



Retirement Plan Assets in Bankruptcy

How well does the BAPCPA “hen” protect your “nest egg”?

In times of economic insecurity, employees question what happens to their accumulated retirement benefits if they or their employer declares bankruptcy. It is settled law that the employer’s creditors have no access to funds set aside for qualified retirement plan benefits for employees. However, the availability of retirement benefits to participants’ creditors has actually undergone some significant changes over the years, due to both legislation and court decisions. The passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), which has been called “one of the most comprehensive overhauls of the Bankruptcy Code in more than 25 years” [See Susan Jensen, A Legislative History of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 79 AM. Bankr. L.J. 485, 485 (2005)], affected not only many of the bankruptcy-related rules that one would expect, such as attorney-client communications; priority rules in bankruptcy cases filed under Chapter 7 and 11; and homestead exemptions, but also the security of retirement benefits earned prior to bankruptcy.

Before BAPCPA

The question of whether a debtor-participant’s retirement plan benefit was protected from creditors in a bankruptcy proceeding depended on whether the retirement plan was subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA). Section 541(c)(2) of the Bankruptcy Code excludes a debtor’s interest in a plan or trust from his or her bankruptcy estate (i.e., the assets available to pay creditors) provided that there is a restriction on the transfer of the debtor’s beneficial interest in the plan or trust and that restriction is “enforceable under applicable non-bankruptcy law.” ERISA contains an anti-alienation clause [ERISA §206(d)(1); Internal Revenue Code (IRC) 401(a)(13)], which provides that retirement plan benefits cannot be assigned or alienated.

“ERISA-qualified” Plans are Deemed Protected

Prior to 1992, courts were divided as to whether §206(d)(1) constituted an enforceable restriction on the transfer of a debtor’s beneficial interest in a plan or trust under

applicable non-bankruptcy law that would warrant the protection afforded under the Bankruptcy Code. The Supreme Court acted to resolve the conflicts in the lower courts in the seminal case of *Patterson v. Shumate* [504 U.S. 753 (1992)], declaring that ERISA’s anti-alienation clause constituted an enforceable non-bankruptcy law restriction. As such, the Court ruled that “ERISA-qualified plans” were excluded from a debtor’s bankruptcy estate and beyond the reach of any claims made by creditors.

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What Constitutes an “ERISA-qualified” Plan?

Unfortunately, the term “ERISA-qualified plans” is a combination of phrases and has no specific independent meaning. Plans are “tax-qualified” if they meet the rules of IRC §401(a). Qualified plans may include programs that are not covered by ERISA, such as plans sponsored by unincorporated companies with no non-owner employees. Similarly, ERISA covers many plans that are not retirement plans, such as health and welfare plans. As a result, the Patterson case may have raised more questions than it answered.

Nonetheless, it was clear after Patterson that assets held in tax-qualified plans covered by ERISA were exempt from bankruptcy estates and outside the reach of creditors. However, there was still confusion surrounding the status of retirement plans not subject to ERISA and what, if any, protection such plans should be afforded during a bankruptcy proceeding. Besides the unincorporated owner-only plans mentioned above, non-ERISA retirement plans include IRAs, SEPs, SIMPLE IRAs, Roth IRAs, 403(b) programs and 457 programs.

State Law Added Further Confusion

State laws added to the confusion concerning whether non-ERISA retirement plans were afforded bankruptcy protection from creditors before the enactment of the BAPCPA. This was due to the fact that the laws of the state in which the debtor was domiciled at the time of his or her bankruptcy filing controlled the level of protection afforded retirement plans falling outside the Patterson ruling. While the federal Bankruptcy Code provided a list of exemptions a debtor could claim during bankruptcy, Congress gave the states permission to opt out of the federal list and develop and utilize their own exemption lists during the bankruptcy proceeding. As a result, some states used the exemptions found on the federal list, other states chose to use their own exemption lists, and still other states opted to allow the debtor to select between the federal or state exemption lists. Thus, the level of protection afforded non-ERISA plans was dependent on whether the state in which the debtor was domiciled opted to follow the federal list of exemptions or the state exemptions.

IRAs best illustrate this confusion. For states that chose to use their own exception list, the matter was clear: state law either provided for a complete or partial exemption of IRAs from a bankruptcy estate, or it did

not. Things were more complex, however for states that chose to use the federal exemption list. Without the anti-alienation language of ERISA §204(d)(1) that protected company retirement plans, the only source of bankruptcy protection for an IRA was in Bankruptcy Code §522(d)(10)(E), which protected a debtor’s “right to receive payment under a stock bonus, pension, profit-sharing, annuity or similar plan or contract on account of illness, disability, death, age or length of service,” but only “to the extent reasonably necessary for support of the debtor and his/her dependents.” What did this mean?

Supreme Court Provided Limited Clarity

In 2005, approximately six months before BAPCPA was enacted and more than 12 years after Patterson, the Supreme Court unanimously held that IRAs were exempted from a bankruptcy estate to the extent reasonably necessary to support the debtor and his/her dependents, because IRA accounts met both of the federal requirements for the §522(d)(10)(E) exemption: i.e., the Court ruled that an IRA is a “similar plan or contract” to the exemptions enumerated under the Bankruptcy Code and further that an IRA “conferred a right to receive payment on account of age.” [Rousey v. Jacoway, 544 U.S. 320 161 L.Ed.2d 563, 125 S. Ct. 1561 (2005)].

It is important to note that the holding in Rousey was limited to bankruptcies filed in federal court. If the state in which the debtor was domiciled at the time he or she filed for bankruptcy opted out of using the federal exemption list, then the IRA would be subject to whatever protection was offered under state law.

Then BAPCPA was Born

BAPCPA provided the needed clarification and uniformity for retirement assets in a bankruptcy proceeding. BAPCPA protects retirement funds from bankruptcy creditors to the extent that those funds or accounts are exempt from taxation under IRC §§401, 403, 408, 408A, 414, 457, or 501(a). [Bankruptcy Code §§522(b)(3)(C), 522(d)(12)] This means that retirement assets held in any tax-deferred retirement plans, such as 401(k) plans, defined benefit pension plans, IRAs, 403(b) plans, profit sharing plans, money purchase plans and ESOPs, are now all exempt from bankruptcy estates.

Retirement Plan Assets in Bankruptcy

Additionally, BAPCPA permits a debtor to claim the exemptions regardless of whether he or she is required to use the federal or state exemptions. [Bankruptcy Code §521(b)(3)(C)]

BAPCPA does not Protect all Plans Equally

Although BAPCPA broadened the protection afforded retirement plans for debtor-participants in bankruptcy, this unfortunately does not mean that all plans are protected equally. The protection afforded IRAs (whether traditional or Roth) is limited to an “aggregate value” of \$1 million, which is adjusted once every three years for inflation. The \$1 million limit has been increased with cost of living to a 2014 maximum exemption of \$1,245,475. The next three-year adjustment will be published before March 1, 2016. A court may, at its discretion, increase the cap on protected IRA assets in the case of a specific debtor, if the “interests of justice so require.” [Bankruptcy Code §522(n)] The limit does not apply to funds in SEP-IRAs or SIMPLE IRAs.

While there is a limit on the amount protected in a bankruptcy for an IRA, the limit does not apply to any amounts or earnings attributable to rollover contributions from qualified plans and 403(b) plans (i.e., rollovers covered under IRC §§402(c), 402(e)(6), 403(a)(4), 403(a)(5), and 403(b)(8)). [See Bankruptcy Code §522(n); see also Bankruptcy Code §104(b)] Therefore, any rollover IRA that originated from a qualified plan is not counted toward \$1,245,475 total cap.

It remains unclear, however, whether rollovers to IRAs from IRA-based employer plans (i.e., SEPs and SIMPLEs) are similarly exempt from the \$1,245,475 limit. On the one hand, rollovers from employer-based IRAs are governed by IRC §408(d)(3)—i.e., not one of the above enumerated sections in the Bankruptcy Code §522(n) exemption from the limitation. On the other hand, these IRA-based retirement plans (i.e., the plans from which such rollovers originate) are exempt from the limitation in §522(n). Does a rollover cause these funds to lose that treatment, subjecting these funds to the limit on the exemption from the bankruptcy estate? It is not clear, but it would appear to be so.

Under BAPCPA, Tax-qualification is Critical

The tax-qualification of the plan also may be critical to the bankruptcy protection. After all, if the plan is not “exempt from taxation,” the BAPCPA exemption does not

apply. In particular, the courts have ruled that a plan can prove its qualification by having an IRS-issued favorable determination letter. This is not an option available to all qualified plans; in particular, plans documented using prototype and volume submitter documents may not obtain favorable determination letters in most situations.

If there is no determination letter, the bankruptcy protection is still available if the retirement fund is in substantial compliance with the applicable IRC requirements or if the failure to be in substantial compliance is not the responsibility of the debtor. In other words, if the debtor controls the plan and the plan is not in substantial compliance with the IRC, the BAPCPA protections are unavailable. [Bankruptcy Code §522(b)(4)(A); See also, e.g., Daniels v. Agin, 2013 BL 330418 (1st Cir. 11/25/13), where a proof of significant loans to family members, which are prohibited transactions, brought the plan’s qualification into question, causing the court to include the retirement plan assets of the sponsor’s owner in the bankruptcy estate.]

This rule can give significant reassurance to rank-and-file participants who have no say-so in the administration of their employer’s retirement plans. On the other hand, it makes it clear that business owners need to be assiduous in ensuring compliance of their plans with the qualification requirements so that there is no doubt in a bankruptcy proceeding that the plan is in substantial compliance with the IRC.

Recent Supreme Court Decision

Surprisingly, the Supreme Court entered the fray in mid-2014 in relation to inherited IRAs. An inherited IRA is an IRA into which retirement plan and IRA assets are rolled by the beneficiary after the original participant’s death. Generally, an inherited IRA does not become equivalent to an IRA in the heir’s name. In particular, IRAs that remain in the deceased’s name and inherited IRAs are subject to special distribution obligations, which are much different than the requirements for those who have contributed to or accumulated IRA or qualified plan funds for their own benefit.

In *Clark v. Rameker*, 134 S.Ct. 2242 (2014), a unanimous Court found that inherited IRAs are not “retirement funds.” As such, the exemption in Bankruptcy Code §422(b)(3)(C) does not apply to heirs of the original IRA or plan participant once the funds are transferred to an inherited IRA. The Court found that inherited IRAs had the following characteristics that were distinct from IRAs intended for retirement:

- They may not receive additional contributions.
- The holders of inherited IRAs are required to withdraw amounts from the accounts, regardless of how many years away they may be from retirement. IRC §401(a)(9) requires either that the funds from the inherited IRA be distributed within five years of the original holder’s date of death or that an annual amount be distributed beginning in the year following the original holder’s death. These required distributions may significantly precede the retirement of the heir of the benefits.
- The inherited IRA holder may withdraw the entire balance of the account at any time without penalty, whereas normal IRA holders are subject to a penalty tax of 10 percent on amounts distributed before age 59-1/2.

The Court did not separately discuss IRAs that are inherited by spouses. There is some thought that those would be protected similarly to the accounts of normal IRAs, as spouses are allowed to delay distributions until they reach age 70-1/2, in the same manner as the original holder. Therefore, there is at least an argument that the IRA represents retirement funds for the widow or widower of the original holder. Furthermore, a spousal beneficiary of retirement plan benefits is uniquely able to roll over the inherited funds into an IRA in his or her own name (i.e., an IRA that is not characterized as an inherited IRA). As a result, a cautious spousal beneficiary would be protected more fully if any IRA assets from the deceased spouse were rolled over to the beneficiary’s own IRA.

Conclusions and Recommendations

While Patterson went a long way to providing bankruptcy protection for ERISA-covered qualified plans, BAPCPA significantly expanded the list of retirement assets that now benefit from bankruptcy protection. This enables individuals who do not participate in their employer’s retirement plan to save significant funds in an IRA in a tax-favored manner and have those funds protected from creditors in a bankruptcy proceeding. Furthermore, participants may roll over their benefits from their employer’s plans into IRAs knowing that such rollovers are also protected from bankruptcy creditors.

Nonetheless, it is important to remember that not all retirement plans are protected equally under BAPCPA. Holders of “customary” IRAs that contain annual IRA contributions made by the debtor (as opposed to rollovers) must understand that the accounts are subject to additional limitations and rules in bankruptcy. A debtor with an IRA rollover account should be sure to retain good records to prove how the assets were deposited in the IRA in the first place, so that there is no doubt as to the level of protection to which the account is entitled in bankruptcy.

Estate planners should also take note of the limitations on protection available to heirs (except, perhaps, spouses) in relation to IRAs. While qualified retirement plans are protected from access by creditors to participants’ accounts, the inherited IRA is not. This may encourage heirs to retain funds in their deceased benefactors’ retirement plans when permitted to do so, rather than transferring them to inherited IRAs and for spousal beneficiaries to eschew inherited IRAs in favor of rollover IRAs in their own names.