As seen in . . .

Nassau Lawyer September 2010

Estate Planning and Creditor Protection Utilizing Retirement Assets, 529 Plans & Life Insurance

By: Melvyn B. Ruskin, Esq. and David R. Schoenhaar, Esq.

Melvyn B. Ruskin

David R. Schoenhaar

Evaluation of creditor risk and the development of a strategy for acquiring creditor protected assets is an essential element of every good estate plan. In an effort to preserve funds for generating retirement income, promote funding for higher education and provide financial security for a loved one upon death, certain creditor protection benefits exist for retirement assets, 529 savings plans and life insurance policies, respectively. Depending on the type of "exempt" asset selected, navigation through complex federal and/or state law is necessary to determine the extent of creditor protection available. This article provides an overview of certain unique creditor protection devices and highlights their limitations outside of bankruptcy.

Retirement Assets

Creditor protection utilizing exempt retirement assets is not a new concept, but has become increasingly important in today's litigious society. This is particularly true for professionals like physicians and risk taking businesspersons who may have significant exposure to lawsuits and the means to defer substantial earnings toward retirement.

I. ERISA Qualified Plans

The federal Employer Retirement Income Security Act of 1974 ("ERISA") regulates ERISA "qualified plans" and preempts state law. These plans consist of employer-sponsored retirement plans, such as a 401(k), pension, or profit-sharing plans. Under federal law, an ERISA qualified plan is off-limits to creditors because it contains an anti-alienation clause. However, there are two common exceptions to be aware of. First, qualified domestic relations orders ("QDROs") can reach plan assets as part of a divorce or support obligation. Second, qualified plan assets are subject to tax levies and judgments by the federal government (i.e., the IRS can seize these assets to satisfy unpaid federal income taxes). It is noteworthy that there is no similar exception for state governments. Thus, New York cannot collect unpaid state income taxes from ERISA qualified plans.

II. Other Retirement Assets

Like many states, New York has extended creditor protection benefits to retirement assets other than ERISA qualified plans. New York's CPLR 5205(c) specifically provides protection from creditors seeking to enforce money judgments against Roth, traditional, SIMPLE and SEP IRAs, Keogh or HR-10 plans, 401(k) plans, 457 deferred compensation retirement plans, etc. Notably, New York's protections are not limited to a specific dollar amount or the debtor's needs during retirement.

However, as with ERISA qualified plans, New York's protections are not absolute. First, contributions to a retirement asset within 90 days before the entry of a money judgment are not protected. Second, creditors can attack retirement assets to the extent such assets were contributed through a fraudulent conveyance. Third, retirement assets are not protected from QDROs or orders of support, alimony or maintenance due to a divorce or legal separation. Additionally, while a debtor in bankruptcy is not the focus of this article, one should be aware that the federal Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 limits the exemption from creditor claims to a total of $1 million in the aggregate for all traditional and Roth IRAs funded directly by the debtor (subject to increase if the "interests of justice so require"). The limitation does not apply to IRA assets funded through an exempt plan rollover. Given this distinction, it is prudent to avoid commingling IRA assets subject to this limitation with those that are not.

Finally, most asset protection benefits enjoyed during lifetime do not terminate with the debtor's death. New York's EPTL § 13-3.2, the companion to CPLR § 5205(c), extends creditor protection against the claims of a decedent's creditors. Moreover, New York case law strongly supports the continuation of lifetime protections to a decedent's retirement assets after death. See In re Gallet, 765 N.Y.S.2d 157 (New York County Sur. Ct. 2003); Matter of King, 764 N.Y.S.2d 519, 523 (Broome County Sur. Ct. 2003) ("Either by statute or case law virtually every type of retirement plan is exempt from the claims of the decedent's creditors.").

529 Plans

State law controls the extent to which creditor protection exists for a 529 plan established to pay the costs of higher education. For example, New York provides different levels of protection depending on who owns the account. Pursuant to CPLR § 5205(j)(2), if a minor is the account owner (e.g., through a parent or guardian) and beneficiary, the account is completely exempt from the minor's creditors. Thus, a parent may want to apply a portion of his or her 529 plan contributions to a minor-owned account because the account assets are not only protected from the minor's creditors, but also from the parent's creditors by the fact that those assets are no longer part of the parent's estate.

However, if the account owner is a parent or grandparent (i.e., not the minor), then CPLR § 5205(j)(3) exempts only $10,000 per account owner from the account owner's creditors. The vast majority of 529 plans will fall into this scenario and New York's protections will thus be subject to this significant limitation. Accordingly, it may be wise to consider creating a 529 plan outside New York. For example, Rhode Island offers broader creditor protection to a debtor's interest in its 529 plans by providing an unlimited exemption amount regardless of the identity of the account owner. See R.I. Gen. Laws §9-26-4(15).

Planners should recognize that in implementing the creditor protection strategies discussed above, certain 529 plan benefits may be lost. For example, a New York taxpayer and account owner is entitled to a state income tax deduction of up to $5,000 ($10,000 for married couples filing jointly) on his or her contributions to New York 529 plans. This deduction only applies to account owner contributions and not to contributions made by a third party. Thus, if a New York minor-owned account or a 529 plan outside of New York is utilized, the parent is not entitled to the New York income tax deduction when making contributions to such accounts. Additionally, in the case of a New York minor-owned account, the parent does not own the account but merely acts as an agent for the minor. Accordingly, the parent has no legal right to access the account funds through a non-qualified withdrawal for his or her own benefit.

Life Insurance

New York's statutory scheme is complex and the creditor protections afforded to life insurance policies are in large measure dependent on the identities of the policy's owner, beneficiary, and insured. Generally speaking, New York's protection against creditors extends to the death benefit, cash surrender value, and available loan value of life insurance policies. For example, pursuant to New York's Insurance Law §3212(b)(1), an insurance policy that the debtor owns on his life for the benefit of his wife is exempt from the debtor's creditors. Also, when the owner of the policy is a life insurance trust (frequently utilized to avoid estate taxes), the creditors of the creator of the trust cannot reach the policy. The exemption statute is for the protection of the beneficiary and not the debtor. In protecting the beneficiary, creditors of the owner cannot force the owner to surrender the policy or borrow against the policy to the detriment of the third party beneficiary. See In re Jacobs, 264 B.R. 274 (Bankr. W.D.N.Y. 2001).

However, it is important to note that loans actually taken by the debtor-policy owner are not protected under the statute because the debtor has full control and disposal of the proceeds. See Tanges v. Schonbrun, 196 N.Y.S.2d 381 (Nassau County Supreme 1959). Additionally, protection from creditors under New York's Insurance Law §3212(e) does not exist when funds are contributed to a life insurance policy with the actual intent to defraud existing creditors as provided under New York's Debtor and Creditor Law.

Conclusion

Subject to the exceptions and limitations discussed above, making contributions to retirement assets, 529 plans, and/or life insurance can offer excellent creditor protection. It is important to keep in mind that these protections are not always absolute, other limitations apply in bankruptcy, and once funds are withdrawn from these protected assets, they become accessible to creditors.

The tax advantages and safe havens from creditors enjoyed by the owner of the protected assets discussed in this article should be embraced and utilized in connection with the estate planning process. A qualified and experienced legal team performing estate planning services should assess the degree of asset protection required and integrate asset protection planning into the client's overall estate plan.

Melvyn B. Ruskin, Esq. is a partner at Ruskin Moscou Faltischek, P.C., a senior member of its Health Law Department and is actively involved in advising physicians and business executives. David R. Schoenhaar, Esq., is an associate at Ruskin Moscou Faltischek, P.C. and is a member of the firm's Trusts and Estates and Estate Litigation Departments. They may be reached at 516-663-6600.

RUSKINMOSCOUFALTISCHEK P.C.

Smart Counsel. Straight Talk.

East Tower, 15th Floor
1425 RXR Plaza, Uniondale, NY 11556-1425
516.663.6600 ▼ www.rmfpc.com

Attorney Advertising