

**Protection of Tax Qualified Retirement Benefits from Creditors under  
the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005**

Thomas C. Foster, Esquire  
McCandlish Holton PC

Retirement and estate planners often find that, when fully and properly advised, a minority of their clients share a concern of overriding importance, i.e., protecting their accumulated tax-qualified retirement benefits<sup>1</sup> from being taken away from them or their loved ones by their potential future creditors. While individuals of any age and many occupations could decide that protection from creditor claims is a matter that they wish to make a centerpiece of their planning, that decision is often made by older physicians. In many cases, those physicians' practices (whatever their organizational form) have made maximum allowed contributions to retirement plans on behalf of its employee or self-employed physicians over several decades and, if those plans have experienced good investment earnings, retirement plan benefits are often a large proportion of the physicians' wealth. If such wealth accumulation is then coupled with trepidation and loathing of possible large medical malpractice claims, creditor protection planning for the retirement benefits is a necessary step. This article will look again at this long-standing planning issue in light of two recent developments, the U.S. Supreme Court's April 4, 2005 decision in *Rousey et ux. v. Jacoway*<sup>2</sup> and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act").<sup>3</sup>

The first planning question to be addressed is the class of creditors that concerns the client. Certain creditors will, generally, have the ability to use appropriate state or federal law to satisfy their definite claims from all sorts of retirement benefits. Those preferred creditors would include: (a) spouses and children who have claims for property or support under applicable state

domestic relations law<sup>4</sup>, (b) the IRS asserting federal tax liens<sup>5</sup> and (c) the plans themselves for losses they have suffered due to the individual's crimes or fiduciary breaches<sup>6</sup>. However, even those preferred creditors will have procedural hurdles with certain types of plans that do not exist for others. For example, domestic relations claimants may have their claims satisfied from an employer sponsored pension plan only if they have an order entered that meets the requirements to be a qualified domestic relations order.<sup>7</sup> For individual retirement accounts ("IRAs"), any domestic relations court order that meets applicable state law standards would be effective.<sup>8</sup> Similarly, the Internal Revenue Service has recognized that levies to enforce federal tax liens should be enforced with special caution against funds accumulated in retirement plans.<sup>9</sup> A Chief Counsel Advisory counsels that payments under such levies should normally be made only when the affected employee's benefit is payable under the employee's benefit election.<sup>10</sup>

However, most contract or tort creditors will not fall within one of the privileged classes. For dealing with such creditors, the next important question is whether the retirement plan holding the benefits is and will be "an ERISA qualified plan."<sup>11</sup> The currently prevailing judicial opinion is that only plans that both: (a) are "employee benefit pension plans" as defined in the Employee Retirement Income Security Act of 1974 and (b) meet the qualification requirements of Internal Revenue Code of 1986, as amended ("IRC") sec. 401(a) fall within that category. The IRC sec. 401(a) qualification question is, usually, pretty easy to answer. The typical pension (defined benefit or money purchase), profit-sharing (including 401(k) plans) or stock bonus plans (including ESOPs) will be clearly designed and operated to meet those requirements and will have documents that have IRS determination or opinion letters approving their qualification as to form. Minor deviations from the strict qualified plan requirements of form or operation will not

be enough to disqualify the plans for this purpose. However, significant disregard of the rules, e.g., self-dealing with plan assets (“a personal piggy bank”) may be a disqualifier. One qualification requirement that has sometimes been troublesome is that such plans must continuously have an employer sponsor and that they must be updated when the applicable law changes. At times, employers have otherwise discontinued their business affairs without terminating their qualified retirement plans and distributing all benefits. In those cases, the benefits are at risk of being deemed to not being held in an ERISA qualified plan.

The most important facts to look for to make the determination about whether the plan is an employee pension benefit plan are whether the plan covers “employees” and whether its assets are held in a trust. For this purpose, the term “employees” does not include self-employed individuals e.g. partners or LLC members (if taxed as a partners), or the sole owner of a corporation and his or her spouse<sup>12</sup>. In *Yates v. Hendon*<sup>13</sup> the Supreme Court concluded that “Congress intended working owners to qualify as plan participants,” but that plans covering only sole shareholders and their spouses fall outside of the scope of ERISA Title I. For example, a plan covering only a group of hospital based anesthesiologists, who are all members of the LLC that had contracted with the hospital, will not be an employee pension benefit plan. However, if the plan covers one or more non-owner employees (for example, if the anesthesiology group has a clerical support staff that has significant accrued plan benefits), the employee pension benefit plan status will apply to all its participants, including the self-employed physicians.

The second important factual determination pertaining to “employee pension benefit plan” status is whether the individual’s benefits are held by a plan trustee. That would not be the case for

those plans that are funded through individual annuity contracts (e.g., most 403(b) plans) or individual IRAs (e.g., SEPs, SARSEPs and SIMPLE IRAs). However, in a non-typical opinion, a Bankruptcy Court recently ruled that the anti-alienation clause in a 403(b) tax sheltered annuity contract sufficiently restricts the debtor's use of funds and therefore caused that contract to be excluded from the account holder's bankruptcy estate<sup>14</sup>.

If the preceding analysis results in a determination that the individual's benefits are being held by an ERISA qualified plan, there will be two important results. First, all state creditor processes will be preempted; i.e., they will be inapplicable. Second, the benefits will be excluded from the individual's bankruptcy estate.<sup>15</sup> Stated differently, such ERISA qualified benefits will not be available to satisfy general creditor claims, whether pursued through state law procedures or through federal bankruptcy.

Assuming that the preceding analysis results in a determination that the individual's benefit is not in an ERISA qualified plan, the benefit is potentially subject to applicable state creditor rights processes and inclusion in the individual's bankruptcy estate (subject to possibly being "exempted," see below). Such potential exposure to creditor's claims will typically be the case for traditional IRAs, Roth IRAs, SEP IRAs, SIMPLE IRAs, 403(b) annuities and 457(b) eligible deferred compensation plans. However, for both state law purposes and bankruptcy, there may then be applicable exemptions. States typically have schemes for allowing debtors to claim exemption for certain assets from creditor process and retirement savings are often among the assets that can be so exempted. The state exemption schemes are quite varied and cannot be covered in this brief article. However, individuals being pressured by their creditors may be able

to avail themselves of federal bankruptcy law, which stays all state court and individual creditor self-help actions and substitutes the more uniform federal bankruptcy law process.

Under the Bankruptcy Code, as it exists prior to the effective date of the amendments made by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, retirement benefits that are not excluded from an individual's bankruptcy estate (i.e., they are not ERISA qualified plan benefits), may be exempted in certain circumstances. The applicable exemptions would depend upon the individual's state of residence. The Bankruptcy Code establishes a federal exemption scheme, but allows states to opt-out of that scheme.<sup>16</sup> Nine states follow a federal exemption scheme set forth in the Bankruptcy Code. Under the federal scheme, retirement benefits may be exempted to the extent that they are reasonably necessary for the support of the debtor and his or her dependents. In its *Rousey*<sup>17</sup> decision, the U.S. Supreme Court held that IRA balances are retirement benefits eligible for the limited federal exemption, despite the facts that the debtor had himself established the IRA and had a right to withdraw funds at any time.

Forty-one states have "opted-out" of the federal exemption scheme and established their own. For example, the author's home state, Virginia, has two separate exemptions<sup>18</sup>. The first provides that a debtor may claim an exemption of a dollar amount equal to the present value of an annuity of \$17,500 per year beginning at age 65 (based on a specified interest rate and mortality table).<sup>19</sup> The second allows debtors who have not excluded any ERISA qualified plan benefits to exempt their entire IRA benefits.<sup>20</sup> As with many states' schemes, Virginia's exemption scheme applies to state law creditor claims as well as to bankruptcy proceedings.

The Act, effective October 17, 2005<sup>21</sup>, changes the bankruptcy law protection of retirement benefits in several important ways. New retirement plan rules apply both to the federal exemption scheme and override all opt-out state exemption schemes. Those rules uniformly provide for complete exemption of employer sponsored qualified plan benefits and a one million dollar exemption for IRAs.<sup>22</sup> To be eligible for the unlimited exemption, the debtor must establish that the plan meets certain standards of compliance with tax law qualification requirements.<sup>23</sup> Benefits in plans that have received IRS determination letters are presumed to be exempt. Benefits in plans that have not received determination letters are exempt if the participant makes one of two quite literal demonstrations. First, the participant could demonstrate that the plan is in substantial tax law compliance and neither the IRS nor a court has determined that the plan is not qualified. Second, the participant would meet his burden if he shows that he or she is not personally responsible for the plan's failure to be tax qualified.

The Act's exemption scheme makes no differentiation between tax-qualified plans that are employee pension benefit plans, under ERISA and those that are not. Further, the unlimited pension plan exemption applies to the portion of IRAs funded by rollovers from employer sponsored plans. Therefore, from a practical perspective, IRA benefits will also be completely exempt. Finally, it appears that the Act will provide exemption for rollover eligible plan distributions provided that they are, indeed, rolled over within 60 days of their distribution date.

From a planning perspective, following the effective date of the Act:

- ERISA employee pension benefit plans will continue to be excluded from debtors' bankruptcy estates and from state law creditor process.

- Employer sponsored plans that meet liberal tax qualification criteria, that do not meet the exclusion requirements, will be subject to the Act's unlimited exemption in bankruptcy.
- The unlimited exemption will apply to benefits rolled over from plans to IRAs.
- Contributory IRAs will be subject to a uniform one million dollar bankruptcy exemption.
- Non-ERISA qualified plans and IRAs will continue to be subject to state law creditor process subject to applicable state exemptions.

The net result of these changes is that individuals concerned about possible creditor claims should have much greater freedom to roll over their retirement benefits from one type of tax sheltered vehicle to another. Further, bankruptcy courts' inquiries into the nature of the retirement plans should be simplified. No longer will it be of such great concern to bankruptcy proceedings whether the benefits in question are in an ERISA qualified plan or another kind of tax qualified retirement vehicle. The practical consequence will be the same in either case; the benefits will be beyond the reach of the participants' creditors. On the other hand, such distinctions, for purposes of state law claims, will remain important. For those plans governed by ERISA, state law process will be preempted. Otherwise, the applicable state exemption scheme will retain its importance.

---

<sup>1</sup> For this article, by "tax-qualified retirement benefits" we mean an individual's accounts or accrued benefits under 401(a) qualified employer sponsored pension, profit-sharing and stock bonus plans, 403(a) qualified annuity plans, 403(b) tax-sheltered annuities, 408(a) individual retirement accounts, 408A Roth individual retirement accounts, and 457(b) eligible governmental deferred compensation plans. This article does not deal with non-qualified deferred compensation plans, severance pay arrangements or similar rights.

<sup>2</sup> *Rousey v. Jacoway* 125 S.Ct. 1561 (2005).

<sup>3</sup> *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, P.L. 109-8.

<sup>4</sup> 29 USC § 1056(d)(3).

<sup>5</sup> 26 USC § 6321.

<sup>6</sup> 29 USC § 1056(d)(4).

<sup>7</sup> 26 USC § 1056(d)(3).

<sup>8</sup> 26 USC § 408 (d)(6).

<sup>9</sup> Internal Revenue Manual 5.11.6.2.

<sup>10</sup> Chief Counsel Advice 200032004.

---

<sup>11</sup> *Patterson v. Schumate*, 504 U.S. 753 (1992).

<sup>12</sup> 29 CFR 2510.3-3.

<sup>13</sup> *Yates v. Hendon* 287 F.3d 521 (2004).

<sup>14</sup> 11 USC § 541(c)(2).

<sup>15</sup> 11 USC § 541(b)(1).

<sup>16</sup> 11 USC § 522 (d)(10)(E).

<sup>17</sup> 11 USC § 541(c)(2).

<sup>18</sup> VA. CODE ANN. § 34-3.1.

<sup>19</sup> VA. CODE ANN. § 34-34(B)-(D).

<sup>20</sup> VA. CODE ANN. § 34-34(H).

<sup>21</sup> P.L. 109-8 § 1501.

<sup>22</sup> P.L. 109-8 § 224

<sup>23</sup> *Id.*