



BUSINESS COUNSELING UPDATE

SPRING 2004

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OBSCURE TAX CREDIT AVAILABLE TO SOME EMPLOYEES WHO PARTICIPATE IN A QUALIFIED RETIREMENT PLAN

Starting in tax year 2002, certain lower to moderate income taxpayers became eligible for a tax credit of up to 50% of the amount of salary reduction contributions of up to \$2,000 made to a 401(k) plan, traditional or Roth IRAs, SEP plans and certain other qualified retirement plans. This tax credit will expire for taxable years beginning after December 31, 2006.

A reminder to employees of this potential credit could serve as a good human resources tool – let your employees know you are looking out for them!

The Saver's Credit plan provides incentives for moderate income individuals to save for their retirement through available qualified plans. To qualify, the taxpayer must have reached the age of 18 by the close of the year and cannot be a full-time student or a dependent of another. The credit ranges from 10% to 50% of the first \$2,000 contributed to a qualified plan during the year. The credit gradually phases out as the taxpayer's income increases and is fully phased out for joint filers when their gross income reaches \$50,000 (\$25,000 for single individuals and \$37,500 for those filing head of household). The credit is in addition to any deduction or exclusion that would otherwise apply for a contribution.

Be sure to tell your employees, however, that you are not providing tax or legal advice if you decide to pass this helpful information along to them.

Brian J. McGrath



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SPENDTHRIFT TRUST BENEFITS DEBTOR

A recent decision by the United States Bankruptcy Court for the District of Nebraska highlights some of the issues which arise when the bankruptcy process interacts with the law of trusts. In *In re Rathe*, Case No. Bk 03-81956 (February, 2004), Chief Judge Timothy J. Mahoney dealt with a Chapter 7 trustee's objection to the claimed exemption of a debtor's right to receive a future distribution from a testamentary trust. The debtor had claimed the trust expectancy as exempt under Neb. Rev. Stat. Section 44-371(1)(a) (an exemption in a specific asset permits a debtor to protect that asset from the claims of creditors, usually in or out of bankruptcy; federal law permits states to utilize their own set of exemptions, which is why Nebraska state exemption law was applied here). "All proceeds, cash values, and benefits accruing under any annuity contract, under any policy or certificate of life insurance payable upon the death of the insured to a beneficiary other than the estate of the insured, or under any accident or health insurance policy shall be exempt from attachment, garnishment, or other legal or equitable process and from all claims of creditors of the insured and of the beneficiary if related to the insured by blood or marriage, unless a written assignment to the contrary has been obtained by the claimant."

The trustee argued that the exemption should be disallowed because the statutory exemption under which it was claimed was inapplicable. (The debtor had previously sought to exempt the interest in the trust distribution under Neb. Rev. Stat. Section 25-

1563.01 as a stock bonus, pension, profit sharing or similar plan, a previous objection to which was sustained by the bankruptcy court.)

In resisting the trustee's objection to the amended claim of exemption, the debtor also asserted that the interest in question was not "property of the estate" under Bankruptcy Code Section 541, and that therefore the issue of whether it was exempt need not be reached. The court agreed, holding that "the appropriate basis for an exemption is not relevant here because the property is not property of the bankruptcy estate." Section 541 of the Bankruptcy Code provides that "the commencement of a case [under the Bankruptcy Code] creates an estate." It is this "estate" which is subject to administration by the court in the bankruptcy process, and property which is not "property of the estate" is generally not subject to administration in a bankruptcy case. The court pointed out that while "property of the bankruptcy estate" is extensive in scope, covering "all legal and equitable interests of the debtor in property as of the commencement of the case" there are exceptions. Specifically, Bankruptcy Code Section 541(c)(2) provides that "a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title."

As the bankruptcy court pointed out, in agreeing with the debtor, this section "generally excludes a debtor's interest in a spendthrift trust to the extent the trust is protected from creditors under applicable state law," (citing *Markmeuller v. Case*, 51 F.3rd 775, 776 (8th Cir. 1995)). The bankruptcy court reasoned that "a spendthrift trust is one in which the right of the

beneficiary to future payments of income or capital cannot be voluntarily transferred by the beneficiary or reached by his or her creditors." In the *Rathe* case, the trust at issue had been created in 1986 by Mr. Rathe's mother as part of her last will and testament to provide for her three children; when the youngest child reached 21 years of age, the trust res was divided into thirds, and each child's share was to be distributed incrementally at specified ages. The language of the *Rathe* trust document clearly evidenced the settlor's intent to protect the beneficiaries' interests from their creditors. The trust instrument provided in pertinent part as follows: "No interest hereunder shall be assignable or transferable by any beneficiary or be subject during his or her lifetime to the claims of his or her creditors. However, this provision shall not be construed as restricting the exercise of any power of appointment granted hereunder or any provision granting rights to withdraw principal."

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The court concluded that under the terms of the trust the debtor had a present interest in the annual distribution of income from the trust, as well as a vested interest in



the final distribution of the trust assets to him in two years, but that the interest in the future distribution of the remaining portion of the trust corpus was not available to the debtor's creditors by operation of the anti-alienation provision in the trust document, and was therefore not "property of the estate."

Although this decision did not really break any new ground, it is a good summary of some of the issues which arise in connection with an individual bankruptcy case where one of the apparent assets of the debtor is a beneficial interest under a trust instrument, and points out the importance of careful draftsmanship in preparing both testamentary and nontestamentary trusts.

Frank M. Schepers



FEDERAL COURT DECISION CREATES TRAP FOR UNWARY LESSEES

A federal appellate court decision, *Precision Industries, Inc. v. Qualitech SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003), has sent shockwaves through the real estate industry. In this case, the Seventh Circuit Court of Appeals attempted to reconcile two provisions of the Bankruptcy Code, Section 363(f), which allow the sale of a debtor's property "free and clear" of most interests and Section 365(h) which provides protection to lessees when a debtor-lessor formally rejects a lease in bankruptcy. The court's decision, that Section 363(f) trumps Section 365(h), poses potentially devastating consequences for long term leases and leasehold deeds of trust whenever a lessor files for bankruptcy.

In *Precision Industries*, the lessor owned and operated a steel mill in Indiana. The lessor entered into an agreement providing for the construction of a warehouse and a ten year lease with the lessee. The lessor filed bankruptcy in March 1999 and sold substantially all of its

assets at an auction three months later to a group of secured creditors. The lessee did not object to the sale, even though it had proper notice of the sale. After the sale, a dispute arose between the new owner of the property and the lessee. Litigation ensued and subsequent appeals led to the case being heard by the 7th Circuit Court of Appeals.

A lender taking a leasehold mortgage or deed of trust against a lessee's interest in property as collateral also needs to be aware of this development or suffer the consequences of losing the collateral securing its loan upon the property's sale.

The court held that the sale of a lessor's assets in accordance with Section 363(f) trumped the provisions of Section 365(h) and held that the lessee lost its

YES, YOU DO NEED A WILL AND A TRUST

Many estate plans today consist of more than just a will. Individuals frequently establish trusts as part of their estate plan.

Trusts are established for various purposes. To the extent you retitle assets to your trust during your lifetime, probate can be avoided upon your death. A trust can provide that trust funds are not distributed to the trust beneficiaries immediately upon your death. Rather, the trust can provide that the beneficiaries receive specified distributions at certain ages or by another method you choose. Trusts also are established to implement tax planning for married couples. The tax planning typically included in a trust ensures that each spouse's estate tax exemption amount is fully utilized.

While trusts generally contain the majority of the dispositive provisions of an estate plan, a will is still necessary. If a trust is

part of your estate plan, your will is probably a "pourover" will. This type of will is a fairly short document and "pours" the assets of your estate into your trust.

A will is the document that will be submitted to the probate court and, consequently, become public record in the event your estate needs to be probated. Trusts can protect the privacy of individuals who do not want the dispositive provisions of their estate plan becoming public record.

In the event all of your assets are transferred to your trust, probate will not be necessary and a will would not need to be filed with the court. However, sometimes an asset is forgotten and the estate must be probated; at that time, a will becomes necessary. Additionally, general household items and personal property are often not transferred to the trust. Consequently, a will controls the disposition of those assets. In order to have a complete estate plan, both a will and trust are needed.

Angie M. Pelan



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possessory rights in the warehouse. However, the court also held that the value of the lessee's leasehold may be compensated from the proceeds of the sale if a lessee asserts an "adequate protection" claim against the proceeds under Section 363(e). In essence, because of its failure to object to the sale, the lessee lost its rights to operate its business on the property, while retaining its claim for the value of its leasehold interest from the proceeds of the sale.

Lessees of property and leasehold lenders should be concerned about the possible ramifications of this decision. It is now more important than ever to be vigilant in defending lessee rights in bankruptcy by raising timely objections to a proposed "free and clear" sale of the property by the debtor/lessor under Section 363(f) and to take the proper steps to seek adequate protection of the leasehold interest of the lessee under Section 363(e). A lender taking a leasehold mortgage or deed of trust against a lessee's interest in property as collateral also needs to be aware of this development or suffer the consequences of losing the collateral securing its loan upon the property's sale under Section 363(f).

Ryan N. Boe



RETAIN TAX RECORDS

As April 15th comes and goes, clients often take inventory of their records and documents, wondering "how long should I keep this stuff?" Many of us have home shredders (mine isn't very good and always seems to jam) and spring just seems to motivate people to clean house. When organizing personal financial documents, here are a few helpful guidelines.

Income Tax Records

The first rule of thumb is to retain your income tax records for as long as the IRS is permitted to audit your return or you are allowed to file an amended return. Generally, this is three years from the due date of the return, or the date the return is actually filed if you file the return late or on extension. There are certain cases, however, when the IRS is permitted to audit your return six years later. Accordingly, it is advisable to retain your income tax records for seven years.

Tax Basis Documentation

Certain tax records should be kept indefinitely. These include documents which establish your tax basis in property. If you later sell this property, you will need to establish your tax basis for purposes of computing any gain or loss on the sale. Additionally, tax returns themselves and IRS and state audit reports should be retained indefinitely.

Business Records

Business records such as ledgers, annual financial statements, corporate and stock records should also be retained indefinitely. Original business agreements, deeds, transfer documents, and promissory notes should also be retained indefinitely.

Electronic Records

The IRS now allows taxpayers to store certain records electronically. The rules allow you to convert paper documents to digital images and maintain only the electronic files, destroying the paper documents. Businesses that choose to maintain records electronically are required to follow certain guidelines. You should contact us for assistance if you are contemplating implementing an electronic storage system for your business.

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