



THE NEW BANKRUPTCY LAW AND ITS EFFECT ON TAX-FAVORED FUNDS

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In the event of individual bankruptcy, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") creates new rules to protect tax-favored funds, including regular IRA's, Roth IRA's, 403(b) plans, all types of qualified retirement plans, and certificates and accounts known as 529 plans and Coverdell Education Savings Accounts.

BAPCPA also provides that participant loans from qualified plans are not dischargeable, and that salary withholdings to repay plan loans are not subject to an automatic stay.

In employer bankruptcies, BAPCPA protects employee funds which have been withheld and not yet deposited to ERISA plans.

1. PROTECTION OF TAX-FAVORED FUNDS FOR INDIVIDUALS IN BANKRUPTCY

BAPCPA protection is available for retirement funds which are exempt from taxation under Sections 401, 403, 408, 408A, 414, 457, 501(a) and for tax favored education programs under Sections 529 and 530 of the Internal Revenue Code of 1986 ("Code"). Regardless of selection of federal or state exemptions in bankruptcy, the protection is unlimited, except as follows:

"Non-rollover" assets in IRA's limited to \$1,000,000

Protection for regular contributions in IRA's is limited to \$1,000,000, but that amount may be increased "if the interests of justice so require." In determining the \$1,000,000 amount, rollovers from other tax-favored plans are disregarded. For example, an IRA which has \$1,000,000 of investments from regular contributions, and an additional \$10,000,000 from a qualified plan rollover, is fully exempt under BAPCPA.

Note: It is a rare IRA account that will have accumulated \$1,000,000 from the modest contributions permitted to IRA's, so this is an unlimited exemption for all practical purposes.

Note: In calculating the \$1,000,000 IRA exemption, rollovers from all 401 qualified plans and 403 (a) and (b) vehicles are not counted. This protection extends to direct rollovers and to those rollovers which were the result of sixty day transfers after a taxable distribution. The need to retain indefinitely the record of rollover transactions is obvious.

Note: Simplified employee pensions (SEP IRA's) under section 408(k) and simple retirement accounts (SIMPLE IRA's) under section 408(p) also get unlimited protection and are not counted towards the \$1,000,000 IRA limit. This \$1,000,000 limit also does not apply to similar types of individual accounts which have been voluntarily funded under 403(b) or 457(b).

Deposits within 720 days of bankruptcy to 529 Plans and to 530 Coverdell Accounts

Subject to reasonable exceptions, Section 529 plans and 530 (Coverdell) education savings accounts are protected. The beneficiary must have been a child, stepchild, grandchild, or stepgrandchild (sic) in the taxable year for which the funds were contributed. The contributions cannot have exceeded IRS limits.

Deposits within 365 days of filing, regardless of amount, are not protected, under the theory that recent deposits are a type of preference better devoted to creditors. Deposits within 720 days of filing, which exceed \$5,000 for any one beneficiary, are also not protected.

2. ESTABLISHING TAX FAVORED STATUS TO QUALIFY FOR THE EXEMPTION

The old concerns about whether assets are in a plan which is an "ERISA-qualified plan" are out the window. The standard now is tax qualification.

Background:

Until BAPCPA, an unlimited amount of retirement assets (without regard to need, or choice of federal or state bankruptcy exemptions) would be excluded from a bankrupt's estate, but only if they were in a plan which was covered by ERISA. Patterson v. Shumate, 504 U.S. 753 (1992). The determination of whether a plan was "ERISA-qualified", a non-statutory term meant to describe ERISA-covered retirement plans, was highly significant.

To be considered "ERISA-qualified" a plan had to cover one or more common-law employees who were not principal owners. Typical IRA's and one person Keogh's were not protected by the Patterson Court. The distinction of "ERISA qualification" sometimes resulted in a mad search for token common-law employee participants, whose presence would sanctify plan assets after an owner's bankruptcy.

Example: *A plan with \$3 million covers only the business owner, who is a consultant without employees. Under Patterson logic, the \$3 million is part of the bankrupt's estate. To protect the \$3 million, the consultant would have had to argue that his plan was protected by state law, and he would have had to opt for state law exemptions in bankruptcy.*

Example: *Consultant with the same \$3 million plan balance has a secretary with a \$10,000 plan balance. The plan is now "ERISA-qualified." Its assets are no longer part of the bankrupt's estate under Patterson, regardless of the bankrupt's choice of federal or state exemptions.*

As noted, pre-BAPCPA law was inimical to IRA's. Just a few weeks before BAPCPA was enacted, the Supreme Court decided that IRA's (and presumably owner-only Keogh's) could be exempt, but only in very limited circumstances. Rousey v. Jacoway, 125 S. Ct. 1561 (2005).

The case is irrelevant after BAPCPA, and is remarkable primarily for the way it was touted by persons unfamiliar with the bankruptcy code. Still, it is worth a footnote.

The Rousey court accepted the Patterson logic that an IRA, which derived from a rollover from an “ERISA-qualified” plan, was not itself an “ERISA-qualified plan” and was part of the bankrupt’s estate. Accordingly, the court had to decide if the bankrupt, who had claimed federal rather than Arkansas exemptions under 522 of the Bankruptcy Code, was entitled to characterize the IRA as a 522 Bankruptcy Code retirement plan, even though he had easy access to his IRA funds with only a 10% tax penalty.

The bankrupt was a humble worker in Arkansas, not an owner, and the IRA was worth about \$50,000. The Court said the IRA should be protected. Although described as the end to all financial worries of IRA holders, the decision offered little solace to persons with large IRA’s who decided to claim federal, rather than state, exemptions in bankruptcy. That is because the federal exemption under 522 of the Bankruptcy Code, prior to BAPCPA, only protected retirement assets which were “reasonably necessary for the support of the debtor and any dependent of the debtor.” Case law demonstrated that the courts were unwilling to extend the federal exemption scheme to protect large retirement accumulations at the expense of other creditors. So, if you represented small IRA holders in a state with poor bankruptcy exemptions, Rousey was a great relief. But it was irrelevant for big IRA’s and for those who have access to generous state exemptions.

THE MECHANICS OF ESTABLISHING QUALIFICATION UNDER BAPCPA

After BAPCPA, bankruptcy trustees who want to collect money for creditors will become more attuned to the rarified world of Internal Revenue Code qualification. Anyone contemplating bankruptcy should consult a retirement plan specialist and allow ample time (at least six months) so that plan flaws can be corrected through Internal Revenue Service self-correction procedures.

If the bankruptcy trustee can establish that a plan is out of compliance, even a plan with a favorable IRS determination letter will lose BAPCPA protection. Based on BAPCPA wording in revised 522, there is a lot of litigation in future:

“(A) If the retirement funds are in a retirement fund that has received a favorable determination under section 7805 of the Internal Revenue Code of 1986, and that determination is in effect as of the date of the filing of the petition in a case under this title, those funds shall be *presumed* (emphasis supplied) to be exempt from the estate.”

Note: Would a savvy trustee not require proof that the plan is up to date for post-determination letter document requirements, such as good faith amendments under EGTRRA and 401(a)(9)? And would the trustee not be within his rights to review 410 coverage and 401(k) ADP tests?

Note: Because the determination letter is only a presumption of tax qualification, a plan review, and self correction under established IRS procedures (i.e. Rev. Proc. 2003-44) is critical prior to filing if the purpose is to protect a large retirement accumulation.

Note: Will the taint of a non-qualified plan follow a rollover of its funds to an IRA? Whereas pre-BAPCPA individuals were reluctant to transfer to IRA’s, there may be more of a rush to do that now, simply to escape, after time, the mind-boggling complexity of keeping plans up to date with IRS qualification requirements.

If there is no determination letter for a plan, all is not lost. BAPCA continues:

“(B) If the retirement funds are in a retirement fund that has not received a favorable determination under such section 7805, those funds are exempt from the estate if the debtor demonstrates that—

(i) no prior determination to the contrary has been made by a court or the Internal Revenue Service; and

(ii) (I) the retirement fund is in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986; or

(II) the retirement fund fails to be in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986 and the debtor is not materially responsible for that failure.”

Note: Although the concepts of “substantial compliance” and “materially responsible” are comforting, do not count on that in practice. It is very clear that plans which were controlled by the bankrupt will be given special scrutiny. Flaws should be corrected, and a specialist conversant in the IRS corrections procedures of Rev. Proc. 2003-44 should be consulted months in advance of a filing.

3. PLAN LOANS IN BANKRUPTCY

Participant loans are permitted from qualified plans (not IRA's) under rules which are reasonably similar under ERISA and the Internal Revenue Code. Provided that the plan loan meets either ERISA or Code Section 72(p) standards, it is not dischargeable in bankruptcy.

As a practical matter, this protects loans up to \$50,000 (or 50% of a plan vested balance, if less) if the loan is pursuant to a plan provision or qualified plan procedure, and is being paid at least quarterly under a level amortization schedule which generally cannot exceed five years (unless the loan was to purchase a principal residence).

This provision will relieve the headache for plan administrators when participants declare bankruptcy and seek to discharge plan loans. But the provision actually is more for the benefit of bankrupts. Typically, bankruptcy trustees have notified plan administrators that loan repayments from salary withholdings must cease after bankruptcy filing. That has forced plans to put the loans into default, and has triggered premature taxation to participants under Code Section 72(p). BAPCPA takes the sting out of that. An employed bankrupt can continue to have loan repayments withheld from salary, and will not be faced with premature income tax burdens on top of other problems.

4. PROTECTION FOR EMPLOYEES OF BANKRUPT EMPLOYERS

It is well known that one of the most common ERISA violations is for employers to withhold compensation, typically for 401(k) and health plan deposits, and then to use them for other purposes. This practice of “playing the float” is a prohibited transaction under ERISA, and is essentially treated as if the plan sponsor had illegally borrowed money from the plan. However, in some bankruptcy situations, trustees have successfully intercepted those employee funds, putting employees into a creditor status with others when the withheld money was clearly meant for employee benefits. BAPCPA is a welcome reform in this respect.

Interestingly, this is one instance where the concept of “ERISA qualified” plan is resurrected.

Presumably, that is to blunt the debtor-owner's defense that his owner-only plan is entitled to additional deposits for his own account. This is a small concession to creditors, and does not affect the general protection provided to plans which are not "ERISA qualified."

5. HOW REAL IS THE PROTECTION?

There is also another, very important consideration which we cannot gauge at this point. Maybe we are all wrong, because no one else is pointing it out. But we think that benefits lawyers may not (yet) comprehend the full import of BAPCPA. The philosophy of BAPCPA is that Chapter 7 discharge should not be available to bankrupts with expected future income in excess of future needs. Those persons are expected to repay a large percentage of their debts under a Chapter 13 plan of reorganization.

Accordingly, we expect that retirement plan accumulations (and the income to be derived from them) will be eyed by bankruptcy courts, as they consider the merits of granting discharges.

We find it hard to believe that BAPCPA is a free pass to skip obligations while holding a multimillion dollar pension.

6. CONCLUSION

BAPCPA added some clarification to a subject matter that has been clouded with litigation for thirty years, and which has affected the lives and well-being of many persons in a manner which the 1974 Congress could not have anticipated in enacting ERISA.

However, litigation will simply now move to different fronts.

- ▶ Hopefully, courts will be skeptical of bankruptcy trustees' efforts to nit-pick and second guess plan qualification, especially when favorable letters have been issued. But this will undoubtedly be a litigated subject matter, at least when parties who were in control of a qualified plan's affairs file for bankruptcy protection.
- ▶ In the case of large pensions, it is not at all clear if their recipients will be protected from the post-bankruptcy obligations which BAPCPA will impose on well-heeled bankrupts.

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