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Planning for Exempt Assets

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I. [7.1] INTRODUCTION

Estate planning can easily accommodate asset protection planning if one understands the assets that are exempt from creditor claims under Illinois law. As with other types of planning, the sheltering of assets within exempt categories is most effective when done well before entering the bankruptcy process and before any creditor claims arise. This chapter discusses assets exempt from the claims of creditors whether or not a bankruptcy proceeding has been filed.

II. [7.2] STATE LAW VS. FEDERAL BANKRUPTCY LAW

For debtors in federal bankruptcy court, one provision of the federal Bankruptcy Code, 11 U.S.C. §522, lists assets that can be exempt from creditor claims. However, in 1980 the Illinois legislature enacted 735 ILCS 5/12-1201, which is an “opt out” statute denying Illinois residents the ability to utilize these federal exemptions. Instead, Illinois residents in a federal bankruptcy proceeding must rely on state law for authority on what assets are exempt. If a debtor has not filed for bankruptcy, other Illinois statutes protect assets from the claims of creditors.

III. EXEMPT ASSET CATEGORIES

A. 529 Plans

1. [7.3] 529 Plans Defined

Originally authorized under the Small Business Job Protection Act of 1996, Pub.L. No. 104-188, 110 Stat. 1755, qualified state tuition programs (called “529 plans” because they are authorized under Internal Revenue Code §529) have exploded in popularity in recent years as a way to save for a child’s education in a tax-efficient manner. These programs, which are operated by either a state or an educational institution, come in two varieties. One type is a prepaid tuition plan; this type of 529 plan allows an individual to make an advance payment of tuition at a particular university. The other type of plan allows an individual (designated as the owner) to set up a tax-exempt (except in certain circumstances that are beyond the scope of this chapter) savings account for a qualified beneficiary, generally a minor child or grandchild.

2. [7.4] 529 Plans and Federal Bankruptcy Code

Section 541(b) of the Bankruptcy Code, as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub.L. No. 109-8, 119 Stat. 23, affords special creditor protection to 529 plans. Specifically, assets in a prepaid tuition plan or savings plan will be excluded from the property of the bankruptcy estate if funded more than a year before the bankruptcy filing. This protection is limited to \$5,000 for funds added to the 529 plan between one to two years before the filing but is unlimited for funds that were added more than two years before the filing. To qualify for this protection, the beneficiary of the 529 plan must be the debtor’s child, step-child, grandchild, or step-grandchild. A debtor cannot take advantage of the new protection by establishing a 529 plan account for himself or herself.

3. [7.5] 529 Plans and Illinois Law

Since Illinois has opted out of the Bankruptcy Code, state law must be relied on with respect to exclusions from creditor claims. 735 ILCS 5/12-1201. Unlike states such as Florida (Fla.Stat. §222.22) or Nevada (Nev.Rev.Stat. §21.090(q)), Illinois has not yet enacted a statute exempting 529 plans from creditor claims. As of the writing of this chapter, legislation that would exempt 529 plan assets from creditor claims in Illinois has been proposed but has not passed. See S.B. No. 2291. It is the authors' understanding that this bill will be tabled until the 2006/2007 legislative session.

4. [7.6] Asset Protection Strategies Using 529 Plans

In order to gain creditor protection for assets that will be placed into a 529 plan, a person might be tempted to open the account in a state (such as Florida or Nevada) that has a favorable statute. However, the Bankruptcy Code provides that the applicable law in a bankruptcy action will be that of the state in which the debtor has been domiciled for at least 730 days prior to the filing of the bankruptcy pleadings. 11 U.S.C. §522(b). As a result, the mere act of opening an account in a state with more favorable laws than Illinois does not necessarily provide a debtor with the benefit of that state's law for purposes of determining exempt assets. Therefore, a prudent strategy to protect 529 plan assets would be to title the account in the name of someone other than the potential debtor, such as a spouse who is unlikely to have creditor issues. If the owner of a 529 plan is concerned that he or she may have to declare bankruptcy, the owner of the account can be changed, but that may create other bankruptcy or tax issues.

B. Life Insurance

1. [7.7] Statutory Protection for Death Benefits and Net Cash Value

In contrast to assets held within a 529 plan, Illinois law protects the death benefit and cash value held within a life insurance policy from creditor claims in certain situations. This exemption comes from two statutes, the aggregate effect of which is to protect an owner/insured of a life insurance policy, as well as his or her spouse and dependents.

One statute that operates to exempt insurance cash value and death proceeds is 215 ILCS 5/238. This statute, which is part of the Illinois Insurance Code, provides in relevant part:

(a) All proceeds payable because of the death of the insured and the aggregate net cash value of any or all life and endowment policies and annuity contracts payable to a wife or husband of the insured, or to a child, parent or other person dependent upon the insured, whether the power to change the beneficiary is reserved to the insured or not, and whether the insured or his estate is a contingent beneficiary or not, shall be exempt from execution, attachment, garnishment or other process, for the debts or liabilities of the insured incurred subsequent to the effective date of this [Insurance] Code, except as to premiums paid in fraud of creditors within the period limited by law for the recovery thereof. [Emphasis added.] 215 ILCS 5/238(a).

Under this statute, the death benefit and net cash value of a life insurance policy is protected from the creditors of the insured. However, this statute does not protect the insurance proceeds from the creditors of a policy's beneficiary. *Roth v. Kaptowsky*, 393 Ill. 484, 66 N.E.2d 664, 667 (1946); *People ex rel. White v. Travnick*, 346 Ill.App.3d 1053, 806 N.E.2d 270, 277, 282 Ill.Dec. 295 (2d Dist. 2004).

The Illinois legislature expanded the insurance exemption in 1982 when it enacted 735 ILCS 5/12-1001 as part of the Code of Civil Procedure, 735 ILCS 5/1-101, *et seq.* Under this statute, life insurance proceeds and net cash value of life insurance, endowment policies, and annuity contracts received by certain beneficiaries are exempt from the beneficiary's creditors. The relevant text of this statute is as follows:

The following personal property, owned by the debtor, is exempt from judgment, attachment, or distress for rent:

* * *

(f) All proceeds payable because of the death of the insured and the aggregate net cash value of any or all life insurance and endowment policies and annuity contracts payable to a wife or husband of the insured, or to a child, parent, or other person dependent upon the insured, whether the power to change the beneficiary is reserved to the insured or not and whether the insured or the insured's estate is a contingent beneficiary or not;

* * *

(h) The debtor's right to receive, or property that is traceable to:

* * *

(3) a payment under a life insurance contract that insured the life of an individual of whom the debtor was a dependent, to the extent reasonably necessary for the support of the debtor or a dependent of the debtor. *Id.*

a. [7.8] Proceeds Payable to Spouse

Section 12-1001(f) of the Code of Civil Procedure seems clear on its face that the entire death benefit and net cash value of a life insurance policy are exempt as long as the primary beneficiary of the policy is the insured's spouse. However, in several bankruptcy cases, the bankruptcy trustee argued that §12-1001(f) was limited to policies owned by the debtors or situations in which the debtor was the insured party and, therefore, a debtor spouse could rely only on 735 ILCS 5/12-1001(h)(3), which limits the exemption for amounts payable to a dependent to the amount necessary for the dependent's support.

The courts rejected this argument and held that the more restrictive exemption contained in §12-1001(h)(3) was inapplicable to life insurance payable to a spouse. *In re Ashley*, 317 B.R. 352 (Bankr. C.D.Ill. 2004); *In re McKinney*, 317 B.R. 344 (Bankr. C.D.Ill. 2004); *In re Bird*, 288 B.R. 546 (Bankr. C.D.Ill. 2002); *In re Bateman*, 157 B.R. 635 (Bankr. N.D.Ill. 1993).

b. [7.9] Proceeds Payable to Other Individuals

Sections 12-1001(f) and 12-1001(h)(3) of the Code of Civil Procedure exempt life insurance payable to persons other than a spouse who was dependent on the insured. A definition of “dependent” is not found in the exemption statute, but the courts have defined a dependent as “an individual who is supported financially, either directly or indirectly by another, and who reasonably relies on such support.” *In re Rigdon*, 133 B.R. 460, 465 (Bankr. S.D.Ill. 1991); *In re Sommer*, 228 B.R. 674, 677 (Bankr. C.D.Ill. 1998), quoting *Rigdon*.

Except for a spouse, simply being a family member of an insured does not automatically make the death benefit or cash value of a life insurance policy exempt from creditor attack. Instead, a finding that a family member (other than a spouse) is financially dependent on the insured is required. This requirement has been the downfall of numerous debtors seeking to shelter the value in their own policies from creditors when the policy beneficiaries were nondependent family members. *In re Schriar*, 284 F.2d 471 (7th Cir. 1960) (cash value of policies not entitled to protection when beneficiaries of insurance policies were nondependent adult children); *Sommer, supra* (exemption unavailable for cash value of policy payable to debtor’s parents because they were not financially dependent on debtor); *In re Bornack*, 227 B.R. 144 (Bankr. N.D.Ill. 1998) (exemption unavailable when debtor’s dependent son was contingent beneficiary but principal beneficiary was debtor’s father, who was not dependent of debtor); *In re McLaren*, 227 B.R. 810, 813 (Bankr. S.D.Ill. 1998) (once child is economically independent, exemption does not apply). Although the court in *In re Heck*, 212 B.R. 314 (Bankr. C.D.Ill. 1997), held that a finding of dependency was unnecessary for life insurance payable to a child or parent of the insured, its holding was reconsidered and reversed in *In re DeRosear*, 259 B.R. 320 (Bankr. C.D.Ill. 2001).

The exemption contained in §12-1001(f) for insurance payable to a child, parent, or other person dependent on the insured is unlimited, while §12-1001(h)(3) limits the exemption to only the proceeds necessary for the dependent’s support. The only cases found by the authors dealing with this discrepancy are in the context of insurance payable to a spouse. However, the court’s reasoning in *In re Bateman*, 157 B.R. 635, 639 (Bankr. N.D.Ill. 1993), for example, may be helpful: “Indeed, §1001(f) does expressly supply protections to spouses, children, and parents of the insured, and because §1001(h)(3) applies to the more general category of ‘dependent’, the express and particular intent of §1001(f) to protect immediate family members must prevail.” Therefore, there may be an argument that a child or parent who is dependent on the insured has a claim to exempt all the insurance proceeds under §12-1001(f) rather than only those needed for support under §12-1001(h).

c. [7.10] *Proceeds Payable to a Trust*

Of particular significance for estate planners is *Dowling v. Chicago Options Associates, Inc.*, 365 Ill.App.3d 341, 847 N.E.2d 741, 301 Ill.Dec. 731 (1st Dist. 2006), in which the court held that the cash value of a life insurance policy was not exempt from the claims of the insured/policy owner's creditors because he designated as the primary beneficiary a trust for the benefit of the insured's minor children. The court concluded that the statute was clear that the exemption applies only to dependent people, not trusts for dependent people.

2. [7.11] Loss of Exemption

Policy proceeds and the net cash value may lose the protection from creditor claims in certain circumstances. For example, the fraudulent conveyance rules, which are discussed in depth in Chapter 3 of this handbook, would likely work against a debtor who added cash to a policy beyond the amount needed to sustain the policy after he or she had been sued or became aware that a claim was about to be filed or within six months of the filing a petition for bankruptcy. Moreover, the exemption would be lost in an amount equal to the premiums paid by an insolvent debtor who was the policy's insured. See 215 ILCS 5/238(a); *Borin ex rel. Novy v. John Hancock Mutual Life Insurance Co.*, 21 Ill.App.2d 139, 157 N.E.2d 673 (1st Dist. 1959).

3. [7.12] Conversion of Insurance Proceeds into Other Assets

Section 12-1001(h)(3) of the Code of Civil Procedure is implicated primarily when assets have been purchased with insurance proceeds. For example, in *In re Jackson*, 95 B.R. 590, 592 – 593 (Bankr. C.D.Ill. 1989), the court allowed a debtor to shield \$8,500 of equity in a home that was purchased with the proceeds of a life insurance policy on the debtor's deceased husband. This amount was protected by §12-1001(h)(3) since that statutory provision “specifically covers property that is traceable to a payment under a life insurance contract that insured the life of an individual of whom the debtor was a dependent.” 95 B.R. at 593. See also *In re Estate of Ashley*, 317 B.R. 352, 361 (Bankr. C.D.Ill. 2004) (“Section (h)(3) will apply when the proceeds have already been converted into other property before the debtor-beneficiary files for bankruptcy relief.”); *E.J. McKernan Co. v. Gregory*, 268 Ill.App.3d 383, 643 N.E.2d 1370, 205 Ill.Dec. 763 (2d Dist. 1994), *appeal denied*, 161 Ill.2d 525 (1995), *overruled on other grounds*, *Premier Property Management, Inc. v. Chavez*, 191 Ill.2d 101, 728 N.E.2d 476, 245 Ill.Dec. 394 (2000) (remanded in order to determine whether mutual funds purchased with accumulated cash values from life insurance policies retained their exempt character).

Therefore, the exemption of insurance policy proceeds continues under §12-1001(h)(3) if converted into other forms of property as long as (a) the debtor is a dependent and (b) the amount converted is determined to be that which is necessary for the dependent's support.

4. [7.13] Asset Protection Strategies Using Insurance

The cases mentioned in §7.12 above provide general guidance on how to use insurance to protect assets from creditor claims.

An individual can purchase a form of permanent insurance on his or her own life, designate his or her spouse or dependent family members as primary beneficiaries, and then shelter a large amount of cash from potential creditors by transferring significant funds to the policy. Of course, one still needs to be concerned about the fraudulent conveyance rules, and the cash value of the policy may still be marital property and subject to a spouse's claim in an action for dissolution of marriage. Moreover, depending on the amount of cash transferred, making large premium payments may cause the policy to be treated as a modified endowment contract under §7702A of the Internal Revenue Code, which may have adverse income tax consequences.

Similar asset protection can be obtained if a policy is owned by an irrevocable insurance trust that is not controlled by the person seeking the creditor protection. If the trust is the owner and beneficiary of the policy, the policy could, if properly drafted, provide federal and state estate tax benefits as well as protection from the creditors of the insured and the insured's family members.

C. Annuities

1. [7.14] Statutory Protection for Annuities

Under the Illinois statute, the cash value of annuities payable to an annuitant's spouse, child, parent, or any other dependent is also exempt from claims from the creditors of the owner or the recipient. 735 ILCS 5/12-1001(f). Annuities paid under a retirement plan are exempt under 735 ILCS 5/12-1006, which is discussed in §§7.16 – 7.20 below. However, in *In re Simon*, 170 B.R. 999, 1003 (Bankr. S.D.Ill. 1994), no exemption was allowed for payments under an annuity contract that funded a structured settlement because §12-1001(f) exempts only the cash value of certain annuities and there was no evidence that there was any cash value. Further, if there was any cash value, it appeared that it didn't belong to the debtors because the annuity was purchased by an assignee of the party to the structured settlement. *See also People ex rel. Director of Corrections v. Ruckman*, 363 Ill.App.3d 708, 843 N.E.2d 882, 300 Ill.Dec. 282 (5th Dist. 2005) (annuity purchased by prison inmate with life insurance proceeds resulting from death of inmate's mother was not exempt from reimbursement for costs of incarceration; exemption did not apply because inmate was not dependent of his mother).

2. [7.15] Planning with Private Annuity

Under the authority discussed in §7.14 above, it is clear that one could shelter from creditors the cash value of an annuity purchased from a commercial seller. Although the authors are not aware of any directly relevant authority, nothing in Code of Civil Procedure §12-1001(f) prohibits the exemption for a private annuity. A "private annuity" is a transaction in which an individual transfers assets to a family member or trust for the individual's family in exchange for a commitment by the family member or trust to make payments to the individual for his or her lifetime, or to an individual and another for their joint lives. Besides creditor protection, if structured properly, a private annuity can potentially provide federal and state income and estate tax benefits. These tax benefits are beyond the scope of this chapter.

D. Qualified Plans and Individual Retirement Accounts

1. [7.16] Statutory Protection for Retirement Plan Assets

Barring any kind of fraudulent transfer, Illinois statutes (as opposed to the Bankruptcy Code) provide that assets held in retirement plans are exempt from creditor claims. The key statute is 735 ILCS 5/12-1006, which reads in relevant part as follows:

(a) A debtor's interest in or right, whether vested or not, to the assets held in or to receive pensions, annuities, benefits, distributions, refunds of contributions, or other payments under a retirement plan is exempt from judgment, attachment, execution, distress for rent, and seizure for the satisfaction of debts if the plan (i) is intended in good faith to qualify as a retirement plan under applicable provisions of the Internal Revenue Code of 1986, as now or hereafter amended, or (ii) is a public employee pension plan created under the Illinois Pension Code, as now or hereafter amended.

The Illinois legislature has reinforced the general rule of §12-1006 by promulgating no fewer than 16 other statutes within the Illinois Pension Code that provide that various forms of public retirement plans and pension funds are exempt from the claims of creditors. See 40 ILCS 5/2-154 (Illinois General Assembly Retirement System); 40 ILCS 5/3-144.1, 5/5-218 (police pension funds); 40 ILCS 5/4-135, 5/6-213 (firefighter pension funds); 40 ILCS 5/7-217, 5/8-244 (municipal retirement funds); 40 ILCS 5/9-228 (county employee retirement plans); 40 ILCS 5/11-223, 5/12-190 (laborer and retirement board benefit fund); 40 ILCS 5/13-805 (sanitary district employees benefit fund); 40 ILCS 5/14-147 (state employee retirement system); 40 ILCS 5/15-185 (state university retirement system); 40 ILCS 5/16-190, 5/17-151 (teachers' retirement funds); 40 ILCS 5/18-161 (Illinois judges' retirement system). A retirement plan that is intended in good faith to comply with the applicable provisions of the Internal Revenue Code and a public employee pension plan created under the Pension Code are conclusively presumed under law to be spendthrift trusts. 735 ILCS 5/12-1006(c).

For debtors in federal bankruptcy court in Illinois, §522(b)(3) of the Bankruptcy Code, as recently amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, exempts retirement funds from creditor claims to the extent that they are in an account that is tax-exempt under Internal Revenue Code §§401 (qualified pension, profit-sharing and stock bonus plans), 403 (employee annuities), 408 (individual retirement accounts (IRAs)), 408A (Roth IRAs), and 457 (deferred compensation plans of exempt organizations and state and local governments). For traditional and Roth IRAs, Bankruptcy Code §522(n) now caps the exemption at \$1 million unless "the interests of justice so require" that the cap be increased. This limit does not apply to the extent the funds in an IRA are attributable to funds rolled over from a qualified plan or qualified annuity. Due to this distinction, a person who receives funds from a qualified plan and rolls them over to an IRA should create a separate IRA for normal IRA contributions. Also note that a "Simplified Employee Pension" (or "SEP," as it is known) is treated as an IRA.

Since Illinois has opted out of the Bankruptcy Code's exemption scheme and already offers broad protection for retirement assets, §522 of the Bankruptcy Code does not operate to provide additional creditor protection for an Illinois debtor. In fact, the previously unlimited protection available with respect to the IRA assets of an Illinois debtor in bankruptcy court may be restricted by the newly enacted \$1 million cap.

2. [7.17] Retirement Assets Received as a Result of Divorce or Death

One court has held that a debtor's interest in a pension plan received from an ex-spouse as a result of a divorce was also exempt from claims.

The Court finds the language of §12-1006(a) to be unequivocal in protecting *any* interests a debtor may have in the assets of a pension or retirement plan and *any* right to receive benefits, distributions, or other payments under such a plan. Had the Illinois legislature wished to restrict the coverage of this section to debtors who earn pension rights as the fruit of their own labor, it could have done so easily. Instead, the statute is drawn broadly and is devoid of any suggestion that its scope excludes debtors who have come into their pension rights derivatively. [Emphasis in original.] *In re Lummer*, 219 B.R. 510, 512 (Bankr. S.D.Ill. 1998).

Section 522(b)(4) of the Bankruptcy Code provides that inherited IRAs that are rolled over within 60 days of distribution or transferred in a direct trustee-to-trustee transfer are also exempt from creditors' claims in bankruptcy court. However, it is unclear how the \$1 million limitation on exemption of IRAs under §522(n) of the Bankruptcy Code will apply to such inherited IRAs if an IRA was created by the decedent as a rollover contribution with funds distributed from a qualified plan. For the decedent, the \$1 million exemption does not apply to an IRA created with funds from a qualified plan. See §7.16 above. The new provisions of the Bankruptcy Code do not indicate whether that tracing continues for the persons who inherit an IRA at death.

3. [7.18] Proceeds of Exempt Retirement Assets

Of course, eventually a debtor will want to remove retirement assets from the exempt account and spend them. Courts in Illinois have recognized this fact and, to a limited degree, assets removed from retirement accounts may be exempt from creditor claims. The analysis in *Auto Owners Insurance v. Berkshire*, 225 Ill.App.3d 695, 588 N.E.2d 1230, 167 Ill.Dec. 1100 (2d Dist. 1992), is instructive. In *Auto Owners Insurance*, the issue was whether \$696.32 distributed from a tort defendant's retirement account and subsequently deposited into his checking account retained the exemption. The court noted that Code of Civil Procedure §12-1006 protects a debtor's interests in retirement assets as well as the right to receive payments under a retirement plan: "Where the purpose of an exemption is to protect income necessary for the support of a debtor and his family, it makes no sense to allow the funds to be exempt so long as the debtor cannot use them." 588 N.E.2d at 1232 – 1233. Therefore, in order to avoid frustrating legislative intent and rendering the statute meaningless, "section 12-1006 allows the debtor to receive benefits and to use them as well." 588 N.E.2d at 1233.

However, the court held that this did not give funds withdrawn from a retirement account unlimited protection. “[I]f the debtor transforms the support payments into an investment, the purpose of the statutes is not being met; the funds are not being used for support and thus should lose their exempt character.” *Id.* Practically speaking, if the disputed funds are from a periodic payment (in this case, a pension), and are deposited into a nonqualified account that retains “the quality of moneys,” the exemption would continue to exist since it could be assumed that the purpose of the income is the support of the debtor. 588 N.E.2d at 1234. In contrast, if the contested funds are the result of a lump-sum payout of the entire balance of a qualified account, and they are not rolled over into another protected plan of some kind, then the funds would take on the character of an investment and lose the exemption. *Id.* The case was remanded for a determination of the character of the payment and use of the funds.

Other cases have followed the “periodic payment vs. lump sum” rule articulated in *Auto Owners Insurance*. See, e.g., *In re Phillips*, No. 04-91842, 2006 Bankr. LEXIS 293 at *4 (Bankr. C.D.Ill. Feb. 16, 2006) (funds distributed in lump sum from qualified plan and used to purchase luxury sedan and minivan were deemed “freely usable for current consumption” and were no longer exempt); *In re Gordon*, No. 96-81341, 1996 WL 33401390 (Bankr. C.D.Ill. July 18, 1996) (debtor made early withdrawal to terminate his IRA and received proceeds in lump sum, which were deposited in savings account; court held that exemption was lost). Although the court in *Gordon* noted that the debtor used the withdrawn funds for support, it concluded that the statute was intended to protect assets for retirement and the early withdrawal of the funds for preretirement purposes was beyond the scope of the exemption.

4. [7.19] Broad Definition of “Retirement Plan” under Illinois Law

The Illinois legislature created an extremely broad definition for “retirement plan.” Under Code of Civil Procedure §12-1006(b), a “retirement plan” is defined to include (a) a stock bonus, pension, profit-sharing, annuity, or similar plan or arrangement, including a retirement plan for self-employed individuals or a simplified employee pension plan; (b) a government or church retirement plan or contract; (c) an individual retirement annuity or individual retirement account; and (d) a public employee pension plan created under the Illinois Pension Code.

The definition of “retirement plan” could include a nonqualified plan, such as a voluntary agreement to defer compensation and other arrangements typically described in §409A of the Internal Revenue Code, as long as the arrangement is structured to provide benefits at retirement. Section 409A of the Internal Revenue Code, which was enacted in 2004, is part of Subpart A of Part I of Subchapter D of the Internal Revenue Code, of which the rest of the provisions relate to qualified plans and individual retirement accounts. Because §12-1006 refers to a “retirement plan under applicable provisions of the Internal Revenue Code of 1986, *as now or hereafter amended*” (emphasis added) (735 ILCS 5/12-1006(c)), one could argue that the addition of §409A to the provisions of the Internal Revenue Code dealing with qualified plans and individual retirement accounts should give a retirement plan under §409A the same protected status under Illinois law. However, since §409A was so recently added to the Internal Revenue Code, there are no Illinois cases on this issue, but it does not appear to be precluded by the 2005 changes to the Bankruptcy Code.

5. [7.20] Asset Protection Strategies Using Retirement Assets

A relatively simple asset protection measure is to contribute as much as possible into qualified plans and leave it there until any creditor threat has passed. With the \$1 million limit on IRAs other than from rollovers from a qualified plan, taxpayers will have to monitor those balances. However, given the small limit on contributions to IRAs (see Internal Revenue Code §219), it would be difficult to have a \$1-million IRA solely from normal contributions. Of course, federal law and/or individual retirement plan rules limit how much a person can place within a retirement plan in any given year and require withdrawals to begin by a certain age or date. While the fraudulent conveyance rules may apply to vitiate a transfer of assets to a retirement plan once knowledge of a claim or an impending claim exists, an individual who does not run afoul of these obstacles can transfer value into a retirement plan to avoid potential creditor claims. Further, amounts distributed periodically from a retirement plan and used for support will likely remain exempt. In contrast, any proceeds distributed in a lump sum that remain outside of a retirement account may be at risk, even if used, or intended to be used, for living expenses.

E. Protections for Primary Residence

1. [7.21] Tenancy by the Entirety

“Tenancy by the entirety” is an estate in real property provided for by §1c of the Joint Tenancy Act, 765 ILCS 1005/1c. Only spouses may hold property as tenants by the entirety, and the tenancy is limited to homestead property.

Pursuant to the Illinois Code of Civil Procedure, holding property in tenancy by the entirety protects spouses because the subject property cannot be sold to satisfy the debt of only one spouse. However, this treatment does not apply to property transferred into tenancy by the entirety with the “sole intent to avoid the payment of debts existing at the time of the transfer beyond the transferor’s ability to pay those debts as they become due.” Further, income generated by the property is subject to garnishment whether the debt is of one or both of the tenants. 735 ILCS 5/12-112.

In *Premier Property Management, Inc., v. Chavez*, 191 Ill.2d 101, 728 N.E. 2d 476, 245 Ill.Dec. 394 (2000), the Illinois Supreme Court held that a creditor looking to set aside a transfer of a property by a debtor from his individual name to himself and his spouse as tenants by the entirety could be avoided only with a showing that the transfer occurred for the sole reason of avoiding creditor claims (the case was remanded to allow the creditor to amend its complaint to make such a showing). The court explained that CCP §12-112 is in contrast to the “actual intent” standard under §5 of the Illinois Fraudulent Transfer Act. 728 N.E.2d at 481 – 482. In other words, it is harder for a creditor to set aside a transfer of a residence under §12-112 than it would be under the Fraudulent Transfer Act due to the more difficult evidentiary standards set by §12-112. While it is difficult to meet this high standard, it is not impossible, and the standard can be met if only the debtor spouse has the sole intent to defraud creditors. See *LaSalle Bank N.A. v. DeCarlo*, 336 Ill.App.3d 280, 783 N.E.2d 211, 216, 270 Ill.Dec. 636 (2d Dist. 2003) (evidence showed that transfer of debtor’s residence from himself and his wife as joint tenants to himself

and his wife as tenants by the entirety was undertaken with sole intent to avoid existing creditor claim because transfer was made at time to render debtor spouse insolvent, lawsuit was pending, and debtor spouse's reasons for the transfer were " 'vague, inarticulate,' and 'specious' ").

Since Illinois is an opt-out state, the federal bankruptcy courts have followed Illinois law with respect to the sheltering of tenancy by the entirety property of an Illinois debtor. *See In re Giffune*, 343 B.R. 883 (Bankr. N.D.Ill. 2006) (bankruptcy court in Illinois chose Illinois law for debtor domiciled in Illinois even though bulk of debtor's tenancy by the entirety property was located in Michigan); *In re Tolson*, 338 B.R. 359 (Bankr. C.D.Ill. 2005) (bankruptcy court held that §12-112 applies to shield property owned in tenancy by the entirety during period when both tenants are living, although not after first tenant's death).

It is noted that holding a residence in tenancy by the entirety is not effective to bar tax claims of the IRS. *See United States v. Craft*, 535 U.S. 274, 152 L.Ed. 2d 437, 122 S.Ct. 1414 (2002) (taxpayer's tenancy by the entirety interest was property to which federal tax lien could attach under 26 U.S.C. §6321; exempt status under state law does not bind federal tax collector).

2. [7.22] Homestead Exemption

Illinois allows a homestead exemption of up to \$15,000 in a debtor's primary residence. The relevant statute is 735 ILCS 5/12-901, which provides as follows:

Every individual is entitled to an estate of homestead to the extent in value of \$15,000 of his or her interest in a farm or lot of land and buildings thereon, a condominium, or personal property, owned or rightly possessed by lease or otherwise and occupied by him or her as a residence, or in a cooperative that owns property that the individual uses as a residence. That homestead and all right in and title to that homestead is exempt from attachment, judgment, levy, or judgment sale for the payment of his or her debts or other purposes and from the laws of conveyance, descent, and legacy, except as provided in this Code or in Section 20-6 of the Probate Act of 1975. This Section is not applicable between joint tenants or tenants in common but it is applicable as to any creditors of those persons. If 2 or more individuals own property that is exempt as a homestead, the value of the exemption of each individual may not exceed his or her proportionate share of \$30,000 based upon percentage of ownership.

The policy underlying §12-901, as articulated by the courts, is to maintain shelter for a debtor and the debtor's family despite the improvidence or financial misfortune of the debtor. *See Dixon v. Moller*, 42 Ill.App.3d 688, 356 N.E.2d 599, 603, 1 Ill.Dec. 411 (5th Dist. 1976) (homestead right upheld even though creditor rented and occupied separate apartment so he could engage in his occupation); *People v. One Residence Located at 1403 East Parham Street*, 251 Ill.App.3d 198, 621 N.E.2d 1026, 1029, 190 Ill.Dec. 573 (5th Dist. 1993) (homestead exemption upheld over forfeiture of real property pursuant to Controlled Substances Act and Drug Asset Forfeiture Procedure Act). Of course, the modest amount sheltered under §12-901 would allow a debtor to maintain only the most inexpensive of homes.

Since Illinois has opted out of the Bankruptcy Code's exemption scheme, federal statute provides no relief from the low exemption of §12-901.

