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Feature

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A Cautionary Tale

Transfer of Real Property from LLC to Debtor May Trigger Statutory Cap on Homestead Exemptions



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The creation and almost universal enactment of statutes governing limited liability companies (LLCs) among the 50 states has led to an increasing number of debtors holding real property in LLCs in which they are the sole member. Although the use of LLCs and other corporate entities may have significant benefits for tax purposes, in the context of tax law, estate planning and liability protection, there are also a number of disadvantages.

In the context of a bankruptcy, perhaps the most significant drawback of using an LLC is that a debtor cannot claim a homestead exemption in real property owned by an LLC.² This limitation may tempt a debtor to engage in prebankruptcy planning, whereby the title to the real property is transferred from the LLC to the debtor's name in fee simple in order to claim the homestead exemption available under 11 U.S.C. § 522(d)³ or applicable state statute. A recent decision from the U.S. Bankruptcy Court for the District of Nevada, however, has held that such a transfer may limit the homestead exemption that a debtor can claim to \$155,675 pursuant to § 522(p) of the Bankruptcy Code.⁴

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) imposes a limitation on the homestead exemption that a debtor can claim, regardless of applicable state law exemptions. Specifically, § 522(p)(1) limits a debtor's homestead in real property to

\$155,675 if it was "acquired by" a debtor within 1,215 days of a bankruptcy filing.⁵ Section 522(p) was enacted to "address the well-documented and often-expressed concern by members of Congress about the so-called 'mansion loophole' by which wealthy individuals could shield millions of dollars from creditors by filing [for] bankruptcy after converting nonexempt assets into expensive and exempt homesteads in one of the handful of states that have unlimited homestead exemptions."⁶

It is well established that the statutory cap under § 522(p) applies in situations where a debtor has purchased real property that has equity in excess of \$155,675 within 1,215 days of a bankruptcy filing. However, a body of case law has developed regarding the applicability of § 522(p) in more-nuanced situations where a debtor held an interest in real property more than 1,215 days before a bankruptcy filing, but only acquired the right to declare a homestead exemption within the 1,215-day period preceding his/her bankruptcy filing. In analyzing such situations, courts have examined the congressional intent behind the phrase "amount of interest that was acquired by the debtor" in § 522(p).

The seminal case in the Ninth Circuit on this issue is *In re Greene*,⁷ wherein a chapter 7 trustee sought to limit a homestead exemption under § 522(p) when a debtor who had owned undeveloped real property since 1994 began residing on the real property in a trailer within 1,215 days of his bankruptcy filing. The Ninth Circuit ultimately held that the statutory cap

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² It is well established among the bankruptcy courts that a debtor who is the sole member of an LLC that owns real property cannot claim a homestead exemption in the real property that is owned by the LLC. This rationale is based on the concept that the LLC would own the real property and that the members are only entitled to a share of the profits and losses from the company. See *Fowler v. Shadel* (*In re Fowler*), 400 F.3d 1016 (7th Cir. 2005); *In re Arnhoelter*, 431 B.R. 453 (Bankr. E.D. Wis. 2010); *In re Coenen*, 487 B.R. 539 (Bankr. W.D. Wis. 2012); *In re Hecker*, 414 B.R. 499 (Bankr. D. Minn. 2009).

³ Unless otherwise indicated, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532.

⁴ 11 U.S.C. § 522(p)(1).

⁵ *Id.*

⁶ *In re Kane*, 336 B.R. 477, 481-82 (Bankr. D. Nev. 2006). The *Kane* court identified the following 10 states as having homestead exemptions in excess of the statutory cap in § 522(p): District of Columbia, D.C. Code Ann., § 15-501(a)(14); Texas, Tex. Prop. Code §§ 41.001 and 41.002; Massachusetts, Mass. Ann. Laws ch. 188, §§ 1 and 1A; Minnesota, Minn. Stat. § 510.02; Rhode Island, R.I. Gen. Laws § 9-26-4.1; Florida, Fla. Stat. Ann. § 222.01; Iowa, Iowa Code Ann. § 561.16; Kansas, Kan. Stat. Ann. § 60-2301; Nevada, Nev. Rev. Stat. §§ 115.010(2) and 21.090(1)(l); and Arizona, Ariz. Rev. Stat. 33-1101.

⁷ *In re Greene*, 583 F.3d 614 (9th Cir. 2009).

under § 522(p) did not apply because the phrase “any amount of interest that was acquired” applied to the “acquisition of ownership of real property.”⁸ Since the debtor owned the real property in fee simple and merely recorded a declaration of homestead within the 1,215 days preceding his bankruptcy filing, the statutory cap under § 522(p) did not apply. The crux of the *Greene* holding was to make the provisions of § 522(p) applicable to those situations where a debtor acquires an interest in real property within the 1,215-day period that was subsequently declared as the homestead.⁹

The First Circuit Bankruptcy Appellate Panel (BAP) and the U.S. Bankruptcy Court for the District of Kansas have also addressed the implications of § 522(p) on transfers of real property from trusts for which the debtors were beneficiaries to the debtor in fee simple. In *In re Aroesty*,¹⁰ the First Circuit (BAP) held that the statutory cap under § 522(p) applied to a debtor who had a beneficial interest in real property on which she lived for more than a decade prior to the petition date, but who acquired legal title within the 1,215-day period preceding her bankruptcy filing. The court reasoned that the transfer of legal title to the property was an “interest” within the meaning of § 522(p) because it had a quantifiable monetary value.¹¹ Since Massachusetts law does not permit the beneficiary of a trust to claim a homestead exemption in real property that is held in the trust, the transfer of the subject property to the debtor constituted a transfer of an interest that entitled the debtor to claim a homestead exemption.

In *In re Peake*,¹² the U.S. Bankruptcy Court for the District of Kansas held that the transfer of a title in real property held in a self-settled trust to the debtor within the 1,215-day period was not subject to the statutory cap. The court distinguished the holding in *Aroesty* on the grounds that Kansas law, unlike Massachusetts law, permits the beneficiary of a self-settled living trust to claim a homestead exemption in trust property. Accordingly, the transfer of the property from the trust to the debtor did not constitute a transfer that entitled the debtor to claim a homestead exemption: “Because all that [the debtor] acquired when he received the trust’s deed to his homestead was legal title to property in which he already had an equitable interest that he could exempt under Kansas law ... [the debtor] received no ‘amount of interest’ in the homestead within the 1,215-day period and his homestead exemption is not subject to Section 522(p)(1)’s statutory cap.”¹³

The clear implication of the holdings in *Greene*, *Aroesty* and *Peake* is to analyze whether there was a transfer of an interest in real property that entitled a debtor to claim a homestead exemption within the 1,215-day period preceding a bankruptcy filing.

The U.S. Bankruptcy Court for the District of Nevada in *In re Caldwell* recently expanded on this body of case law and held that the § 522(p) exemption cap applied to real property that had been transferred from an LLC in which the debtor and his spouse were the sole members to a revocable trust within 1,215 days prior to his bankruptcy filing,¹⁴ notwithstanding the fact that the debtor had continuously

owned the real property — either in fee simple or through a membership interest in an LLC — since 1994. Applying the reasoning from the recent decisions in *Greene*, *Aroesty* and *Peake*, the court held that the central issue was whether the debtor would have been entitled to claim a homestead exemption in the real property had it remained owned by the LLC. If the debtor could not claim a homestead exemption in the real property while it was owned by the LLC, then the transfer entitled the debtor to claim a homestead exemption within 1,215 days of his bankruptcy and triggered the provisions of § 522(p).¹⁵ The bankruptcy court reasoned that the debtor could not have claimed a homestead exemption in the real property while it was owned by the LLC because he had no ownership interest in the underlying assets owned by the company. In fact, the only interest that the debtor had by virtue of his membership interest was a right to a “share of the profits and losses of [the LLC] ... and a ... right to receive distributions of the [LLC’s] assets.”¹⁶ Such an ownership interest did not entitle the debtor to claim a homestead exemption in the underlying real property.¹⁷ Since the debtor could not claim a homestead exemption while the property was held in the LLC, the transfer of title to the debtor’s trust implicated the provisions of § 522(p).¹⁸

The impact of the bankruptcy court’s holding in *Caldwell* is not only limited to a situation whereby a debtor transfers real property from his/her wholly-owned LLC to a revocable trust. Rather, the bankruptcy court’s reasoning was broad enough to include instances wherein real property owned by a corporation, partnership or LLC that is wholly owned by a debtor is transferred in a manner that entitles a debtor to claim a homestead exemption. If a debtor cannot claim an exemption on real property while it is owned by a particular entity and the transfer occurred within 1,215 days of the debtor’s bankruptcy filing, it is likely that the statutory cap under § 522(p) would apply because the primary concern surrounding the enactment of § 522(p) (the conversion of nonexempt property to exempt property on the eve of bankruptcy) would be implicated. As aptly stated by the U.S. Bankruptcy Court for the District of Connecticut, “when an individual chooses to take advantage of the benefits of an artificial entity, he or she must also bear the corresponding burdens.”¹⁹ Prospective debtors and their counsel should take this suggestion to heart when transferring real property from their wholly owned entities in order to claim a homestead exemption on the eve of a bankruptcy filing. **abi**

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15 Nevada Revised Statute § 115.020(5) allows an individual to declare a homestead exemption in real property that is held in trust.

16 See Del. Ann. Code § 18-101(8).

17 See *In re B&M Land*, 498 B.R. 262 (Bankr. D. Nev. 2013) (holding that where debtor has membership interest in ordinary single-member LLC and files chapter 7 petition, the rights to manage LLC are automatically transferred to chapter 7 trustee without need to take further actions to comply with state law).

18 A transcript of the bankruptcy court’s oral ruling concerning the objection to the Homestead Exemption in *Caldwell* is available at nelsonhoumand.com/u-s-bankruptcy-court-holds-statutory-homestead-cap/ (last visited April 2, 2015).

19 *In re Kochman*, 2011 WL 5325792 (Bankr. D. Conn. 2011).

8 *Id.* at 624.

9 *Id.*

10 *In re Aroesty*, 385 B.R. 1 (B.A.P. 1st Cir. 2008).

11 *Id.* at 7.

12 *In re Peake*, 480 B.R. 367 (Bankr. D. Kan. 2012).

13 *Id.* at 369.

14 See *In re Caldwell* (Case Number BK-S-14-16024-LED) [Docket No. 87].