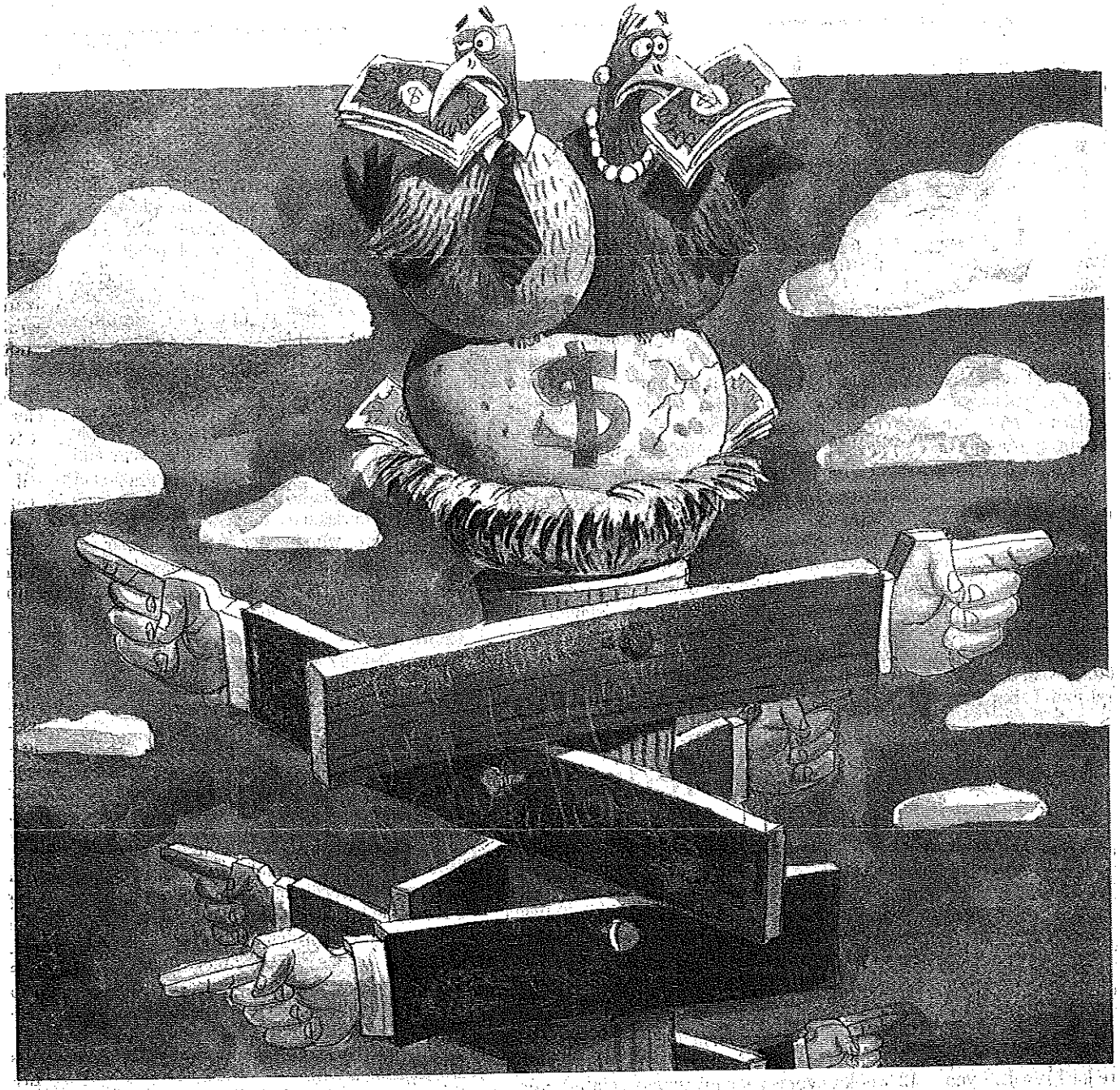

New Tax Decision, Legislation Have Little Impact in California

By Bruce Givner

The law used to be relatively clear. California Code of Civil Procedure Section 704.115(a)(3) defines "private retirement plans" to include IRAs and "Keoghs" as follows:

"Self-employed retirement plans and individual retirement annuities or accounts provided for in the Internal Revenue Code of 1954 as amended, to the extent the amounts held in the plans, annuities, or accounts do not exceed the maximum amounts exempt from federal income taxation under that code."

Section 704.115(e) goes on to limit the protection for these types of retirement funds to the extent you can prove you actually need the money to retire on:

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"The amounts described in Paragraph (3) of (a) are exempt only to the extent necessary to provide for the support of the judgment debtor when the judgment debtor retires and for the support of the spouse and dependents of the judgment debtor, taking into account all resources that are likely to be available for the support of the judgment debtor when the judgment debtor retires."

By contrast, all other "private retirement plans" are completely protected under state law, while in the retirement plan and after distribution to the beneficiary: "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." Section 704.115(b). "After payment, the amounts described in ... (b) and all contributions and interest thereon returned to any member of a private retirement plan are exempt." Section 704.115(d).

What does the phrase "private retirement plans" include? Section 704.115(a) has a definition that, as students, we learned to avoid — a definition in which the defined term is used in the definition itself: "'Private retirement plan' means: (1) Private retirement plans, including, but not limited to, union retirement plans [and] (2) profit-sharing plans designed and used for retirement purposes."

So the phrase certainly refers to plans that have received favorable determination letters as to their tax qualified status from the Internal Revenue Service National Office. However, the statute clearly is not limited in that fashion, meaning nonqualified plans of deferred compensation should qualify for the statute's absolute protection, while IRAs and Keoghs are examined under the subjective "support" test.

The U.S. Supreme Court's decision in *Patterson v. Shumate*, 504 U.S. 753 (1992), introduced a term that confused specialists: "ERISA-qualified." Retirement plans are referred to as "tax qualified" when they meet the requirements of the Internal Revenue Code. Retirement plans that have "rank and file" employees (those who are neither shareholders nor spouses of shareholders) must operate in accordance with ERISA, the Employee Retirement Income Security Act of 1974.

Although ERISA amended the relevant portions of the Internal Revenue Code, it is usually referenced in connection with the provisions enforced by the Department of Labor. So Justice Harry Blackmun's introduction of the term "ERISA-qualified plan" has been interpreted to mean a shorthand way of referring to a plan that is tax qualified and has the requisite ERISA provisions. *In re Harline*, 950 F.2d 669 (1991).

The Supreme Court's *Patterson* decision led to years of confusing decisions. For example, in *In re Witwer*, 148 B.R. 930 (1992), affirmed, 163 B.R. 614 (1994), the bankruptcy court distinguished *Patterson* by reasoning that a sole owner of a corporation was not an employee and, therefore, no protection was available under ERISA. However, as a non-ERISA plan, the court held that the debtor's plan interest was, nevertheless, exempt under California law.

Last month, the U.S. Supreme Court's decision in *Rousey v. Jacoway*, 125 S.Ct. 1561 (2005), received much attention in the popular press as it seemed to signal that IRAs are completely exempt from creditors. However, it merely answered a technical question (that IRAs are "similar" to "stock bonus, pension, profit sharing [and] annuity plans" under Bankruptcy Code Section 522(d)(10)(E)). What's more, there was little surprise as that question had already been favorably resolved in California. *In re Robert D. McKown*, 203 F.3d 1188 (2000). Third, it is irrelevant for California IRA holders because they have the California exemption discussed above (with the subjective "support" limit).

Further confusing matters was the enactment two weeks later, on April 19, of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (P.L. 109-8). BAPACPA (I'm pronouncing it "BAP-ah-CAP-ah" so it sounds like a fraternity) was enacted to provide curbs to perceived bankruptcy abuses. It also provides a new federal exemption for retirement funds held in any of several types of tax-favored plans or accounts.

This new exemption is tied to the plan's or account's code qualification, but it eliminates other requirements and conditions that existed under pre-act law. It imposes a $1 million (inflation-adjusted) cap on the exemption for all types of IRAs. The act generally takes effect on Oct. 17, 2005 (180 days after it was signed into law), but does not apply to cases begun before that date. Section 1501.

A debtor's interest in an ERISA-qualified plan continues to be excluded from the debtor's bankruptcy estate, at least if the plan is a trust. *Patterson*.

As before, the bankruptcy exclusion applies neither to a debtor's interest in an IRA nor to a plan that covers 'working owners,' a phrase that generally includes sole proprietors, partners and sole shareholders of a business, and their spouses. However, that phrase does not include common law employees. Those types of interests are not excluded from the debtor's bankruptcy estate.

A debtor's retirement funds that don't qualify for exclusion may qualify for a bankruptcy exemption. Under Bankruptcy Code Section 522(b)(1), a debtor may choose exemptions under Section 522(b)(3) or Section 522(d). However, states may foreclose the choice ("opt out") of Section 522(d).

Of the states, like California, that have opted out of the federal exemption, many have adopted exemptions that mirror the federal exemption.

Under Bankruptcy Code Section 522(d)(10)(E) (unaffected by the act, the section that was the subject of the decision in *In re McKown*), a federal exemption is provided generally for a debtor's right to receive funds held in a stock bonus, pension, profit-sharing, annuity, or similar plan or contract — but only if the payment is on account of illness, disability, death, age or length of service, and reasonably necessary for the support of the debtor or his dependents.

Before the act, Bankruptcy Code Section 522(d)(10)(E) and state law were the only significant provisions under which a debtor's retirement funds could have been kept out of the creditors' reach through a bankruptcy exemption.

To qualify retirement funds for the new federal bankruptcy exemption, a debtor must establish that the retirement fund or account that holds the funds is tax exempt. The debtor's burden here is more easily met if the plan or account has received a favorable determination letter from the IRS.

If the debtor's retirement funds are in a fund that has received a favorable determination letter under Internal Revenue Code Section 7805, and that determination is in effect as of the date of the filing of the bankruptcy petition, then those funds will be presumed to be exempt from the debtor's bankruptcy estate. Bankruptcy Code Section 522(b)(4)(A).

The conclusion to be drawn from all of this activity is that taxpayers are still well advised to keep their retirement funds in plans that are sponsored by corporations and that include meaningful benefits being accrued by rank-and-file (nonspouse, nonshareholder) employees. Anything less leaves important retirement benefits open to the question of whether the taxpayer (judgment debtor) needs the money for retirement. Why subject yourself, or your client, to that stress?

Of course, retirement plans are still subject to fraudulent transfer rules *In re Steven H. Stern*, 345 F.3d 1036 (2003). And contributing funds to a retirement plan are only one part of an overall strategy to protect your assets from unforeseeable future creditors. Other elements that should be considered include:

- A qualified personal residence trust (also known as "house GRIT") for the principal residence and one vacation residence per person.
- A family limited partnership with a corporate general partner wholly owned by an irrevocable trust for your heirs. See *Estate of Bigelow*, TC Memo 2005-65 (2005).

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