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Explanation of Provisions of Bankruptcy Reform Act (S 256) Affecting Retirement Plans and Arrangements

by

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After years and years of legislative efforts, the highly controversial bankruptcy reform bill has finally become law. S 256 cleared the Senate in March and, in early April, was passed by the House. Unlike a predecessor, HR 2415 which was quietly vetoed by President Clinton at the end of December 2000, S 256 was quickly signed into law by President Bush on April 20, 2005. Putting aside whatever one may think of other parts of S 256, the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005" does provide significant new benefits to debtors who participate in tax-favored retirement plans and arrangements and/or have retirement savings in IRAs and Roth IRAs.

As discussed more fully below, S 256 does the following:

- Provides a new exemption in bankruptcy for interests in retirement plans and arrangements and retirement savings not protected under current law; however, in the case of contributory IRAs and Roth IRAs (but not rollover IRAs), the exemption is capped at \$1 million.
- Assures the bankruptcy of a plan participant will not affect the ability of the participant to repay plan loans.
- Provides that required employee contributions to a retirement plan or arrangement are not to be included in a debtor's bankruptcy estate and are not to be treated as "disposable income" subject to creditor claims in Chapter 13 bankruptcy cases.

The following is a summary of the favorable provisions in S 256:

New Exemption

Currently, some bankruptcy debtors may have little, if any ability to exempt their retirement interests from the claims of creditors. While debtor interests in IRC §401(a) qualified plans subject to ERISA have been held excluded from the debtor's estate in bankruptcy by the Supreme Court in Patterson v. Shumate, 504 US 753 (1992) pursuant to Bankruptcy Code §541(c)(2), that exclusion may not apply to other types of retirement plans and arrangements.² Additionally, while Bankruptcy Code §522(d)(10)(E) allows

debtors to exempt some retirement interests from creditor claims, there has been uncertainty as to whether that exemption covers all types of retirement plans and arrangements.³ That exemption, moreover, is limited to amounts considered by the bankruptcy court to be “reasonably necessary for the support of the debtor and any dependent of the debtor”. Finally, a state can “opt out” of that exemption for debtors from that state and provide its own more limited exemption or no exemption at all.

To fill the gaps in current law, Section 224(a) of S 256 amends Bankruptcy Code §522 to allow debtors to exempt their interests in tax-favored retirement plans and arrangements established under sections 401, 403, 408, 408A, 414, 457 and 501(a) of the Internal Revenue Code from creditors’ claims. For the purposes of determining whether a plan or arrangement is exempt from tax (so that the interest may be exempted), section 224(a) provides that a plan or arrangement is presumed to be exempt from tax if the plan or arrangement has received a favorable ruling from the IRS. Alternatively, a retirement plan or arrangement is considered exempt from tax for bankruptcy purposes even if it has not received an IRS ruling, provided it is in substantial compliance with the Internal Revenue Code and there is no prior IRS or court determination that it is not in compliance with Internal Revenue Code requirements. Even if a plan or arrangement is not in substantial compliance with Internal Revenue Code requirements, it is still considered exempt for bankruptcy purposes if the debtor is not materially responsible for its non-compliance. The exemption also covers plan assets directly transferred to another tax-favored plan or to an IRA under IRC §401(a)(31) and to retirement assets in the process of being rolled over which would qualify as an eligible rollover distribution under IRC §402(c).

Significantly, the new exemption has been written so as to be available to all debtors without regard to whether the debtor’s state has or has not “opted out” of the federal list of bankruptcy exemptions. On the other hand, section 224(e) of S 256 establishes one significant limitation on the use of the new exemption. Specifically, the aggregate value of assets in a debtor’s IRAs and Roth IRAs which may be exempted from creditors’ claims may not exceed \$1 million in value. Amounts rolled over from other plans to IRAs, as well the earnings on those rolled over amounts, however, are **not** included when testing for the \$1 million limit. The \$1 million limit is indexed for inflation and a bankruptcy court can insulate amounts in excess of the limit if required in the interests of justice.

Concern had been expressed as to whether the addition of the new exemption might be construed as superseding existing protections in bankruptcy for retirement interests. It should be noted that nothing in S 256 amends Bankruptcy Code §541(c)(2) or §522(d)(10)(E) so to withdraw or confine the protections afforded debtor interests under current law. In any event, under the discussion of section 224 in its section-by-section analysis, House Report 109-031 states as follows:

“The intent of section 224 is to expand the protection for tax-favored retirement plans or arrangements that may not be already protected under

Bankruptcy Code section 541(c)(2) pursuant to *Patterson v. Shumate*, or other state or Federal law.”

During the Senate deliberations, Senator Hatch, one of the managers in the Senate, stated:

“Let me take this opportunity to point out that the assets of some pension plans already are protected from bankruptcy proceedings. The United States Supreme Court has ruled in *Patterson v. Shumate*, reported at 504 U.S. 753 (1992), that assets of pension plans which have, and are required by law to have, anti-alienation provisions, are excluded from bankruptcy estates.

“Let me absolutely clear that this provision is not intended in any way to diminish the protections offered under existing law and under the United States Supreme Court’s decision in *Patterson v. Shumate*, but rather, is intended to provide protection to other retirement plans and accounts not currently protected.” Congressional Record, p. S2462 (March 10, 2005)

Treatment of Plan Loans

In re Villarie, 648 F2d 810 (2d Cir 1981) has long stood for the proposition that loans to plan participants from their accumulated contributions do not constitute “claims” or “debts” subject to the jurisdiction of bankruptcy courts, because the participants are essentially borrowing their own money. Under Villarie, the continued withholding of amounts necessary to repay such loans from the wages of participant debtors is not subject to the automatic stay under Bankruptcy Code §362 and such loans are not subject to discharge under Bankruptcy Code §522. Concern, however, has arisen because ERISA has mistakenly treated loans to plan participants out of their accumulated contributions like other types of loans of plan assets. As a result, private sector practitioners have been confused about the impact of bankruptcy on participant loans from ERISA plans.

To alleviate that concern, section 224(b) of S 256 amends Section 362(b) of the Bankruptcy Code to provide that amounts withheld from the wages of the debtor to repay a loan from a tax favored retirement plan or arrangement are not subject to the automatic stay of creditor collection actions provided by Section 362(b). And section 224(c) of S 256 amends Section 523(a) of the Bankruptcy Code to provide that a plan loan shall not be discharged by the bankruptcy court. However, in each case, S 256 provides specifically with respect to any loan from a governmental plan under IRC §414(d) or a contract or account under IRC §403(b), that such loan does not constitute a “claim” or “debt” in bankruptcy, thereby leaving the holding of Villarie undisturbed in those cases.

To further protect the ability of participant debtors to repay their plan loans, section 224(d) of S 256 amends Section 1322 of the Bankruptcy Code to provide that a Chapter 13 plan to repay creditors may not materially alter the terms of a plan loan and that any amount required to repay a plan loan shall not constitute “disposable income”

under section 1325 of the Bankruptcy Code which must be made available to pay creditors during the period of the Chapter 13 plan. Section 224(d) thus legislatively overrules court decisions, such as In re Anes, 195 F 3d 177 (3d Cir 1999), which have essentially barred plan participants from repaying their plan loans during the term of their Chapter 13 plans and required the payments on those loans to be redirected to satisfy the claims of creditors.

Exclusion of Required Employee Contributions From the Bankruptcy Estate

Section 323 of S 256 amends Section 541 of the Bankruptcy Code which defines what property of a debtor is or is not part of the debtor's bankruptcy estate available to satisfy creditor claims. Specifically, Section 323 adds language which excludes from a debtor's bankruptcy estate any amount withheld by an employer from an employee's wages or received by the employer as a contribution to a tax-favored retirement plan or arrangement (including any governmental plan under Section 414(d) of the Internal Revenue Code, any deferred compensation plan pursuant to Section 457 of the Internal Revenue Code, and any tax-deferred annuity pursuant to Section 403(b) of the Internal Revenue Code, but not any IRA or Roth IRA). Additionally, section 323 of S 256 provides that such amounts, insofar as they have been withheld by an employer from an employee's wages, shall not constitute "disposable income" as defined in Section 1325(b) of the Bankruptcy Code. This latter provision legislatively overrules cases, such as In re Taylor, 243 F 3d 124 (2d Cir 2001), which held that a bankruptcy court could determine on a case-by-base basis that required employee contributions to a governmental plan constitute "disposable income" which must be turned over to creditors under a Chapter 13 payment plan, instead of being paid to the plan.

Effective Date

Under section 1501 of S 256, the above amendments will apply to all cases commenced under the Bankruptcy Code beginning 180 days after S 256 became law.

¹ The opinions expressed in this article are those of the author and do not necessarily represent the views of the System by which he is employed.

² For example, the 6th Circuit has held that interests in trustee governmental retirement plans not subject to ERISA are likewise excluded from debtors' bankruptcy estates pursuant to Bankruptcy Code §541(c)(2). In re Wilcox, 233 F 3d 899 (6th Cir 2000), cert denied, 533 US 929 (2001). On the other hand, it was held in In re Adams, 302 BR 535 (BAP 6th Cir 2003) that interests in IRC §403(b) annuities which are not trustee are not excluded under Bankruptcy Code §541(c)(2).

³ Only just recently has the Supreme Court resolved a conflict among the circuits and held in Rousey v. Jacoway, 125 Sup Ct 1561 (2005) that an eligible debtor could use Bankruptcy Code §522(d)(10)(E) to exempt interests in rollover IRAs.