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Retirement Plan Assets in Bankruptcy

By Joseph "Jay" Van Heyde, Esq.

When the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("Act") became effective on October 17, 2005, one of the classes of assets (in term of creditor protection) favored by the Act were assets held in tax qualified retirement plans ("Retirement Plans") and individual retirement accounts ("IRAs"). The Act contains provisions that exempt those assets from the claims of creditors in bankruptcy.

Assets held in Retirement Plans that are subject to the federal employee benefits law known as the Employee Retirement Income Security Act of 1974 ("ERISA") have been excluded from a bankrupt's estate since the 1992 landmark case of Patterson v. Shunate. However, by applying only to Retirement Plans subject to ERISA, participants in governmental and church plans, and owners of IRAs, had to look elsewhere for possible protection from the claims of creditors.

Protection Under the Act

The Act substantially expanded the types of Retirement Plan and IRA assets that are excluded from a bankrupt's estate (and thus protected from creditors in bankruptcy) to include accounts or plans covered by Internal Revenue Code Sections (i) 401(a) (tax-qualified plans like profit sharing, 401(k) and defined benefit pension plans); (ii) 403 (tax-sheltered annuities); (iii) 408 (IRAs and individual retirement annuities); (iv) 408A (Roth IRAs); (v) 414 (governmental plans); (vi) 457 (non-profit and local government deferral plans) and (vii) 501(a) plans funded solely with employee contributions.

With respect to IRAs, the Act limits the exclusion to \$1 million, but there are three special provisions that greatly enhance the IRA provision. First, the \$1 million cap does not include amounts rolled into the IRA from Retirement Plans (such as a profit sharing or 401(k) plan). (Note, there is no such cap for Retirement Plans). Second, the cap does not apply to IRAs funded by a Simplified Employee Pension Plan ("SEP") or Simple IRA. Finally, the Act allows the bankruptcy court to increase the \$1 million cap if "the interests of justice so require."

From a planning standpoint, to the extent a participant is involved in the management of his or her employer, or participants in the administration of the Retirement Plan,

the participant will want to make sure the plan remains in compliance with the Code sections enumerated above. If the \$1 million cap for IRAs is an issue, then the IRA owner will want to maintain records that establish the value of any assets rolled into the IRA from a tax-qualified retirement plan.

Wage Withholding

The Act excludes from a bankrupt's estate amounts withheld from his or her wages for contribution to a Retirement Plan or welfare benefit plan. For example, if amounts are withheld from the bankrupt's paycheck for contribution to a 401(k) plan or group medical plan just prior to bankruptcy, those amounts may be contributed to the plan and do not have to be returned to the bankruptcy trustee.

Plan Loans

Plan loans no longer are dischargeable or modifiable in bankruptcy and are not subject to a collection stay during the pendency of the bankruptcy. Thus, if the bankrupt participant previously had agreed to repay a plan loan by payroll deduction payback, the employer will continue to withhold those payments from the bankrupt's paycheck and remit them to the Retirement Plan, even though other debt collection activities have been frozen. Effectively, the participant will continue to repay himself or herself while all other creditors receive only what is permitted by the court.

Summary

Retirement Plan assets and IRAs clearly are favored under the Act. If a person is concerned about making himself or herself as creditor-proof as possible, every attempt should be made to maximize contributions to a Retirement Plan or IRA. To the extent that such person is involved in the operation or administration of the Retirement Plan, he or she should work with the Retirement Plan's attorney and/or consultant to make sure that the Retirement Plan or IRA remains in compliance with the Internal Revenue Code. The attorneys in the Benefits Department at Dean Mead are available to show you how to maximize Retirement Plan contributions and to keep your Retirement Plan in compliance with federal pension laws.