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Client Alert

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The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Retirement Plans are Provided More Protection

On April 20, 2005, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") into law. The Act's provisions generally will be effective on October 17, 2005.

Before the Act was passed, it was unclear whether individual debtors in bankruptcy proceedings could shield from their creditors retirement savings held in employee benefit plans or individual retirement accounts ("IRAs") that were not covered by the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), because courts that addressed the issue differed. The Act resolves any remaining doubts in favor of providing some protection for the retirement savings of individual debtors.

Generally, under the Bankruptcy Code, when an individual files a bankruptcy petition, all of his or her interests in property become the property of the bankruptcy estate and are available to be distributed to the debtor's creditors. Property is only insulated from creditors if it is excluded or exempt from the bankruptcy estate.[1]

The U.S. Supreme Court made clear in 1992 in *Patterson v. Shumate*[2] that a debtor's interest in an "ERISA-qualified pension plan" was excluded from the property of the bankruptcy estate as a spendthrift trust under nonbankruptcy law. That is, the assets never became the property of the bankruptcy estate and, as excluded assets, were outside the reach of creditors. On the other hand, retirement plans that are not "ERISA-qualified" are only safe from creditors if the plans fall within a federal or state exemption statute. Exemption statutes list property, including in some cases an individual's retirement funds, that are entitled to protection from creditors.

Retirement Savings Are Protected In Bankruptcy

The Bankruptcy Code provides exemptions from the bankruptcy estate for certain retirement savings, but these exemptions are subject to various interpretations by courts (as noted below). With the Act's passage, the exemptions for tax-favored retirement plans were clarified and expanded to protect retirement plans that are not "ERISA-qualified."

The Act amends Section 522 of the Bankruptcy Code to provide that a debtor is entitled to exempt from the bankruptcy estate any interest in "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation" under the Internal Revenue Code ("IRC") under Section 401 which covers qualified pension, profit-sharing and stock bonus plans, Section 403 which covers annuities, Section 408 which covers IRAs and simplified employee pensions ("SEPs"), Section 408A which covers Roth IRAs, Section 457 which covers 457 deferred compensation plans, or Section 501(a) concerning certain trusts. The Act expands the protection provided to retirement savings of a debtor in bankruptcy to include tax-qualified plans that are not subject to ERISA (*i.e.*, certain "Keogh plans" established by self-employed individuals, 403(b) annuities and IRAs).

The Act provides that the funds in a retirement plan are presumed to be tax-exempt if: (1) there is a favorable determination letter and the determination

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[1] Excluded property never becomes a part of the bankruptcy estate, while exempt property becomes property of the bankruptcy estate, but may be shielded from creditors' claims by virtue of a federal or state exemption statute.

[2] 504 U.S. 753 (1992).

letter is in effect as of the date of the debtor's filing of a bankruptcy petition; or (2) there is no favorable determination letter, but the debtor can demonstrate that neither a court nor the Internal Revenue Service has made a contrary determination. In addition, if there is no favorable determination letter, the debtor must show either (i) that the retirement plan or arrangement is in substantial compliance with the applicable requirements of the IRC, or (ii) if the plan is not in substantial compliance with the requirements of the IRC, the debtor was not materially responsible for that failure.

However, while the Act includes IRAs in the list of retirement funds that are exempt from the bankruptcy estate, it limits the amount that can be protected in a traditional IRA, a Roth IRA or a deemed IRA to $1 million. This $1 million cap does not apply if the amounts held in the IRA were rolled over from a Section 401(a) tax-qualified plan or 403(b) annuity. In addition, the cap does not apply to SEPs under Section 408(k) of the IRC or a simple retirement account under Section 408(p) of the IRC. The Act also permits a bankruptcy court to increase the $1 million cap "if the interests of justice so require."

Plan Loans Are Not Dischargeable

The Act contains other benefit-related provisions. For example, the Act amends Section 523 of the Bankruptcy Code to provide that employees who have filed for personal bankruptcy may not discharge any amount they owe on a loan from a pension, stock bonus, or other plan established under Section 401, 403, 408, 408A, 414, 457 or 501(c) of the IRC. The Act also amends Section 362 of the Bankruptcy Code to except from the automatic stay certain income withheld from the employee's wages as long as the amounts withheld and collected are used solely for payments on a loan from a qualified employer plan. As a result, employees can continue to make contributions and repay loans without such amounts being part of the bankruptcy estate.

Recent Court Cases Related to Retirement Savings in Bankruptcy

The issue of whether a debtor's interest in IRAs and other retirement plans should be exempt from the debtor's estate under the Bankruptcy Code had been addressed by several courts prior to the passage of the Act with conflicting results. The U.S. Supreme Court just this year resolved a division among the Courts of Appeals by holding in *Rousey v. Jacoway*[3] that IRAs were exempt from the bankruptcy estate and, therefore, debtors could protect certain of their IRA assets from creditors. Further in *Gould v. Skiba*,[4] a Pennsylvania bankruptcy court held that a debtor's interest in his 403(b) plan could be exempt from the property of the estate, but a Sixth Circuit court[5] concluded that a married couple's interests in their 403(b) plans could be reached by their creditors. Finally, courts have concluded that funds held in deferred compensation plans established under Section 457 of the IRC and Section 408(k) simplified employee pension plans ("SEP IRAs") could not be exempt from the bankruptcy estate.

The passage of the Act provides much-needed clarity and significant enhancements to the protection for debtors' retirement savings in a bankruptcy by implementing a broader and more uniform set of rules. Individuals should consider the level of protection provided when selecting a vehicle for accumulating savings for retirement, including the protection provided under state law.

[3] 125 S.Ct. 1561 (2005).

[4] 322 B.R. 741 (Bankr. W.D.Pa. 2005)

[5] *In re Adams*, 302 B.R. 535 (6th Cir. 2003).

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Client Alert

The Employee Benefits and Executive Compensation Law Practice Group at Proskauer Rose LLP counsels clients on the full spectrum of benefit and compensation issues, communicating technical and complex legal concepts in an intelligible, pragmatic manner.

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