A.P. Brief 12 - August 12, 1994

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Current Deduction for Funding Severance Benefit Plan Denied — *Wellons* Case

Background

Under the 1993 tax law, the search for corporate deductions for income which will eventually be channeled back to the business owner (i.e., an indirect plan of deferred compensation) has become the national pastime. This is especially true for high income professionals, who are in a 35% corporate and perhaps a 45% individual bracket. The roadblock to traditional deferred compensation plans is that a current deduction for funding the obligation is not allowable.

The most recent attempt to “back-road” this obstacle has been to establish a severance benefit within a “multiple employer welfare benefit plan” under IRC § 419A(f)(6). The doctor, for example, deducts from current P.C. income contributions to the plan. With some creative “fact planning,” the doctor receives a severance benefit at “termination,” or terminates the plan with the idea of distributing plan assets to the then existing employees (the doctor and perhaps one remaining P.C. employee) in proportion to salary paid during the life of the plan.

IRS has informally grumbled that such plans are disguised deferred compensation plans for which no current deduction is allowable. And yet the lure of the deduction in those high brackets is so great that many have engaged in this plan. NML Agents who have competed against it know the difficulty of dissuading its implementation absent evidence that someone “has been hung” for using it.

Our position is that most of these “severance” plans are not legitimate and will be challenged successfully by IRS. While no case or ruling has yet ruled on such a plan under IRC § 419A, the following case comes pretty close and was decided against the taxpayer.

Facts

In *Harry A. Wellons, Jr., M.D., S.C.,* 64 TCM 1498 (1992), *Dr. Wellons* established what was intended to be a VEBA to provide a severance benefit of up to twice final salary. A benefit could not begin to accrue until after five years of service; the amount was based on an employee’s weekly salary and linked to years over five in service; and benefits commenced upon termination of employment. *Wellons’* P.C. deducted $194,000 in each of 1984 and 1985 as plan contributions. IRS disallowed the entire deductions claimed, asserting that the plan was one of deferred compensation and that, as such, a deduction was not permitted under IRC § 404(a)(5) until amounts were includable in an employee’s income.

Holding

The Tax Court looked to the definition of a pension plan in Reg. Sec. 1.401-1(b)(1)(i)—systematic post-retirement payments generally measured by years of service and compensation received—and held that *Wellons’* plan was one of deferred compensation. Deductions, therefore, are allowable only in the year that benefits attributable to the contributions are includable in an employee’s income.

Observations

Although the Court explicitly noted that its decision was based on the laws prior to effectivity of § 419 and § 419A, it is instructive as to the IRS’ and the Court’s “attitude” toward such plans. This appeared to be a case of a high income professional attempting, under the auspices of providing a legitimate benefit to all employees, to defer taxation of compensation which, because of the terms of the plan, would be channeled back to the professional. The benefit was based on longevity and salary. In 1984, the P.C. had three employees: the doctor, his wife and a third employee. The doctor’s 1984 salary was $1.1 million, his wife’s, $3,600, his assistant’s, $5,300.

In 1985, the figures were $1.18 million, $4,000 and $15,000 (plus two new employees). No one gets a benefit until after five years; the professional of the P.C. is the only employee who, practically speaking, will be guaranteed to meet that requirement. Ideally, for the professional, he would somehow become “severed” near retirement and receive a two-times salary severance benefit.

How much was the Court influenced by the glaring fact that a deductible $194,000 a year was being pumped into a plan primarily to provide a multimillion dollar severance to a sole shareholder employee who either couldn’t in reality, be “severed” or, if he could, would time his own severance at his convenience? We do not know, but we believe these kinds of facts—the kinds we usually see in these plans—beg for audit, challenge and court-backed deficiencies

Admittance or Withdrawal of Partners Does Not Cause ‘Transfer’ of Partnership Policy — Private Letter Ruling 94-10-039

Introduction

The transfer-for-value rule triggers perhaps the most feared of all tax consequences found in the Internal Revenue Code -- income taxation of otherwise tax-free life insurance proceeds. As has been stated in these Briefs and numerous other publications, any potential transfer of any interest in a life insurance policy needs to be scrutinized to make certain the rule is either inapplicable or the transferee is an excepted party. One can usually find comfort that the harsh treatment of the transfer-for-value rule will not apply when there is a partnership present. However, what about the situation where the partnership-owned policy covers an insured who is not one of the partners? PLR 94-10-039 dealt with just such a situation.

Facts

The partnership, a law firm, bought a life insurance policy on its Managing Director, a non-partner. The policy was bought to provide key-person coverage to protect against the expected costs which would be incurred upon the Managing Director’s death, such as securing a replacement and other incidental losses. From time to time, new partners were admitted to the firm, and existing partners would retire or otherwise withdraw. New partners would be required to make a capital contribution and existing partners would receive back their capital contribution. The IRS was called upon to rule whether or not there could be an underlying shift of ownership interests in the policy which would constitute a transfer for valuable consideration as partners came and went. This was of concern to the partnership since the insured was not a partner and, therefore, no exception to the transfer-for-value rule would apply.

IRS’s Ruling

The IRS held that there was no transfer for valuable consideration, since the partnership was the owner of the policy both before and after any changes in the makeup of the partners. Since the partnership was never considered “terminated” under IRC § 708(b), the owner of the policy never changed. (Although not specifically mentioned, the IRS applied what is known as the “entity” theory of partnership taxation.) A partnership will only be considered terminated if either: (1) no part of any business, financial operation or venture of the partnership continues to be carried on by any of the partners in a partnership or (2) within a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. Since neither of these facts were present in the situation presented to the IRS,the partnership was deemed to continue and no ownership transfer of the life insurance policy took place. Of course, the IRS (in typical “I know something you don’t know” fashion) would express no opinion as to the tax consequences if the partnership was considered terminated under § 708(b).

Significance of Ruling

Obviously, this ruling provides some comfort (although remember, it is a PLR) to those partnerships who have similar fact situations. However, although the fact situation may appear similar, this ruling should not be

considered as eliminating the need for an underlying partnership under an escrowed buy-sell arrangement among corporate shareholders. When one shareholder dies under an escrowed buy-sell arrangement, there is an underlying shift in the ownership interest in the policies covering surviving shareholders. The fact that the escrow agent remains the named owner of the policy does not change the fact that a transfer for valuable consideration has taken place and that an exception to the transfer-for-value must be present. If an exception is not present, income taxation of at least a portion of the death proceeds paid on the remaining policies will result.

More on Partnership and Transfer-for-Value — The 'Right Way' To Do It

Background

In our most recent A.P. Brief (No. 11 at page 5), we expressed some misgivings at forming a partnership exclusively to hold life insurance for a cross-purchase buy-sell (into which policies would be transferred from the insured's corporation). Specifically, we recommended that the policies be transferred directly to the partners, that the partnership not become involved in policy ownership or in the buy-sell and that the partnership engage in an independent business enterprise—not in the mere ownership of life insurance. This is exactly what was proposed in PLR 93-47-016, where the IRS ruled favorably for the taxpayers on the transfer-for-value issue.

Facts

Dad (D) is a 50% owner and each of two sons (S1 and S2) is a 25% owner of C Corporation. D, S1 and S2 are also partners in P partnership formed several years ago. P invests in stocks and looks generally for business venture opportunities. C owns policies on D, S1 and S2. To facilitate a cross-purchase buy-sell, C proposes the following policy transfers: policy on D to S1 and S2 jointly; policy on S1 to S2; policy on S2 to S1. Each transferee will pay to C an amount equal to the received policy's cash value. Transferee will name himself as policy beneficiary.

Issue

Do the proposed transfers fall within the "transfer to a partner of the insured" exception to the rule so that the death proceeds will retain their income-excludable character?

Results

1. Under IRC § 7701(a)(2), P is a partnership for federal tax purposes and D, S1 and S2 are partners of P.
2. The proposed transfers satisfy the "to a partner" exception in IRC § 101(a)(2)(B); the death proceeds will be excludable from income.

Observations

It is apparent from the ruling that the applicants took pains to explain the nature of the partnership (begun in 1987 to invest in an oil and gas well concern, futures contracts and stocks), the joint and several liability of the partners, partnership management; and the entity had filed returns since its inception. The parties also represented that they intended to continue the partnership indefinitely into the future.

These facts appear to be ideal; an existing partnership with its own business purpose, carried on in proper form years before the proposed transfers. But there is no reason as to why a partnership formed for similar purposes immediately before similar policy transfers would not offer the same umbrella of transfer-for-value protection.

Questions yet to be answered:

1. Are limited partners "partners" for purposes of the rule?
2. Are members of a limited liability company "partners" for purposes of the rule?

We think that the answer to these questions should be "Yes." However, the IRS has never formally ruled on these issues and caution must be exercised. We will keep you posted.

Applying for Life Insurance and the Three-Year Rule — Private Letter Ruling 93-23-002

Introduction

When purchasing life insurance to meet estate liquidity needs, it is important to have the insurance owned by a third party (trust or children) to keep it out of the insured's estate. Often, however, the insured doesn't want to go through the expense and trouble of establishing an irrevocable trust before the insured finds out whether he or she is insurable or perhaps highly rated. The difficult choice is whether to establish the trust first and allow the trust to apply for the policy or have the insured apply and then transfer ownership to the trust after a favorable determination by the insurance company.

The downside to having the insured apply for the policy is that the "bring back" rule of Section 2035 may apply. The so-called three-year rule provides that the proceeds will be brought back into the insured's estate if the insured dies within three years of transferring ownership of the policy. The path to follow when applying for a life insurance policy became clearer with the issuance of PLR 93-23-002. The PLR is instructive because it sets forth the steps which may be taken to avoid the three-year rule.

Facts

The exact chronology of the facts is important, so they are set forth below.

- On June 1, 1989, the decedent signed a "non-prepaid" application for a life insurance policy as the proposed insured and owner and designated her estate as beneficiary.
- Later in 1989, she completed a "supplementary application" requesting that the policy be split into two policies, one for each son as the owner and beneficiary. At this point, no policy had been issued because no premiums had been paid and the policies had not been delivered, both prerequisites under state law before a policy can become effective.
- On August 28, 1989, the decedent's sons paid the premiums on the policies and the policies were put into force with the sons listed as owners and beneficiaries, respectively. At this time, the sons alone retained all incidents of ownership over the policies and their mother, the decedent, was merely listed as contingent owner.
- Between the time that the decedent made her original application and the time the supplementary application was signed, the life insurance company raised its rates. However, the insurance company allowed the sons to retain the lower rates, even though the new higher rates would have applied to their applications had mom never previously made any application.
- On July 27, 1990, the decedent died (within three years of her original application), survived by her two sons.

Analysis

Code Sections 2035(a) and 2035(d)(2) provide that life insurance proceeds will be brought back into the decedent's estate if the decedent made a gift of the policy within three years of death. The courts have interpreted the statutory language to require that the decedent must have actually owned the policy (or have had an incident of ownership) and must have actually transferred the policy within three years of death.

The issue in the PLR was: Did the decedent's original application constitute a transfer of an ownership interest in a life insurance policy? In a correct ruling, the IRS ruled NO; the decedent never had an incident of ownership in the policy because the policy did not become operative while she owned it.

Key Fact

Under Texas State Law, the policies did not become effective until the premiums were paid and the policies delivered to the owners. Thus, the decedent's initial application, without a premium and delivery, was a mere offer to the insurance company for an insurance contract. Without a policy in force, the insured could neither have an incident of ownership nor transfer the policy, the IRS reasoned.

Side Bar

Note that the decedent transferred valuable rights to her sons; the right to receive the lower rates in effect when she applied for the policies. The IRS was generous on this point, stating that the mere right to apply for life insurance and the lower rates did not constitute an incident of ownership. It is interesting to note, however, that the ruling does call this a "transfer of afavorable premium rate." This implies that the difference between the old and new rates is a gift from Mom to Sons. But since Mom never had in hand the value of the old rates to transfer, the benefit conferred to the Sons was not really a transfer from Mom, but a feature open to the Sons as a result of the carrier's policy application rules.

Planning Tip

If the irrevocable life insurance trust is not in existence yet, consider using the "substitute application" method, whereby the insured is the original owner and applicant of a "non-prepaid policy." Then, once the trust is completed, the trustee is the new applicant and owner of the policy. The key to this arrangement is that the policy is "non-prepaid" so there is never a policy in force while the insured is listed as owner.

Ability to Change Trustees and Estate Tax — *Estate of Wall*

In a recent case, *Estate of Wall,* 101 TC 300 (1993), the Tax Court ruled against the position taken by the Service in Revenue Ruling 79-353, 1979-2 CB 325. In that ruling, the Service concluded that the assets held in an irrevocable trust would be included in the estate of the grantor if the grantor retained the right to replace the corporate trustee with another independent trustee where the trustee had unlimited discretion to make distributions to trust beneficiaries. The Service's reasoning was that the right to replace the trustee is equivalent to the right to exercise the trustee's powers which would trigger inclusion of the trust assets in the grantor's estate under either Section 2036 or 2038.

Background

Section 2036 of the Code provides that the value of the gross estate shall include the value of any interest in property transferred by the decedent where he retained the right for life, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income from that property. Section 2036 would apply in the case of a gift in trust where the transferor named himself trustee and, as trustee, had the unrestricted power to make distributions of trust income or principal to trust beneficiaries. The power to make trust distributions is tantamount to the right to designate who will enjoy the trust property.

Under Section 2038, the value of the gross estate includes the value of all property to the extent that the decedent made a gift, but retained the right to alter, amend, revoke or terminate the recipient's use or enjoyment of the property transferred. Section 2038 causes property held in revocable trusts to be included in the estate of the grantor because of the grantor's control over the property by virtue of his ability to alter, amend or revoke the trust. That section can also apply to trusts in which the grantor has retained the discretion to make distributions because the grantor can, in effect, alter or amend the beneficiaries' use or enjoyment of the trust property through his control over trust distributions.

The regulations under both Sections 2036 and 2038 state that if a decedent makes a transfer in trust and reserves the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee. The assets held in trust would then be included in the estate

of the grantor if the outright retention of thetrustee's powers would have caused the trust assets to be included in the grantor's estate.

In Revenue Ruling 79-353, the Service took the position in the regulations one step further. In the Ruling, the corporate trustee of an irrevocable trust had the unrestricted power to distribute trust property to the grantor's adult children. The grantor had reserved the power to remove the corporate trustee without cause and to substitute another corporate trustee. In holding that the trust property was includable in the estate of the grantor, the Service reasoned that reservation by the grantor of the power to remove the trustee at will and appoint another trustee is equivalent to reservation of the trustee's powers even though the trustee is independent of the grantor.

In reaching its conclusion, the Service relied on the premise established in the case of *Corning v. Commissioner,* 24 TC 907 (1955), aff'd per curiam, 239 F.2d 646 (6th Cir. 1956). The issue in that case was whether the grantor should be taxed on trust income because the trustee had the right to amend or revoke the trust and the grantor retained the right to replace the trustee. In the *Corning* case, the Tax Court determined that the grantor's power to substitute trustees without cause gave the grantor some level of dominion and control over the trustee by virtue of the fact that the grantor could continue to substitute trustees until he found a trustee who would cooperate with his wishes.

In Revenue Ruling 79-353, the Service adapted the income tax rule developed in the *Corning* case to the estate tax treatment of irrevocable trusts. The publication of Revenue Ruling 79-353 generated a significant amount of criticism. The Service's position ignored the fact that a trustee is bound by its fiduciary obligation to the trust beneficiaries. In addition, it created a potential trap for those grantors who might wish to retain the power to replace the trustee of an irrevocable trust for practical reasons such as a poor level of service by the trustee or an unreasonable increase in the trustee's fees.

The *Wall* Case

The estate tax issue in the Wall case involved three irrevocable trusts that Helen Wall had established during her life. The original trustee was an independent trust company which held the position of trustee until Helen Wall's death. The trust agreement provided that the grantor, Helen Wall, could substitute trustees, but that the successor must be an independent corporate trust company and not the grantor or any firm or corporation in whichthe grantor had an interest. The trustee's powers included the unlimited discretion to distribute trust income and principal.

The Service argued that Sections 2036(a)(2) and 2038(a)(1) required inclusion of the trust assets in the decedent's gross estate. The argument with respect to Section 2036 was that the retained power to change the corporate trustee was equivalent to a power to designate the persons who are to possess or enjoy the property or the income from the property. With regard to Section 2038, the Court agreed that the power to change the trustee was a power to alter or amend the trust. The issue, then, was whether the power was extensive enough to affect the enjoyment of the trust property.

As authority for its position that the trusts should have been included in Mrs. Wall's estate, the Service cited Revenue Ruling 79-353. In evaluating the validity of that ruling, the Court noted that the *Corning* case, which was the primary basis for the ruling's conclusion, could be distinguished from the facts in the *Wall* case. The opinion in *Corning* noted that the terms of the trust at issue would not prevent the grantor from appointing as trustee a corporation in which he was the sole shareholder allowing him to control the trust through his control of the trust company. In addition, the Court pointed out that the *Corning* case was an income tax case and it is well established that the income tax rules and estate tax rules are not necessarily consistent. In its final analysis, the Court concluded that Revenue Ruling 79-353 was not supported by "cogent argument" or by the cases cited in the ruling.

The Court concluded that the right to replace the corporate trustee with another corporate trustee did not encompass the right to exercise the powers of the trustee. Even if the grantor could attempt to influence the trustee by a threatened replacement, that did not give the grantor a legally enforceable right to control the beneficial enjoyment of trust property. Moreover, the trustee would violate its fiduciary duty if it acquiesced in the wishes of the grantor by taking action that the trustee would not otherwise take regarding the beneficial enjoyment of any interest in the trust, or agreed with the grantor, prior to appointment, as to how fiduciary powers should be exercised over the distribution of income and principal. In short, the Court concluded that the

right to change trustees did not give the grantor any legally enforceable right to control the enjoyment of trust property.

The Court also criticized the implication by the Service that the grantor could compel the trustee to act in accordance with her wishes by threatening to exercise her replacement power. In the view of the Court, such conclusion would require some compelling reason to infer that there was a fraudulent side agreement between the trustee and the grantor as to how the administration of the trusts would be manipulated by the grantor. No evidence of such an agreement was presented by the Service.

Planning Implications

The decision in the *Wall* case has expanded the available scope of a grantor's retained right to replace the trustee of an irrevocable trust where the trustee's dispositive powers are not limited by an ascertainable standard. The decision by the Tax Court overrules the position taken by the Service that the grantor's reservation of the right to remove and replace the trustee with another independent trustee is equivalent to a reservation of the trustee's powers. It is important to note that the decision does not open the door completely with respect to the grantor's ability to replace the trustee of an irrevocable trust. If the grantor retains the right to remove the trustee and name himself as trustee, he will be treated as if he retained the trustee's powers. Likewise, if the grantor's power is not limited to the right to replace the trustee with another independent trustee, the *Wall* case can be distinguished and the trustee's powers could be imputed to the grantor. Under those circumstances, if the trustee has the unrestricted discretion to make distributions to the beneficiaries, the trust assets would be included in the grantor's estate.

In the case of life insurance trusts, greater caution should be exercised in deciding whether the grantor should retain the right to remove and replace the trustee. The "incidents of ownership" standard under Section 2042 of the Code is much broader than the conditions that will cause inclusion in the estate under Sections 2036 or 2038. If the trust only allows the grantor to replace the trustee with another trustee who is independent, the *Wall* decision should prevent any incidents of ownership held by the trustee from being attributed to the grantor. Nevertheless, the risk of inclusion of death proceed in the estate of the grantor probably outweighs the benefit of retaining the right to replace the trustee. This is particularly true where the trustee's duties during the life of the grantor entail nothing more than paying premiums on the life insurance policy or policies held in trust.

Split-Dollar Plan Does Not Create Incidents of Ownership — Private Letter Ruling 93-48-028

Introduction

In PLR 93-48-028, the insured created an irrevocable life insurance trust with Crummey withdrawal powers and the trustee of the trust entered into a split-dollar arrangement with the insured's employer, a bank. The split-dollar plan utilized the traditional split of policy proceeds: the at-risk portion belonged to the trust and the balance (cash value) was retained by the bank. The insured in his individual capacity retained no incidents of ownership over the policies; however, the insured was an employee, director, and a minority shareholder of the bank which acted as trustee of the insured's trust and a participant in the split-dollar plan.

Even though an insured doesn't own life insurance policy in the legal technical sense, the insured may be found to have possessed incidents of ownership, directly or indirectly. The facts in PLR 93-48-028 raise two scenarios where the insured might be deemed to possess incidents of ownership over a policy (even though the insured does not own the policy): first, a split-dollar arrangement involving a shareholder and second, an insured acting in a fiduciary capacity concerning life insurance on his life.

Split-Dollar

Where a shareholder is a majority shareholder (51% or more), the corporation's incidents of ownership will be attributable to the shareholder-insured to the extent that the proceeds are payable to a third party, i.e., an irrevocable life insurance trust. Reg. Sec. 20.2042-1(c)(6). In the PLR, the IRS ruled that the incidents of

ownership will not be attributed to the insured because the insured owned less than 50% of the corporation. But note, if the insured acquires a controlling interest in the future, the proceeds will be brought back into his estate.

Recommendation

In situations where the insured is, or may become, a controlling shareholder, utilize the so-called sole ownership method of split-dollar, where the trust owns the policy and enters into a split-dollar agreement with the corporation; note: there is no collateral assignment to the corporation. By eliminating the collateral assignment (which gives the corporation the right to borrow from or surrender the policy), the corporation has no incidents of ownership which can be attributed to the shareholder. For a detailed analysis of this issue, see NML's study entitled, *"Federal Estate Taxation of Split-Dollar Life Insurance for Majority Shareholders,"* by William B. Lynch (F.O. 22-3430) and *"The NML Agent's Guide to Split Dollar"* (F.O. 22-3031).

Insured as Trustee

If an insured serves as trustee of an irrevocable life insurance trust which contains life insurance on the trustee's life, the incidents of ownership that the trustee holds will be attributed to the insured, causing inclusion in the trustee-insured's estate. Reg. Sec. 20.2042-1(c)(4). The facts in PLR 93-48-028 indicated that the insured was general legal council and had fiduciary duties over the bank's trust department which held his policies. However, in the bank's by-laws, any officer was prohibited from exercising any control over policies on the officer's life. This carve-out provision saved the day for the insured because the IRS ruled that the insured could not exercise any control over his policies and, therefore, did not possess any incidents of ownership.

Red Flag

The insured-grantor of an irrevocable trust should never serve as trustee of his or her own trust. Furthermore, the grantor should not retain the power to replace the trustee and name himself or herself as successor trustee. By avoiding these two problem areas, the insured will have a much better chance of avoiding estate tax inclusion of the proceeds.

Medicaid Eligibility Under OBRA '93

Introduction

Medicaid is a welfare program financed by both state and federal tax dollars which pays for long-term care expenses when a nursing home resident depletes her assets. Under "Medicaid Estate Planning," individuals with substantial assets have been able to take advantage of loopholes in the Medicaid law allowing them to shelter assets yet still qualify for Medicaid.

To qualify for Medicaid assistance, a recipient must be "poor enough" to meet the state requirements. The common strategy for meeting the requirements is for the individual to transfer his/her assets before entering a nursing home or applying for Medicaid.

Prior Law

Under prior law, when an individual applied for Medicaid, the law required a look-back period of 30 months to determine eligibility. If the transfer occurred within this 30-month period, the applicant became ineligible to receive Medicaid benefits until 30 months after the date the transfer occurred.

OBRA Changes

The new law has extended the look-back period of ineligibility from 30 to 36 months. This period applies for institutionalized individuals. However, OBRA '93 also gives states the option to create a look-back period of 36

months for non-institutionalized individuals as well. If a transfer of assets occurs within the look-back period of 36 months, then a certain number of months, beginning with the month during which the transfer occurred, must pass before the individual will become eligible for Medicaid benefits. This delay period, which varies from state to state, is computed by dividing the value of the applicant's transferred assets by the states "Official Rate" which represents the average monthly cost of private care. A delay period, however, does not apply to transfers to spouses, minors or disabled individuals under the age of 65.

The new law also requires states to recover Medicaid expenditures from the estates of deceased Medicaid recipients. States must establish hardship procedures for waiver of recovery in cases where undue hardship would result. At the option of the state, the estate against which recovery is sought may include any real or personal property or other assets in which the recipient had any legal title or interest at the time of death, *including the home.*

Planning for Disabled Children

OBRA '93 also affects planning for disabled children who seek Medicaid. The planning dilemma facing parents is how to provide assistance to their disabled child after the parents' death without interfering with the child's eligibility for government assistance. Basically, for assets transferred by the child, the rules as described above apply. Under the new rules, self-created trusts will be treated as an asset for purposes of Medicaid eligibility. There are, however, three exceptions from the general rule for trusts established after OBRA '93:

1. The trust contains assets of a disabled individual under the age of 65 years and was established for the individual's benefit by a parent, grandparent, legal guardian or court.
2. The trust is composed only of pension, Social Security and other income of an individual.
3. There are segregated trust accounts containing the assets of a disabled individual which are part of a pooled trust arrangement established and managed by a non-profit association.

These trusts will not affect Medicaid eligibility during the lifetime of the disabled individual, however, upon the death of the individual, the trust must require reimbursement to the state in an amount equal to the total Medicaid assistance benefits paid on behalf of the individual.

The new rules and exceptions apply only to certain non-testamentary self-created trusts which benefit the person who established, or is deemed to have established, the trust. While the rules affect self-created trusts traditionally used to qualify persons who are disabled by reason of the aging process for Medicaid benefits, they should not affect the eligibility of an adult disabled child who is a beneficiary of a discretionary spendthrift trust created by a parent and funded with the parent's assets.

Caution

OBRA '93 has clamped down many of the opportunities for Medicaid planning, but a few good opportunities still exist, especially for disabled children. This is a very specific and complicated area of planning and the new rules with all the ambiguities do not make it any easier. Since eachstate determines eligibility requirements, local counsel must be consulted.

Creditor Protection and Section 457 — *Pedersen* Case

Issue

In general, assets in a qualified retirement plan are exempt from the participant's creditors, even if the creditor has filed for bankruptcy protection. What about a nonqualified deferred compensation plan which is subject to § 457? Is a debtor's interest as participant in an IRC § 457 plan excludable from the bankruptcy estate? This question has been answered yes and no by different courts.

Facts

A city employee in the State of Iowa deferred income under a Section 457 plan which described his rights as those of a general creditor of his employer.

The employee went bankrupt and the bankruptcy trustee demanded that the § 457 plan administrator pay the amounts deferred and all income attributable to those amounts to it, as assets of the bankruptcy estate. In Re *Pedersen,* 155 B.R. 750 (1993).

Holding

The employee's rights and assets in the nonqualified deferred compensation plan are not excludable from the bankruptcy estate.

Observation

The *Pedersen* case ruled in direct conflict with another bankruptcy court in Florida which had previously ruled that a debtor's interest in a § 457 plan was excludable from the bankruptcy estate. In Re *Wheat,* 149 B.R. 1003 (1992.)

Comment

Both bankruptcy courts used a two-pronged analysis to determine whether the requirements for protection were met. First, there must be "a restriction on the transfer of a beneficial interest of the debtor in a trust;" and second, it must be "enforceable under applicable nonbankruptcy law."

The *Wheat* court ruled that both IRC § 457 and certain sections in the "457 plan" document created a restriction which was enforceable under federal law; therefore, the debtor's interest in the plan was protected and excluded from the bankruptcy estate.

The *Pedersen* court on the other hand, interpreted the section to require a beneficial interest in a "trust." It concluded that nothing the plan document or in IRC § 457(b)(6) created the equivalent of a trust, and so there was no protection. It went further and stated that if there were a trust, the plan would not meet the requirements of § 457.

Conclusion

Until clarification is provided, the treatment under federal bankruptcy law of an employee's interest in a non-qualified § 457 plan remains uncertain. Treatment under state exemption laws are also relevant; therefore, any conclusion about a specific situation must be left to a plan participant's local counsel.