAL.

[249] 196 F. 3d 1225 (11th Cir. 1999).

The Florida Supreme Court has stated that "[a] piece of land, never occupied as a dwelling place or home, and incapable of such occupancy, is not a homestead within the meaning of the Constitution and laws of this State."[250] Thus, if an individual owns a commercial property or a vacant property where county or city law prevents residential use, the property will not qualify for creditor protection on the property. Does the resident need to be a Florida/U.S. resident or green card holder? To qualify for the homestead creditor protection afforded under the Florida Constitution, the individual homeowner must not only be a Florida resident but must legally reside in the U.S. as the result of being a U.S. citizen or a permanent resident ("green card" holder).[251],[252],[253]

WHAT IF SOMEONE BESIDES THE DEBTOR OWNS PART OF THE HOMESTEAD AND RESIDES THERE?

In the 2007 Bankruptcy Court decision of *In re Gatto,*[254] Judge Michael Williamson observed that the homestead ownership interest of a married debtor could not be seized by a creditor where the debt owed to such creditor was the debt of only one spouse, and the co-owner spouse was not indebted to the creditor. The Court noted that one spouse cannot destroy the other's homestead rights. Footnote 4 of such decision reads as follows:

> While a bankruptcy trustee, pursuant to Bankruptcy Code Section 363(h) may attempt to partition and sell the debtor's interest in the home where the debtor does not claim the homestead as exempt under Section 4, Article X of the Florida Constitution, it is questionable whether such an attempt to utilize Section 363 (h) in this fashion would be successful. In Florida, homesteads are regarded as sacred cows and cannot be alienated so as to harm the interests of those meant to be protected by its very character as homestead. As such, the rights of each spouse pertain to the entire home. To this end, homestead status of a home may not be destroyed unless both spouses join in the conveyance of the homestead to a third party, even where the homestead is owned by only one spouse. Moreover, one spouse cannot destroy the other's homestead rights by apparent abandonment, mere express or implied intent, or indication of his choice. That is, one spouse acting alone cannot abandon the homestead rights of the other spouse. In bankruptcy, property comprising the bankruptcy estate, as broadly defined by Section 541(a), includes all legal or equitable interest of the debtor in property as

250 *Drucker v. Rosenstein,* 19 Fla. 191 (Fla. 1882).

251 *In re Boone,* 134 B.R. 979, 981 (Bankr. M.D. Fla. 1991) (See also *Raheb v. DiBattisto,* 513 So. 2d 717 (Fla. App. 3 Dist. 1987) (holding that Iranian nationals did not have the requisite permanent alien status to qualify for a Florida homestead).

252 Debtors without green cards were nonetheless domiciled in Florida and entitled to its exemptions. *See In re Mendoza*, 597 B.R. 686, Bankr. S.D. Fla. (2019) – *Declined to extend the holding in Raheb v. Dibattisto* (Footnote 489).

253 Trustee objected to Florida homestead exemption claimed by debtor based on the fact that she was not a lawful permanent resident of the United States. BR Court held that debtor, who, while not herself a permanent resident of the United States, had an adult daughter who resided with her, who had applied for relief under the Deferred Action for Childhood Arrivals (DACA) program, was entitled to Florida homestead exemption. *See In re De Bauer*, 628 B.R. 355 (Bankr. M.D. Fla. 2021)

254 380 B.R. 88 (Bankr. M.D. Fla. 2007).

exist under state law as of the commencement of the case. However, in *In re Bryant Manor, LLC,* the court held that there are two exceptions to the general rule. If Congress modifies state law through legislation enacted under its authority to establish uniform bankruptcy laws under the U.S. Constitution or if federal interest requires a different result, property rights of a bankruptcy will not be determined by state law. As importantly, the bankruptcy trustee has no greater rights to the estate property than the debtor and is subject to all claims, liens, and equities that the debtor is subject to with respect to such property. It would appear to follow, therefore, that because a debtor cannot act on behalf of his spouse to alienate or abandon his spouse's interest in their homestead, a debtor's failure to claim homestead rights does not create a right in the trustee that the debtor does not have to partition that homestead property.[255]

The *Gatto* court further held that the debtor spouse cannot claim the special personal property exemption of $4,000 in bankruptcy (which applies when the debtor does not claim homestead) if the debtor is receiving the protection of the homestead exemption through the non-debtor spouse.

In *Tullis v. Tullis*, the Florida Supreme Court allowed a partition of homestead property when one of the co-owners brought suit for partition of the property.[256] In that case, marital property owned as tenants by the entireties became owned as tenants in common pursuant to Florida Statutes Section 689.15 when the spouses divorced, thereby losing tenancy by the entireties status, and causing the property to be owned as tenants in common. The husband lived in the home with the daughter, and the wife brought suit for partition. Both parties agreed that the property was not divisible, and the Court stated that "forced sale is the only method through which the wife can obtain beneficial enjoyment of her one-half undivided interest in the property." The Court also noted that "[h]omestead interests should be protected from forced sale whenever possible, but not at the expense of others owning interests in the property."

In the important case of *In re Lezdey*,[257] a creditor obtained a judgment against two brothers. The two brothers each owned an undivided one-half interest in property in Pinellas County, Florida. One brother lived on the property and claimed that it was his protected homestead.

The Middle District of Florida Bankruptcy Court found that the creditor had a valid lien on the property but that the lien did not apply to the one-half beneficial interest of the brother who had a homestead interest in the property. The Bankruptcy Court held that the creditor could not enforce the lien or partition the property as long as the property remained the homestead property of the brother who lived there.

The debtor was represented by Michael Markham, which is part of the reason that we say that it is important above.

<u>Mobile Homes Are Different—Protection is Only Statutory if Not Attached to Land</u>

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[255] *Id.* at 96 n.4.

[256] 360 So.2d 375 (Fla.1978).

[257] *In re Lezdey*, 373 B.R. 164 (Bankr. M.D. Fla. 2007).

Unfortunately, not all Florida decisions support the position that a debtor can claim constitutional homestead creditor protection absent an ownership interest. For example, in *In re Lisowski,*[258] the United States Bankruptcy Court for the Middle District of Florida sought to determine whether a debtor owning a mobile home was entitled to claim homestead creditor protection under Article X, Section 4 of the Florida Constitution, which would disqualify him from claiming the greater personal property exemption ($4,000 instead of $1,000) under Florida Statutes Section 222.25. The court held that the debtor's interest in a mobile home on a leased land did not constitute an "interest in realty" for purposes of homestead creditor protection, thus he could not claim homestead protection under the Florida Constitution. However, he could claim Florida's statutory modular home exemption under Section 222.05, which allows owners who live in modular homes on land not owned by the debtor to protect these homes from creditors, but fraudulent transfer rules will apply.

Long-term leases—Renters Homestead Protections

The *Lisowski* court held that homestead creditor protection only applies to "improved land or real property owned by a debtor, provided [that] the debtor's residence is situated on the land," seemingly interpreting Article X, Section 4 of the Florida Constitution to require ownership in order to qualify for homestead creditor protection.

When an owner rents out a portion of the property to a tenant, a two-part analysis has been used in determining whether the homestead exemption extends to the entire property. The court must determine whether the residence is a fraction of the entire property and whether the property can be severed.[259] In duplex cases, homestead has been limited to the portion of the duplex in which the owner resided with their family.[260] When renters and owners alike have access to the same common areas, homestead may apply to the whole.[261]

A homeowner does not abandon their homestead protection merely by renting a portion of the property.[262] Loss of protection is dependent upon whether the property is "susceptible to division by perpendicular and/or horizontal lines" and "Lawfully conveyable as an independent parcel under existing law."[263]

WHAT ABOUT RECREATIONAL VEHICLES AND HOUSEBOATS AS HOMESTEAD?

Florida Statutes Section 222.05, which is referred to above, extends homestead protection to unconventional homes stating:

> Any person owning and occupying any dwelling house, including a mobile home used as a residence, or modular home, on land not his or her own which

[258] 395 B.R. 771 (Bankr. M.D. Fla. 2008).
[259] Anderson v. Letosky, 304 So. 3d 801 (Fla. 2d Dist. App. 2020)
[260] *Id.*
[261] *Id.*
[262] *Id.*
[263] *Id.*

he or she may lawfully possess by lease or otherwise, and claiming such house, mobile home, or modular home as his or her homestead, shall be entitled to the exemption of such house, mobile home, or modular home from levy and sale as aforesaid.[264]

In *Matter of Leroy George Yettaw*, Judge Baynes of the Bankruptcy Court for the Middle District of Florida held that a motor home was a "dwelling house" for purposes of Section 222.05 and was thus entitled to homestead creditor protection where the debtor intended to make it his homestead.[265] Mr. Yettaw's motor home was parked in a motor home park. The motor home was equipped with water, sewage and electrical service, and was maintained for long-term habitation.

Although mobile and modular homes are specifically protected under Section 222.05, courts have found that more non-traditional types of housing, such as houseboats, are also protected under this statute. In *Miami Country Day School v. Bakst,* the Bankruptcy Court for the Middle District of Florida found that a 3,000 square-foot houseboat, fully equipped with four bedrooms, three bathrooms, and a garden, qualified for homestead protection under Section 222.05.[266] The houseboat had never been equipped with a motor and was towed to its location.

On the other hand, in *In re Major*, the court held that a 34-ft. boat with a broken engine did not qualify for the homestead exemption.[267] In this case, the boat was only inoperable because the debtors did not have the funds to repair the motor, but would be operable if the motor were fixed.

In contrast to *In re Major,* in the case of *In re Mead* the United States Bankruptcy Court for the Southern District of Florida noted in 2000 that it was "not convinced that the distinctions on which [*In re Major* and cases of like import] turn are meaningful."[268] The Court, in holding that a debtor's 34-foot boat which was connected to a leased boat dock qualified as exempt homestead property under Florida law, noted that "[w]hile the Boat was immobile on the date of the petition, the Court would reach the same result even if the Boat could have been moved. A better test to determine homestead exemption is one based on function and use of the dwelling structure, rather than its size, design, utility hookups, or ability to be moved. Homestead protection should be extended to any dwelling house on land that the debtor may lawfully possess, if the debtor resided there on the petition date, and if the debtor had no other residence."

EFFECT OF BEING ANNEXED.

Where the owner of homestead property, which exceeds one-half acre outside of city limits becomes annexed, that owner becomes "grandfathered" for homestead creditor protection so long as he or she continues to own the homestead property.[269]

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[264] Fla. Stat. § 222.05 (2015).
[265] 316 B.R. 560 (Bankr. M.D. Fla. 2004).
[266] 641 So.2d 467 (Fla. 4th DCA 1994).
[267] 166 B.R. 457 (Bankr. M.D. Fla. 1994).
[268] 255 B.R. 80 (Bankr. S.D. Fla. 2000)
[269] Art. X, § 4(a)(1), Fla. Const.

THE IRS CAN TAKE YOUR HOME!

The Middle District Bankruptcy Court case *In re McFadyen* confirmed that the Commissioner of the Internal Revenue Service has the ability to seize a homestead from a Florida resident for payment of unpaid taxes.[270] The court quoted Internal Revenue Code Section 6321, which provides that:

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

This statute codifies the IRS's super creditor status and ability to seize otherwise creditor exempt assets to collect a debt owed to it, as mentioned earlier in "Watch out for "Super Creditors!" section. [271]

Nevertheless, a judge or magistrate of a United States District Court must approve the levy in writing under Internal Revenue Code Section 6334, the Taxpayer Bill of Rights.

IRC 6334(13) Residences Exempt In Small Deficiency Cases And Principal Residences And Certain Business Assets Exempt In Absence of Certain Approval Or Jeopardy.

A. **Residences in small deficiency cases.** If the amount of the levy does not exceed $5,000;

(i) any real property used as a residence by the taxpayer; or

(ii) any real property of the taxpayer (other than real property which is rented) used by any other individual as a residence.

B. **Principal residences and certain business assets.** Except to the extent provided in subsection (e);

(i) the principal residence of the taxpayer (within the meaning of section 121); and

(ii) tangible personal property or real property (other than real property which is rented) used in the trade or business of an individual taxpayer.

However, Internal Revenue Code Section 6334(a)(13) provides an exception for residences in small deficiency cases. Under this Section, real property used as a residence by the taxpayer or any other property, except rental property, owned by the taxpayer that serves as the residence of another is exempt in small deficiency cases if the amount of the levy does not exceed $5,000.

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[270] 216 N.R. 1006 (Bankr. M.D. Fla. 1998).

[271] *Supra*, note 215; *U.S. Craft*, 535 at 288.

HOMESTEAD TAX PROTECTION AND PLANNING.

Like many states, Florida law provides for lower ad valorem tax assessments on property that is used as a homestead. Article VII, Section 6 provides the following taxation exemption:

> Every person who has the legal or equitable title to real estate and maintains thereon the permanent residence of the owner, or another legally or naturally dependent upon the owner, shall be exempt from taxation thereon, except assessments for special benefits, up to the assessed valuation of twenty-five thousand dollars and, for all levies other than school district levies, on the assessed valuation greater than fifty thousand dollars and up to seventy-five thousand dollars, upon establishment of right thereto in the manner prescribed by law. The real estate may be held by legal or equitable title, by the entireties, jointly, in common, as a condominium, or indirectly by stock ownership or membership representing the owner's or member's proprietary interest in a corporation owning a fee or a leasehold initially in excess of ninety-eight years.

Under this provision, every Florida homeowner can receive a homestead exemption of up to $50,000. The first $25,000 in property value is exempt from all property taxes, including school district taxes. The additional $25,000 exemption is available for non-school taxes and applies only to the assessed value between $50,000 and $75,000.

The recession of 2008 caused most real estate in Florida to be reset to a lower tax assessed value, while being limited to increases of 3% per year thereafter, where the economy had recovered.

An irrevocable trust formed by the debtor for the benefit of the debtor may facilitate maintaining the homestead tax exemption and 3% cap while making this distinct and separate from the one-half acre that would be creditor protected.

SHOULD THE CLIENT FILE A NOTICE OF HOMESTEAD?

Under Florida Statutes Section 222.01, a Notice of Homestead can be filed with the County Property Appraiser to put the public on notice that property is homesteaded. There is no substantive legal effect of filing an affidavit under this statute, but clients may be well advised to file such an affidavit if there is any question as to whether some or all of the subject property is a homestead because it demonstrates intent. This may particularly be the case where a client owns homestead property and expands this by purchasing one or more adjoining lots.

Florida Statutes Section 222.01 (1) reads as follows:

Whenever any natural person residing in this state desires to avail himself or herself of the benefit of the provisions of the constitution and laws exempting property as a homestead from forced sale under any process of law, he or she may make a statement, in writing, containing a description of the real property, mobile home, or modular home claimed to be exempt and declaring that the real property, mobile home, or modular home is the homestead of the party in whose behalf such claim is being made. Such statement shall be signed by the person making it and shall be recorded in the circuit court.

Section 222.01(2) provides a suggested form for the notice, which is set forth below:

NOTICE OF HOMESTEAD

To: (Name and address of judgment creditor as shown on recorded judgment and name and address of any other person in the recorded judgment to receive a copy of the Notice of Homestead).

You are notified that the undersigned claims as homestead exempt from levy and execution under Section 4, Article X of the State Constitution, the following described property:

(Legal description)

The undersigned certifies, under oath, that he or she has applied for and received the homestead tax exemption as to the above-described property, that _______________ is the tax identification parcel number of this property, and that the undersigned has resided on this property continuously and uninterrupted from _____________ (date) to the date of this Notice of Homestead. Further, the undersigned will either convey or mortgage the above-described property pursuant to the following:

(Describe the contract of sale or loan commitment by date, names of parties, date of anticipated closing, and amount. The name, address, and telephone number of the person conducting the anticipated closing must be set forth).

The undersigned also certifies, under oath, that the judgment lien filed by you on _____________(date) and recorded in Official Records Book ____, Page ____, of the Public Records of ___________ County, Florida, does not constitute a valid lien on the described property.

YOU ARE FURTHER NOTIFIED, PURSUANT TO SECTION 222.01 ET SEQ., FLORIDA STATUTES, THAT WITHIN 45 DAYS AFTER THE MAILING OF THIS NOTICE YOU MUST FILE AN ACTION IN THE CIRCUIT COURT OF ___________ COUNTY, FLORIDA, FOR A DECLARATORY JUDGMENT TO DETERMINE THE CONSTITUTIONAL HOMESTEAD STATUS OF THE SUBJECT PROPERTY OR TO FORECLOSE YOUR JUDGMENT LIEN ON THE PROPERTY AND RECORD A LIS

PENDENS IN THE PUBLIC RECORDS OF THE COUNTY WHERE THE HOMESTEAD IS LOCATED. YOUR FAILURE TO SO ACT WILL RESULT IN ANY BUYER OR LENDER, OR HIS OR HER SUCCESSORS AND ASSIGNS, UNDER THE ABOVE-DESCRIBED CONTRACT OF SALE OR LOAN COMMITMENT TO TAKE FREE AND CLEAR OF ANY JUDGMENT LIEN YOU MAY HAVE ON THE PROPERTY.

This ___ day of ____________, 20___.

(Signature of Owner)

(Printed Name of Owner)

(Owner's Address)

Sworn to and subscribed before me by __________________, who is personally known to me or produced _____________________ as identification, this ____ day of ____________, 20___.

(Notary Public)

BANKRUPTCY AND OTHER IMPLICATIONS OF HOMESTEAD PROTECTION – IS THE PARTY OVER?

The "mansion loophole closing" provisions of the 2005 revisions to the Bankruptcy Code can reduce the protected homestead equity value to as low as $189,050 (formerly $125,000) and the entire value of the home will not be protected if the ten-year fraudulent set aside provision applies.

When a homestead has been purchased within 1,215 days of filing bankruptcy with the proceeds from a previously protected homestead, the exemption will be the sum of $189,050 and the amount that has come from the previously protected homestead.[272]

The Bankruptcy Code's limitation upon the protection of homestead for a debtor in bankruptcy applies under the supremacy clause of the U.S. Constitution.[273]

The $4,000 wildcard exemption that applies if there is no homestead protection elected by the debtor will apply for a married couple where both spouses file bankruptcy together and they elect for only tenancy by the entireties protection to apply, such as where each spouse has separate creditors, so that there is no common creditor that would be able to pursue tenancy by the entireties property, including a jointly owned homestead.

A bankruptcy court may deny the debtor's discharge when the debtor pays a mortgage on a homestead with non-exempt funds in a fraudulent transfer that occurs within one year before the filing of bankruptcy. As further described in Section 4(F), in the case of *In re Chauncey*,[274] the

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[272] Nelson, Barry, *Estate Planning and Asset Protection in Florida*, Juris Publishing, Inc., 2019.
[273] *Id*.
[274] 454 F.3d 1292 (11th Cir. 2006).

Eleventh Circuit affirmed the bankruptcy court's decision to deny a discharge when the debtor used her non-exempt personal injury settlement proceeds to pay down the mortgage on her homestead just a few days before filing before bankruptcy.

TEN YEAR FRAUDULENT TRANSFER SET ASIDE.

The entire value of homestead property will not be protected to the extent that its net value has been increased by a disposition of non-exempt property made by the debtor during the ten years prior to filing bankruptcy with the intent of hindering, delaying or defrauding creditors. Specifically, Section 522(o) states the following:

For purposes of subsection (b)(3)(A), and notwithstanding subsection (a), the value of an interest in–

1) real or personal property that the debtor or a dependent of the debtor uses as a residence;
2) a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence;
3) a burial plot for the debtor or a dependent of the debtor; or
4) real or personal property that the debtor or a dependent of the debtor claims as a homestead; shall be reduced to the extent that such value is attributable to any portion of any property that the debtor disposed of in the 10-year period ending on the date of the filing of the petition with the intent to hinder, delay or defraud a creditor, and that the debtor could not exempt, or that portion that the debtor could not exempt, under subsection (b) if on such date the debtor had held the property so disposed of.

The reduction is based upon the value of the homestead resulting from such "fraudulent transfers." The courts must determine how to apportion appreciation in the value of a homestead that occurs after the "fraudulent conversion" has occurred.

In *In re Cook*, the Bankruptcy Court found that a couple's conversion of $175,000 in proceeds from a non-exempt tax refund into an exempt homestead was not done with fraudulent intent, and therefore, the ten-year "look back" provision under Bankruptcy Code Section 522(o) did not apply.[275] In determining that the investment was not a fraudulent transfer, Judge Killian of the United States Bankruptcy Court for the Northern District of Florida stated that "[t]he Debtors' explanation that the purchase of the homestead using the non-exempt tax refund was to ensure that they had a permanent place to live is credible and realistic" and "receiving the tax refund finally gave the Debtors the opportunity to procure a stable and permanent residence."[276]

The court also determined that the couple could aggregate their caps under Bankruptcy Code Section 522(p)(1). In 2011, the applicable cap on the homestead exemption was $146,450 for property acquired within the 1,215 days preceding the filing of a bankruptcy; however, because the

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[275] 460 B.R. 911 (Bankr. N.D. Fla. 2011).
[276] *Id.* at 914.

cap applies separately to each individual debtor, the couple's cap was $292,900, thus allowing the entire amount of equity in the home to remain exempt.[277]

In this case, the Cooks obtained a $3 million loan to begin a car dealership. With the economic downturn in 2008, the car dealership suffered substantial losses, causing the Cooks to default on the loan and file for bankruptcy. The Cooks sold their home, once valued at $5 million, for $2.3 million to pay the remainder of the mortgage and to pay down part of the loan. The couple was then forced to move into a mobile home afterwards as they were unable to afford a down payment or receive credit to purchase a new home.

In 2010, the Cooks received a tax refund of $184,769, which they used to make a down payment on a waterfront home on January 3, 2011, with a purchase price of $800,000. The Cooks made a $155,000 cash down payment, and the seller gave them a mortgage for the remaining amount owed. In addition to the down payment, the Cooks spent $20,000 making improvements to the home.

In mid-January 2011, the bank initiated a lawsuit against the Cooks as a result of their default on the loan, and a judgment was entered against the couple in March of 2011. Unable to pay the judgment, the Cooks filed for bankruptcy on May 23, 2011, and claimed the property as homestead, even though it was acquired less than five months before filing the petition.

The creditor challenged the homestead exemption under Section 522(o)(4) of the Bankruptcy Code, which provides that "a debtor's homestead exemption shall be reduced to the extent that the debtor, with an intent to hinder, delay or defraud a creditor, converted non-exempt assets into exempt assets within ten years of the bankruptcy filing."

In arguing that the Cooks acted with fraudulent intent, the creditors relied on a "badges of fraud approach," claiming that purchasing an $800,000 waterfront home immediately preceding collection efforts and shortly after defaulting on a $3 million loan established that this was a fraudulent transfer that could be set aside. The court rejected this claim, explaining that the Bank failed to establish that there was a fraudulent transfer by a preponderance of the evidence. The court found that it was reasonable for the Cooks to use the tax refund to buy another home, noting that "receiving the tax refund finally gave the Debtors the opportunity to procure a stable and permanent residence."

Further, the court noted, "[w]hile it may seem unreasonable to purchase an $800,000 waterfront property after living in a mobile home, the Debtors actually went from living in a $5 million home to a home worth substantially less."

Although the court ruled in the Cooks' favor, transferring non-exempt assets shortly before filing bankruptcy was a gutsy move on the part of the Cooks. If the court had determined that they committed a fraudulent transfer by using the tax refund to purchase the home, not only would the Cooks have lost their home, but they also would have been eternally unable to discharge the judgment owed to the bank.

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[277] Dollar amounts shall be adjusted "at each 3-year interval ending on April 1." 11 U.S.C. § 104 (2017).

From the above-described cases, it seems that if there is a good reason for the transaction, separate and apart from incidental creditor protection benefits, a debtor may be able to transfer assets before filing for bankruptcy without this being considered to be a fraudulent transfer; but such actions are not without risk.

A debtor cannot exempt any amount of homestead property worth in excess of the current cap ($189,050 for 2022) that is acquired during the 1,215 days (three years and four months) before the bankruptcy filing.[278]

Also, remember that the "730 Day Rule will apply," which requires the Debtor to be domiciled in Florida for the 730 days (2 years) prior to filing a bankruptcy petition in order for the Florida exemption laws to apply in the bankruptcy.

Section 522(p) reads as follows:

A. 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 $125,000 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 dependent of the debtor claims as a homestead.

B.
    a. The limitation under paragraph (1) shall not apply to an exemption claimed under subsection (b)(3)(A) by a family farmer for the principal residence of such farmer.
    b. For purposes of paragraph (1), any amount of such interest does not include any interest transferred from a debtor's current principal residence, if the debtor's previous and current residences are located in the same state.

This is not an intent-based provision, but applies automatically when a person does not have the requisite time period to qualify for protection.

An exception to this $189,050 cap applies when money derived from the sale of a prior residence is applied to facilitate the purchase of a replacement property. Where the new homestead costs significantly more than the prior homestead, the amount of homestead protection is limited to $189,050 plus the proceeds from the sale of the prior residence used to purchase the new residence.

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[278] 11 U.S.C. § 522(p) (2017).

TRANSFERS BETWEEN SPOUSES

The transfer of an ownership interest from one spouse to another should not constitute a fraudulent transfer under Florida law, but may implicate the 1,215-day requirement under the Bankruptcy Code.

In the 2006 Bankruptcy Court case of *In re Leung,*[279] the Eastern District of Massachusetts Bankruptcy Judge held that the transfer of homestead property by the debtor's spouse to the two of them as tenants by the entireties constituted a transfer to the debtor under the 1,215-day rule. The debtor argued that the property should not be subject to the then statutory $136,875 cap because he had been living there as his primary residence since before the 1,215-day period started, and because he had contributed to the home's upkeep and had an equitable interest under marital law. However, the court rejected this argument and found that there was no basis under Massachusetts law for holding that the debtor had an equitable interest in the property.

Further, courts have allowed spouses to enjoy the benefit of two caps when they can separately claim a homestead exemption. In *In re Rasmussen*, the Bankruptcy Court in the Middle District of Florida ruled that two spouses could stack their "caps," creating $250,000 of coverage for their home when they both filed bankruptcy in 2006.[280] The court noted that Section 522(p) "clearly says 'a' debtor is subject to the cap." The court also analogized to state law exemptions and stated that "in this respect, it is clear under Florida law that each debtor gets to claim exemptions separately. For example, each spouse is entitled to the constitutional exemption for $1,000 of personal property even though the personal property is jointly owned, resulting in an aggregate exemption of $2,000."

ARE MORTGAGE PAYMENTS CONSIDERED ACQUISITION OF EQUITY?

Again, "any equity acquired" in a homestead asset during the 1,215 days prior to *filing is subject to the reach of creditors pursuant to Bankruptcy Code Section 522(p).* This raises the issue of whether regular mortgage payments constitute "any equity acquired" that would trigger the provisions of this cap. The literal interpretation of the statute and a handful of earlier cases suggested that the increase in equity would trigger the cap.

However, more recent cases have found that the language of Section 522(p) does not apply to mortgage payments. Congress' obvious intent was to cap the homestead exemption for debtors who choose to flee to debtor-friendly homestead exemption states, the most notable being Florida and Texas, unless the debtor resides in the homestead protection state for at least 1,215 days before filing.

As discussed below, the Bankruptcy Court for the Middle District of Florida in *In re Burns*[281] held that making regular mortgage payments relative to a mortgage note encumbering homestead property, which is otherwise exempt during the 1,215 days immediately preceding the filing of a

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[279] 356 B.R. 317 (Bankr. D. Mass. E.D. 2006).
[280] 349 B.R. 747 (Bankr. M.D. Fla. 2006).
[281] 395 B.R. 756 (Bankr M.D. Fla. 2008).

bankruptcy case, will not be treated as the acquisition of an interest in real property for purposes of calculating the then applicable $136,875 limitation contained in Section 522(p)(1). While the decision is promising, the court did not address whether the prepayment of all or a portion of the mortgage note (i.e., not a regularly scheduled payment) will also not be treated as an acquisition in real property if the homestead has been owned by the debtors for a period in excess of 1,215 days. Since the date of publication of *In re Burns* there have been 15 cases that have cited the case for the above proposition, and the only disagreement with the holding has come from a non-binding court decision.

Further, *In re Chouinard* held that the equity passively resulting from market appreciation is not to be counted toward the homestead exemption cap imposed by Section 522(p) on an interest in property "acquired" during the 1,215 prepetition period.[282]

In another post-BAPCPA case decided in October of 2005, *In re Wayrynen*, the debtor had not owned property in Florida long enough to meet the 1,215-day requirement.[283] However, the court found that the debtor was not subject to the cap, despite the fact that he purchased his home within 1,215 days prior to filing. The debtor argued that he was entitled to exempt the full value of his home because he made no "election" pursuant to Section 522(p)(1) to invoke the exemption provisions of either state or federal law. The court strictly construed the statute and stated that "since a Florida resident is not entitled to claim federal exemptions, it could be construed that, at least as to Florida residents filing for bankruptcy relief, the limitations provided in Section 522(p)(1) do not apply." However, this reasoning has not been routinely followed by Florida courts.

LIMITATION ON HOMESTEAD PROTECTION FOR "BAD ACTIONS."

Section 522(q) provides another limitation on the homestead exemption for "bad actions" and provides the following:

> (1) 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 an interest in property described in subparagraphs (A), (B), (C), and (D) of subsection (p)(1) which exceeds in the aggregate $125,000 if-
>
> (a) the court determines, after notice and a hearing, that the debtor has been convicted of a felony (as defined in section 3156 of title 18), which under the circumstances, demonstrates that the filing of the case was an abuse of the provisions of this title; or
>
> (b) the debtor owes a debt arising from-
>
> i. any violation of the Federal securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934), any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws;
>
> ii. fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered

[282] 385 B.R. 814 (Bankr. M.D. Fla. 2006).
[283] 332 B.R. 479 (Bankr. S.D. Fla. 2005).

under section 12 or 15(d) of the Securities Exchange Act of 1934 or under section 6 of the Securities Act of 1933;

iii. any civil remedy under section 1964 of title 18; or

iv. any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding 5 years.

(2) Paragraph (1) shall not apply to the extent the amount of interest in property described in subparagraphs (A), (B), (C), and (D) of subsection (p)(1) is reasonably necessary for the support of the debtor and any dependent of the debtor.

Based on this provision, the homestead exemption can be limited to an absolute cap of $146,450 where the debtor is convicted of a felony, which evidences that the filing of the bankruptcy was abusive (perhaps the rationale here is that the debtor won't need a house if he is going to jail).

Thus, homestead protection is limited to $146,450 where the debt involved arises from the violation of federal or state securities laws, fiduciary fraud violations of RICO, intentional torts, or willful or reckless conduct resulting in serious physical injury or death in the preceding five years. Undoubtedly, there will be more suits filed against doctors alleging willful and reckless conduct in malpractice actions as a result of this provision.

However, the Section 522(q)(1) reduction to $146,450 will not apply to the extent that the homestead property is reasonably necessary for the support of the debtor and any dependent of the debtor.

A DOG OF A CASE: *In Re Burns*

The definition of willful or reckless misconduct under the Bad Acts Statute was discussed in the August 8, 2008 Bankruptcy Court decision of *In re Burns*.[284]

In this "ruff" case, the court noted that an act can result from reckless misconduct if the act was intended by the actor, even if the actor did not intend to cause the harm that results from it. The court stated that "[i]t is enough that he realizes or, from facts which he knows, should realize that there is a strong probability that harm may result, even though he hopes or even expects that his conduct will prove harmless."

In *Burns,* the debtors' chow-mix dog "Teddy" lunged at an unfortunate motorcyclist, causing him to lose control of the bike. Sadly, Teddy died in the accident (and was thus unable to testify), and the motorcyclist was seriously injured. A canine behavior expert testified that the dog's owners acted with reckless misconduct in allowing the four-year-old chow-mix to be unrestrained when they lived on the road, their house was partially unfenced, and the dog was typically chained, got insufficient exercise, and had aggressive tendencies. The court rejected the expert's opinion, noting that he was an expert on animal temperament and not on human behavior. While the dog acted

[284] 395 B.R. 756 (Bankr. M.D. Fla. 2008).

wrongly in lunging at the motorcycle, the court found that the plaintiff did not satisfy the burden of showing "highly unreasonable conduct involving an extreme departure from ordinary care in a situation where a high degree of danger is apparent." In fact, the debtors did not even know how the dog had gotten out.

HOMESTEAD DISPOSITION LIMITATIONS.

The Florida Constitutional and statutory limitations on the ability of a homestead owner to transfer or mortgage the property without permission of a spouse, or to leave the property by Will or other testamentary devise in a manner not permitted by Florida law merit the discussion below.

Notwithstanding common sense and how the law works in other states, the Florida Constitution imposes limitations on how a homestead can be devised upon the owner's death to protect the surviving spouse and minor children in some circumstances regardless of whether they may need or even want such protection. Specifically, the Constitution prohibits the devise of the property if the owner is survived by a spouse or minor child, except the homestead may be devised to the owner's spouse if no minor child exists. Thus, both spouses must sign on a mortgage even if only one spouse is the borrower.

The Constitution also prevents a married homeowner from transferring or mortgaging his or her homestead property without the consent of the owner's spouse or an appropriate waiver. This is why a spouse will have to sign on a mortgage if the homeowner spouse wants to borrow money, even though the non-owner spouse is not actually a borrower and is not necessarily guaranteeing the note. The Florida Constitution Article X, Section 4 restricts the devise of the homestead. Subsection (c) reads as follows:

> The homestead shall not be subject to devise if the owner is survived by spouse or minor child, except the homestead may be devised to the owner's spouse if there be no minor child.

However, the Florida Constitution does not address how homestead property descends upon the death of the owner of the homestead. The descent of homestead property is controlled by Florida Statutes Section 732.401. Under the prior law, if the devise violated the Florida Constitution, the spouse was given a life estate and the children were given the remainder interest.

Effective October 1, 2010, Florida Statutes Section 732.401 was amended to provide the surviving spouse with a choice. If the homeowner is married and has one or more children, then upon the homeowner's death, a home in his or her sole name will become owned as a "life estate" held by the surviving spouse and a "remainder interest" held by the child or children of the deceased homeowner. The surviving spouse can then choose to keep the life estate or to convert this to a fifty percent ownership, whereby the other fifty percent interest will be owned by the deceased homeowner's descendants. This fifty percent ownership conversion option became effective for homesteads owned by decedents who have died on or after October 1, 2010. The surviving spouse must make the election to take a tenant in common interest within six months of the decedent's death. The statute provides that the election is irrevocable.

These changes will not change the fact that a full estate tax marital deduction will be allowable where the spouse receives a life estate. If the spouse elects the one-half tenant in common interest, then the one-half interest received by the spouse will also qualify for the federal estate tax marital deduction.

Expenses for a life tenant differ from that of a 50% tenant in common. The following chart taken from the Legislative white paper explains the differences:

	Life Tenant Obligations	Obligation as 50% Tenant in Common
Mortgage Principal	None	50%
Mortgage Interest	100%	50%
Property Taxes	100%	50%
Ordinary Maintenance	100%	50%
Long-Term Maintenance	None	50%

If the spouse instead receives a life estate, then he or she will have the exclusive right to use and ownership of the home during his or her lifetime, which includes the right to rent it out to third parties or to otherwise make use of it in any reasonable way. The children or grandchildren, as "remaindermen," have no right to occupy the property during the time that the owner of the life estate is still alive, and become the sole owners of the property on the death of the life tenant.

The life tenant, however, has a duty to make and pay for ordinary and reasonable repairs to the house in order to prevent "waste." The life tenant is also responsible for paying property taxes and insurance. This can be problematic because some spouses cannot afford the obligations of the life estate, or the remainder interest holders cannot or will not make the principal payments on the mortgage or make extraordinary repairs. Remaindermen are responsible for paying for extraordinary repairs and costs assessed to the property, as evidenced by the Fourth District Court of Appeals case, *Schneberger v. Schneberger*, which held that the remaindermen had to pay for hurricane repair costs from the proceeds of the insurance as well as a special hurricane assessment from the homeowners' association.[285]

Before making such a transfer, the client should consider whether segregated ownership is permitted under deed restrictions, condominium associations, or related rules, whether it is worth the risk of violating those rules even if they do not permit the segregated ownership, whether insurance or insurability will be affected by such a transfer, and whether a spouse will consent, as required by applicable law.[286]

The transfer of the remainder interest to the irrevocable trust MAY be an "incomplete gift" (not considered to be a gift for gift tax purposes) if the grantor retains the power to direct how the trust assets will pass on death. This was a well-accepted practice until February 2012, when the IRS

[285] 979 So.2d 981 (Fla. 4th DCA 2008).

[286] Thanks to attorney A. Stephen Kotler of Naples, Florida for providing the above planning idea. His email address is skotler@kotlerpl.com.

shocked the estate planning community in IRS CCA 2012208026[287] by concluding that a taxpayer made a taxable gift to an irrevocable trust, despite retaining a power to appoint trust assets upon death. Now more extensive powers may need to be retained to be sure an arrangement will not be considered a complete gift by the IRS.

When the parties cannot agree, selling the homestead property may be an option. However, the children must agree to sell the house and the spouse who owns the life estate cannot force the remaindermen children to sell the house. Furthermore, selling the house could create federal gift tax consequences.

If the surviving spouse instead elects to be a one-half owner, every joint owner in a Florida tenancy in common property has equal rights of occupancy, but any owner also has the right to require that the property be sold to the highest bidder "on the courthouse steps" in a partition action.

The amendment to the statute also provides the surviving spouse with the option of partition whereby the surviving spouse may sell the house, with half of the proceeds payable to the spouse, and the rest to the decedent's descendants in equal shares. Partition is not an option for a life tenant.

Please note that these rules do not apply if the house is being treated as owned jointly with right of survivorship or as tenants by the entireties between a husband and wife. In that event, the home will be completely owned by the surviving spouse. This will apply whether or not the married co-owners have children.

Florida Statutes Section 732.401 provides a sample form for the election of a surviving spouse to take a tenant in common interest instead of a life estate interest:

ELECTION OF SURVIVING SPOUSE TO TAKE A ONE-HALF INTEREST OF DECEDENT'S INTEREST IN HOMESTEAD PROPERTY

STATE OF __________
COUNTY OF __________

a. The decedent, _____________, died on ________. On the date of the decedent's death, the decedent was married to _____________, who survive the decedent.

b. At the time of the decedent's death, the decedent owned an interest in real property that the affiant believes to be homestead property described in s. 4, Article X of the State Constitution, that real property being in ___________ County, Florida, and described as: (description of homestead property).

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[287] *For more information on this decision see* Alan S. Gassman, Leslie A. Share, Ken Crotty & Kacie Hohnadell, *Planning After IRS Memo 201208026: How Foreign Can Creditor Protection Trust Laws Get?,* Leimberg Information Services Newsletter No. 207 (Sept. 11, 2012).

c. Affiant elects to take one-half of decedent's interest in the homestead as a tenant in common in lieu of a life estate.

d. If affiant is not the surviving spouse, affiant is the surviving spouse's attorney in fact or guardian of the property and an order has been rendered by a court having jurisdiction of the real property authorizing the undersigned to make this election.

____
(Affiant)

Sworn to (or affirmed and subscribed before me this ____ day of (month), (year), by (affiant)

____
(Signature of Notary Public – State of Florida)
(Print, Type, or Stamp Commissioned Name of Notary Public)
Personally Known OR Produced Identification
(Type of Identification Produced)

Previously, practitioners have used disclaimers to attempt to cure invalid homestead devises. Effective October 1, 2010, Florida Statutes Section 732.4015 was amended to add section (3) to clarify that disclaimers may not be used to cure invalid homestead devises.

Florida Statutes Section 732.4015(3) states that if an interest in homestead property has been properly devised to the surviving spouse, and the surviving spouse disclaims the property, the disclaimed property interest transfers according to the disclaimer statutes in Florida Statutes, Chapter 739. Therefore, the decedent's Will or intestate succession will determine how the surviving spouse's interest passes, but not the remaindermen's interest. Therefore, if the devise was a valid devise, a disclaimer of the devise affects only the surviving spouse's interest. The disclaimer does not cut off any vested rights of the decedents descendants under the constitution. For example, if the property went life estate to the wife and remainder to the children, and the wife disclaimed, her life estate would pass pursuant to her husband's Will or intestate succession, but the disclaimer would not affect the children's remainder interest.

TIME TO BUY HOMES FOR THE CHILDREN?

A parent's creditors should not be able to obtain title to his or her child's homestead if it is gifted or purchased for the child before the parent has creditor issues. Affluent parents often purchase homes for their adult children. There are many reasons, however, not to place a homestead in the child's individual name, including divorce planning, creditor planning, and the possibility that the client's spouse or other children may need monies derived from the home equity at a later date. The following is a letter written to a client, and describes various alternatives:

Dear Client:

1. *The first alternative is that you loan money to the child and the child buys the home.*

Upon later sale, the child can take the $250,000 capital gains exclusion. The child can take the Florida $50,000 homestead exemption and will have the advantage of the 3% per year cap on homestead tax valuation.

On divorce, you would get the first monies out of the house in repayment of the loan owed to you, and any equity might need to be shared with a present or future spouse.

The equity that would otherwise be shared with a present or future spouse might be handled by having a Prenuptial Agreement.

2. You could own the house and let the child and their family live there.

You would not qualify for the $250,000 capital gains exclusion on the later sale of the house.

You would not have the benefit of the homestead exemption or the 3% homestead cap, unless the child signs a 99-year lease, which may be feasible. A 99-year lease might provide that it is terminable upon certain events and might pass muster with the county as far as homestead exemption and 3% cap purposes.

On divorce, the home should be protected as well as possible. You would have continuing absolute control over the house.

3. We discussed an Irrevocable Homestead Spousal Limited Access Trust.

There are two different types of Irrevocable Homestead Bypass Trusts that you can form and fund. Each would be held by Mama Bear as Trustee, and could be used not only for the purchase of a home, but also for the health, education and maintenance of Mama Bear and one or more descendants as Mama Bear deems appropriate.

One variety of this trust is a "Section 678 Homestead By-Pass Trust." Under this type of trust, you are treated as if you gifted the money for the home to the child, and the child then made an immediate gift to the Trust by putting the money in the Trust. Your transfer of monies or the house to the Trust is considered for income tax and state law purposes to be a transfer of assets via your daughter.

As a consequence of this, the child's $250,000 exemption from capital gains tax can apply upon sale of the house. The downside of this Trust is that if your daughter is considered to have been the contributor, then her creditors would be able to reach into the Trust if they know to do so, although, if she had a creditor who might reach into the Trust, Florida law would probably allow Mama Bear, in her capacity as Trustee, to transfer the home into your daughter's direct name, and then in it would in all likelihood be protected from your daughter's creditors under the Florida Homestead Law.

The second variety of Homestead Bypass Trust is a "Direct Client Funded Homestead Bypass Trust." Under this type of trust, you would gift the money from the home directly to the trust. This Trust would not be considered to have been funded by your daughter, so her creditors could not reach *into it. However, this Trust would not qualify for the $250,000 exclusion for the sale of a primary residence upon eventual sale of the house.*

Both varieties of Trusts should be fairly well protected from potential divorce claims against the house, and should allow for homestead exemption and 3% cap application while your daughter lives there.

If you utilize the Direct Client Funded Homestead Bypass Trust, the Trust would be treated for income tax purposes, as if it is owned by you, so all of the items of income and deduction associated with the house would be included on your personal tax return. This would include the real estate taxes and any deductions or income associated with an eventual sale of the property.

If you utilize the 678 Homestead Bypass Trust, the child is considered to be the owner of the Trust for income tax purposes and would receive the tax deductions associated with the property, and be responsible for income tax upon the sale of the home, even though the child would have no control over the disposition of the home. At the time of funding the Trust, you would file a gift tax return reporting the amount of the contribution, whether directly to the Trust or via your child. No gift tax would be payable as a result of the contribution. However, the contribution would utilize some of your lifetime gift allowance.

If you utilize the 678 Homestead Bypass Trust, your child may need to file a gift tax return reporting the amount of the contribution. No gift tax would be payable as a result of the contribution. However, the contribution would utilize some of your child's lifetime gift allowance.

If you decide to use one of the Trust techniques for multiple children, we will prepare a separate Trust for each child.

Best personal regards,

[ATTORNEY]

COMPARISON OF METHODS TO PURCHASE HOMES FOR THE CHILDREN					
	$250,000 Exemption on Sale of Home	**$50,000 Homestead Exemption and 3% Per Year Cap on Valuation**	**Divorce**	**Control**	**Notes**
Father and Mother loan money to child. Child purchases and owns home.	Child gets income tax exemption.	Child gets homestead exemption and cap.	Loan will be repaid to parents. Equity may be subject to claim by spouse if this is not waived by Prenuptial Agreement.	Child controls the house. However, we may be able to call the Note to force a sale.	Note: Child gets equity above Note.
Father and Mother own the home and child lives in the house.	No.	Generally, no. However, it may be possible to obtain these with a 99-year lease.	Better protected.	Father and Mother control.	
Via Child Funded Homestead Bypass Trust.	Child gets income tax exemption.	Child gets homestead exemption and cap.	Better protected.	Mother would be Trustee of the Trust and would retain control.	Note: Creditors may be able to get into the Trust. It may be possible for Mother to transfer the house to the child's individual name in the event of a Creditor issue.
Direct Client Funded Homestead Bypass Trust.	No.	Child gets homestead exemption and cap.	Better protected.	Mother would be Trustee of the Trust and would retain control.	Note: The $250,000 exemption is lost, but no Creditor of the child should be able to get the asset.

One-half purchased by child and one-half owned by Father and Mother.	One-half.	Child gets homestead exemption up to value of child's interest in property (can receive entire exemption if interest value is $50,000 or greater). Only receives half of 3% valuation cap.	One-half, better protected.	Each controls one-half.	

NEGATIVE PLEDGE AGREEMENTS.

Under a Negative Pledge Agreement, a debtor agrees not to mortgage a particular property or properties so that a lender would have the ability to obtain a judgment that could presumably be recorded in the public records to become a lien upon the property. One question that comes up quite often is whether a bank with a Negative Pledge Agreement has the equivalent of a mortgage.

In the 2007 bankruptcy case of *In re Gosman*,[288] the Bankruptcy Court refused to allow an equitable lien in bankruptcy to be placed on property for a breach of contract where the debtor had entered into a "Negative Pledge Agreement" which provided that the debtor could not sell, convey or encumber any of his assets without the consent of the lender. The Bankruptcy Court noted that the monies that were used to purchase the homestead were not obtained fraudulently or through egregious conduct.

ASSESSMENT LIMITATIONS FOR HOMESTEAD AND NONHOMESTEAD PROPERTY.

In 2008, the Florida Constitution was amended to provide non-homestead property protection against substantial increases in their annual property tax assessments. Homestead property owners are provided with an even greater protection from property value increases through a 3% assessment limitation which was implemented in 1995 through the addition of the "Save Our Homes Amendment" to the Florida Constitution. Since 2009, the Florida Constitution has prohibited the assessment of most non-homestead properties from increasing by more than 10% per year, for non-homestead properties, although unlike the homestead 3% cap, the property appraiser can raise the non-homestead property's value by 10%, even in years when the value has not increased, until reaching the actual value. Originally, the 10% cap was enacted for a temporary 10-year period and was scheduled to sunset on January 1, 2019. However, Florida voters in 2018

[288] *In re Gosman*, 382 B.R. 826 (Fla. S.D. Dist. Ct. 2007) *declined to extend by In re-Hintze*, 525 B.R. 780 (Bankr. N.D. Fla. 2015).

approved another amendment to make the 10% cap permanent. The amendment is implemented through Florida Statutes sections 193.1554 (for non-homestead residential [not more than 9 units per parcel] property) and 193.1555 (certain residential [10 or more units in a parcel] and nonresidential [commercial] real property).

The 10% cap does not apply to the part of the property taxes that include school district levies, which typically consist of approximately one-third of the property tax bill, and that portion of the property tax bill is typically just under 2% of the tax assessor value of the property.

The 10% cap does not apply whatsoever to properties that qualify for lower tax values because of agricultural or conservation belted (also known as "green belted") status.

The cap will remain year-over-year, provided that certain actions by the landowner are not taken. Generally, an application for the homestead exemption, splitting or combining property during the previous year, or adding significant improvement will cause loss of the entire 10% cap. These actions which trigger loss of the cap are what we affectionately refer to as "10% cap traps."

The protection of the 10% cap can also be forfeited when there is a change of ownership or control. A change of ownership or control means, "any sale, foreclosure, transfer of legal title or beneficial title in equity to any person, or the cumulative transfer of control of more than 50 percent of the ownership of the legal entity that owned the property when it was most recently assessed at just value." If a change of ownership or control is not recorded on a deed, it will still trigger a reassessment. Under Florida Statute 193.1556, any person or entity owning property under the 10% cap provision must notify the property appraiser promptly of any change of ownership or control. Failure to do so may subject the property owner to a lien of back taxes plus interest of 15% per annum and a penalty of 50% of the taxes avoided.[289]

ACTIONS THAT TRIGGER LOSS OF THE 10% CAP

Perhaps the most important thing to know about the 10% cap is when it is lost.

For example, with commercial property, a transfer of ownership between spouses will cause loss of the cap, but a transfer of non-homestead residential property between spouses will not cause loss of the cap.

When an LLC or other entity owns property, the transfer of more than 50% ownership of the LLC can cause loss of the cap.

If LLC "A" owns property and is owned 100% by LLC "B", would the transfer of 51% of ownership in LLC "B" from Spouse 1 to Spouse 2 trigger loss of the cap? The answer is probably

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[289] Palm Beach County Property Appraiser, "10% Cap Assessment Limitation for Non-homestead Property"

yes.

When entity ownership is transferred, the entity is required to report the transfer to the county property appraiser, and the county property appraiser can impose significant penalties going back as far as 10 years from when the entity transfer occurred.

Section by Section Comparison of 193.1554 & 193.1555

F.S. 193.1554 - Assessment of nonhomestead residential property (less than 11 units)	**F.S. 193.1555** - Assessment of certain residential and nonresidential real property (over 10 residential units)
(1) “nonhomestead residential property” means residential real property that contains nine or fewer dwelling units, including vacant property zoned and platted for residential use, and that does not receive the exemption under s. 196.031.	(1) As used in this section, the term: (a) “Nonresidential real property” means real property that is not subject to the assessment limitations set forth in subsection 4(a), (b), (c), (d), or (g), Art. VII of the State Constitution. (b) “Improvement” means an addition or change to land or buildings which increases their value and is more than a repair or a replacement.
(2) For all levies other than school district levies, nonhomestead residential property shall be assessed at just value as of January 1 of the year that the property becomes eligible for assessment pursuant to this section.	(2) For all levies other than school district levies, nonresidential real property and residential real property that is not assessed under s. 193.155 or s. 193.1554 shall be assessed at just value as of January 1 of the year that the property becomes eligible for assessment pursuant to this section.
(3) Beginning the year following the year the nonhomestead property becomes eligible for assessment pursuant to this section, the property shall be reassessed annually on January 1. Any change resulting from such assessment may not exceed 10% of the assessed value for the prior year.	(3) Beginning in the year following the year the property becomes eligible for assessment pursuant to this section, the property shall be reassessed annually on January 1. Any change resulting from such reassessment may not exceed 10 percent of the assessed value of the property for the prior year.
(4) If the assessed value of the property as calculated under subsection (3) exceeds the just value, the assessed value of the property shall be lowered to the just value of the property.	(4) If the assessed value of the property as calculated under subsection (3) exceeds the just value, the assessed value of the property shall be lowered to the just value of the property.

F.S. 193.1554 - Assessment of nonhomestead residential property (less than 11 units)	**F.S. 193.1555** - Assessment of certain residential and nonresidential real property (over 10 residential units)
(5) Except as provided in this subsection, property assessed under this section shall be assessed at just value as of January 1 of the year following a change of ownership or control. Thereafter, the annual changes in the assessed value of the property are subject to the limitations in subsections (3) and (4). For purpose of this section, a change of ownership or control means any sale, foreclosure, transfer of legal title or beneficial title in equity to any person, or the cumulative transfer of control or of more than 50 percent of the ownership of the legal entity that owned the property when it was most recently assessed at just value, except as provided in this subsection. There is no change of ownership if: (a) The transfer of title is to correct an error. (b) The transfer is between legal and equitable title. (c) The transfer is between husband and wife, including a transfer to a surviving spouse or a transfer due to a dissolution of marriage. (d) For a publicly traded company, the cumulative transfer of more than 50 percent of the ownership of the entity that owns the property occurs through the buying and selling of shares of the company on a public exchange. This exception does not apply to a transfer made through a merger with or an acquisition by another company, including an acquisition by acquiring outstanding shares of the company.	(5) Except as provided in this subsection, property assessed under this section shall be assessed at just value as of January 1 of the year following a qualifying improvement or change of ownership or control. Thereafter, the annual changes in the assessed value of the property are subject to the limitations in subsections (3) and (4). For purpose of this section: (a) A qualifying improvement means any substantially completed improvement that increases the just value of the property by at least 25 percent. (b) A change of ownership or control means any sale, foreclosure, transfer of legal title or beneficial title in equity to any person, or the cumulative transfer of control or of more than 50 percent of the ownership of the legal entity that owned the property when it was most recently assessed at just value, except as provided in this subsection. There is no change of ownership if: 1. The transfer of title is to correct an error. 2. The transfer is between legal and equitable title. 3. For a publicly traded company, the cumulative transfer of more than 50 percent of the ownership of the entity that owns the property occurs through the buying and selling of shares of the company on a public exchange. This exception does not apply to a transfer made through a merger with or acquisition by another company, including acquisition by acquiring outstanding shares of the company.

F.S. 193.1554 - Assessment of nonhomestead residential property (less than 11 units)	**F.S. 193.1555** - Assessment of certain residential and nonresidential real property (over 10 residential units)
(6)(a) Except as provided in paragraph (b) and s. 193.624, changes, additions, or improvements to nonhomestead residential property shall be assessed at just value as of the first January 1 after the changes, additions, or improvements are substantially completed.	(6)(a) Except as provided in paragraph (b), changes, additions, or improvements to nonresidential real property shall be assessed at just value as of the first January 1 after the changes, additions, or improvements are substantially completed.
(6)(b)(1) Changes, additions, or improvements that replace all or a portion of nonhomestead residential property, including ancillary improvements, damaged or destroyed by misfortune or calamity must be assessed upon substantial completion as provided in this paragraph. Such assessment must be calculated using the nonhomestead property's assessed value as of the January 1 immediately before the date on which the damage or destruction was sustained, subject to the assessment limitations in subsections (3) and (4), when: a. The square footage of the property as changed or improved does not exceed 110 percent of the square footage of the property before the damage or destruction; or b. The total square footage of the property as changed or improved does not exceed 1,500 square feet.	(6)(b)(1). Changes, additions, or improvements that replace all or a portion of nonresidential real property, including ancillary improvements, damaged or destroyed by misfortune or calamity must be assessed upon substantial completion as provided in this paragraph. Such assessment must be calculated using the nonresidential real property's assessed value as of the January 1 immediately before the date on which the damage or destruction was sustained, subject to the assessment limitations in subsections (3) and (4), when: a. The square footage of the property as changed or improved does not exceed 110 percent of the square footage of the property before the damage or destruction; and b. The changes, additions, or improvements do not change the property's character or use.

F.S. 193.1554 - Assessment of nonhomestead residential property (less than 11 units)	**F.S. 193.1555** - Assessment of certain residential and nonresidential real property (over 10 residential units)
(6)(b)(2)-(4) 2. The property's assessed value must be increased by the just value of that portion of the changed or improved property which is in excess of 110 percent of the square footage of the property before the damage or destruction or of that portion exceeding 1,500 square feet. 3. Property damaged or destroyed by misfortune or calamity which, after being changed or improved, has a square footage of less than 100 percent of the property's total square footage before the damage or destruction shall be assessed pursuant to subsection (8). 4. Changes, additions, or improvements assessed pursuant to this paragraph shall be reassessed pursuant to subsection (3) in subsequent years. This paragraph applies to changes, additions, or improvements commenced within 3 years after the January 1 following the damage or destruction of the property.	(6)(b)(2)-(4) 2. The property's assessed value must be increased by the just value of that portion of the changed or improved property which is in excess of 110 percent of the square footage of the property before the damage or destruction. 3. Property damaged or destroyed by misfortune or calamity which, after being changed or improved, has a square footage of less than 100 percent of the property's total square footage before the damage or destruction shall be assessed pursuant to subsection (8). 4. Changes, additions, or improvements assessed pursuant to this paragraph must be reassessed pursuant to subsection (3) in subsequent years. This paragraph applies to changes, additions, or improvements commenced within 3 years after the January 1 following the damage or destruction of the property.
(6)(c) Changes, additions, or improvements include improvements made to common areas or other improvements made to property other than to the nonhomestead residential property by the owner or by an owner association, which improvements directly benefit the property. Such changes, additions, or improvements shall be assessed at just value, and the just value shall be apportioned among the parcels benefitting from the improvement.	No (6)(c) in 193.1555

F.S. 193.1554 - Assessment of nonhomestead residential property (less than 11 units)	**F.S. 193.1555** - Assessment of certain residential and nonresidential real property (over 10 residential units)
(7)(a)-(c) (7) Any increase in the value of property assessed under this section which is attributable to combining or dividing parcels shall be assessed at just value, and the just value shall be apportioned among the parcels created. (a) For divided parcels, the amount by which the sum of the just values of the divided parcels exceeds what the just value of the parcel would be if undivided shall be attributable to the division. This amount shall be apportioned to the parcels pro rata based on their relative just values. (b) For combined parcels, the amount by which the just value of the combined parcel exceeds what the sum of the just values of the component parcels would be if they had not been combined shall be attributable to the combination. (c) A parcel that is combined or divided after January 1 and included as a combined or divided parcel on the tax notice is not considered to be a combined or divided parcel until the January 1 on which it is first assessed as a combined or divided parcel.	(7)(a)-(c) (7) Any increase in the value of property assessed under this section which is attributable to combining or dividing parcels shall be assessed at just value, and the just value shall be apportioned among the parcels created. (a) For divided parcels, the amount by which the sum of the just values of the divided parcels exceeds what the just value of the parcel would be if undivided shall be attributable to the division. This amount shall be apportioned to the parcels pro rata based on their relative just values. (b) For combined parcels, the amount by which the just value of the combined parcel exceeds what the sum of the just values of the component parcels would be if they had not been combined shall be attributable to the combination. (c) A parcel that is combined or divided after January 1 and included as a combined or divided parcel on the tax notice is not considered to be a combined or divided parcel until the January 1 on which it is first assessed as a combined or divided parcel.
(8) When property is destroyed or removed and not replaced, the assessed value of the parcel shall be reduced by the assessed value attributable to the destroyed or removed property.	(8) When property is destroyed or removed and not replaced, the assessed value of the parcel shall be reduced by the assessed value attributable to the destroyed or removed property.

F.S. 193.1554 - Assessment of nonhomestead residential property (less than 11 units)	**F.S. 193.1555** - Assessment of certain residential and nonresidential real property (over 10 residential units)
(9)(a)-(c) (9) Erroneous assessments of nonhomestead residential property assessed under this section may be corrected in the following manner: (a) If errors are made in arriving at any assessment under this section due to a material mistake of fact concerning an essential characteristic of the property, the just value and assessed value must be recalculated for every such year, including the year in which the mistake occurred. (b) If changes, additions, or improvements are not assessed at just value as of the first January 1 after they were substantially completed, the property appraiser shall determine the just value for such changes, additions, or improvements for the year they were substantially completed. Assessments for subsequent years shall be corrected, applying this section if applicable. (c) If back taxes are due pursuant to s. 193.092, the corrections made pursuant to this subsection shall be used to calculate such back taxes.	(9)(a)-(c) (9) Erroneous assessments of nonresidential real property assessed under this section may be corrected in the following manner: (a) If errors are made in arriving at any assessment under this section due to a material mistake of fact concerning an essential characteristic of the property, the just value and assessed value must be recalculated for every such year, including the year in which the mistake occurred. (b) If changes, additions, or improvements are not assessed at just value as of the first January 1 after they were substantially completed, the property appraiser shall determine the just value for such changes, additions, or improvements for the year they were substantially completed. Assessments for subsequent years shall be corrected, applying this section if applicable. (c) If back taxes are due pursuant to s. 193.092, the corrections made pursuant to this subsection shall be used to calculate such back taxes.

F.S. 193.1554 - Assessment of nonhomestead residential property (less than 11 units)	**F.S. 193.1555** - Assessment of certain residential and nonresidential real property (over 10 residential units)
(10) If the property appraiser determines that for any year or years within the prior 10 years a person or entity who was not entitled to the property assessment limitation granted under this section was granted the property assessment limitation, the property appraiser making such determination shall serve upon the owner a notice of intent to record in the public records of the county a notice of tax lien against any property owned by that person or entity in the county, and such property must be identified in the notice of tax lien. Such property that is situated in this state is subject to the unpaid taxes, plus a penalty of 50 percent of the unpaid taxes for each year and 15 percent interest per annum. Before a lien may be filed, the person or entity so notified must be given 30 days to pay the taxes and any applicable penalties and interest. If the property appraiser improperly grants the property assessment limitation as a result of a clerical mistake or an omission, the person or entity improperly receiving the property assessment limitation may not be assessed a penalty or interest.	(10) If the property appraiser determines that for any year or years within the prior 10 years a person or entity who was not entitled to the property assessment limitation granted under this section was granted the property assessment limitation, the property appraiser making such determination shall serve upon the owner a notice of intent to record in the public records of the county a notice of tax lien against any property owned by that person or entity in the county, and such property must be identified in the notice of tax lien. Such property that is situated in this state is subject to the unpaid taxes, plus a penalty of 50 percent of the unpaid taxes for each year and 15 percent interest per annum. Before a lien may be filed, the person or entity so notified must be given 30 days to pay the taxes and any applicable penalties and interest. If the property appraiser improperly grants the property assessment limitation as a result of a clerical mistake or an omission, the person or entity improperly receiving the property assessment limitation may not be assessed a penalty or interest.

<u>CHAPTER 6:</u>
WAGES AND WAGE ACCOUNTS

BASIC RULES.

In many states wages earned by the <u>head of household</u> are not subject to creditor claims and may be invested in other exempt assets without constituting a fraudulent transfer. Florida Statutes Section 222.11 protects earnings, including compensation paid or payable, in money of a sum certain, for personal services or labor whether denominated as wages, salary, commission, or bonus of a <u>head of family</u>.[290]

The statute defines the "head of family" as any natural person providing more than one-half of the support for a child or other dependent.[291] The dependent is typically a child, but can also be a spouse, grandparent, or other family member. "A person qualifies as a dependent under § 222.11 if that person's income is insufficient to sustain him or her without the support of the person claiming him or her as a dependent."[292]

However, the courts have been somewhat limited in their protection of wages that could have been re-characterized as profits when related to professional practice entities and closely held businesses owned or controlled by them, and there is some confusion in the case law caused by the tendency of judges to refer to independent business holders as "independent contractors", while independent contractors who do not have their own separate business and simply earn monies for services rendered have been able to protect their wages under the statute.

Florida Statutes Section 222.11 "head of family" exemption was amended in October of 2010, to change the amount of disposable earnings that are automatically exempt (garnishment exemption) from $500 to $750 per week,[293] and created supplemental requirements for creditors who wish to obtain an enforceable waiver of the garnishment exemption from a borrower.[294] Pursuant to Florida Statutes Section 222.11(b), the waiver of the judgment debtor is now required to be stated on a separate document, in this mentioned exclusion, and therefore can no longer be discreetly placed within an agreement or contract.[295] The wage and wage accounts exemption under

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[290] Fla. Stat. § 222.11.
[291] Fla. Stat. § 222.11(c).
[292] *In re Beckmann*, 2000 WL 33722204, at 3 (Bankr. M.D. Fla. 2000).
[293] Fla. Stat. § 222.11(2)(a).
[294] Fla. Stat. § 222.11(2)(b).
[295] The waiver must also be in at least 14-point font and "substantially" in the following form: If you provide more than one-half of the support for the child or other dependent, all or part of your income is

Florida Statutes Section 222.11 provides that the first $750 per week of such disposable earnings are exempt from attachment or garnishment, and disposable earnings above that amount will not be subject to attachment or garnishment unless such person has agreed otherwise in writing by separate document, as described below. The effectiveness of wage garnishment from an otherwise financially solvent judgment debtor may be substantially limited under the garnishment wage exemption, as it enables debtors to exempt significant amounts of disposable earnings for up to six months.[296]

Section 222.11(3) provides for the protection of monies deposited into a "wage account" for up to six months after the deposit has been made. The account must be held in "any financial institution." Many advisors encourage physicians to establish wage accounts, deposit their wages into the accounts, and then to move the monies from the wage account into other protected investments within six months of each wage check deposit. Section 222.11(3) is further discussed in the section below entitled "WAGE ACCOUNTS AND THE SIX MONTH RULE."

Advisors negotiating bank loan documents should be sure to ask the bank to strike any reference to waiver if Florida wage exemption rights apply. Waiver of wage exemption documents have been upheld by multiple courts. For example, in a 2011 case, *USAmeriBank v. Klepal,*[297] the Second District Court of Appeals upheld a waiver of disposable earnings in a promissory note.

But even if loan documents purport to waive the exemption of wages, such clauses may not be enforceable if the debtor did not have reason to know that they were part of the loan document package. Recently revised Florida Statute Section 221.11(2)(b) provides the following requirements for a waiver to be valid:

> (b) Disposable earnings of a head of a family, which are greater than $750 a week may not be attached or garnished unless such person has agreed otherwise in writing. The agreement to waive the protection provided by this paragraph must:
>
> 1. Be written in the same language as the contract or agreement to which the waiver relates;
>
> 2. Be contained in a separate document attached to the contract or agreement; and
>
> 3. Be in substantially the following form in at least 14-point type:
>
> IF YOU PROVIDE MORE THAN ONE-HALF OF THE SUPPORT FOR A CHILD OR OTHER DEPENDENT, ALL OR PART OF YOUR INCOME IS EXEMPT FROM GARNISHMENT UNDER FLORIDA LAW. YOU CAN WAIVE THIS PROTECTION ONLY BY SIGNING THIS DOCUMENT. BY

exempt from garnishment under Florida law. You can waive this protection only by signing this document. By signing below, you agree to waive the protection from garnishment.

296 *Id.*

297 100 So.3d 56, 61 (Fla. 2d. Dist. App. 2011).

> SIGNING BELOW, YOU AGREE TO WAIVE THE PROTECTION FROM GARNISHMENT.

It is noteworthy that Bankruptcy Code Section 522(f) may prevent the waiver of exemption rights from applying in bankruptcy. The specific language of the statute is as follows:

> (f)(1) Notwithstanding any waiver of exemptions but subject to paragraph (3), the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is…

The paragraph (3) referred to above reads as follows:

> (3) In a case in which state law that is applicable to the debtor—
>
> (A) permits a person to voluntarily waive a right to claim exemptions under subsection (d) or prohibits a debtor from claiming exemptions under subsection (d); and
>
> (B) either permits the debtor to claim exemptions under State law without limitation in amount, except to the extent that the debtor has permitted the fixing of a consensual lien on any property or prohibits avoidance of a consensual lien on property otherwise eligible to be claimed as exempt property; the debtor may not avoid the fixing of a lien on an interest of the debtor or a dependent of the debtor in property if the lien is a nonpossessory, nonpurchase-money security interest in implements, professional books, or tools of the trade of the debtor or a dependent of the debtor or farm animals or crops of the debtor or a dependent of the debtor to the extent the value of such implements, professional books, tools of the trade, animals, and crops exceeds $6,425.

In *In re Holmes*, a 2009 case from the Bankruptcy Court for the Southern District of Florida, a debtor successfully argued that the "gratuities" that were added to and thus included in his paycheck were exempt from garnishment under Section 222.11.[298] In this case, the debtor was a bartender who moonlighted as an event photographer. His employer automatically added a "service charge" to all orders. This service charge was then passed along to the debtor in his paychecks under a line item labeled "gratuities." The decision does not indicate whether the service charge was added to photography, bartending, or both. The Bankruptcy Court stated that commissions are only eligible for the exemption under Section 222.11 when the debtor is an employee, and not when the debtor is an independent contractor.

The court went on to explain that "[i]n order for compensation to be exempt under the statute, a debtor must receive regular compensation dictated by the terms of an arm's-length employment agreement to perform services that are much like a job."[299] In this case, the Bankruptcy Court held that the debtor's gratuities were exempt because they were earned under an arm's-length employment agreement and could be properly traced and identified as earnings.

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[298] 414 B.R. 868, 870 (Bankr. S.D. Fla. 2009).

[299] *Id.* at 870.

As alluded to earlier in the section, compensation is looked at with more scrutiny in closely-held businesses. In cases such as these the court makes it a point to determine whether the monies paid to the debtor actually qualify as "wages" or are simply profits derived from the company. The more regular the payments look, the more likely they are to be considered as wages.

CAN A BUSINESS OR PROFESSIONAL PRACTICE PAY WAGES TO AN OWNER FOR SERVICES RENDERED?

In *In re Harrison*[300], a dentist who owned 50% of a dental practice that he worked for entered into an employment agreement which stated his compensation would be set forth in an attached exhibit, which was never completed or attached. The debtor and the other 50% shareholder who both worked full time controlled the timing and amount of their compensation. The debtor argued that his wages were the "regular" $4,000 he was paid every two weeks. The evidence showed, however, that the debtor was only paid when the business had enough cash on hand. When the business had more than enough cash on hand, his payments were above $4,000. The court determined that the debtor was not entitled to the exemption because the payments were not regular, and the distributions were more akin to a return on equity investment than earned wages.

A written agreement memorializing the arms-length agreement, however, did not seem to be a requirement in *In re Harrison*, or in future cases. In both *In re Pettit*[301] and *In re Cook*[302], the debtors were able to claim the exemption despite the employment agreement being a verbal one. It is important to note that in both cases the absence of a written employment contract seemed to bring into question whether or not the agreement was entered into at arms-length. In *Pettit*, the debtor had no ownership interest, and in *Cook* the debtor was a 33% owner. Because each compensation plan was paid regularly and not at the full discretion of the debtor, the exemption was allowed.

<u>CAN THE EMPLOYEE WORK OUTSIDE OF FLORIDA?</u>

APPARENTLY YES – In the 2015 Fourth District Court of Appeals case of *Ulisano v. Ulisano*, the court found that a debtor qualified for Florida's wage garnishment exemption under Florida Statutes Section 222.11 despite the fact that he resided outside of Florida.[303] The debtor had lived in South Carolina for the past seven years, worked for a Florida corporation, and used his wages to support his family. The creditor argued that the debtor's claim of exemption under Florida Statutes Section 222.11 should not be granted because the head of household garnishment exemption does not apply to non-residents. The court rejected this argument because the words "residing in this state" were removed from the statute by amendment in 1993. The court went on to note that "[b]y removing the phrase 'residing in this state,' the plain language of the statute applies the exemption to both non-resident and resident heads of family."[304]

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300 *In re Harrison*, 216 B.R. 451 (Bankr. S.D. Fla. 1997).
301 *In re Pettit*, 224 B.R. 834 (Bankr. M.D. Fla. 1998).
302 *In re Cook*, 454 B.R. 204 (Bankr. N.D. Fla. 2011).
303 *Ulisano v. Ulisano*, 154 So. 3d 507 (Fla. 4th Dist. App. 2015).
304 *Id.* at 509.

THE HEAD OF FAMILY MUST HAVE A FINANCIALLY DEPENDENT PERSON TO HAVE PROTECTED WAGES

As discussed above, Florida Statute Section 222.11 defines "head of family" as "any natural person who is providing more than one-half of the support for a child or other dependent." Notably, the term "child" is not limited to a specific age in the statutory language, such as the age of majority.[305] "Even when the child has reached the age of majority, a parent will qualify as head of the family so long as the child looks to the parent for support."[306] The child could potentially be a 30 year old receiving more than one-half of support.[307] Nor is "dependent" defined in the statute. A dependent could be an aunt, uncle, or parent who does not necessarily reside in Florida, but receives financial support from a Floridian. However, there has not been a case to support this!

In cases where debtor is attempting to claim a spouse as a dependent in order to qualify as the "head of household" requirement, courts have explained that "[a] person qualifies as a dependent under § 222.11 if that person's income is insufficient to sustain him or her without the support of the person claiming him or her as a dependent."[308]

In *In re Beckman* the debtor received $58,000 a year in salary while the debtor's wife received $53,000 a year. The court stated that the husband was the functional head of the family, made decisions on which bills to pay and when to pay them, and was the primary financial source for the majority of the marriage. Despite all of this, however, the court determined that because the income of the debtor's wife precluded her form "becoming a public charge or an object of charity," she was therefore "not a dependent of the Debtor."[309]

In *In re Holland* the court analyzed *Beckman* and previous case law to determine that "the case law demonstrates[,] that **showing actual dependency** is the more important factor, rather than the mere existence of some financial support."[310] When the debtor in *Holland* was unable to demonstrate that the wife would be incapable of supporting herself or would become a charge upon society without her husband's income, the court held that the "Husband [was] not a head of family under section 222.11 because, even though he brings in marginally more net income, the Wife would not become an object of charity without the Husband."[311]

Any natural person may be found to be the head of family for purposes of the wage garnishment exemption under Florida Statutes Section 222.11. For example, an unmarried parent may qualify as the head of the household when he or she voluntarily continues to provide more than one-half of the support of a child, even though he or she is not legally required to do so. As noted in *Mazzella*, "child" can mean "any son or daughter, regardless of his or her age."[312] Thus, an

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305 Fla. Stat. § 222.11.
306 *Mazzella v. Boinis*, 617 So.2d 1156, 1157 (Fla. App. 4 Dist. 1993).
307 *Id*.
308 *In re Beckmann*, 98-10325-6B7, 2000 WL 33722204, at *1 (Bankr. M.D. Fla. June 30, 2000).
309 *Id*.
310 *In re Holland*, 3:15-BK-3084-JAF, 2017 WL 6550493, at *3 (Bankr. M.D. Fla. Apr. 11, 2017)
311 *Id*. at *5.
312 *Mazzella v. Boinis*, 617 So.2d 1156, 1157 (Fla. App. 4 Dist. 1993).

unmarried woman financially supporting her son while he attends college qualifies for the exemption.

<u>But Can Wages of a Non-Head of Household Nevertheless Be Protected Once Deposited into a Wage Account?</u>

In a 2009 case in Bankruptcy Court for the Southern District of Florida, *In re Weinshank*, a debtor successfully argued that he was not required to be a head of family to be entitled to the wage exemption under Section 222.11.[313] In this case, the debtor was a single man earning about $4,200 a month working at a hospital. The court found that even though the debtor did not have dependents or a "family" to speak of, that the plain language of the statute did not require the debtor to be the "head of household" because Section (2)(c) of Florida Statute 222.11 provides that the earnings of someone other than a head of family cannot be garnished in excess of what is allowed under the Consumer Credit Protection Act.[314] Thus, even though the debtor was not a "head of family," he was entitled to exemption for funds deposited into his checking account within six months of his bankruptcy filing that could be traced and properly identified as wages.

YOU SUPPORT TOMMY AND I'LL SUPPORT JANE.

Where two working spouses have two or more children, it would seem possible that each of them can support a designated child by maintaining proper records and allocating expenses so that each spouse provides most of the support for one or more designated children or other dependents. Can you therefore have two "heads of family" in one house?

Unfortunately, this is not the case according to multiple Florida courts which have held that "there cannot simultaneously be two heads of household in the same family."

For example, in *Matter of Hersch*,[315] the Bankruptcy Court for the Middle District of Florida held that "[i]t is without any serious dispute that there cannot be two heads of one family unit and in a split household situation the Court must make a determination based on the facts involved in each case who is, in fact, the head of the household." In this 1982 decision, Judge Alexander L. Paskay noted that the debtor received $1,000 per month in child support and earned only $600 per month. The children lived with her. Judge Paskay found that "children of such tender age do not require $1,000 per month and the bulk of this provision was, in fact, an alimony provision for her, at least in substantial part…" The Judge concluded that Mrs. Hersch's wages could be protected, apparently assuming that her net paycheck could be considered to be what was primarily supporting the children.

INDEPENDENT CONTRACTORS QUALIFY FOR WAGE PROTECTION.

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[313] 406 B.R. 413, 417-18 (Bankr. S.D. Fla. 2009).
[314] *Id.* at 417-418.
[315] 23 B.R. 42, 44 (Bankr. M.D. Fla. 1982).

Florida Statutes Section 222.11 does not require that the person earning "wages, salary, commission, or bonus" be an employee, and the case law is consistent therewith. A good example of an independent contractor arrangement that can qualify under the wage exemption statute is the case of *In re Jans*.[316]

Mrs. Jans was a licensed real estate agent who managed an office owned by a real estate company for the sole purpose of selling pre-construction condominium units for a particular project. She was classified as an independent contractor, and not involved in the administration of the condominium business. She received a monthly draw of $4,000 as an advance on future commissions, and additionally received $2,500 per month for serving as the team leader/officer manager of the sales office. She and the other two sales people were required to share the office hours of 10 a.m. to 6 p.m. Monday through Saturday, and 12:00 p.m. to 5:00 p.m. on Sunday. She was also required to attend weekly meetings and to use her own automobile to take prospective purchasers on tours of the property. The Bankruptcy Court for the Middle District of Florida held that her earnings were exempt under the statutes and qualified as a "sum certain", whether determined before or after payment was received.

In contrast, the Eleventh Circuit Court of Appeal's decision of *In re Tobkin* found that a lawyer who had his own legal practice that was run as a proprietorship could not protect legal fees that he received under contingency fee arrangements to be considered as protected wages.[317]

In this case, Bankruptcy Judge Laurel M. Isicoff of the Southern District noted that in the 1995 case of *In re Zamora*, a solo practitioner lawyer who also owned a marina business was not able to exempt monies derived from those activities as wages because they were "both in the nature of running a business." What is important is whether "the debtor had an arm's-length arrangement to perform services that were much like a job," and "whether the debtor had control over the amount of his compensation."[318]

Footnote 15 of the 2016 *Tobkin* decision reads as follows:

> [15] This is not an easy decision for the Court. Debtors that are independent contractors and run their own business also have to worry about providing for their families. This Court recognizes the importance of this decision not only for this Debtor, but other debtors in similar circumstances. Because federal courts dominate the interpretation of Florida's head of household wage exemption, to the extent this issue reaches the Eleventh Circuit Court of Appeals, this Court respectfully suggests that this matter should be certified to the Florida Supreme Court – a step that this Court is unable to take under applicable law.

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[316] Case No. 9:15-bk-01763-FMD.

[317] *In re Tobkin,* 11-34669-BKC-LMI, 2013 WL 1292679 (Bankr. S.D. Fla. Mar. 26, 2013), subsequently aff'd, 638 Fed. Appx. 822 (11th Cir. 2015)(unpublished)

[318] *Id.*

What would prevent a lawyer, doctor, or other professional from operating a professional practice from a company, and being compensated under an Employment Agreement that clearly provides that the professional is receiving a fixed or otherwise determined periodic wage for services that are legally required to be rendered?

Time will tell whether that approach will be successful.

Under the statute, earnings are defined as "compensation payable, in money of sum certain, for personal services or labor whether denominated as wages, salary, commission, or bonus." In various cases, Florida courts have found that proceeds from a debtor's business, including a law practice, are not earnings, and the Eleventh Circuit came to the same conclusion in *Tobkin* because Tobkin was a solo practitioner and his earnings were the result of running a business, not being an employee.

There may also be an issue where compensation is received from an entity taxed as a partnership, since under Internal Revenue Code Section 707(c) salary paid to a partner is considered for federal tax purposes to be what is known as a "guaranteed payment" as opposed to being subject to withholding or payroll tax. It is best to characterize a debtor as an employee and not have him or her be a partner in a partnership that he or she works for if wage exemption is important.

WHAT ABOUT A SHAREHOLDER WHO IS EMPLOYED BY A WHOLLY OR PARTLY OWNED COMPANY?

In *In re Harrison*, a 50% shareholder in a professional association (P.A.) dental practice, in which the two dentists worked full time and each derived equal salaries, was not entitled to wage exemption protection for compensation .[319]

In *In re Manning*, the court denied wage protection status for the spouse of a business owner, while seeming to recognize that an owner of a business can benefit from Section 222.11's wage exemption if the owner/debtor receives regular compensation under the terms of an arm's-length Employment Agreement.[320]

The court stated that "for the exemption to apply, the debtor must not only perform personal services to the business, but he must also receive regular compensation dictated by the terms of an arm's-length employment agreement." In this case, however, the debtor's wife owned all of the stock of a general contracting corporation and the debtor served as President, had no written employment agreement, and determined his own salary, including commissions and bonuses. Thus, the debtor was not entitled to the exemption because he determined the amount and timing of compensation and "essentially constituted discretionary distributions from the family-owned business."

Additionally, the Employment Agreement in place should provide for a schedule of regular compensation that is actually followed. In *In re Harrison*, the court held that the debtor was appropriately characterized as an owner rather than as a wage-earning employee based in large part

[319] 216 B.R. 451, 454 (Bankr. S.D. Fla. 1997).
[320] 163B.R. 380, 382 (Bankr. S.D. Fla. 1994).

upon the fact that he and his 50/50 partner shared all monies equally notwithstanding their relative productivity, and would only pay themselves when there was sufficient cash flow, or, conversely, would supplement their paychecks when there was excess cash flow.[321],

In *Brock v. Westport Recovery Corporation*, the Fourth District Court of Appeals determined in 2002 that an individual's earnings are not exempt wages if they are actually profit distributions in lieu of earnings for services rendered under Section 222.11.[322] The court described the debtor, Mr. Brock's testimony as follows:

> Brock testified that he received a salary of about $56,000 per year, being paid once every two weeks on a regular basis. He claimed his salary never fluctuated. Brock and his brother were the principals of All Island. Somewhat confusingly, Brock testified that he owned fifty percent, or forty-nine percent, or zero percent of the company; "technically" his brother was "a hundred percent shareholder," but they had an agreement that they would be "partners." Brock was the vice president of operations, overseeing warehouse employees, and his brother took care of sales.

Mr. Brock's 1999 and 2000 tax returns showed wages of $108,000 and $56,000 respectively, and dividend income of $57,000 and $94,859 respectively. The court quoted the *Manning* case for the proposition that "a debtor that owns and controls a business cannot exempt the funds that he distributes to himself from the business simply by calling the money 'wages.'" Thus, the court concluded that "Brock's earnings did not qualify for the exemption because they were not compensation. Paid or payable, in money or a sum certain for personal services or labor."

This line of cases has essentially found that where a professional has a degree of control in the management of the company he or she works for, and could manipulate between compensation and dividends, no wages received would be considered as protected under Section 222.11. The authors believe that these cases are incorrect, but recognize the number of cases supporting this position. The Ninth Circuit Court of Appeals has come to an opposite conclusion based upon a California Statute that is almost identical to Florida's Wage Statute.[323] The above makes little or no sense given that Florida's exemption statutes are to be liberally construed and that wage exemption procedures in Florida must be liberally construed in favor of the debtor.[324]

The July 27, 2016 decision of *Kane v. Stewart Tilghman Fox & Bianchi, P.A.* by Florida's Fourth District Court of Appeal found that two lawyers who owned and operated their own law firm and were the sole shareholders, officers and directors thereof, could not protect salaries that they received from the firm as wages because the monies that they received were "the equivalent of shareholder distributions from their wholly owned law firm."[325]

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[321] *In re Harrison*, at 454.
[322] 832 So. 2d 209 (Fla. 2002).
[323] See *In re Nell Carter*, 182 F.3d 1027 (9th Cir. 1999).
[324] See *Miami Herald Publishing Co. v. Payne*, 258 So.2d 541, 543 (Fla. 1978).
[325] *Kane v. Stewart Tilghman Fox & Bianchi, P.A.,* 197 So. 3d 137 (Fla. 4th Dist. App. 2016)

The Court noted that the Kanes had Employment Agreements which called for fixed salaries of $120,000 per annum, which were never paid in full because the law firm had inadequate cash flow.

The Court reiterated much of the previous jurisprudence in this area, but did not specifically rule that wages that a wholly owned professional entity pays to a shareholder employee pursuant to the terms of an Employment Agreement would not be protected from creditors.

It seems possible that contractual obligations with respect to salary, and possible limitations thereon, that are entered into at arm's-length, may facilitate having a company owned by its employees be able to pay wages that would be protected under the statute.

The Court's opinion in *Kane* included the following discussion:

> The issue in this case is whether the payments flowing from the firm to the Kanes are exemptible wages or salary, or some other form of compensation. "To decide whether monies from employment qualify for the section 222.11(2)(b) exemption, the relevant inquiry is often whether a person's employment is a salaried job or is in the nature of running a business."[326]
>
> Courts have looked to a number of factors when determining if payments are salary/wages or actually come from the running of the business, including how the debtor defines the payments.[327] However, this self-determination is not dispositive. "A debtor that owns or controls a business cannot exempt the funds he distributes to himself from the business simply by calling the distributions wages."[328]
>
> Establishing that the debtor receives "regular compensation dictated by the terms of an arms-length employment agreement" is a factor favoring a finding that the payments are exemptible wages.[329] Courts are more likely to find income to be wages where the debtor has less control "over the amount of his compensation and the terms of his employment,"[330] including whether the debtor was able to be fired.[331]

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[326] *Brock v. Westport Recovery Corp.*, 832 So.2d 209, 211 (Fla. 4th DCA 2002).

[327] Id. at 212 (noting that the debtor "characterized his earnings as disbursements from profits").

[328] *In re Harrison*, 216 B.R. 451, 454 (Bankr. S.D. Fla.1997); see also 13 Fla. Jur. 2d Creditors' Rights § 12.

[329] Brock, 832 So.2d at 212 (quoting *In re Manning*, 163 B.R. 380, 382 (Bankr. S.D. Fla.1994)); see also Harrison, 216 B.R. at 454 (same).

[330] Brock, 832 So.2d at 212

[331] Manning, 163 B.R. at 382 (finding that income was not exemptible where, "[a]s a practical matter," the debtor was not subject to firing where his wife was sole owner of corporation and the debtor "sometimes did not take the salary if [the business] was running low on cash"); see also *In re Im*, 495 B.R. 46, 51 (Bankr.M.D.Fla.2013) ("Florida courts have held, in essence, that where the debtor controls

> In this case, the Kanes operated under contracts that were negotiated only between themselves. They controlled the firm, were not able to be terminated except by themselves, and were not paid in accordance with their purported contracts, but rather received payment when the firm could afford to do so. One Appellant testified that since the contracts were formed, he had yet to receive the amounts of money the contract promised. These facts lead to the conclusion that the payments flowing from the firm to the Kanes were not salary, in the ordinary sense of the word, but were actually akin to shareholder distributions that were outside the scope of the exemption found in section 222.11. Therefore, we agree with the trial court and hold that these funds were not exempt from garnishment.
>
> Conclusion
>
> For the foregoing reasons, we affirm the trial court's decision allowing the entry of a second writ of garnishment and finding that the monies owed to the Kanes from the firm were not exempt.
>
> Affirmed.

WHAT ABOUT DEFERRED COMPENSATION AS PROTECTED WAGES?

In *Harrison*, discussed above, the Bankruptcy Court for the Southern District of Florida ruled that the deferred compensation rights of a dentist to receive deferred wages, secured by a UCC-1 lien on the assets of the professional association in which he owned 50% of the stock, were not protected as wages under the Florida Statutes.

Dr. Harrison was a 50% shareholder, and he and the other 50% shareholder were the only two dentists working in the practice. The two dentists entered into an arm's-length agreement, whereby on termination of employment, $75,000 would be paid over time to the terminating shareholder as deferred compensation.

The court ruled that "for the exemption to apply, the debtor must not only perform personal services for the business, he must also receive regular compensation dictated by the terms of an arm's-length employment agreement. Although the debtor . . . has indeed executed an employment agreement with the P.A., it is, in substance, an agreement between himself and the only other shareholder and is accordingly enforceable only by themselves."[332]

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the timing and amount of distributions from a family owned business, those distributions do not qualify as 'earnings' for purposes of Fla[.] Stat. § 222.11." (quoting *In re McDermott*, 2011 WL 740727, at *2 (Bankr.M.D.Fla.2011))).

[332] 216 B.R. 451, 454 (Bankr. S.D. Fla.1997)

The court noted that the debtor and his fellow shareholder did not follow a schedule of regular compensation, and basically paid themselves based upon available cash flow. The court further observed that the compensation provisions of the employment agreement were left blank, and that the agreement failed to lay out specific terms of employment, specified work hours, or vacation schedules.

Although in the *Harrison* case, the dentist's wage agreement was found not to be protected, one reason was that the set deferral amount of $75,000 was found by the court to be a return on equity, and not the result of professional services.[333] A similar finding occurred in *In re Stroup*, where the court found that a Salary Continuation Agreement was not directly attributable to Dr. Stroup's personal services and was not correlative to the services he performed.[334] The court indicated that the Florida Bankruptcy Courts are uniform that severance pay is not "earnings" under Florida Statutes Section 222.11.

Some experts believe that a properly drafted and followed Salary Continuation Agreement should withstand judicial scrutiny where it defines the payment based upon the professional employee's "unpaid productivity compensation," which may be defined as 100% or less of the Accounts Receivable collected from professional services rendered by the professional debtor and which are collected after the period of active employment. The authors agree, but are cognizant that the case law in this area has not been as would be expected.

It is probable that the Florida Legislature did not intend to discriminate against working professionals who earn their wages the same way that non-shareholder employees and independent contractors (who by definition have their own independent business) earn monies.

Does this mean that a professional who may have creditor problems should go to work for someone else's practice or company? Professionals who work for a professional corporation may be better protected by giving some or all of the ownership and control over their corporation to a third party, and having airtight employment agreements with airtight wage definition provisions.

Hopefully an appellate court will eventually set the record straight on what many believe to be a line of incorrect decisions, or perhaps the legislature will come to the rescue**.**

THE FEDERAL CONSUMER CREDIT PROTECTION ACT.

Creditors of those who are not a head of family may not have their disposable earnings (which are the earnings of any head of family reduced by those amounts required to be withheld by law) garnished above certain limits under the Consumer Credit Protection Act.[335] The Act provides that the amount attached or garnished will not exceed the lesser of 25% of the person's disposable income for that week or the amount by which the person's disposable income exceeds thirty times the Federal minimum wage at that time. However, the Consumer Credit Protection Act's limits <u>do not apply</u> where support of any person has been court ordered, in a Chapter 13 or Chapter 11 Bankruptcy, or where any Federal or State taxes are owed.

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[333] 216 B.R. 451, 455 (Bankr. S.D. Fla. 1997).
[334] 221 B.R. 537, 539 (Bankr. M.D. Fla. 1997).
[335] 15 U.S.C. § 1673.

Where support of any person is court ordered, the maximum disposable income for any workweek that may be garnished will not exceed 50% of those earnings if the person is supporting a spouse or a dependent child. If the person is **not** supporting a dependent child or spouse, the maximum weekly disposable earnings subject to garnishment cannot exceed 60%.

WAGE ACCOUNTS AND THE SIX MONTH RULE.

Some practitioners believe that the transfer of monies from a wage account to another exempt asset may be subject to fraudulent transfer set-aside rules, unlike other "exempt to exempt asset" transfers. The theory is that if the wage account is only protected for six months, then there may be a time limitation on protection of what the money therein is converted into as well, but the authors are not aware of any case or specific support for this position.

Florida Statute Section 222.11(3) reads as follows:

> (3) Earnings that are exempt under subsection (2) and are credited or deposited in any financial institution are exempt from attachment or garnishment for 6 months after the earnings are received by the financial institution if the funds can be traced and properly identified as earnings. Commingling of earnings with other funds does not by itself defeat the ability of a head of family to trace earnings.

Exempt earnings that have been commingled do not necessarily lose their exemption – so long as the funds can be traced and properly identified as earnings. This statutory flexibility opens the door to various tracing methods, but it also creates a practical challenge: how do you prove that the funds left in a bank account are still the exempt wages?

Florida courts have not mandated a single accounting method for withdrawals from commingled accounts. Instead, they accept any reasonable tracing approach—so long as it is supported by reliable documentation. Two common methods emerge in case law: FIFO (First-In, First-Out) and the Lowest Intermediate Balance Rule (LIBR).

FIFO: First In, First Out

Under FIFO, the first dollars deposited into an account are presumed to be the first withdrawn. If exempt wages were deposited after other funds, they are deemed to remain until the earlier, non-exempt funds are spent. This can work to a debtor's advantage if the exempt wages were deposited later in time and the balance never dropped below that amount.

One Florida bankruptcy case involved a debtor who proposed FIFO to trace exempt commissions deposited into a commingled account. The court accepted the method as allowable but ultimately declined to apply it because the debtor failed to prove that all the relevant deposits were exempt.[336] This highlights a core principle in all tracing cases: the method is only as effective as the records supporting it.

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[336] *In re Pettit*, 224 B.R. 834, 841 (Bankr. M.D. Fla. 1998).

LIBR: Lowest Intermediate Balance Rule

LIBR is a more protective method when exempt funds are deposited before non-exempt funds. Under LIBR, non-exempt funds are presumed to be withdrawn first, preserving exempt wages until the account balance drops below their original amount. At that point, the exemption is lost to the extent of the shortfall.

This method has long been accepted in trust and fraudulent transfer contexts. In one notable Florida case, a trustee who had commingled trust funds with personal funds was presumed to have spent their own money first—preserving the trust's interest under LIBR.[337] Another case applied LIBR to trace clean versus tainted funds in a Ponzi scheme, concluding that tracing did not require a dollar-for-dollar match, only a reasonable identification of the flow of funds.[338]

Courts have explicitly acknowledged both FIFO and LIBR as legitimate methods. In a Florida criminal case involving forensic accounting, the state's expert witness used FIFO and explained its principles, while also recognizing LIBR as a reliable alternative. The defense's expert attempted to apply a hybrid method, which the court rejected due to lack of clarity and established methodology.[339] When choosing an accounting method to trace earnings, the method should be applied consistently, without modification to suit a certain outcome.

Practical Considerations

The real-world success of tracing claims depends less on the method selected and more on whether the client maintains clear, contemporaneous records. In one case, a debtor lost her claim of wage exemption when the court found insufficient documentation to support the exempt nature of the deposits in a commingled account, even though wage income was present.[340]

Because of the six-month expiration deadline, and the work caused by depositing wage checks into special wage accounts and then having to remember to move the money out of the wage account within six months, many advisors recommend that clients simply deposit their wage checks into otherwise protected vehicles, such as tenancy by the entireties accounts, family limited partnership accounts, annuity investments, or life insurance contracts where protection of the wages will not be a concern.

As noted by commentators, the term "financial institution" is not defined under Florida Statutes Section 222.11. We assume that a brokerage firm will qualify as a "financial institution" to hold a wage account since the Statute was specifically changed to allow "financial institution" accounts within its breadth to overturn a court decision to not allow wage account protection to a Merrill Lynch brokerage account. Florida Statutes Section 710.102(8) defines financial institution as a "bank, trust company, savings institution, or credit union," and does not mention brokerage firms.

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337 *Wilkins v. Wilkins*, 144 Fla. 590, 594, 198 So. 335, 336 (1940).
338 *Wiand v. Lee (In re Lee),* 574 B.R. 286, 295–96 (Bankr. M.D. Fla. 2017).
339 *May v. State*, 326 So. 3d 188, 191–92 (Fla. 1st DCA 2021).
340 *Hancock Whitney Bank v. Adams*, 288 So. 3d 759, 762 (Fla. 1st DCA 2020).

The authors believe that brokerage firm money market and similar accounts will be protected so long as the debtor can prove that the funds in the account are."

FLORIDA'S PHYSICIANS GUIDE TO PROTECTION OF WAGES AND WAGE ACCOUNTS.

Florida law provides limitations upon the access that creditors may have to "wages" and "wage accounts" earned and funded by Florida residents. As discussed in part A of Chapter 6 (Basic Rules), the statute states that wages earned by a head of household will generally be immune from creditors.

Courts have indicated that where the wage earner is a shareholder in a closely held corporation, and can thus manipulate between what would be received as wages and what would be received as dividends, then no wages may be protected. These unfortunate bankruptcy court decisions have not been appealed, and point out the importance of taking regular paychecks and having arm's-length employment agreements in place so that wages are paid periodically in a traditional manner to enhance the probability that they will be protected.

If wages are "creditor exempt," then it is important to maintain the creditor exempt status of the wages by depositing them into an account or other investments that will also be creditor exempt.

Other creditor exempt assets that wages may be "converted to" can include paying down the mortgage on a protected home, investing the paycheck directly into a properly titled annuity contract or life insurance policy, funding a tenancy by the entireties account where the wage earner's spouse would not be sued by the same creditor as the wage earner, or making deposits into a wage account.

Physicians who have monies or investments that are not creditor exempt might be well advised to spend down the non-creditor exempt savings, while accumulating wages in a wage or other protected account.

The Florida Statutes do not explicitly impose any ownership, titling, naming or other specific requirement for an account to qualify as a wage account. A "wage account" can be owned by the physician earner, or may be held as tenancy by the entireties by the physician earner and the physician's spouse.

Most, if not all, married physicians whose spouses do not practice with them will be better protected by depositing their wages into a tenancy by the entireties account so that the wages may be safeguarded for two reasons: (1) the wage exemption rules as described above will apply, and (2) to "invade" a tenancy by the entireties bank account, a creditor must have a judgment against both spouses or show that the transfer into the account was a fraudulent transfer. If a wage check is a creditor exempt asset, then the deposit of the wage check directly into a protected tenancy by the entireties account should not be considered a fraudulent transfer.

Many physicians and bankers waste a lot of time opening "wage accounts" where tenancy by the entireties accounts or other vehicles are just as, if not more, protective and would qualify as wage accounts anyways.

The statute simply says that wages are protected for six months in the account so long as they can be traced, and thus are not confused with non-wage or older wage deposits that would not be protected.

It makes sense to have an account funded solely by wages, and to "empty the account" into other exempt investments, at least every six months, so that there would never have to be a tracing and proof analysis as to wage money protection.

DEPOSITING WAGES INTO A TENANTS BY THE ENTIRETIES ACCOUNT.

Typically, wages regularly deposited into a tenant by the entireties account will retain protection by reason of being an exempt asset transferred into another exempt asset. But what if the wages would not be exempt for one of the reasons the courts have denied exemption as discussed above? Will the transfer of wages to a tenant by the entireties account be considered a fraudulent transfer that be set aside by a creditor when the debtor has always transferred his or her paychecks into tenancy by the entireties accounts?

In *Ellis Sarasota Bank & Trust Co. v. Nevins*,[341] Florida's Second DCA considered whether a husband's deposit of wages into a tenant by the entireties account constituted a fraudulent transfer. The court held that such a transfer may constitute a fraudulent transfer in some cases, but not in the facts before the court in *Ellis*.[342] The court also stated that "[t]he sole fact of a transfer into an entireties account will not always be sufficient evidence of such fraud," but that certain factors, such as how long the tenancy by the entireties account existed, whether a previous entireties account existed, and whether all of the funds in the account were from one source.[343] While the case was remanded to the trial court to determine whether there was any fraud in the transfer of wages to the tenants by the entireties account based on the principles enumerated in this case, the rule of law established in *Ellis* is sound.

Chapter 10 of this book provides detail on federal government employee benefits that can be creditor exempt under the federal law.

By analogy, in the case of *In re Cook*,[344] the court found that a couple's conversion of $175,000 in proceeds from a non-exempt tax refund into an exempt homestead was not done with fraudulent intent, so that the ten-year "look back" provision under Bankruptcy Code Section 522(o) did not apply. The court looked at the circumstances surrounding the transfer and found that it was reasonable for the Cooks to use the tax refund to buy another home, noting that "receiving the tax refund finally gave the Debtors the opportunity to procure a stable and permanent residence."

In a December 31, 2012 Forbes online publication, Attorney and commentator, Jay Adkisson, described a Pennsylvania case regarding the transfer of wages to a tenants by the

[341] 409 So.2d 178, 179 (Fla. 2d DCA 1982).
[342] *Id.* at 180.
[343] *Id.*
[344] 460 B.R. 911, 915 (Bankr. N.D. Fla. Dec. 7, 2011).

entireties account. In *In re Cohen*,[345] the Bankruptcy Court for the Western District for Pennsylvania held that wages directly deposited into a tenant by the entireties account following a stable pattern that had been followed for over twenty years did not constitute an actual fraudulent transfer, but did constitute constructive fraud under Pennsylvania law. As to the "actual fraudulent transfer" decision, the court stated the following:

> The Trustee failed to prove that the Debtor actually intended to hinder, delay, or defraud Trizec when he transferred his wages into the Entireties Account. As was the Defendants' custom for at least twenty years before the Trizec Litigation, they continued to deposit their paychecks directly into the Entireties Account after Trizec sued them. While Mrs. Cohen retired subsequent to the commencement of the Trizec Litigation, she deposited her monthly pension payments into the Entireties Account. Thus, the Trustee has not provided evidence sufficient to establish that the Debtor, after Trizec sued him, made any change in the way he handled his paychecks, or otherwise proven that the Debtor acted with any actual fraudulent intent.

However, the court found that the debtor was liable for constructive fraud. To show constructive fraud in Pennsylvania, the Trustee must prove that the "[d]ebtor made the transfer without receiving reasonably equivalent value in exchange, and was insolvent at the time of the transfer or was rendered insolvent by the transfer." This decision was overturned in the case of *Cohen v. Sikirica*, where the U.S. District Court concluded that the Trustee (Sikirica), "failed to satisfy his burden that Mr. Cohen's funds alone were used to pay the unexplained expenditures."[346]

Jay Adkisson has stated that "the Court found that the transfers of the Debtor's wages to the entireties account constituted fraudulent transfers because no consideration [was given] for the transfers (although the Court allowed the Debtor to try to prove that a portion of the moneys were spent on necessities, which would have been consideration), and the transfers rendered the Debtor insolvent or he was insolvent when they were made."

Florida Statutes Section 726.105 recognizes the concept of "constructive fraud" and reads as follows:

> A. A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:
>
> (1) With actual intent to hinder, delay, or defraud any creditor of the debtor; **or**
> (2) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

[345] 2012 WL 5360956 *2 (Bankr. W.D. Pa. Oct. 31, 2012).
[346] 487 B.R. 615, 628 (W.D. Pa. 2013).

(a) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
(b) Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due.

However, the court in *Ellis*, discussed above, found that depositing wages into tenants by the entireties account will only constitute a fraudulent transfer when "clothed with fraud."[347]

[347] 409 So.2d 178, 180 (Fla. 2d DCA 1982).

CHAPTER 7:
DISABILITY INSURANCE, WORKER'S COMPENSATION AND PROCEEDS

Florida Statutes Section 222.18 exempts disability payments from creditors. The statute specifically provides:

> Disability income benefits under any policy or contract of life, health, accident, or other insurance, shall not in any case be liable to attachment, garnishment, or legal process in the state, in favor of any creditor or creditors of the recipient of such disability income benefits, unless such policy or contract of insurance was effected for the benefit of such creditor or creditors.

In order for a debtor to claim funds as exempt under Florida law as "disability benefits", it must be established that (1) the funds are disability income benefits, and (2) that the benefits are under a policy.[348]

In the 1997 case of *Broward v. Jacksonville Med.*, the Supreme Court of Florida held that any benefits due or payable under workers compensation law continue to be exempt even after they are received and put into a bank account.[349] The Court found that such funds, when placed into a bank account, will continue to be exempt from creditor claims so long as the funds being claimed as exempt are traceable to the benefits.[350] The Court reasoned that the legislature must have intended for residents of Florida to be able to protect their worker's compensation benefits, even after they were deposited into a bank account.[351]

In a related 1997 case, *In re Ryzner*, the Bankruptcy Court of the Middle District of Florida specifically ruled that disability benefits placed in a bank account were exempt from creditors.[352] The Bankruptcy Trustee in *Ryzner*, contended that disability payments were not exempt once those benefits were deposited in a checking bank account because the statute did not explicitly discuss exempt status for disability income monies placed into bank accounts.[353] The debtors, however, contended that Section §222.18 exempted all disability income benefits from "legal process."[354]

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[348] *In re Chesley*, 526 B.R. 888 (M.D. Fla. 2014).

[349] *Broward v. Jacksonville Med. Ctr.*, 690 So. 2d 589 (Fla. 1997).

[350] *Id*.; distinguished by *Sullo v. Cinco Star, Inc.*, 755 So. 2d 822, 823 (Fla. Dist. Ct. App. 2000)(The court found, and was later upheld by the Circuit Court, that section 440.22 protection does not extend to Worker's Compensation funds that are later used to purchase a CD.)

[351] *In re Ryzner*, 208 B.R. 568 (Bankr. M.D. Fla. 1997).

[352] *Id.* at 570.

[353] *Id.* at 569.

[354] *Id.*

Chief Judge Paskay agreed with the debtors.[355] Adopting the reasoning in *Broward* that worker's compensation benefits were exempt as long as the monies was traceable to those benefits, Judge Paskay overturned the Bankruptcy Trustee's objection and ruled that the disability income in the debtor's checking bank account was "allowed as exempt" under Section 222.18.[356]

Even lump sum proceeds resulting from settlement of a claim against a disability carrier will be exempt according to the Florida Supreme Court. In *Zuckerman v. Hofrichter & Quiat, P.A.*,[357] the Florida Supreme Court held that the debtor's settlement proceeds of $75,000 were exempt under Section 222.18. Specifically, the court stated:

> Section 222.18 expressly reads that disability income benefits "of whatever form" paid pursuant to an insurance contract or policy shall not be subject to garnishment, unless such insurance was affected for a creditor's benefit. The words "of whatever form" are dispositive. The clarity of these words leads us to conclude that the Section 222.18 exemption is not contingent upon the form of payment, i.e., lump sum versus monthly payments, nor does it discriminate between monies paid pursuant to settlement or otherwise.

Thus, when a Floridian receives disability insurance proceeds, whether in a lump sum or monthly payments, the proceeds are protected from creditors.

Internal Revenue Code Section 104 reads as follows:

(a) **IN GENERAL** Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;

(3) amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer);

(4) amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, or as a

[355] *Id.* at 570.
[356] *Id.*
[357] 646 So.2d 187, 188 (Fla. 1994).

disability annuity payable under the provisions of section 808 of the Foreign Service Act of 1980;

(5) amounts received by an individual as disability income attributable to injuries incurred as a direct result of a terroristic or military action (as defined in section 692(c)(2)); and

(6) amounts received pursuant to—

(A) section 1201 of the Omnibus Crime Control and Safe Streets Act of 1968 (42 U.S.C. 3796); [1] or

(B) a program established under the laws of any State which provides monetary compensation for surviving dependents of a public safety officer who has died as the direct and proximate result of a personal injury sustained in the line of duty, except that subparagraph (B) shall not apply to any amounts that would have been payable if death of the public safety officer had occurred other than as the direct and proximate result of a personal injury sustained in the line of duty.

For purposes of paragraph (3), in the case of an individual who is, or has been, an employee within the meaning of section 401(c)(1) (relating to self-employed individuals), contributions made on behalf of such individual while he was such an employee to a trust described in section 401(a) which is exempt from tax under section 501(a), or under a plan described in section 403(a), shall, to the extent allowed as deductions under section 404, be treated as contributions by the employer which were not includible in the gross income of the employee. For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress.

(b) **TERMINATION OF APPLICATION OF SUBSECTION (A)(4) IN CERTAIN CASES**

(1) **IN GENERAL**
Subsection (a)(4) shall not apply in the case of any individual who is not described in paragraph (2).

(2) **INDIVIDUALS TO WHOM SUBSECTION (A)(4) CONTINUES TO APPLY**An individual is described in this paragraph if—

(A) on or before September 24, 1975, he was entitled to receive any amount described in subsection (a)(4),

(B) on September 24, 1975, he was a member of any organization (or reserve component thereof) referred to in subsection (a)(4) or under a binding written commitment to become such a member,

(C) he receives an amount described in subsection (a)(4) by reason of a combat-related injury, or

(D) on application therefor, he would be entitled to receive disability compensation from the Department of Veterans Affairs.

(3) **SPECIAL RULES FOR COMBAT-RELATED INJURIES** For purposes of this subsection, the term "combat-related injury" means personal injury or sickness—

(A) which is incurred—

(i) as a direct result of armed conflict,

(ii) while engaged in extrahazardous service, or

(iii) under conditions simulating war; or

(B) which is caused by an instrumentality of war.

In the case of an individual who is not described in subparagraph (A) or (B) of paragraph (2), except as provided in paragraph (4), the only amounts taken into account under subsection (a)(4) shall be the amounts which he receives by reason of a combat-related injury.

(4) **AMOUNT EXCLUDED TO BE NOT LESS THAN VETERANS' DISABILITY COMPENSATION**

In the case of any individual described in paragraph (2), the amounts excludable under subsection (a)(4) for any period with respect to any individual shall not be less than the maximum amount which such individual, on application therefor, would be entitled to receive as disability compensation from the Veterans' Administration.

(c) **APPLICATION OF PRIOR LAW IN CERTAIN CASES** The phrase "(other than punitive damages)" shall not apply to punitive damages awarded in a civil action—

(1) which is a wrongful death action, and

(2) with respect to which applicable State law (as in effect on September 13, 1995 and without regard to any modification after such date) provides, or has been construed to provide by a court of competent jurisdiction pursuant to a decision issued on or before September 13, 1995, that only punitive damages may be awarded in such an action.

This subsection shall cease to apply to any civil action filed on or after the first date on which the applicable State law ceases to provide (or is no longer construed to provide) the treatment described in paragraph (2).

(d) **CROSS REFERENCES**

(1) For exclusion from employee's gross income of employer contributions to accident and health plans, see section 106.

(2) For exclusion of part of disability retirement pay from the application of subsection (a)(4) of this section, see section 1403 of title 10, United States Code (relating to career compensation laws).

CHAPTER 8:
PENSION PLANS, IRAS, AND OTHER QUALIFIED RETIREMENT PLANS

INTRODUCTION.

Pension and IRA accounts enjoy exempt asset status both under the Florida Statutes and the Federal Bankruptcy Code.

Many new businesses and professionals do not have pension plans, or have plans which are not of optimum design for their situation. Fortunately, some pension actuaries will not charge to take a look at an existing plan and employee information in order to advise on optimum plan design, which may include consideration of cross-tested defined benefit or cash-balanced plans, which are not well understood. The census that follows can be used to provide the information that an advisor will need to facilitate plan design.

Many advisors are not aware of the Affiliated Service Group rules and Employee Leasing rules under Internal Revenue Code Sections 414(m) and (n) which can cause individuals who work indirectly or in associated companies to be required to be included in a pension plan in order to avoid disqualification under the anti-discrimination rules.

In Bankruptcy, individuals who are not able to use state law to facilitate exemption of IRAs will be subject to loss of exemption for any inherited IRAs they own or receive, because the federal Bankruptcy Code protection does not extend to any inherited IRA, at least if it was not inherited by a surviving spouse. The present cap, which was last updated for inflation on April 1, 2022, totals $1,512,350. The cap is next set to be adjusted for inflation in April of 2025.

Florida's exemption status applies to the unlimited values of both pension and IRA accounts, and includes rollover IRAs that pass to surviving spouses and other beneficiaries who reside in Florida, but can be somewhat finicky. See, for example, what might happen if the owner of an IRA gives a blanket UCC-1 financing statement to a lender – does this disqualify all IRAs, and cause loss of the applicable exemption, as described in Section H of this chapter?

Previously case law permitted creditors of an IRA beneficiary to reach an inherited IRA, but this was changed when a Florida Statute was amended in 2011.[358] The updated language under Florida Statutes Section 222.21 and Bankruptcy Code Section 522 provides protection for plans that have legal or operational flaws, and for single person pension plans that were not considered to be qualified under ERISA, as further discussed below.

For example, pension and IRA accounts will be considered to be in compliance with applicable law "<u>unless it has been ... determined that the plan or governing instrument is not exempt from taxation in a proceeding that has become final and nonappealable.</u>"[359] Pension plans and IRAs with documentation or operational flaws will still be protected under the Florida statute if the debtor claiming the exemption proves by a preponderance of the evidence that the fund or account would have been in substantial compliance with the applicable requirements for tax exemption but for the negligent or wrongful conduct of a person or persons other than the debtor claiming the exemption.

The Florida statute reads as follows, with forgiveness provisions being underlined for the convenience of the reader:

> **§ 222.21 Exemption of pension money and certain tax-exempt funds or accounts from legal processes.**
>
> (1) Money received by any debtor as pensioner of the United States within 3 months next preceding the issuing of an execution, attachment, or garnishment process may not be applied to the payment of the debts of the pensioner when it is made to appear by the affidavit of the debtor or otherwise that the pension money is necessary for the maintenance of the debtor's support or a family supported wholly or in part by the pension money. The filing of the affidavit by the debtor, or the making of such proof by the debtor, is prima facie evidence; and it is the duty of the court in which the proceeding is pending to release all pension moneys held by such attachment or garnishment process, immediately, upon the filing of such affidavit or the making of such proof.
>
> (2)(a) Except as provided in paragraph (d), any money or other assets payable to an owner, a participant, or a beneficiary from, or any interest of any owner, participant, or beneficiary in, a fund or account is exempt from all claims of creditors of the owner, beneficiary, or participant if the fund or account is:
>
> 1. Maintained in accordance with a master plan, volume submitter plan, prototype plan, or any other plan or governing instrument that has been preapproved by the Internal Revenue Service as exempt from taxation under s. 401(a), s. 403(a), s. 403(b), s. 408, s. 408A, s. 409, s. 414, s. 457(b), or s. 501(a) of the Internal Revenue Code of 1986, as amended, <u>unless it has been subsequently</u>

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[358] Fla. Stat. § 221.21(c)(2).

[359] Fla. Stat. § 222.21(2)(a)(1) 2017.

determined that the plan or governing instrument is not exempt from taxation in a proceeding that has become final and nonappealable;

2. Maintained in accordance with a plan or governing instrument that has been determined by the Internal Revenue Service to be exempt from taxation under s. 401(a), s. 403(a), s. 403(b), s. 408, s. 408A, s. 409, s. 414, s. 457(b), or s. 501(a) of the Internal Revenue Code of 1986, as amended, unless it has been subsequently determined that the plan or governing instrument is not exempt from taxation in a proceeding that has become final and nonappealable; or

3. Not maintained in accordance with a plan or governing instrument described in subparagraph 1. or subparagraph 2. if the person claiming exemption under this paragraph proves by a preponderance of the evidence that the fund or account is maintained in accordance with a plan or governing instrument that:

a. Is in substantial compliance with the applicable requirements for tax exemption under s. 401(a), s. 403(a), s. 403(b), s. 408, s. 408A, s. 409, s. 414, s. 457(b), or s. 501(a) of the Internal Revenue Code of 1986, as amended; or

b. Would have been in substantial compliance with the applicable requirements for tax exemption under s. 401(a), s. 403(a), s. 403(b), s. 408, s. 408A, s. 409, s. 414, s. 457(b), or s. 501(a) of the Internal Revenue Code of 1986, as amended, but for the negligent or wrongful conduct of a person or persons other than the person who is claiming the exemption under this section.

(b) It is not necessary that a fund or account that is described in paragraph (a) be maintained in accordance with a plan or governing instrument that is covered by any part of the Employee Retirement Income Security Act for money or assets payable from or any interest in that fund or account to be exempt from claims of creditors under that paragraph.

(c) Any money or other assets or any interest in any fund or account that is exempt from claims of creditors of the owner, beneficiary, or participant under paragraph (a) does not cease to be exempt after the owner's death by reason of a direct transfer or eligible rollover that is excluded from gross income under the Internal Revenue Code of 1986, including, but not limited to, a direct transfer or eligible rollover to an inherited individual retirement account as defined in s. 408(d)(3) of the Internal Revenue Code of 1986, as amended. This paragraph is intended to clarify existing law, is remedial in nature, and shall have retroactive application to all inherited individual retirement accounts without regard to the date an account was created.

(d) Any fund or account described in paragraph (a) is not exempt from the claims of an alternate payee under a qualified domestic relations order or from the claims of a surviving spouse pursuant to an order determining the amount of elective share and contribution as provided in part II of chapter 732. However, the interest of any alternate payee under a qualified domestic relations order is exempt from all claims of any creditor, other than the Department of Revenue, of the alternate payee. As used in this paragraph, the terms “alternate payee” and “qualified domestic relations order” have the meanings ascribed to them in s. 414(p) of the Internal Revenue Code of 1986.

(e) This subsection applies to any proceeding that is filed on or after the effective date of this act.

The Bankruptcy Code section on pension and IRA accounts can be relied upon by individuals whose states do not provide as much protection[360]. The following language is from Bankruptcy Code Section 522(b)(4):

1. If the retirement funds are in a retirement fund that has received a favorable determination under section 7805 of the Internal Revenue Code of 1986, and that determination is in effect as of the date of the filing of the petition in a case under this title, those funds shall be presumed to be exempt from the estate.

2. If the retirement funds are in a retirement fund that has not received a favorable determination under such section 7805, those funds are exempt from the estate if the debtor demonstrates that—

   (i) no prior determination to the contrary has been made by a court or the Internal Revenue Service; and

   (ii)

      (I) the retirement fund is in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986; or

      (II) the retirement fund fails to be in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986 and the debtor is not materially responsible for that failure.

3. A direct transfer of retirement funds from 1 fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986, under section 401(a)(31) of the Internal Revenue Code of 1986, or otherwise, shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such direct transfer.

   (D)

> **(i)** Any distribution that qualifies as an eligible rollover distribution within the meaning of section 402(c) of the Internal Revenue Code of 1986 or that is described in clause (ii) shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such distribution.
>
> **(ii)** A distribution described in this clause is an amount that—
>
>> **(I)** has been distributed from a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986; and
>>
>> **(II)** to the extent allowed by law, is deposited in such a fund or account not later than 60 days after the distribution of such amount.

Neither the Florida Statute nor the Bankruptcy Code makes mention of retirement plans that arise under Internal Revenue Code Sections 412(i) or 419A, so it is possible that these types of retirement plans are not exempt from creditor claims unless they qualify under the Florida and Bankruptcy Code statutes discussed below.

A 412(i) plan is like a defined benefit plan, but simplified rules apply, and the plan must be funded only with life insurance and annuity products. Many commissioned insurance agents are not licensed to sell other types of investments, such as mutual funds, stocks and bonds, and encourage 412(i) plans. Such a plan is clearly permitted under the Internal Revenue Code as a retirement plan for employees that can be funded in a tax deductible manner, and may facilitate contributions exceeding what would normally be permitted under 401(k) plans, but clients and advisors are best served by having knowledgeable actuaries or pension lawyers and investment advisors involved to assure that conventional pension planning is considered.

419A plans are often referred to as Welfare Benefit Plans and it is said that the IRS has challenged a high proportion of 419A plans as a matter of routine procedure. As a result of this they are often challenged by the IRS, and normally not recommended by conventional advisors. An excellent summary of 419A plans and their possible effect and risks can be found on the website of tax lawyer Harvey M. Katz who can be reached at (212) 878-7976 or hkatz@foxrothschild.com.

While life insurance and annuities are protected from the creditors of a policy owner who is the insured as to life insurance, or the owner of an annuity, having life insurance or annuities under a 412(i) plan or a 419A plan will not help from a Florida asset protection standpoint, because only life insurance and annuity contracts owned by Florida residents will be protected.[361]

[361] See *In re Allen*, 203 B.R. 786 (Bankr. M.D. Fla. 1996).

Florida Statutes Section 222.201 provides that the exemptions under Bankruptcy Code Section 522(d)(10) will apply. Subsection (10)(E) includes the following, which may protect 412(i) plans when provided for "non-insiders"[362]:

> **(E)** a payment under a stock bonus, pension, profit sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor, unless—
>
> > **(i)** such plan or contract was established by or under the auspices of an insider that employed the debtor at the time the debtor's rights under such plan or contract arose;
> >
> > **(ii)** such payment is on account of age or length of service; and
> >
> > **(iii)** such plan or contract does not qualify under section 401(a), 403(a), 403(b), or 408 of the Internal Revenue Code of 1986.

419A plans are much more controversial than 412(i) plans, but may qualify for creditor protection under the same rationale.

BANKRUPTCY PROTECTION FOR IRAS.

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[362] The term "insider" includes (A) if the debtor is an individual - (i) relative of the debtor or of a general partner of the debtor; (ii) partnership in which the debtor is a general partner; (iii) general partner of the debtor; or (iv) corporation of which the debtor is a director, officer, or person in control; (B) if the debtor is a corporation - (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor; (C) if the debtor is a partnership - (i) general partner in the debtor; (ii) relative of a general partner in, general partner of, or person in control of the debtor; (iii) partnership in which the debtor is a general partner; (iv) general partner of the debtor; or (v) person in control of the debtor; (D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor; (E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and (F) managing agent of the debtor.

Pursuant to Bankruptcy Code Section 522(n),[363] when the Federal exemptions apply, assets held in traditional and Roth IRA accounts[364] are exempt from creditors and thus not part of the bankruptcy estate in the present amount of up to $1,512,350.[365] This limitation does not apply where state law explicitly provides for unlimited protection, as per the 1993 11th Circuit Court of Appeals decision in *In Re Schlein*.[366] Additionally, IRA accounts attributable to amounts properly rolled over from a qualified retirement plan or certain other retirement plan accounts into an IRA plan will not be subject to the Section 522(n) limitation.

However, in the 2014 decision of *In re Clark v. Rameker*, the United States Supreme Court held that inherited IRAs are not classified as retirement funds within the Federal bankruptcy law, and will therefore be lost to creditors in the bankruptcy.[367] Because of this case, and the uncertainty of being able to predict where the beneficiary of an IRA may reside when they inherit an IRA, it is often best to have IRAs made payable to "accumulation trusts" which may be held for the benefit of the intended beneficiary after the death of the IRA owner in a manner that will protect the IRA from creditors of the intended beneficiary. Florida Statutes Section 222.21 does exempt inherited IRAs from the bankruptcy estate, and may not apply if the intended beneficiary resides in a state that does not provide similar protection.

PROTECTING THE INTENDED BENEFICIARIES OF IRA AND PENSION PLAN ACCOUNTS.

Make Benefits Payable to Trusts

Although the beneficiary of an IRA or pension plan who resides in Florida will have protection from a creditor standpoint on the death of the planned participant or IRA holder under Florida Statutes Section 222.21(2)(a), beneficiaries who reside outside of Florida may not have this protection.

Additionally, Florida Statutes Section 222.14 protects the cash value of insurance policies and all annuities from creditor's claims. While a Florida resident is alive, the cash value of any insurance policy that the individual owns for herself or for another Florida resident is exempt from

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[363] Section 522(n) provides: For assets held by debtors in traditional or Roth IRAs, other than a simplified employee pension under section 408(k) or a simple retirement account under section 408(p), the aggregate value of such assets exempted under this section, without regard to amounts attributable to rollover contributions under IRC sections 402(c), 402(e)(6), 403(a)(4), 403(a)(5), and 403(b)(8), and earnings thereon, shall not exceed $1,000,000, except that such amount may be increased if the interests of justice so require.

[364] In *In re Hoffman*, the 11th circuit affirmed this exclusion, "[A] debtor's property is excluded from his bankruptcy estate pursuant to federal law if: (1) the debtor has 'a beneficial interest in the trust', (2) the interest has a restriction on transfer; and (3) the restriction is enforceable under either state or federal law." 22 F.4th 1341, 1346 (U.S. 11th Cir. App. 2022). According to the 11th circuit, Roth IRAs meet all three requisite elements. *Id*.

[365] This value is adjusted every three years for inflation, with the last increase occurring April 1, 2016.

[366] *Schlein v. Mills (In re Schlein),* 8 F.3d 745, 746 (11th Cir. 1993).

[367] *Clark v. Rameker*, 134 S. Ct. 2242 (U.S. 2014).

creditor's claims. However, this benefit is only for the owner/insured. The law does not protect the cash value of life insurance when the insured is someone other than the debtor.

The 2019 SECURE Act changed the playing field for many aspects of IRA and pension distribution planning that applies when an IRA owner or pension plan participant dies. The minimum distribution rules can be followed by those who become adept in this complicated area to facilitate having trusts that may protect a beneficiary from his or her creditors receive distributions.

INHERITED IRAS ARE NOW PROTECTED IN FLORIDA.

Despite the apparent intent of the legislature, court decisions issued in 2001 and 2010 came to the conclusion that IRAs that were inherited by beneficiaries were not protected from their creditors under Florida Statutes Section 222.21.[368] However, as mentioned in the Introduction, the statute was amended in 2011 to clarify that inherited IRAs are protected. The following language became effective on May 31, 2011 and applies retroactively to all inherited individual retirement accounts:

> Any money or other assets or any interest in any fund or account that is exempt from claims of creditors of the owner, beneficiary, or participant under paragraph (a) does not cease to be exempt after the owner's death by reason of a direct transfer or eligible rollover that is excluded from gross income under the Internal Revenue Code of 1986, including, but not limited to, a direct transfer or eligible rollover to an inherited individual retirement account as defined in s. 408(d)(3) of the Internal Revenue Code of 1986, as amended. This paragraph is intended to clarify existing law, is remedial in nature, and shall have retroactive application to all inherited individual retirement accounts without regard to the date an account was created.

While it is commonly believed that IRAs that are rolled over and thus delayed as to distributions for a surviving spouse will yield substantially more for the family than IRAs that must immediately begin making payments over the life expectancy of a trust beneficiary, the numbers do not all bear this out.

WILL MONEY OR ASSETS DISTRIBUTED FROM IRAS OR PROTECTED QUALIFIED RETIREMENT PLANS BE EXEMPT? HOPEFULLY SO.

The 2001 Florida Northern District Bankruptcy Court decision in *In re Ladd* held that distributions from a 401(k) plan were exempt even after being placed into a checking account

[368] In *Robertson v. Deeb*, 16 So.3d 936, 939 (Fla. 2d DCA 2001), Florida's Second District Court of Appeals found that an inherited IRA was not exempt under Section 222.21. In this case, Mr. Robertson was named as the beneficiary of his father's IRA, and upon his father's death, he chose to transfer the IRA into another IRA. The court denied the exemption, noting that the "fund or account" language in Section 222.21 does not apply when the original fund or account passes to a beneficiary upon the death of the participant. The Middle District of Florida reached a similar conclusion in the 2010 case of *In re Ard*, 435 B.R. 719, 722 (Bankr. M.D. Fla. 2010).

because the funds were traceable to the distribution.[369] In *Ladd*, the debtor was terminated from his place of employment and his qualified 401(k) plan required that his account be distributed within 60 days after his employment ended.[370] The court in *Ladd* stated that:

> While prematurely distributed benefits that do not roll over into another qualified plan may be subject to income taxes, there is no provision in the IRS Code, the Bankruptcy Code, or Florida Statute that strips the exempt status of the plan proceeds with regard to creditors other than the IRS and other exception creditors.
>
> If the Debtor's plan was qualified, the proceeds were received by the Debtor as a mandatory distribution. Regardless of the tax status of those proceeds, they would be exempt from creditors under F.S. § 222.21(2)(a), and would be exempt from the bankruptcy estate under 11 U.S.C. § 522(d)(10)(E). The Trustee did not attack the qualification status of the 401(k) plan. Instead, she offered the legal argument that the plans proceeds lost their exempt status when they left the confines of the 401(k) plan, and were deposited into a checking account.
>
> If the retirement plan bearing the distribution was qualified under the IRS Code, then the monies paid from the plan are exempt, despite their deposit into a checking account.[371]

Two 2016 Middle District Bankruptcy Court decisions have distinguished *In re Ladd*, by ruling that exempt status is removed if the retirement benefit is voluntarily withdrawn. In *In re Ladd*, the withdrawal was involuntary because the debtor was terminated from employment, and had no choice but to make the withdrawal.

On the other hand, in *In re Jones*, the debtor withdrew all of the funds from his pension account and deposited the proceeds into his personal checking account.[372] Within two months after the liquidation of the pension account, Mr. Jones filed bankruptcy. The court held that:

> The transferred property originated with Mr. Jones' pension fund, and may have been entitled to an exemption from the claims of Mr. Jones' creditors if it had remained in the account at Fidelity Investments.

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[369] 258 B.R. 824 (N.D. Fla. 2001); West's Bankr. Newsl. 9 (Mar. 28, 2001) (West's Bankruptcy Newsletter describes *In re Ladd* and states, :Funds distributed from a Chapter 7 debtor's 401(k) plan were exempt under Florida law, even though the proceeds had been placed into the debtor's checking account).

[370] *Id.* at 824.

[371] *Id.* at 827, Brown, Ahearn & McLean, *Bankruptcy Exemption Manual*, § 5.11 at 11 (2011 ed.) (The 2011 Bankruptcy Exemption Manual states that *In re Ladd* "concluded that funds from an otherwise exempt 401(k) plan did not lose their exempt status when they were placed into a segregated checking account.")

[372] *In re Jones*, 2016 WL 492439 (Bankr. M.D. Fla. 2016).

> Under the circumstances of this case, however, the Court finds that the property transferred by Mr. Jones was not an asset that was exempt from the claims of his creditors. Specifically, the funds that originated from the pension account did not retain their exempt status for a number of reasons . . .[373]

The *Ladd* court provided four reasons as to why it concluded that the funds did not retain creditor exempt status:

A. The withdrawals were voluntary;[374]

B. The funds were not rolled over into another investment vehicle;[375]

C. The funds were not exempt under Florida Statutes Section 222.21;[376] and

D. The withdrawn funds were not claimed as an exemption on bankruptcy schedules.[377]

As a result, the court found that Mr. Jones was not eligible for the exemptions under the Florida Statutes because his voluntary liquidation of the account was actually different from the situation in *Ladd*; therefore, his pension proceeds were subject to creditors.[378]

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373 *Id.* at *3-4.

374 "The "cash out" of the account was a voluntary withdrawal by Mr. Jones of the entire amount of the fund. His voluntary liquidation of the account, therefore, is unlike the situation in *In re Ladd*, 258 B.R. 824 (Bankr. M.D. Fla. 2001) and *In re Hickox*, 215 B.R. 257 (Bankr. M.D. Fla. 1997). In each of those cases, the debtor's employment was terminated, and the debtors received the proceeds of their pension accounts as mandatory distributions under the terms of the accounts as a result of such termination." *Id.* at *4.

375 "Mr. Jones deposited the proceeds of the fund into his general checking account. The checking account was not opened or specially designated to receive the proceeds of the pension fund. Instead, the checking account was an existing bank account that was overdrawn at the time that Mr. Jones deposited the pension proceeds. After the deposit, Mr. Jones continuously drew down and replenished the account to accommodate his transfers, and the pension funds were never placed in any other investment vehicle." *Id.* at *4.

376 "Section 222.21(2) provides an exemption for 'money or other assets *payable to* an owner, a participant, or a beneficiary' from an account that is maintained in accordance with certain requirements of the Internal Revenue Code Fla. Stat. § 222.21(2) . . . therefore, it appears that the exemption under § 222.21(2) is provided only to those funds that are payable or owing to the beneficiary of such a plan, but not to funds that have already been distributed to or received by the beneficiary." *Id.* at *5.

377 "On their bankruptcy schedules. The Debtors claimed the petition-date balance in Mr. Jones' checking account as exempt only pursuant to the *personal property* exemptions provided by Fla. Stat. § 222.25(4) and the Florida constitution…Despite filing an amended SOFA, however, the Debtors never claimed an exemption for any of Mr. Jones' pension funds pursuant to § 222.21(2) of the Florida Statutes." *Id.* at *5. Note that in *In re Jorge Rivera-Cintron* mentioned below, the debtor did not list the IRA account on the exemption schedules, but notified the Trustee in the first hearing and was permitted to have them exempted.

378 Prior to the decisions in *Jones* and *McMillan*, a District of Columbia Bankruptcy case, *In re Kemp*, was illustrative. *In re Kemp*, 2011 WL 4434996 (Bankr. D.C. Sept. 22, 2011). In *Kemp,* the debtor sought to exempt funds held in a checking account because the funds were proceeds of a pension. The court rejected

Presumably, the *Ladd* decision will apply, even if the *Jones* decision is accurate, where individuals who have reached age 72 (age 73 after 2023)[379] are required to make minimum distributions to avoid the 50% federal excise tax that would otherwise apply. Such minimum distributions should be creditor exempt, along with anything that they are used to purchase.

The 2015 Middle District Bankruptcy Court case of *In re McMillan*[380] addressed this issue. Mr. McMillan used withdrawals from his IRA to purchase an auto repair shop and claimed that the auto repair shop was an exempt asset under Florida Statutes Section 222.21. Mr. McMillan, however, failed to disclose his interest in the auto repair shop on his bankruptcy schedules, so the Court found that the shop would not be an exempt asset, regardless of whether it would have otherwise been exempt. The decision includes the following observation:

> The instant case is clearly distinguishable from *Ladd* for the obvious reason that while Mr. McMillan used funds from his exempt IRA to invest in the LLC, Mr. McMillan, unlike the debtor in *Ladd*, did not claim his interest in the business as exempt on his bankruptcy schedules. The proceeds from the sale of Mr. McMillan's interest in the LLC are not exempt.[381]

MONIES RECEIVED FROM PENSION AND IRA ACCOUNTS AND PLACED INTO PERSONAL ACCOUNTS FOR 60 DAYS BEFORE A SUBSEQUENT ROLLOVER TO AN IRA WILL BE PROTECTED.

Another related question is whether monies withdrawn from an IRA or qualified plan will remain protected if they are reinvested in a rollover IRA within the time parameters permitted under the income tax rules.

In two Florida decisions, debtors received monies from protected retirement accounts and placed these into individual non-IRA accounts for a period of time before eventually transferring the funds to IRAs within sixty days of initial receipt.

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this argument and noted that *In re Ladd* interpreted a Florida Statute differing from the relevant District of Columbia statute, which only provides for "a right to receive" such benefits, where Florida's statute specifically protects payments.

379 "Beginning in 2023, the SECURE 2.0 Act raised the age that an IRA owner begin taking Required Minimum Distributions to age 73. If you reach age 72, in 2023, the required beginning date for your first RMD is April 1, 2025, for 2024. *Retirement Plan and IRA Required Minimum Distributions*, IRS (April 9, 2023) https://www.irs.gov/retirement-plan-and-ira-required-minium-distributions-faqs (Last Reviewed or Updated Mar. 14, 2023).

380 3:11-BK-5348-JAF, 2015 WL 2147044 (Bankr. M.D. Fla. May 4, 2015).

381 *Id.* at *2; Further, although Florida Statute 222.21 provides that "any money or other assets payable to an owner . . . in a fund or account is exempt from all claims of creditors," this language does not explicitly state that distributions will remain exempt. In a 2005 Florida State University Business Review Article, attorneys Richard Jacobs and Tye Klooster concluded "that distributions from retirement vehicles enumerated in [Florida Statute] Section 222.21 are also provided creditor protection by the statute*." See* Richard O. Jacobs & Tye J. Klooster, *Asset Protection Tools for Florida Business Professionals: Strategies to Pursue and Strategies to Avoid*, 4 Fla. St. U. Bus. Rev. 1, 67 (2005).

In the 1997 case of *In re Hickox*,[382] the debtor received a 401(k) distribution that was deposited into her checking account and transferred the funds to her mother, who then gave some of the money back to Ms. Hickox, who used it to fund an IRA within the time limits provided under the Internal Revenue Code. The Court found that the IRA was protected, even though the bankruptcy was filed shortly thereafter.

The same result occurred in the 2016 Middle District Bankruptcy Court Case of *In re Jorge Rivera-Cintron*.[383] The debtor did not list the IRA account on the exemption schedules, the Court noted that failure to disclose assets on schedules does not cause loss of exemption where the debtor made the Trustee in bankruptcy aware of the IRA at the first hearing with respect to the bankruptcy.

The Court noted that the 2014 U.S. Supreme Court decision of *Law v. Siegel* "struck down any notion of a Bankruptcy Court's 'general equitable power . . . to deny exemptions based on a debtor's bad faith conduct,'" and concluded that "federal law provides no authority for Bankruptcy Courts to deny an exemption on a ground not specified in the Code."

DANGER LURKS FOR SELF-DIRECTED IRAS THAT ARE NOT HANDLED "EXACTLY RIGHT."

As indicated in Section A of this Chapter, IRA mismanagement can result in loss of both the tax deferred status and creditor protection. A case on point is *Willis v. Menotte,* where the Eleventh Circuit Court of Appeals decided that the signing of an indemnity agreement with Merrill Lynch that exposed an IRA to creditors of the IRA owner almost caused the IRA to be accessible to creditors.[384]

The 2019 case of *In re Yerian* is discussed in depth below.

Also, the Fourth Circuit Court of Appeals 2013 opinion in *Daley v. Mostoller* determined that an agreement that would have allowed Merrill Lynch to seize IRA assets if there was a loan to the IRA owner in default did not disqualify the IRA when there was no loan taken.

The court described the law in this area as follows:

> *Willis v. Menotte* does not help the trustee either.[385] Willis did much more than sign a lien provision; he "transferred $700,000.00 from his Merrill Lynch account to a non-IRA account held with his wife, and then transferred the money to a third party in order to fund a real property mortgage."[386] Even though Willis had a favorable-determination letter from the IRS, the court said, Willis's transfer of funds from his IRA went beyond the approved form

[382] 215 B.R. 257 (Bankr. M.D. Fla. 1997).

[383] *In re Jorge Rivera-Cintron*, 2015 WL 4749217, at *1 (Bankr. M.D. Fla. Aug. 12, 2015).

[384] *Willis v. Menotte*, 06 Apr 2010 United States District Court, S.D. Florida, Miami Division. *Willis v. Menotte*, docket no. 09-82303-CIV (S.D. Fla., aff'd, 11th Cir. (4/21/2011)).

[385] No. 09-82303, 2010 WL 1408343 (S.D. Fla. April 6, 2010).

[386] Id. at *1.

of the account.[387] In marked contrast, other than signing the papers to open the retirement account, Daley authorized no remotely comparable transactions. The Bankruptcy Code explains how to treat a Chapter 7 debtor's assets-what goes to creditors and what remains exempt. The bankruptcy trustee obtains control of the debtor's non-exempt property and distributes it to creditors.[388] A debtor may exempt "retirement funds" if they are in an "account that is exempt from taxation under section" 408 of the tax code.[389] Section 408 designates certain trusts as "individual retirement account[s],"[390] and says that "[a]ny individual retirement account is exempt from taxation."[391] An IRA loses its tax-exempt status if the owner "engages in any transaction prohibited by section 4975" of the Tax Code.[392] There are six such transactions, including the one bedeviling Daley: "any direct or indirect" "lending of money or other extension of credit" between the IRA and its owner.[393] The question is whether Daley used his IRA to obtain credit from Merrill Lynch, resulting in an indirect extension of credit between Daley and the IRA. We think not for several reasons.

To start, there is a statutory presumption that his account is exempt. If a retirement fund "has received a favorable determination" from the IRS, "those funds shall be presumed to be exempt from the estate."[394]

In the second place, the exemption does not apply in this setting. Yes, the phrase "any direct or indirect . . . lending of money or other extension of credit" is broad.[395] "Any" and "direct or indirect" are roomy terms; so too are "extension[s]" of "credit," as other provisions in the United States Code confirm.[396] ("The term 'credit' means the right granted by a creditor to a debtor to defer payment of debt or to incur debt and defer its payment.")[397]; ("[T]he term 'loans and extensions of credit' shall include . . . all direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person . . . .").[398] But this breadth of phrasing still

[387] Id. at *5.
[388] 11 U.S.C. § 541(a) (2017).
[389] Id. § 522(b)(3)(C) (2017).
[390] 26 U.S.C. § 408(a) (2017).
[391] Id. § 408(e) (2017).
[392] Id. § 408(e)(2)(A).
[393] Id. § 4975(c)(1)(B).
[394] 11 U.S.C.§ 522(b)(4)(A).
[395] 26 U.S.C. § 4975(c).
[396] See18 U.S.C. § 891(1) ("To extend credit means to make or renew any loan, or to enter into any agreement . . . whereby the repayment or satisfaction of any debt or claim . . . mayor will be deferred.")
[397] 15 U.S.C. § 1602(f).
[398] 12 U.S.C. § 84(b)(1).

> demands the “lending of money or other extension of credit between a plan [the IRA] and a disqualified person [Daley],”[399] and nothing of the sort happened here.

On June 26, 2019, the case *In re Yerian* was decided by the U.S. Court of Appeals, Eleventh Circuit, and provides an excellent explanation and interpretation of Florida Statute § 222.21 (2), which reads as follows:

> **§ 222.21 (2)**
>
> **(a)** Except as provided in paragraph (d), any money or other assets payable to an owner, a participant, or a beneficiary from, or any interest of any owner, participant, or beneficiary in, a fund or account is exempt from all claims of creditors of the owner, beneficiary, or participant if the fund or account is:
>
> **[. . .]**
>
> **(2).** Maintained in accordance with a plan or governing instrument that has been determined by the Internal Revenue Service to be exempt from taxation under s. 401(a), s. 403(a), s. 403(b), s. 408, s. 408A, s. 409, s. 414, s. 457(b), or s. 501(a) of the Internal Revenue Code of 1986, as amended, unless it has been subsequently determined that the plan or governing instrument is not exempt from taxation in a proceeding that has become final and nonappealable[4006]

The court found that the debtor “forfeited his exemption when he engaged in self-dealing transactions prohibited by the IRA’s governing instruments.”[401]

In the beginning of his opinion, Judge Grant put it mildly by stating that Mr. Yerian “made some interesting choices with respect to the management of his individual retirement account.”[4022] These choices, the court noted, included “titling IRA-owned cars in his own name and his wife’s name, as well as purchasing a condo in Puerto Rico with IRA funds and then using the condo for his personal travel needs.”[4033]

Yerian did not dispute that these were prohibited transactions and conceded that his IRA had lost its tax exempt status. However, Yerian maintained that “his IRA [was] still creditor exempt under Section 222.21(2)(a)(2). In his view, the Florida exemption statute shields even an IRA operated in violation of the federal tax code, so long as the form of the IRA’s governing instrument satisfies the requirements of Section 408(a) on paper.”[4044]

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[399] 26 U.S.C. § 4975(c)(1)(B).

[4006] Fla. Stat. Ann. § 222.21(2)(a)(2).

[4011] *Yerian v. Webber (In re Yerian)*, 27 Fla. L. Weekly Fed. C 2093 (U.S. 11th Cir. 2019).

[4022] *Id.* at 1.

[4033] *Id.*

[4044] *Id.* at 9.

Mr. Yerian attempted to evoke the statutory exemption set forth in Florida Statutes Section 222.21(2)(a)(2). There are three prongs to the protection of an IRA under this section of the statute.

The first prong is that the IRA's plan or governing instrument was initially determined by the IRS to be exempt from tax. Even though that may not have happened in this case, the creditor did not challenge whether that happened, so this was not fully addressed by the court in its decision.

The second prong is what the court found Mr. Yerian failed: whether the IRA had been maintained in accordance with the plan or governing instrument. There is no mention in this prong that there has to be compliance with tax law, only with the plan or governing instrument. However, the plan or governing instrument will have to be compliant with tax law in order for the IRA to be compliant.

The judge noted that when this man "titled an IRA-owned car into his own name and his wife's name and bought a condo in Puerto Rico with IRA funds and used the condo for personal travel needs,"[4055] he did not follow the governing instrument and did not satisfy the second prong.

The judge noted that given the statutory language of Florida Statute Section 222.21(2)(a)(2) whereby conformance to the IRA's governing instruments is necessary to satisfy prong number two, there are two important things to consider:

e. An IRA that conforms to its governing instruments, but not necessarily to a shift in the tax code, may experience somewhat of a safe harbor in Florida in terms of creditor protection because the statute emphasizes conformity to the governing instrument directly.

f. An IRA's governing instrument may have requirements that go *beyond* the tax law. In this way, an IRA could theoretically satisfy the tax law, but not live up to the restrictions set forth in the governing instrument. Thus, an IRA could lose creditor protection in Florida by virtue of violating the governing instrument, even in the absence of a tax code violation.

The third prong was that no final and non-appealable proceeding has been subsequently determined that the plan or governing instrument is no longer exempt. It did not matter that this prong was not satisfied because the second prong was not satisfied.

It therefore appears that Floridians who choose to have self-directed IRA accounts are putting themselves at risk for the loss of both tax advantages and of creditor protection if they do not strictly follow the governing instrument of the IRA. As highlighted in this case, examples of self-dealing and prohibited transactions are scrutinized if they do not conform to the governing instrument (which they likely will not). At the very least, it is likely that titling cars in your own name, if you are deemed a "disqualified person" by the governing instrument of the IRA, will trigger the loss of exemption status for your IRA in bankruptcy.

Below is an excerpt of Florida Statutes Section 222.21 containing the provisions relevant to the opinion summarized by the court in *In re Yerian*.

[4055] *Id.* at 1.

The above statutory language and the judicial interpretation of the three prong test outlined in *In re Yerian* is summarized in the chart below:

<table>
<tr><th colspan="2">Summary of the Statutory Prongs and the Judicial Analysis of Each in In re Yerian</th></tr>
<tr><th>Fla. Stat. Ann. § 222.21(2)(a)(2)</th><th>Judicial Interpretation in In re Yerian</th></tr>
<tr><td>(1) The IRA’'s plan or governing instrument was initially “determined by the [IRS] to be exempt from taxation” under § 408.</td><td>“It is the Trustee who must demonstrate that an exemption is inapplicable, and the Trustee has not challenged the exemption on that ground.”

“Because the parties here agree that Yerian properly invoked section 222.21(2)(a)(2), we examine the matter no further.”</td></tr>
<tr><td>(2) Over time, the IRA has been “maintained in accordance with” that plan or governing instrument.t</td><td>“Florida statute says that to be exempt, an IRA must be “maintained in accordance with a plan or governing instrument that has been determined by the [IRS] to be exempt from taxation under . . . s. 408.” Fla. Stat. § 222.21(2)(a)(2) (emphasis added).”

“The Florida exemption thus turns on whether the IRA has been maintained in accordance with its own governing instrument, not on whether the IRA has been maintained in compliance with § 408 in the first instance.”

“This will often be a distinction without a difference where (as we will see is the case here) the IRA owner engages in behavior that turns out to be prohibited by both the governing instrument and the tax code.”

<u>However, this could theoretically have two important impacts</u>:

1. If/when federal laws governing retirement accounts change, the tax code may require changes to IRAs for them to conform to the tax code. If that doesn’t occur, the fund may not comply with the tax code, but may still allow the pensioner to have his IRA protected from creditors through the Florida exemption statute as long as the IRA complies with its governing instrument. The court noted that “The Florida exemption thus contains somewhat of a safe harbor, allowing IRAs to maintain creditor-exempt status for a period of time after the law changes.”

2. “Conversely, because an IRA’s plan or governing instrument may contain requirements that go beyond the law, an IRA could be operated in a way that satisfies the tax code, yet violates additional restrictions set out in its own governing instruments.” So an IRA could impose requirements that go beyond the tax code, and those requirements would have to be satisfied to maintain the exemption.</td></tr>
</table>

(3) No final and nonappealable proceeding has "subsequently determined" that the plan or governing instrument is no longer exempt from taxation under § 408.	"The third requirement—that no final and nonappealable proceeding has declared that Yerian's IRA is no longer tax-exempt—is satisfied as well. It is settled law that a "claim of exemption is to be determined as of the petition date." *In re Fodor*, 339 B.R. 519, 521 (Bankr. M.D. Fla. 2006). And it is clear from the record before us that, prior to Yerian's bankruptcy petition date, no final and nonappealable proceeding—before the IRS or any court—had determined that his IRA's governing instrument was no longer exempt under the tax code."

Rollover as Business Startup Plan

The following article discusses the "Rollover as Business Start Up Plan" ("ROBS") arrangements whereby taxpayers may be able to use their IRAs to own business companies and other investments. These arrangements should be approached very carefully if the IRA participant will be working in the business, because of the need to be paid no more or no less than the fair market value for services actually rendered.

CAN I USE MY IRA TO START A BUSINESS? MAYBE, BUT WITH GREAT POWER, COMES GREAT RESPONSIBILITY

By: Brandon Ketron & Alan Gassman, Reprinted with permission from Leimberg Information Services 07-Feb-17 Steve Leimberg's Asset Protection Planning Email Newsletter – Archive Message #668

EXECUTIVE SUMMARY:

One potential way for an entrepreneur to fund a new business is with his or her retirement plan assets. This is known as a Rollover as Business Start Up Plan (ROBS).

A typical ROBS plan involves forming a new C corporation and adopting a simple 401(k) plan. The entrepreneur can then roll over his or her IRA account into the new 401(k) plan. The 401(k) plan then purchases stock in the new corporation. This results in the funding of a new corporation with the entrepreneur's former IRA account. [i] While ROBS Plans do not violate the prohibited transaction rules per se, the IRS heavily scrutinizes these plans to ensure their compliance with these complex rules. If a Plan Participant engages in a prohibited transaction, the plan will be disqualified and result in a deemed taxable distribution of the entire account balance, which will also be subject to the 10% excise tax if the Plan Participant is under the age of 59 ½.

It is important to note that while a ROBS plan may satisfy the retirement plan rules initially, any failure to comply with the rules during the life of the plan will also result in a deemed distribution of the entire retirement plan.

COMMENT:

The authors do not advocate or recommend that clients use their retirement plan or IRA assets to establish a ROBS, but it should be known that this is a possible way for entrepreneur clients to find capital to start a business. No-one should even think about starting a ROBS without specific written guidance from a qualified tax and ERISA lawyer. The C corporation owned by the 401(k) plan will be taxed as a corporation and will be burdened by the compliance described herein, and possible future restrictive legislation.

The following are some potential traps for the unwary involved with the establishment and maintenance of a ROBS Plan.

1. Personal Guarantees of Corporate Loans

In *James E. Theissen et ux. v. Comm'r* and *Peek v. Comm'r,* the Tax Court held that a personal guarantee of a corporate loan when the Plan Owner's IRA owned stock in the corporation was a prohibited transaction.[i] As a result, the taxpayers' IRAs ceased to be IRAs as of the first day of the taxable year in which the guarantee occurred, and were deemed to have received distributions on that first day of the entire fair market value of their IRA assets.[ii] These cases involved IRAs and not 401(k)s or ESOPs. It is unclear whether the same reasoning would apply to a ROBS Plan, but account owners and parties related thereto should strictly avoid personal guarantees of loans to be safe. Unrelated parties may be paid reasonable guarantee fees, but only from the business entity. Traditional lenders will be reluctant to lend to ROBS for concern of the tax impact of disqualification.

2. Payment of reasonable compensation to Entrepreneur

Unlike a self-directed IRA, a 401(k) or ESOP may pay compensation to the owner of the Plan and related parties, provided that the compensation is reasonable.

In *Ellis, et ux. v. Comm'r*, the IRA owner purchased a used-car dealership inside of his IRA, and ran the day-to-day operations of the business. The dealership paid the IRA owner reasonable compensation for his role as the manager of the business. The Tax Court held that the payment of compensation to the IRA owner was a prohibited transaction and resulted in the indirect use of plan assets for the benefit of the individual. Accordingly, the IRA was deemed distributed to the owner and the owner was immediately liable for taxes on the entire value plus the 10% excise tax and other applicable penalties and interest. [iii]

Natalie Choate points out that this is particularly problematic for IRA-owned businesses. She states that "if your IRA-owned business cannot pay you compensation, you really cannot run a small business inside your IRA". If you work with no compensation, there is a risk of an "assignment of income problem."[iv]

Had Mr. Ellis rolled over his IRA into a 401(k) using a ROBS Plan, Mr. Ellis may have been able to avoid the prohibited transaction rules. The ERISA rules do not prevent an employee from taking a reasonable salary from a 401(k) owned business; however, the IRS may argue that the immediate payment of compensation to the Entrepreneur results in the indirect use of plan assets for the benefit of the individual. Entrepreneurs may consider only taking a salary from the profits of the company in order to avoid this characterization.

Additionally, any compensation paid to the Entrepreneur should be W-2 compensation, and not classified as 1099 independent contractor compensation. [v] In order for the

Entrepreneur to participate in the 401(k) plan, he or she must be a legitimate employee of the Corporation. If the Entrepreneur fails to qualify as a qualified employee the Plan may be disqualified.

3. Providing Direct or Indirect Services to an IRA

Leimberg and Jones caution that providing any kind of service to an IRA-owned business may constitute furnishing of services to the IRA by a disqualified person. [vi] This rule does not apply to a 401(k) or ESOP, and it is therefore vitally important to roll the funds over into an employer sponsored plan prior to providing any services to the company.

4. Lack of Notification of Plan Existence

If current or future employees are not notified of the existence of an ESOP or 401(k) plan, then it would cause a violation of the rule that a retirement plan must "be a definite, written program communicated to employees."[vii]

If employees are not notified the Plan will be disqualified resulting in a taxable distribution of the entire Plan.

The IRS has cautioned against Entrepreneurs using independent contractors to avoid offering stock ownership to employees. [viii] If an independent contractor is reclassified as an employee this could disqualify the entire Plan in addition to the other problems caused by this reclassification.

5. Plan Assets Used for Personal Expenses

A plan was disqualified when a corporation bought an RV for the business owner using some of the money it received in exchange for the stock of the corporation in a ROBS plan. [ix] The use of corporate money or assets for personal expenses or purposes also presents other problems, so appropriate corporate formalities must be followed.

6. Stock Sale Must Be a Transaction for Adequate Consideration

ERISA exempts a plan's acquisition of employer stock from the prohibited transaction rules only if the purchase was for adequate consideration. [x] Therefore, a valuation of the business may need to be completed to have proof that the stock sale as part of the ROBS plan was for adequate consideration. [xi]

7. Improper Use of Funds to Pay Promoter Fees

The IRS has stated that when a corporation uses part of the cash it raises from the stock sale to pay the fee of a promoter it may result in the indirect use of plan assets in a prohibited transaction. [xii]

8. Discrimination in Favor of Highly Compensated Employees

Natalie Choate states that this is the IRS's best argument to disarm a ROBS, but that it is only useful against ROBS plans that have employees other than the plan owner and that do not in fact offer employer stock to rank and file employees. [xiii]

9. Failure to Issue a Form 1099-R when the Assets Are Rolled Over into the ROBS Plan.

A reputable CPA should be retained to assure that all proper tax returns and forms are filed, including the Form 1099-R.

10. Failure to file 5500's

A reputable actuary or qualified pension plan lawyer should be retained to assure that appropriate plan rules and formalities are followed, including the filing of a timely and accurately prepared Form 5500.

CONCLUSION:

In conclusion, the IRS heavily scrutinizes these types of arrangements, and has issued literature as to the technical reasons why they might be seen as problematic. The IRS has not issued any specific adverse rulings related to ROBS plans, but will target ROBS plans for other violations of retirement account rules. Entrepreneurs should consult with the appropriate advisors in order to comply with the complex rules involved with a ROBS Plan. If a ROBS plan is undertaken it will be important to make sure that all your I's are dotted and your T's are crossed due to the fact that one mistake will result in a termination and taxable distribution of the entire retirement account.

CITATIONS:

[i] *James E. Theissen et ux. v. Comm'r,* 146 T.C. 7 (2016); *Peek v. Comm'r,* 140 T.C. 216 (2013).
[ii] For further discussion see Leimberg and Jones, Employee Benefits and Retirement Planning Newsletter #654, (April 4, 2016).
[iii] *Id.*
[iv] *See* Choate, *What Goes in Your IRA? None of Your Small Business!* (September 11, 2015).
[v] Curry & Esposito, *You Invested 401(k) Money Into Your Company: Common Myths and Important Compliance Reminders* (Presented January 24th, 2017, a copy of the slides can be obtained by emailing Jewell.Esposito@jacksonlewis.com).
[vi] Leimberg and Jones, Employee Benefits and Retirement Planning Newsletter #654, (April 4, 2016).
[vii] *See* Choate, Employee Benefits and Retirement Planning Newsletter # 471.
[viii] Michael D. Julianelle, *Guidelines Regarding Rollovers as Business Start-ups*.
[ix] *Id.*
[x] IRC § 4975(d)(13).
[xi] Michael D. Julianelle, *Guidelines Regarding Rollovers as Business Start-ups*.
[xii] *Id.*
[xiii] *Id.*
[xi] Michael D. Julianelle, *Guidelines Regarding Rollovers as Business Start-ups*, (October 1, 2008).
[xii] *Id.*
[xiii] *Id.*

MORE UNPLEASANT SURPRISES AND A RECENT EXAMPLE - A BLANKET UCC-1 FILING CAN OBLITERATE PROTECTION OF IRAS

Bankruptcy is a mode of litigation, and therefore somewhat unpredictable. Unpleasant surprises can certainly occur.

An example on point is the 2019 11th Circuit Case of *Kearney Construction Company, LLC, v. Travelers Casualty and Surety Company of America*. Before filing bankruptcy, Mr. Kearney had executed one or more promissory notes and a security agreement to enable an LLC owned by his son to place a lien against all of his tangible and intangible assets that could be secured by the lien under Florida law. The court did not cite the fact that the LLC was owned by Mr. Kearney's son as determinative so its holding likely would have been the same if the lender were a completely unrelated third party.

The court found that this lien attached to Mr. Kearney's IRA accounts at the time that it was executed and that this constituted a Prohibited Transaction under Internal Revenue Code Sections 408 and 4975, which penalizes taxpayers who make personal use of their IRA accounts by pledging them as security for a personal loan. Florida Statute Section 222.21(2) generally requires that an IRA must be properly qualified under Code Section 408, to be exempt from creditors. Code Section 408 states that "[a]ny individual retirement account is exempt from taxation," but this status can be lost if the owner "engages in any transaction prohibited by section 4975."[406]

Mr. Kearney argued that there was no intent to pledge the IRAs as collateral, but the "boilerplate language" of the Security Agreement and the Form UCC-1 Financing Statement that was filed nevertheless attached, according to the Eleventh Circuit Court of Appeals, and this caused loss of the creditor-proof nature of the IRA, even though the creditor that had the lien did not attempt to garnish the IRA, and was apparently paid in full.

The court in Kearney held that the plain language of the UCC-1 agreement signed was sufficient to implement a lien on six of Mr. Kearney's accounts including his IRA. The plain language of the UCC-1 agreement was as follows:

> Grant of Security Interest. As security for any and all Indebtedness (as defined below), the Pledgor hereby irrevocably and unconditionally grants a security interest in the collateral described in the following properties[:] all assets and rights of the Pledgor, wherever located, whether now owned or hereafter acquired or arising, and all proceeds and products thereof, all goods (including inventory, equipment and any accessories thereto), instruments (including promissory notes)[,] documents, accounts, chattel paper, deposit accounts, letters of credit, rights, securities and all other investment property, supporting obligation[s], any contract or contract rights or rights to the payment of money, insurance claims, and proceeds, and general intangibles (the "Collateral")

[406] 26 U.S.C. § 408(e)

The court stated that “the above language constitutes an unambiguous pledge of ‘all assets and rights of the Pledgor,’ including his IRA Account.”[407]

Some commentators have read the Eleventh Circuit opinion as holding that the words “all assets and rights of the Pledgor” are sufficient to grant a valid security interest in an IRA. Such a holding would be clearly erroneous in view of Florida Statute § 679.1081(3), which requires a degree of specificity. Alternatively, the opinion may be read to hold that the words “all assets and rights of the Pledgor” were sufficient to show, in this particular case, that there was no ambiguity as to the debtor’s intent to pledge his IRA, because he had argued that there was no intent to pledge the IRA.

It seems to us that the Eleventh Circuit recognized that further language was needed to create a valid security interest. In point of fact, such additional language was included in the security agreement at issue in *Kearney* and was quoted in its entirety early in the Eleventh Circuit’s written opinion.

Kearney had a unique set of facts. Mr. Kearney initially argued that his son’s LLC had a valid interest in the IRA which protected it against other creditors. Later, Mr. Kearney provided a “self-serving, conclusory” affidavit to try to prove that there was no intent to pledge the IRA. The Eleventh Circuit agreed with the district court’s rejection of the affidavit and any assertion that Mr. Kearney did not intend to pledge the IRA.[408] The Court further noted in a footnote that that Mr. Kearney “exercised considerable control over [his son’s LLC].”[409]

Without providing analysis of why the blanket “all assets and rights” description was sufficient to lien the IRA – merely a conclusion that it was – the court erred by not addressing several relevant factors, including inexplicably not addressing the sufficiency of description requirements under Florida Statute § 679.1081(3) that provide that a blanket description in a security agreement, such as “all the debtor’s assets and personal property,” is an insufficient identification of the collateral.[410]

By ignoring these requirements, the court left Floridians who have signed blanket financing statements (including nearly every Floridian who has obtained a mortgage, credit card, or other loan)[411] unsure of whether their IRAs are creditor protected and further left future debtors

[407] *Kearney Construction Company v. Travelers Casualty and Surety Company of America*, 795 Fed.Appx. 671, 674 (2019)

[408] *Id.*

[409] *Id.* at 673, fn.3.

[410] This may partially be due to the decision being on a summary judgment motion, in which the court can look only to the record when determining whether there is “no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law.” However, the summary judgment standard should not have prevented the court from examining Florida’s description of sufficiency requirements.

[411] Richard R. Gans, *1 Asset Protection in Florida § 3.3* (2022).

wondering how they can structure their blanket financing statements to exclude their IRAs.

That uncertainty is compounded because, having determined that the "all assets and rights" language was sufficient, the court did not analyze whether the IRA was included in the financing statement's more specific list that described the collateral beyond the blanket "all assets and rights" as indicated above.

The question remains whether Kearney's IRA would be included in one of the commonly used categories (such as "accounts," "deposit accounts," "securities and all other investment property," "any contract or contract rights or rights to the payment of money," or "general intangibles") listed in the financing statement's description of collateral. The holding of the opinion (but not its reasoning) is supportable by at least some case law (as examined in the "Statutory and Case Law Analysis" section below) that has held that an IRA is a "deposit account" or "investment property" that is liened under the UCC. The Fifth Circuit Court of Appeals and at least one bankruptcy court case have said that an IRA is not a deposit account, while the Court of Appeals of Indiana has said that an IRA is a deposit account.[412] A bankruptcy court also found that an IRA was "investment property" for purposes of the Virginia UCC.[413] Regardless of which collateral type an IRA may be classified as, all published opinions we have found have determined that it is possible to lien IRAs.

Similarly, and more recently, in *U.S. v. Shkreli*[414], the Second Circuit found that anti-alienation provisions do not prohibit garnishment of funds in a 401(k) account to satisfy a restitution order under the Mandatory Victims Restitution Act (MVRA).[415] In this case, defendant Greebel and his outside attorney Shkreli were convicted of Conspiracy to Commit Wire Fraud and Conspiracy to Commit Securities Fraud. As a result of this conviction, Greebel was ordered to pay $10,447,979 in restitution. The U.S. Government sought recovery of about $900,000 of the restitution under the MVRA allowing them to garnish two of Greebel's retirement accounts.

The Second Circuit upheld the U.S. District Court for the Eastern District of New York's decision for the government to be able to recover restitution therefrom; the Second Circuit then remanded for determination as to whether the early withdrawal tax will be imposed upon such garnishment and therefore limiting the actual amount the government can access of the funds.[416]

Greebel argued that ERISA anti-alienation provisions protect against benefits being assigned or alienated.[417] The Court went on to cite *U.S. v. Irving*, which confirmed that MVRA restitution orders are enforced in the same manner as tax levies, which can be enforced against ERISA-protected assets.[418] Further, language in ERISA instructs that judgements may not be imposed "[n]otwithstanding other Federal law[.]"[419] Since the MVRA carved out specific federally authorized

[412] *In re Nix*, 864 F.2d 1209, 1212 (5th Cir. 1989); *In re Raymond*, 210 B.R. 710 (1997); *Aaron v. Scott*, 851 N.E.2d 309 (2007).
[413] *In re Richards*, 336 B.R. 722 (2004).
[414] *U.S. v. Shkreli*, No. 21-993, (2d Cir. Aug. 24, 2022).
[415] 18 U.S.C. § 3663A (1995).
[416] *Shkreli*, No. 21-993.
[417] *U.S. v. Novak*, 476 F.3d 1041 (9th Cir. 2007).
[418] *U.S. v. Irving*, 425 F.3d 110 (2d Cir. 2006).
[419] 18 U.S.C. § 3613(a) (2018).

pensions from being subject to garnishment, and ERISA-protected benefits were not named, the Second Circuit ultimately found that the MVRA was enforceable over ERISA's anti-alienation provisions.[420]

The Kearney case can be distinguished from the 2013 bankruptcy decision in *In re Daley*, where Mr. Daley executed loan documentation with Merrill Lynch that reported to place a lien upon all of his individual accounts, including one or more IRAs that he had with Merrill Lynch. Mr. Daley signed a "blanket" Client Relationship Agreement (not a UCC-1) with Merrill Lynch was as follows:

> All of your securities and other property in any account–margin or cash–in which you have an interest, or which at any time are in your possession or under your control, shall be subject to a lien for the discharge of any and all indebtedness or any other obligations you may have to Merrill Lynch.[421]

Fortunately for Mr. Daley, he never actually borrowed any money from Merrill Lynch, so the court in Daly concluded that there was never a Prohibited Transaction because he did not directly or indirectly borrow against the IRA.[422]

The court's opinion stated that "[t]he mere existence of a "cross-collateralization agreement," as the IRS calls it, does not by itself disqualify an IRA from exempt status."[423] The appellant in *In re Daley* did not engage in any disqualified transactions under section 4975 with his IRA account, and therefore the IRA was exempt from creditors because of Florida Statute 222.21. The "blanket" agreement was not enforceable.

The court also discussed that the IRS had issued IRS Announcement 2011-81 in 2011 which indicated that pledging an IRA as collateral under loan documents will not constitute a Prohibited Transaction unless or until a loan is actually taken.

This is an example of one of the many cases where new law gets made at the expense of a surprised and unfortunate debtor, along with the debtor's legal counsel.

Courts have traditionally liberally construed exemptions in favor of debtors. The Supreme Court of Florida noted in the 2007 case of *Chames v. DeMayo*, that a "blanket" statement is unenforceable unless the statement is "knowing, intelligent, and voluntary."[424]

The Supreme Court of Florida compared the informality of these "blanket" statements to those that a client is required to sign from their attorney, in which they initial each paragraph to note their understanding of the agreement.

Nevertheless, the *Kearney* decision has caught many by surprise, as the prevailing thought is that the creditor protection afforded by Florida Statute Section 222.21 was not considered to be

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[420] *Shkreli*, No. 21-993.
[421] *In re Daley*, 717 F.3d 506, 509 (6th Cir. 2013).
[422] *In re Daley*, 717 F.3d 506, 509 (6th Cir. 2013).
[423] *Id.*
[424] *Chames v. DeMayo*, 972 So.2d 850, 861 (Fla. 2007)

waived as a result of boilerplate language and a Pledge Agreement, which is often found in substantially all consumer loan and mortgage documents. The decision therefore has wide reaching effects in that it could cause many unsuspecting individuals to be considered to have received a deemed distribution of the assets in his or her pension plans, IRAs or qualified retirement plans, which could subject the individual to taxes, interest and penalties, and also could subject such assets to creditor claims of Florida residents.

As of publication of this Book, the Tax Section of the Florida Bar has failed to pass legislation in the 2021 and 2022 legislative sessions that would have provided an exception which would not cause loss of creditor exemption provisions for pension plans, IRAs and other retirement plans. Specifically, the *Kearney* "patch" bill would have provided that exempt assets under § 222 must be specifically pledged in order for a valid security interest in the exempt asset to be created. Unfortunately, Governor Ron Desantis vetoed Senate Bill 406, the legislature's attempt at a Kearney patch bill in the 2022 Florida Legislative Session. Surely this issue will be one to monitor and in the meantime it is important to note that the current state of Florida law is unsettled regarding the treatment of pledge agreements with respect to IRAs.

While the *Kearney* opinion is unpublished and is technically non-binding, creditors will almost certainly cite Kearney; it will be up to opposing counsel and judges in subsequent cases to recognize that *Kearney* is not binding on any court. For now, debtors are encouraged to pledge assets with great specificity; security agreements should be closely reviewed and should carve out any tax-advantaged assets from being pledged under the agreement.

THE ROBS TECHNIQUE

Many financial planners evaluate the pros and cons of a non-deductible IRA and often advise clients that from a financial perspective. In some cases, it is not determined to be a worthwhile step. However, in many states a non-deductible IRA contribution can create an asset protected "pot" even if it is small. While small additions to IRAs will not safeguard significant wealth, they can constitute useful sources of creditor proof capital, and clients who have judgments against them, and protected IRAs may have a protected IRA start and own a business that the client can work in using the ROBS technique.[425]

ROBS stands for Roll Over Business Start Up, and refers to an arrangement whereby an IRA owner converts his or her IRA into a 401(k) plan, which can attach to and start a business that the IRA/401(k) owner can operate, but these are not without technical or practical challenges. In fact, the IRS website at: https://www.irs.gov/retirement-plans/rollovers-as-business-start-ups-compliance-project has the following discussion of ROBS, which is well written:

> What is a ROBS? ROBS is an arrangement in which prospective business owners use their retirement funds to pay for new

[425] Leimberg LISI Newsletter #668, 07-Feb-17

business start-up costs. ROBS plans, while not considered an abusive tax avoidance transaction, are questionable because they may solely benefit one individual – the individual who rolls over his or her existing retirement funds to the ROBS plan in a tax-free transaction. The ROBS plan then uses the rollover assets to purchase the stock of the new business.

Promoters aggressively market ROBS arrangements to prospective business owners. In many cases, the company will apply to IRS for a favorable determination letter (DL) as a way to assure their clients that IRS approves the ROBS arrangement. The IRS issues a DL based on the plan's terms meeting Internal Revenue Code requirements. DLs do not give plan sponsors protection from incorrectly applying the plan's terms or from operating the plan in a discriminatory manner. When a plan sponsor administers a plan in a way that results in prohibited discrimination or engages in prohibited transactions, it can result in plan disqualification and adverse tax consequences to the plan's sponsor and its participants.

Employee Plans ROBS Project

EP initiated a ROBS project in 2009 to:

- Define traits of compliant versus noncompliant ROBS plans;
- Identify ROBS plans that are noncompliant and take action to correct them; and
- Use results to design compliance strategies focusing on identified issues and trends (for example, Employee Plans Compliance Resolution System, Fix-It Guides, Web-based information, newsletters, and speeches).

Using compliance checks, we initially focused on companies that sponsored a plan and received a DL but didn't file a Form 5500, Annual Return/Report of Employee Benefit Plan, or Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan (PDF), and/or Form 1120, U.S. Corporation Income Tax Return.

Our contact letter to plan sponsors asked questions about the ROBS plan's recordkeeping and information reporting requirements, including:

- the plan's current status
- plan contribution history
- information on the rollover or direct transfer of the assets into the ROBS plan
- participant information
- stock valuation and stock purchases
- general information about the business itself
- why no Form 5500 or 5500-EZ and/or Form 1120 were filed

We always invite a plan sponsor to furnish any other documents or materials that they believe will be helpful for us to review as part of the compliance check.

ROBS Project Findings

New Business Failures

Preliminary results from the ROBS Project indicate that, although there were a few success stories, most ROBS businesses either failed or were on the road to failure with high rates of bankruptcy (business and personal), liens (business and personal), and corporate dissolutions by individual Secretaries of State. Some of the individuals who started ROBS plans lost not only the retirement assets they accumulated over many years, but also their dream of owning a business. As a result, much of the retirement savings invested in their unsuccessful ROBS plan was depleted or 'lost,' in many cases even before they had begun to offer their product or service to the public.

Not Filing Form 5500 or Form 1120

Many ROBS sponsors did not understand that a qualified plan is a separate entity with its own set of requirements. Promoters incorrectly advised some sponsors they did not have an annual filing requirement because of a special exception in the Form 5500-EZ instructions. The exception applies when plan assets are less than a specified dollar amount and the plan covers only an individual, or an individual and his or her spouse, who wholly own a trade or business, whether incorporated or unincorporated. In a ROBS arrangement, however, the plan, through its company stock investments, rather than the individual, owns the trade or business. Therefore, this filing exception does not apply to a ROBS plan and the annual Form 5500 or 5500-EZ (5500-SF for filing electronically) is still required.

Specific Problems with ROBS

Some other areas the ROBS plan could run into trouble:

- After the ROBS plan sponsor purchases the new company's employer stock with the rollover funds, the sponsor amends the plan to prevent other participants from purchasing stock.

- If the sponsor amends the plan to prevent other employees from participating after the DL is issued, this may violate the Code qualification requirements. These types of amendments tend to result in problems with coverage, discrimination and potentially result in violations of benefits, rights and features requirements.

    - Promoter fees
    - Valuation of assets
    - Failure to issue a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., when the assets are rolled over into the ROBS plan

Additional Resources

- Guidelines regarding rollovers as business start-ups, Memorandum from Michael Julianelle, Director, Employee Plans Rulings & Agreements (October 1, 2008)

IRA RECEIVED IN DIVORCE

On June 3, 2022, Governor Ron DeSantis signed SB 968, amending Section 222.21, F.S., and made the new law effective immediately. The law clarifies that any interest in an individual retirement account (IRA) or individual retirement annuity received in a transfer incident to divorce remains exempt from creditor claims after the transfer is complete. The law is intended to clarify existing law and apply retroactively to all inherited IRA accounts without regard to the date the account was created. This law seems to have come as a reaction to the 2018 Minnesota Bankruptcy Court case, *In re Lerbakken*.[426]

Background of the *Lerbakken* Case.

In *Lerbakken*, the Court held that Mr. Lerbakken ("Lerbakken"), a Chapter 7 debtor who was awarded part of his ex-wife's Individual Retirement Account (IRA) and her 401(k) account (together, "Accounts") in their pre-bankruptcy dissolution proceeding, could not claim those accounts as exempt "retirement funds" under Section 522(b)(3)(c) of the Bankruptcy Code.

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[426] *In re Lerbakken*, 590 B.R. 895 (B.A.P. 8th Cir. 2018), *aff'd*, *In re Lerbakken*, 949 F.3d 432 (8th Cir. 2020).

Lerbakken retained Sieloff & Associates, P.A. (“Sieloff”) to represent him in his divorce proceeding in Minnesota. The state court's order dissolving the marriage adopted the parties' stipulated property settlement which awarded Lerbakken one-half of the value in the Accounts.

Lerbakken filed a voluntary Chapter 7 bankruptcy petition and claimed the inherited Accounts as exempt retirement funds for the values agreed to under the property settlement. Lerbakken had unpaid legal fees with Sieloff. Sieloff was listed as a creditor for the unpaid fees and objected to Lerbakken’s claim of exemption in the Accounts.

The *Lerbakken* court found that two requirements must be satisfied for a debtor to claim funds as exempt retirement funds pursuant to the Bankruptcy Code:[427]

(1) the amount must be retirement funds, and
(2) the retirement funds must be in an account that is exempt from taxation under one of the provisions of the Internal Revenue Code.

[427] 11 U.S.C. § 522(d)(12).

Ultimately in *Lerbakken*, the interests were not found to be “retirement funds” under the U.S. Supreme Court case of *Clark v. Rameker*, where the Supreme Court held that Section 522(b)(3)(c) applied only to the person who created and contributed to the retirement account.[428] In *Clark,* the Supreme Court defined "retirement funds" as "sums of money set aside for the day an individual stops working." In doing so, the Supreme Court focused on three legal characteristics of ordinary retirement funds. The Court found that account holders of ordinary retirement funds (1) are able to make additional contributions to the funds, (2) are not obligated to withdraw the funds, and (3) must pay a penalty to withdraw the funds at any time, for any purpose, prior to the age of 59 ½.[429]

Lerbakken argued that *Clark* dealt only with inherited IRAs, where the Internal Revenue Code explicitly excludes IRAs inherited from a spouse.[430] Lerbakken argued that the *Clark* test can be met because the Accounts were marital funds set aside for his and his ex-spouse’s retirements and are in tax qualifying accounts. Lerbakken continues his argument, and provides the following:[431]

As a matter of public policy, retirement funds that were marital property received from a debtor's ex-spouse pursuant to a domestic relations order should be considered the debtor's own retirement funds. This promotes the purpose of the Bankruptcy Code's exemption provisions to achieve a fresh start and to provide for their and their spouse's retirements. Moreover, to disallow the exemption of a retirement account received by a spouse in a divorce because he or she did not earn and fund the account would unfairly prejudice the stay at home or under employed spouse. How is it fair and in line with the purpose of the exemptions to allow one of the spouses in a divorce to exempt his or her share of the marital retirement account but not to allow the other to exempt his or her share of the same account after the divorce? It isn't.

The *Lerbakken* court ultimately held that because, as of the date Lerbakken filed for bankruptcy, his interests in the funds did not satisfy all three requirements under *Clark*: Lerbakken was not able to claim the accounts as exempt under Bankruptcy Code.

The *Lerbakken* court reasoned that even a surviving spouse (which Lerbakken was not) does not have "retirement funds" when the surviving spouse does not roll over the IRA into his or her own IRA. On this point, the court reiterated that Mr. Lerbakken failed to roll over the funds from his ex-wife's accounts into his own accounts by the date when exemptions were determined.

The court concluded its opinion by writing, “Any interest [Mr. Lerbakken] holds in the Accounts resulted from nothing more than a property settlement. Applying the reasoning of *Clark* the 401K and IRA accounts are not retirement funds which qualify as exempt under federal law.”

Why the Florida Legislature Addressed *Lerbakken.*

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[428] *Clark v. Rameker*, 573 U.S. 122 (2014).

[429] It is important to also note, that in *Clark*, the Supreme Court pointed out that in these types of disputes, a fact-intensive, case-by-case analysis was not permitted: if the funds were not objectively for retirement purposes, then the funds may not qualify as exempt.

[430] *See* 26 U.S.C. §408(d)(3)(C)(“An individual retirement account... shall be treated as inherited if--(i) the individual for whose benefit the account or annuity is maintained acquired such account by the reason of the death of another individual, and (ii) such individual was not the surviving spouse of such other individual.”)

[431] Appellant’s Brief and Addendum, *In Re: Brian A. LERBAKKEN, Debtor. Brian A. LERBAKKEN, Debtor-Appellant, v. SEILOFF & ASSOCIATES, P.A., Creditor-Appellee.*, 2019 WL 359681 at *6.

The second requirement of the *Clark* test, the obligation to withdraw funds, is relevant for the new Florida law. In *Lerbakken*, the Court noted that state law obligated Lerbakken to withdraw his conditional interest in the IRA because, "the governing state law – the dissolution decree and the court-ordered attorney's lien – define Lerbakken's interest as a debt owed to Sieloff."[432] By the decree and lien, Lerbakken was supposed to effectuate a transfer or renaming of his ex-wife's IRA to pay a debt, regardless of [his] proximity to retirement.[433]

While the *Lerbakken* decision is not controlling in the 11th Circuit, of which Florida is a part, some planners and lawmakers clearly took notice. A similar issue to that in *Lerbakken* arose in the 11th Circuit, but the Court ultimately did not reach a decision on the IRA issue because the parties settled outside of court.[434] However, the United States Bankruptcy Court for the Middle District of Florida, Tampa Division, acknowledged that there was no controlling decision of the 11th Circuit on this issue, and that the Bankruptcy Court intended to certify the issue for appellate review due to the presence of conflicting opinions from other jurisdictions.[435]

The Florida Law.

As amended, the new Florida law does the following:

1. Section 222.21(2), F.S., provides that IRAs, and interests therein, maintained in accordance with Section 408 of the Internal Revenue Code are exempted from legal processes, such as forced sale by creditors.

2. Section 222.21(2)(c), F.S., provides that the exemption for such money, other assets, or interest in certain qualified tax-exempt retirement accounts applies to any such accounts that are received by a beneficiary upon rollover or other eligible rollover that is excluded from gross income under the Internal Revenue Code, such as, but not limited to, the direct transfer or eligible rollover to an inherited IRA. This allows the beneficiary of the IRA to enjoy the creditor exemption upon transfer.

3. Additionally, Section 222.21(2)(c) provides that any interest in any qualified tax-exempt retirement account awarded or received in a transfer incident to a divorce is exempt from creditors.

The Bankruptcy Code allows a debtor to "opt-out" of federal bankruptcy law exemptions and instead use the exemption laws of the state in which the debtor has been domiciled for at least 730 days prior to filing a bankruptcy petition. Specifically, Florida residents can elect to have Florida law apply to their bankruptcy in lieu of the bankruptcy exemptions that apply under federal law.

Because Lerbakken's interest in the inherited Accounts was governed by state law, and as a result was ordered as a debt owed to Sieloff, Lerbakken could not claim the Accounts as exempt from creditors. The new Florida law provides added protection against this situation for Floridians because presumably, a court could not order a lien against an inherited IRA because it would be contrary to Section 222.21, as amended. Therefore, individuals who have resided in Florida for at least 730 days before filing for bankruptcy should have the advantage of this new degree of certainty going forward.

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432 *Lerbakken*, 949 F.3d at 436.
433 *Id*.
434 *Carapella v. Glass*, No. 8:19-cv-3050-T-02 (M.D. Fla. Jan. 8, 2021).
435 *In re Glass*, 613 B.R. 33, 41 (Bankr. M.D. Fla. 2020).

CHAPTER 9:
MISCELLANEOUS FLORIDA EXEMPTIONS

ALIMONY.

The Fourth District Court of Appeals in *Waters v. Albanese*, held that garnishment of alimony payments would be contrary to public policy, but this decision did not discuss whether the alimony being received by the debtor was necessary for her support and maintenance.[436] We discuss below that the Bankruptcy Code provision to protect alimony, support, or separate maintenance requires that it be "reasonably necessary for the support of the debtor and any dependent of the debtor."

We have reproduced the entire (very short) Waters opinion:

STONE, Judge.

> A former husband appeals from an order holding him in contempt for failure to pay alimony. The appellant defended on the theory that he was obligated to withhold the alimony payments pending the outcome of garnishment proceedings that had been instituted against him as a garnishee. The garnishment involved a judgment against both provides that a garnishee is liable to the creditor for all "debts" due to the debtor defendant. The appellant contends that alimony is a debt.
>
> The trial court determined that the alimony obligation was not subject to garnishment because Section 222.11, Florida Statutes, exempts wages due for personal labor or services. The court also found alimony to be exempt from garnishment under the Federal Wage Garnishment Act, 15 U.S.C. Section 1673. That statute limits the percentage of wages subject to garnishment and gives priority to orders of support.
>
> We note that the same public policy behind Section 222.11 and the Federal Act, which prevents the debtor, and his or her family, from being a charge on the public, applies equally to the debtor who is dependent, in whole or in part, on alimony for support.
>
> Cf. *Killian v. Lawson*, 387 So.2d 960 (Fla. 1980); *Holmes v. Blazer Financial Services, Inc.*, 369 So.2d 987 (Fla. 4th DCA 1979). The policy considerations favoring the protection of support and alimony payments from the garnishment of creditors are readily apparent. See *198 *Joel Bailey Davis Inc. v. Poole*, 194 Ga. 824, 22 S.E.2d 795 (1942); *Columbus Personnel Service v. Gachette*, 158 Ga.App. 298, 279 S.E.2d 746 (1981); *Siver v. Shebetka*, 245 Iowa 965, 65 N.W.2d 173 (1954); *Wright v. Wright*, 93 Conn. 296, 105 A. 684 (1919); *Shanahan V. Klyn*, 268 Mich. 120, 255 N.W. 733 (1934).
>
> The order holding the appellant in contempt is affirmed.

[436] 547 So.2d 197 (Fla. 4th DCA 1989), rev. den., 560 So.2d 235 (Fla. 1990).

Multiple secondary sources cite this case to support the proposition that alimony payments are not subject to garnishment from creditors. For example, a legal encyclopedia, American Jurisprudence, states that "public policy considerations favor the protection of support and alimony payments from the garnishment of creditors."[437]

For bankruptcy purposes, Florida Statutes Section 222.201 provides that the federal bankruptcy exemption for "alimony, support or separate maintenance, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor" will apply, by coordination with Bankruptcy Code Section 522(d)(10).

In applying this provision, bankruptcy courts in Florida have considered the debtor's need for the alimony payments. For example, in *In re Brackett*, the Bankruptcy Court for the Middle District of Florida, the court stated:

> Although Debtor undoubtedly needs spousal support to some degree, whether an additional $200 per month is necessary for her support is questionable. "If the obligations under consideration relate to the preservation of an asset, which is necessary to preserve the lifestyle of a spouse, particularly to keep a roof over her head, [it] would clearly be an obligation in the nature of support . . . ."[438]

In *Brackett*, the court ultimately determined that the $200 payments were not reasonably necessary for the spouse's support. Thus, at least for bankruptcy purposes, the entire amount of alimony will not be exempt; only the amount reasonably needed for support will be exempt. However, it is unclear under Florida law whether the entire amount of the alimony will be exempt from garnishment.

UNEMPLOYMENT COMPENSATION BENEFIT RIGHTS.

Unemployment compensation benefits as defined in Florida Statutes Section 443.051(2) are exempt from all claims of creditors outside of Florida, at least according to the Florida Statutes.

FLORIDA PREPAID TUITION FUNDS AND 529 PLANS.

Tax advantaged college savings plans are creditor protected even if the sponsor is outside of Florida.[439] Clients with children or grandchildren likely to attend college should strongly consider having one or more 529 plans. In addition, there is no language in the Internal Revenue Code that prohibits the owner of a 529 plan from setting up a 529 and naming himself as a beneficiary if he is going to be attending college. No income tax is payable on plan earnings so long as all monies are spent on college tuition and living expenses for the initial or subsequent beneficiary. Nevertheless, the "plan" is owned by the person designated in the documents, which may be the contributing individual.

Under state law, the contributor has the right to withdraw any or all of the plan assets for his or her own use, provided that income tax and a 10% of income excise tax will apply to the withdrawal of plan earnings.

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[437] 24A Am. Jur. 2d Divorce and Separation § 574, n.5 (current through Feb. 2017) (citing *Walters v. Albanese*, 547 So.2d 197 (Fla. 4th Dist. Ct. App. 1989).

[438] 259 B.R. 768, 775 (Bankr. M.D. Fla. 2001).

[439] 11 U.S.C. § 541(b)(6)(c) (2017).

Monies paid into or out of, the assets of, and the income of any validly existing qualified tuition program (including the Florida Pre-Paid Post-Secondary Education Expense Trust Fund) are not subject to attachment, garnishment or legal process pursuant to Florida Statutes Section 222.22. This protection is against the creditors of "any program participant, purchaser, owner or contributor, or program beneficiary."

Further, monies paid into or out of, and the income held under a health savings account or medical savings account authorized under Internal Revenue Code Sections 220 and 223 respectively, are creditor proof, as are educational IRAs.

Some planners have speculated that 529 plans sponsored by states other than Florida may not be creditor protected because the legislature does not have the power to require that out of state intangibles would qualify for tenancy by the entireties protection. Most planners believe otherwise. The legislature clearly intended to protect all 529 plans owned by Florida residents, as evidenced by the fact that the requirement that a plan be in Florida was explicitly removed from the Statute in 2005. One author signed up to take Conflicts of Law in law school, but found it to be very confusing on the first day, and therefore switched to Agricultural Law, which was much more "meat and potatoes."

529 plans are favored for gifting purposes, in that taxpayers can place assets in a 529 plan and consider the transfer to have been made one-fifth over five consecutive taxable years, beginning in the year of the transfer, if the gift tax return is filed with a special election being made. Notwithstanding that the 529 plan can be excluded from the person's estate for estate tax purposes, the donor can be the plan holder and have complete control thereof, including the right to stem the plan monies for personal purposes, or to simply make a withdrawal to keep the money.

For non-Floridians, the 2005 revisions to the Bankruptcy Code exempt up to $6,425 contributed no earlier than two years and no later than one year before the date of filing bankruptcy. However, the 2005 version of the Bankruptcy Code is unclear on whether the provisions that invalidate 529 plan contributions made within one year of filing will apply when state law exempts 529 plans. It is therefore unknown whether Florida's 529 Plan exemptions will apply to residents who file bankruptcy.

Contributions to a 529 plan made by a debtor are not included in the bankruptcy estate to the extent that such contributions (a) were made no later than 365 days before the date of filing for bankruptcy and (b) the designated beneficiary of the 529 plan was a child, stepchild, grandchild, or step-grandchild of the debtor for the taxable year in which the funds were contributed. Contributions that are made within the 730 to 365-day window before the date of filing bankruptcy are only excluded from the estate to the extent of $6,425.

The exemptions that exclude 529 plan contributions from the bankruptcy estate only apply to the extent that the 529 plan provides adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for qualified higher education expenses.

HURRICANE SAVINGS ACCOUNTS.

This protection will not be effective until there are federal law changes to provide tax exempt or tax-deferred status to "hurricane savings accounts," and these are not expected to exist anytime in the near future.

The hurricane savings account legislation in Florida Statutes Section 222.22(4)(a) permits an insurance policyholder for residential property to fund an account equal to twice the deductible sum of any insurance to cover an insurance deductible or other uninsured portion of the risks of loss from a hurricane, rising flood waters, or other catastrophic windstorm events.

The residential real estate must meet the requirements of the Homestead Exemption at Section 4 Article X of the State Constitution (of an acre of contiguous land upon which the exemption is limited to the owners' residence).

The account must specify that its purpose is to cover the amount of the insurance deductible and other insured portions of risks of loss.

PHYSICAL ASSETS EXEMPTIONS – "CAN THEY TAKE MY CAR, FURNITURE, AND ELECTRIC WHEELCHAIR?"

Florida Statutes Section 222.25 also affords a debtor the following exemptions:

A. Up to a $5,000 interest in a motor vehicle to be exempted from creditors.

B. Any interest in professionally prescribed health aids for the debtor or a dependent of the debtor. Aggressive planners may encourage debtors to have expensive health items that might be resold in the same way that homesteads can be adorned with gold and silver doorknobs and other finishings that could have an independent value upon later being severed.

C. Florida Statutes Section 222.25(4) provides for up to $4,000 for tangible personal property if the client is not claiming the homestead creditor exemption in bankruptcy. This is in addition to the $1,000 exemption in personal property under the homestead provision of the Florida Constitution, for a total of $5,000.

In *In re Bezares*, the court held that an individual may claim as exempt $5,000 in personal property provided he or she does not own a homestead property or claim a homestead exemption.[440] In this case, the debtor claimed a $5,000 personal property exemption. The Trustee argued that because of Florida Statutes Section 222.25, the maximum allowable personal property exemption was $4,000. The debtor's counsel relied on the well-established principle that the legislature has no power to abrogate, alter or amend any provision in the Constitution. A cursory reading of the statute would warrant the conclusion that the amount stated is a cap that indirectly includes the $1,000 exemption provided in the Constitution. However, the court agreed with the debtor that the legislature does not have the power to amend or alter a constitutional provision. The court concluded that Florida Statute added $4,000 to the previous $1,000 personal property exemption, making a total of $5,000 as the allowable amount for a person who does not own homestead property or claim a homestead exemption.

If the debtor does claim the homestead exemption, as in *Bezares*, the exemption will remain at $1,000 as provided for in the Florida Constitution. The $1,000 or $5,000 per person exemption can be aggregated when spouses jointly file bankruptcy to protect up to $2,000 or $10,000 worth of assets.[441]

Where a debtor's homestead interest is protected by reason of tenancy by the entireties and the debtor files bankruptcy without explicitly using his or her homestead exemption, the courts are divided on whether the debtor receives a $1,000 or $5,000 exemption.

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[440] 377 B.R. 413, 414 (Bankr. M.D. Fla. 2007).
[441] *In re Rasmussen*, 349 B.R. 747 (Bankr. M.D. Fla. 2006).

In *In re Ellis*,[442] an August 8, 2008 decision from the Bankruptcy Court Middle District of Florida, Judge Funk determined that a debtor who owns a homestead as tenants by the entireties with his non-debtor spouse receives the benefits of the constitutional homestead exemption because of the spouse's ability to assert the constitutional exemption; thus, the debtor can only receive the $1,000 personal property exemption.

In *In re Gatto*, however, the court allowed the debtors to use the $4,000 personal property exemption, stating that because "the debtors did not claims their homes exempt pursuant to the Florida Constitution and stated their intention to surrender their home, they did not receive the benefits of the Constitutional homestead exemption and therefore were entitled to the enhanced personal."[443]

The relevant question is whether a debtor protecting a homestead as tenancy by the entireties is "directly or indirectly receiving the benefits of the constitutional homestead exemption" under Florida Statutes Section 222.25.

In 2024, Florida Statutes Section 222.26 was added and provides the following higher exemptions for those with medical debt:

A. Up to a $10,000 interest in a motor vehicle to be exempted from medical service creditors.

B. Up to a $10,000 interest in personal property to be exempted from medical service creditors.[444]

[442] 395 B.R. 751 (Bankr. M.D. Fla. 2008).
[443] 380 B.R. 88, 90 (Bankr. M.D. Fla. 2007).
[444] Fla. Stat. § 222.26 (2025).

<u>CHAPTER 10:</u>
FEDERAL NON-BANKRUPTCY EXEMPTIONS

The following items are exempt from creditor claims in all states, including Florida, by reason of federal law. Please note that Chapter 1, Section D reviews federal bankruptcy exceptions.

Some states allow debtors to choose between the federal bankruptcy exemptions and the exemptions of their individual state; however, in Florida debtors are required to use the state exemptions, but may also protect pension, IRA, and tenancy by the entireties assets under the Bankruptcy Code, and also the following non-bankruptcy exempt assets.

RETIREMENT BENEFITS.

<u>Civil Service Employees</u>. 5 U.S.C. § 8346. Under this provision, federal employees' retirement or disability benefits are exempt from garnishment, attachment, levy, execution, or similar legal process.

<u>Foreign Service Employees</u>. 22 U.S.C. § 4060. Members of the Foreign Service with annuities and benefits for retirement or disability qualify for exemption of such assets from execution.

<u>Railroad Workers</u>. 45 U.S.C. § 231m. Retirement annuities paid pursuant to the Railroad Retirement Act of 1974 are exempt. 45 U.S.C. § 352(e). Railroad Workers' unemployment benefits are also exempt.

<u>Military Service Employees</u>. 10 U.S.C. §§ 407 and 1383. Benefits provided pursuant to the Social Security Act are exempt from execution. Such benefits include retirement and survivors' benefits, supplemental security income benefits, disability insurance benefits and child support payments that are processed pursuant to Part D of Title IV of the Social Security Act. These benefits are exempt from garnishment, execution, levy, attachment, or any other legal process including bankruptcy and cannot be assigned. Even if the payments are commingled with other funds they are still protected.[445] Payments are not, however, exempt from child support or alimony obligations.

> The Federal Social Security Act provides a specific exemption for Social Security benefits, which is applicable for both bankruptcy and garnishment purposes. Title 42 U.S.C. § 407(a) provides the following:
>
> The right of any person to any future payment under this subchapter shall not be transferable or assignable, at law or in equity, and none of the moneys paid or payable or rights existing under this subchapter shall be subject to execution levy attachment, garnishment, or other legal process, or to the operation of any bankruptcy or insolvency law.

Earlier federal appellate decisions, particularly the Eleventh Circuit's ruling in *Citronelle Mobile-Gathering, Inc. v. Watkins* (1991), adopted a flexible approach, authorizing garnishment of Social Security benefits when doing so would not impair the recipient's ability to meet basic needs.[446] Under this framework,

[445] *S & S Diversified Services, L.L.C. v. Taylor*, 897 F. Supp. 549 (D. Wyo. 1995).
[446] 934 F.2d 1180 (11th Cir. 1991).

courts applied a "basic needs" balancing test, allowing creditors to reach Social Security funds to the extent the debtor had surplus income or assets beyond essential living costs.

Similarly, certain bankruptcy courts, including those in the Middle District of Florida, held that Social Security benefits lost exemption status once accumulated in bank accounts beyond what was needed for the debtor's immediate basic care and maintenance. For example, *In re Lazin* and *In re Crandell* limited exemptions based on assessments of the debtor's current financial condition and resource needs.[447]

This judicial approach changed decisively with the Supreme Court's 2014 decision in *Law v. Siegel* and subsequent application in *In re Franklin*.

Law v. Siegel arose from a bankruptcy proceeding where the debtor's fraudulent conduct was exposed at significant trustee expense.[448] The bankruptcy court authorized "surcharging" the debtor's homestead exemption to pay legal fees. The Supreme Court unanimously reversed, holding that courts cannot override or surcharge statutory exemptions on equitable grounds not explicitly authorized by the Bankruptcy Code. The ruling emphasized that statutory exemptions are strictly limited to those provided by Congress, and equitable powers cannot be used to create exceptions—even for debtor misconduct.

Building on *Law v. Siegel*, the Bankruptcy Court for the Central District of Illinois in *In re Franklin*,[449] held that Social Security benefits accumulated in a debtor's bank account remain fully exempt so long as they are traceable. The court rejected any "basic needs" limitation and ruled that § 407's exemption is absolute. Consequently, judicial attempts to curtail the exemption based on a debtor's lack of immediate need or the amount of accumulated funds are impermissible.
The statutory language of 42 U.S.C. § 407 remains unchanged and continues to provide broad protection of Social Security benefits from legal process. Following *Law v. Siegel* and *In re Franklin*, courts no longer entertain equitable or judicially created exceptions, such as the "basic needs" standard previously recognized in some circuits. Social Security benefits, whether current payments or accumulated in bank accounts, retain their exempt status provided their source can be traced. This interpretation ensures uniform application of the statute's protections and upholds Congressional intent to safeguard Social Security funds.

<u>Veteran's Benefits</u>. 38 U.S.C. § 5301. Veteran's Benefits paid from the Veterans Administration are exempt from garnishment, levy, and other legal process including bankruptcy, except for the payment of child and spousal support obligations, federal taxes, and federal student loans. Comingling the assets will not subject them to garnishment. Florida Statutes Section 222.201 provides that property listed in Bankruptcy Code Section 522(d)(10) will apply for any Florida bankruptcy action.

<u>CIA Employees</u>. 50 U.S.C. § 2001. Retirement benefits are exempt for past and present CIA employees.

<u>Military Medal of Honor Roll Pensions</u>. 38 U.S.C. § 1562(c). In addition to any other pensions they might receive, recipients of the Medal of Honor are paid a pension that is exempt from garnishment, levy, attachment, tax lien, execution or detention under any process. Florida Statutes Section 222.201 provides that property listed in Bankruptcy Code Section 522(d)(10) will be exempt in bankruptcy for Floridians. This includes "a veteran's benefit" under Section 522(d)(10)(B).

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[447] *In re Lazin*, 217 B.R. 332, 336 (Bankr. M.D. Fla. 1998); *In re Crandell*, 200 B.R. 243, 245 (Bankr. M.D. Fla. 1995).
[448] 134 S. Ct. 1188 (2014).
[449] 506 B.R. 765 (Bankr. C.D. Ill. 2014).

Fraudulent Transfers. The authors do not know of any Florida case law that has determined that the transfer of exempt federal retirement benefits into a Florida exempt asset (such as a tenants by the entireties account) would constitute a fraudulent transfer.

Although not exactly on point, the case of *In re Short*[450] from the Bankruptcy Court for the Middle District of Florida references the fact that the transfer of a creditor exempt asset to an account owned by a person other than the debtor is not considered to be a "fraudulent transfer" under Florida law because the creditor had no claim to the property whether it was transferred or not.

Thus, it appears possible to transfer a federal exempt asset, such as federal retirement benefits, into a Florida exempt asset, although the courts may not agree with this observation. This is reflected by *In re Lazin*, where a trustee contended that the social security benefits and annuity payments received and deposited by a debtor pre-petition were accumulated funds, and lost their exemption status once received and deposited in a bank account.[451] However, the court determined that, under Florida law, a debtor does not lose exemption in proceeds of annuity contracts to which the debtor was entitled under non-bankruptcy federal law merely by depositing proceeds into a bank account.[452]

The *Lazin* court cited to *Treadwell,*[453] an 11th Circuit case regarding the transfer of funds accumulated from social security benefits to family members by a debtor, within one year of filing for petition in bankruptcy. In *Treadwell*, the debtor claimed exemptions pursuant to 11 U.S.C. § 407, not 11 U.S.C. § 522(d), and therefore relinquished the right to immunize the funds.[454] The *Treadwell* court found the transfers to be fraudulent because the transfer was not for value, the debtor was insolvent at the time of transfer, and the exemption granted to social security income did not apply since the income was fraudulently conveyed and was not being used for living expenses.[455]

Because the debtor represented that the exemption claimed was based on non-bankruptcy federal law, the *Lazin* court found that "[t]here is nothing in *Treadwell* to mean that once the funds have been received by the Social Security recipient and deposited into the bank that the funds lost their immunity from creditor claims. On the contrary, it expressly recognized that one could claim an exemption under 42 U.S.C. § 407 as long as one did not also claim the exemption under § 522(d)."[456]

SURVIVOR'S BENEFITS.

Military Service. 10 U.S.C. § 1450. Benefits paid to the surviving spouse, child, or other natural person designated as a beneficiary under an annuity are protected from creditors.

Members of the Judiciary. 28 U.S.C. § 376. Annuities paid to survivors of members of the judiciary, U.S. court directors, judicial center directors, and U.S. Supreme Court Justice's administrative assistants are exempt.

Lighthouse Workers. 33 U.S.C. § 775. Payments are exempt from execution, levy, lien, attachment, garnishment, or other legal process.

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450 188 B.R. 857 (Bankr. M.D. Fla. 1995).
451 217 B.R. 332 (Bankr. M.D. Fla. 1998).
452 *Id.* at 336.
453 699 F.2d 1050 (11th Cir. 1983).
454 *Id.* at 1052.
455 *Id.* at 1053.
456 217 B.R. 332, 334 (Bankr. M.D. Fla. 1998).

DEATH AND DISABILITY BENEFITS.

5 U.S.C. § 8130. Compensation for injuries of government employees are exempt from creditor claims.

33 U.S.C. § 916. Compensation or benefits due or payable to long-shore and harbor workers are exempt from all claims of creditors, and from levy, execution, and attachment or other collection of debt, which exemption may not be waived.

42 U.S.C. § 1717. Compensation for injury, death, or detention of employees of contractors with the United States outside the United States is exempt from execution, levy, attachment, garnishment, or to the operation of any bankruptcy or insolvency law.

MISCELLANEOUS FEDERAL EXEMPTIONS.

Military Deposits and Life Insurance. 10 U.S.C. § 1035(d). Military deposits to savings accounts are exempt while the service member is on active duty outside the U.S. 38 U.S.C. § 1970(g). Benefits from Group Life Insurance for military members and veterans are exempt.

Wages. 15 U.S.C. § 1673. Those who are not a head of family may not have their disposable earnings garnished above certain limits under the Consumer Credit Protection Act. The Act provides that the amount attached or garnished will not exceed the lesser of 25% of the person's disposable income for that week or the amount by which the person's disposable income exceeds 30 times the Federal minimum wage at that time. However, the Consumer Credit Protection Act's limits do not apply where support of any person has been court ordered, in a Chapter 13 or Chapter 11 Bankruptcy, or in any case where any Federal or State taxes are owed. This is further discussed in Section II.

Student Loans. 20 U.S.C. § 1095a. Federal student loan payments are exempt from execution.

Merchant Seamen. 46 U.S.C. § 11109. Wages due or accruing to merchant seamen are exempt from execution except in the case of child or spousal support obligations.

46 U.S.C. § 11110. A seaman's clothing is exempt while on voyage.

46 U.S.C. § 11111. The debts of a seaman incurred while on voyage are exempt.

Indian Tribal Lands. 26 U.S.C. § 7871. Certain Indian tribal lands are also exempted from creditors under federal law.