

THE SAN DIEGO BANKRUPTCY FORUM

AN ASSOCIATION OF PROFESSIONALS INTERESTED
IN BANKRUPTCY AND INSOLVENCY

PRESENTS

“RETIREMENT ACCOUNTS - SAVING OR LOSING THE NEST EGG”

SPEAKERS:

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and THE HONORABLE JUDGE JOHN J. HARGROVE

with MODERATOR:

RONALD E. STADTMUELLER

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I. ERISA QUALIFICATION REQUIREMENTS

- A. Is there an IRS Favorable Determination letter? The plan may be prototype or individually designed.
- B. Is the plan still qualified and tax exempt? The following should be considered and will require administrative analysis:
1. No prohibited transactions exist, IRC Section 4975.
 2. No defaulted and foreclosed participant loans or inservice distributions exist. Loans are properly evidenced with promissory notes, consents, payment schedules.
 3. No self-dealing by owners or plan trustees using plan money for personal or company purposes.
 4. Terminated participants do not create a "partial termination" (30% or more of all participants terminate) which result in 100% vesting IRC Section 411.
 5. The plan is a definite written program with trust agreement.
 6. The plan is communicated to the employees-notice is posted.
 7. The plan prohibits the diversion of funds for purposes other than the exclusive benefit of employees.
 8.
 - a. The plan must satisfy minimum coverage requirements and a defined benefit plan must satisfy minimum participation requirements. [IRC Section 401(a)(3), 401(a)(26)]
 - b. Contributions or benefits under the plan may not discriminate in favor of highly compensated employees [IRC Section 401(a)(4)]
 - c. The plan must meet requirements for the vesting of benefits [IRC Section 401(a)(7)]
 - d. The plan must provide for required minimum distribution of benefits. [IRC Section 401(a)(9)]
 - e. Additional requirements apply to top-heavy plans. These additional requirements include minimum vesting rules, and for employees who are not key employees, minimum benefits and/or minimum contributions. A retirement plan can qualify only if it contains

provisions satisfying the top-heavy plan requirements that automatically take effect if the Plan becomes top heavy. [IRC Section 401(a)(10)(B)]

- f. With few exceptions, plans must provide for the payment of benefits in the form of a joint and survivor lifetime annuity and for death benefits in the form of a preretirement survivor annuity. [IRC Section 401(a)(11)]
- g. The plan must provide that benefits may not be assigned or alienated. [IRC Section 401(a)(13)]
- h. The plan must limit the contributions that can be made to the plan on behalf of an employee (in the case of a defined contribution plan), or it must limit the benefits that can be paid to an employee (in the case of a defined benefit plan). [IRC Section 401(a)(16)]
- i. The plan must impose a \$150,000 cap (subject to cost-of-living adjustments) on the amount of compensation that can be taken into account. [IRC 401(a)(17)]
- j. A defined benefit plan must specify the actuarial assumptions that are used to determine the value of a. [IRC Section 401(a)(25)]
- k. The plan must permit certain types of distributions to be made by a direct trustee-to-trustee transfer to another eligible retirement plan. [IRC Section 401(a)(31)]
- l. A defined benefit plan subject to Pension Benefit Guaranty Corporation (PBGC) coverage cannot be amended to increase plan liabilities while the employer is in bankruptcy [IRC Section 401(a)(33)]

II. EFFECTS OF DISQUALIFICATION

- A. Employees will be subject to personal income tax on all employer contributions which are vested. This includes earnings and forfeitures.
- B. Employees are also subject to a 10% pre-59½ distribution excise tax.
- C. IRS may also impose sanctions on the sponsoring entity.
- D. There are remedial programs available with the IRS to prevent plan disqualification and loss of tax exempt status for the trust.

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RETIREMENT ACCOUNTS
SAVING OR LOSING THE NEST EGG
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I

Non-Property of the Estate
Under 11 U.S.C. §541(c)(2)

A. ERISA Qualified Plans

1. Restrictions on transfer of beneficial interests contained in ERISA Qualified Plans are enforceable in bankruptcy under 11 U.S.C. §541(c)(2). Patterson v. Shumate, 504 U.S. 743, 112 S.Ct. 2242, 119 L.Ed.2d 519 (1992); In re Rueter, 11 F.3d 850 (9th Cir. 1993).

2. Employee as well as employer-funded contributions to ERISA Qualified Plans are exempt. In re Rueter, 11 F.3d 850.

3. After tax contributions to ERISA Qualified Plans are excluded from the estate even if debtor has complete access and can withdraw at any time. In re Conner, 73 F.3d 258 (9th Cir. 1996).

4. An otherwise ERISA Qualified Plan loses its exclusion under ERISA if the only participants are the owners/shareholders. In re Witwer, 148 B.R. 930 (Bankr. C.D.Cal. 1992), Aff'd Mem., 183 B.R. 614 (9th Cir. BAP 1994). See also In re Acosta, 182 B.R. 561 (Bankr. N.D.Cal. 1994).

B. California Spendthrift Exclusions from the Estate.

1. California law recognizes the general validity of spendthrift trusts. In re Neuton, 922 F.2d 1379 (9th Cir. 1990). But a settlor of a spendthrift trust cannot simultaneously be a beneficiary of the same trust. Cal.Prob.Code §15304(a); In re Moses, 215 B.R. 27 (9th Cir. BAP 1997).

2. Key issue - Degree of Control.

(a) If debtor has excessive control over trust, the anti-alienation provision will not be enforced. In re Kincaid, 917 F.2d 1162 (9th Cir. 1990); In re Witwer, 148 B.R. 930, 937; In re Moses, 215 B.R. 27.

(b) In In re Moses, 215 B.R. 27, a non-ERISA Keogh Plan containing an anti-alienation clause was excluded from the estate when plan was created by partnership involving others with the debtor, the debtor could not terminate or amend the plan, the contributions were mandatory, the debtor could not borrow against the plan, and could not receive funds unless he retired.

(c) In In re Witwer, 148 B.R. 930, the anti-alienation clause was invalid as the debtor could terminate the plan and his sole discretion, and had borrowed extensively for his own benefit. (Allowed exempt on other grounds).

(d) In In re Reid, 139 B.R. 19 (Bankr. S.D.Cal. 1992), Judge Hargrove held that debtor's right to receive lump sum distribution at any time did not constitute valid spendthrift trust under California law.

II Private Retirement Plans Under California Law

A. Private Retirement Plans and Profit Sharing Plans Under C.C.P. §704.115(a)(1)&(2).

1. All amounts held, controlled or in process of distribution by a private retirement plan, for the payment of benefits as an annuity, pension, retirement allowance, disability payment or death benefit from a private retirement plan are exempt. C.C.P. §704.115(b).

2. What is a "private retirement plan?"

(a) The term is not defined in the statute in any meaningful way. In re Phillips, 206 B.R. 196, 202 (Bankr. N.D.Cal. 1997). A self-settled trust was not a retirement plan.

(b) The purpose of §704.115, and therefore, the plan claimed exempt under that section should be to safeguard a stream of income for retirees. In re MacIntyre, 74 F.3d 186, 188 (9th Cir. 1996). In MacIntyre, the debtor's 403(b) retirement annuities were private retirement plans that were fully exempt under C.C.P. §704.115(a)(1) and not subject to the "necessary for retirement" limitation applicable to self-employed retirement plans and IRA's under C.C.P. §704.115(a)(3).

3. Retirement benefit plans established by a corporation solely owned by the debtor constitute fully exempted "private retirement plans" under §704.115(a)(1), rather than partially exempted "self-employed retirement plans" under §704.115(a)(3). In re Cheng, 943 F.2d 1114 (9th Cir. 1991).

4. The debtor may exempt his interest in non-ERISA qualified pension plans from the bankruptcy estate pursuant to §704.115(a)(1) or (2). In re Acosta, 182 B.R. 561 (N.D. Cal. 1994).

5. A debtor's profit sharing plan was used for retirement purposes and exempt under C.C.P. 704.115(a)(2) though she had taken a number of loans and withdrawals from the plan. The trustee contended the plan was used for tax avoidance rather than retirement, but failed to meet the burden of proof under Bankruptcy Rule 4003(c) placed on a party objecting to a claim of exemption. In re Crosby, 162 B.R. 276 (Bankr. C.D. Cal. 1993).

6. The fact that the debtor had loaned more than half of the funds in her retirement plan to herself without security did not constitute such an abuse of the profit sharing plan, so as to lose its retirement purposes and exemption under C.C.P. 704.115(a)(2). The debtor followed the provisions for obtaining the loans, charged a reasonable rate of interest on the loans, regularly made interest payments, and there was no indication that she used the plan to hide otherwise ineligible assets from the bankruptcy estate. In re Bloom, 839 F.2d 1376 (9th Cir. 1988).

7. The debtor's abuse of his retirement plan to take extensive loans, withdrawals and utilizing the plan to hide otherwise non-exempt assets from creditors by depositing money into the plan on the eve of bankruptcy, caused the plan to be found not used for retirement purposes. In re Daniels, 771 F.2d 1352 (9th Cir. 1985).

B. Private Plans Under C.C.P. §703.140(10)(E).

1. The debtor's right to receive a payment under a stock bonus, pension, profit sharing, annuity, or similar plan on account of illness, disability, death, age or length of service is exempt to the extent reasonably necessary for the support of the debtor and dependants unless all of the following apply: (1) the plan or contract was established by an insider that employed the debtor; (2) the payment is on account of age or length of service; (3) the plan does not qualify under §§401(a), 403(a), 403(b) or 408 of the Internal Revenue Code.

2. This section seemingly prohibits self-employed or sole owner corporate plans where the owner is the sole beneficiary in the plan.

C. Self-Employed Retirement Plans, IRA's, SEP-IRA's and Keogh Plans.

1. C.C.P. §704.115(a)(3) provides that self-employed retirement plans and individual retirement annuities are exempt to extent contributions do not exceed maximum amounts exempt from federal income taxation.

(a) Amounts are only exempt to extent necessary for support of debtor and dependants when the debtor retires, taking into account all resources likely to be available. C.C.P. §704.115(e).

(b) Even if not necessary for support, the debtor may retain an amount necessary to pay federal and state income taxes due as a result of the turnover. C.C.P. §704.115(e).

2. The debtor's IRA account is exempt under C.C.P. §704.115(a)(3) so long as it is reasonably necessary for retirement notwithstanding the debtor has control over the account. In re Vigghiany, 74 B.R. 61 (Bankr. S.D.Cal. 1987).

3. Exemptions for IRA's under C.C.P. §703.140(b)(10)(E).

(a) An IRA may be exempt under C.C.P. §703.140(b)(10)(E) to the extent reasonably necessary for retirement purposes since the statute has the same purpose of protecting retirement accounts. In re Rawlinson, 209 B.R. 501 (9th Cir. BAP 1997).

(b) Even though debtors might use IRA funds for other than retirement purposes, that is not enough to nullify exemption without evidence of misuse as IRA's may be exempt under C.C.P. §703.140(b)(10)(E). In re McKown, 203 B.R. 722 (Bankr. E.D.Cal. 1996).

4. Determinations of Reasonably Necessary for Retirement.

(a) In determining what is reasonably necessary for retirement, all of the debtor's present and future circumstances should be taken into account, including disruption in earning capacity, debtor's ability to regenerate retirement funds, healthcare costs as a result of age, and debtor's life expectancy. In re Switzer,

146 B.R. 1 (Bankr. C.D.Cal. 1992). In Switzer, the court allowed a 60-year-old debtor to retain \$500,000 of \$600,000 of various retirement funds exempt under C.C.P. §704.115(a)(3) where the debtor had unstable income, health problems and tax obligations.

(b) In In re Bernard, 40 F.3d (9th Cir. 1994), the court upheld the bankruptcy court's finding that \$250,000 in an annuity policy was not reasonably necessary for support considering the 60-year-old debtor's other retirement income and present income in excess of \$200,000 a year.

(c) In In re Spenser, 212 B.R. 625 (9th Cir. BAP 1997), the court upheld the bankruptcy court's finding a 55-year-old single debtor with no dependants who had projected retirement income without the IRA's of \$62,500 a year, did not need the IRA's for retirement.

(d) Judge Hargrove held that the court may take into consideration future needs of the debtor despite lack of present need of the debtor while retired in determining what was reasonably necessary. In re Dalaimo, 88 B.R. 268 (Bankr. S.D.Cal. 1988).

(e) There is no limit on the number of IRA accounts joint debtors may have so long as the aggregate amount does not exceed what is reasonably necessary for their retirement. It is not an impermissible "stacking" of exemption. In re Elster, 86 B.R. 631 (Bankr. C.D.Cal. 1988).

5. Is a Keogh Plan covered under C.C.P. §704.115(a)(1)&(2) or (a)(3)?

(a) Schwartzman v. Wilshinsky, 50 Cal.App.4th 619, 630, fn. 9 (1997) noted that "self-employed retirement plans" or "individual retirement annuities" in C.C.P. §704.115(a)(3) referred to IRA's and Keogh plans.

(b) In re Rawlinson, 209 B.R. 501, 504 stated because Keogh plans are funded exclusively by self-employed individuals who retain complete control over the amounts, and the individual retains the right to terminate the plan and withdraw the funds at any time subject to tax penalty, the Keogh plans may be subject to greater restrictions than an employer-funded pension plan.

III

How far may a Debtor go in Using Pension Plans for Pre-Petition Planning?

A. Different results from same facts. In re Johnson, 80 B.R. 953 (Bankr. D.Minn. 1987), Aff'd, 101 B.R. 997 (D.Minn. 1988), remanded by 880 F.2d 78, 84 (8th Cir. 1989) and final disposition in 124 B.R. 290 (Bankr. D.Minn. 1991); compared to In re Tveten, 70 B.R. 529 (Bankr. D.Minn. 1987), Aff'd, 82 B.R. 95 (D.Minn. 1987), Aff'd, 848 F.2d 871 (8th Cir. 1988). (One debtor denied discharge and the other granted discharge).

B. In In re Daniels, 771 F.2d 1352 (9th Cir. 1985), the debtor lost the exemption by depositing substantial sums of money into the account on the eve of bankruptcy.