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## Retirement Plans

Planning for retirement plans is a challenging undertaking. Retirement plans provide owners with many advantages, including income tax, estate tax and asset protection. The income tax rules applicable to retirement plans, specifically the rules dealing with required minimum distributions are very technical. The estate planning uses of retirement plans are also present, including the use of retirement plans to fund the bypass trust and to qualify for the marital deduction. These considerations are beyond the scope of this outline.

The asset protection advantages of retirement plans are the focus of the following discussion. Retirement plans present a major planning opportunity for asset protection purposes. Both federal and state laws favor retirement plans, and allow owners of such plans a certain sense of security with respect to the assets within the plan.

From an asset protection standpoint retirement plans are broken down into two categories: qualified and nonqualified. This is the same distinction that is made for income tax purposes.

### A. Qualified Plans

Qualified plans are a very important asset protection tool because such plans are required to include anti-alienation provisions pursuant to the Employee Retirement Income Security Act of 1974<sup>1</sup> (“ERISA”) and therefore are excluded from the debtor’s bankruptcy estate. Commonly used plans which are protected by ERISA include defined benefit plans (like a pension plan), defined contribution plans (like a profit sharing plan), and plans to which employees make voluntary contributions (401(k) plans). Similarly, for a plan to be treated as “qualified” under the Code, it must contain anti-alienation provisions.<sup>2</sup>

Protection of ERISA is afforded to employees only and does not cover employers. The owner of a business is treated as an employer, even though he may also be an employee of the same business, as in a closely-held corporation. Accordingly, ERISA protection does not apply to sole proprietors, to one owner businesses, whether incorporated or unincorporated, and to partnerships, unless the plan covers employees other than the owners, partners and their spouses.<sup>3</sup> A sole proprietor can never be protected under ERISA (because you cannot be your own employee). For all other businesses where the owner is seeking ERISA protection, non-owner employees (other than spouses) should be covered under the plan to maximize the plan’s asset protection benefits.

Section 541(c)(2) of the Bankruptcy Code provides an exclusion<sup>4</sup> from the debtor’s estate of a beneficial interest in a trust that is subject to a restriction that is enforceable under “applicable nonbankruptcy law.” The Supreme Court held that “applicable nonbankruptcy law” includes not only traditional spendthrift trusts, but all other laws, including ERISA provisions that require plans to include anti-alienation provisions.<sup>5</sup> Accordingly, all plans that are required to include anti-alienation provisions pursuant to ERISA are excluded from the debtor’s bankruptcy estate.

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<sup>1</sup> 29 U. S. C. Section 1056(d)(1).

<sup>2</sup> Code Section 401(a)(13).

<sup>3</sup> 29 C. F. R. Section 2510.3-3(b), 2510.3-3(c); *Giardono v. Jones*, 876 F. 2d 409 (7<sup>th</sup> Cir. 1989) (sole proprietor denied standing to bring ERISA action); *Pecham v. Board of Trustees, Etc.*, 653 F. 2d 424, 427 (10<sup>th</sup> Cir. 1981) (sole proprietor is not eligible for protection under ERISA); *In re Witwer*, 148 B. R. 930, 938 (Bankr. C.D. Cal. 1992), *aff'd*, 163 B. R. 914 (9<sup>th</sup> Cir. BAP 1993) (debtor’s interest in a qualified plan maintained by a corporation of which he was sole shareholder and employee was not protected by ERISA).

<sup>4</sup> An exclusion, as opposed to an exemption, is not limited in amount.

<sup>5</sup> *Patterson v. Shumate*, 112 S. Ct. 2242 (1992).

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Protection afforded by ERISA does not apply only in a bankruptcy setting. Even outside of bankruptcy, a creditor cannot reach the assets of an ERISA plan.<sup>6</sup>

Perhaps the most telling evidence of ERISA's protection is the Supreme Court's decision in Guidry v. Sheetmetal Pension Fund.<sup>7</sup> In Guidry a union official embezzled money from the union and transferred it to his union pension plan. The union official was convicted of the crime of embezzlement and the union attempted to recover the embezzled proceeds from the pension plan. Other than the fact that the proceeds were embezzled, the transfer to the pension plan was a fraudulent conveyance.

The Court held that the money in the pension plan could not be reached by creditors, whether by way of a constructive trust, writ of garnishment, or otherwise, because of ERISA's anti-alienation requirements. Prior to that, various courts and states carved out exceptions to ERISA's anti-alienation provision. The Court declared that exceptions to the anti-alienation rules were not justified by ERISA.<sup>8</sup> The protection afforded by ERISA's anti-alienation provisions applied regardless of how distasteful the debtor's behavior may have been or any applicable state public policy reasons (including a state's fraudulent transfer laws).

In response to Guidry and other cases like Guidry, Congress carved out several exceptions to the protection afforded by ERISA. These exceptions include: (i) a criminal violation of ERISA; (ii) a judgment, order, decree, or settlement agreement in connection with a violation of the fiduciary provisions of ERISA; or (iii) a settlement between the Secretary of Labor and the participant or settlement agreement between the Pension Benefit Guaranty Corporation and the participant in connection with a violation of ERISA's fiduciary duties. These exceptions obviously apply only to criminal conduct and only as such conduct relates specifically to an ERISA plan. Consequently, Guidry and its progeny continue to provide full protection to ERISA plans.

How important is it for a would-be debtor to keep money in a qualified plan? Certainly, at the time of a collection action, the debtor should have its money in a qualified plan. However, because the tax rules allow for such easy rollovers between qualified and nonqualified plans, in either direction,<sup>9</sup> and because ERISA trumps fraudulent transfer laws, debtors may keep their retirement funds in nonqualified plans. Prior to a creditor's collection action the debtor should roll the funds into a qualified plan.

It should be noted that ERISA's anti-alienation provisions do not apply to traditional support obligations for spouse and children. Also, under ERISA, retirement benefits can be divided pursuant to a qualified domestic relations order issued in connection with provision for child support, alimony payments, or marital property rights.<sup>10</sup> ERISA also does not protect monies distributed from the plan to the plan's beneficiaries.

The final exception to ERISA's protection are federal tax liens. There is no statutory exemption for ERISA plans from federal liens and levies and the courts have held that the Service may collect against an ERISA plan.<sup>11</sup>

## ***B. Nonqualified Plans***

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<sup>6</sup> Retirement Fund Trust of Plumbing v. FTB, 909 F. 2d 1266 (9<sup>th</sup> Cir. 1990) (attempts to seize plan benefits pursuant to state tax levy procedures are prohibited by ERISA's anti-alienation provisions).

<sup>7</sup> 493 U. S. 365 (1990).

<sup>8</sup> However, the Court made it clear that the domestic relations and child support exceptions to the anti-alienation provisions of ERISA continued to apply.

<sup>9</sup> Code Section 408(d)(3)(a).

<sup>10</sup> Code Section 414(p); 29 U. S. C. Section 1056(d)(3).

<sup>11</sup> U. S. v. Sawaf, 74 F. 3d 119 (1996).

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Nonqualified plans are generally not protected by ERISA, but may be protected by state statutes that exempt retirement plans from claims of creditors. The protection afforded by each state varies, based on the applicable statute and its interpretation by the courts.

For example, California protects “private retirement plans.”<sup>12</sup> The California statute provides that private retirement plans are protected from creditors, both before and after distribution to the debtor, and defines private retirement plans to include: (i) private retirement plans (the California legislature has not fully mastered the art of defining a term); (ii) profit sharing plans; and (iii) IRAs and self-employed plans. Under California law plan assets continue to be exempt even following the distribution from the plan.<sup>13</sup> Similar to ERISA, an exception is carved out for child support obligations.

California’s protection, although seemingly broad is not without a limitation. The statute provides that for IRAs and self-employed plans’ assets “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.”<sup>14</sup>

What is reasonably necessary is determined on a case by case basis, and the courts will take into account other funds and income streams available to the beneficiary of the plan.<sup>15</sup> Debtors who are skilled, well-educated, and have time left until retirement are usually afforded little protection under the California statute as the courts presume that such debtors will be able to provide for retirement.<sup>16</sup>

In California, the protection of a nonqualified plan focuses principally on defining the so-called “private retirement plan” and determining the amount that the debtor will need to have to provide for retirement needs.

The question of what constitutes a retirement plan was considered in Yaesu Electronics Corp. v. Tamura.<sup>17</sup> In that case the court held that the design and purpose of an IRS-qualified plan was not for retirement, since the debtor “admitted that he had never had a retirement account,” and “conceded that his purpose in establishing the [Retirement] Plan was not to save money to use for his retirement but to take advantage of the tax laws and to save money for his children.” Further, there was no evidence that the debtor used the money for retirement even though he was retired.

California courts have set forth several relevant factors to determine whether a nonqualified plan constitutes a “private retirement plan”: (i) the purpose of any withdrawals from the retirement plan; (ii) whether the applicable procedures were followed, in this case for withdrawals; (iii) the frequency of withdrawals; (iv) whether the retirement plan was used to shield or hide funds from creditors or the bankruptcy court; (v) whether any withdrawals diminished or will diminish the assets to such an extent that they are inconsistent with the majority of

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<sup>12</sup> CCP Section 704.115(a).

<sup>13</sup> CCP Section 704.115(d).

<sup>14</sup> CCP Section 704.115(e).

<sup>15</sup> In re Bernard, 40 F. 3d 1028, 1032–1033 (9<sup>th</sup> Cir. 1994) (annuity did not meet the reasonably necessary standard for an individual, age 60, who earns in excess of \$200,000 a year, where he was also entitled to income from other sources upon retirement, including social security and pension benefits); In re Spenler, 212 B. R. 625 (9<sup>th</sup> Cir. BAP 1997) (\$275,000 IRA was not “necessary” within the meaning of CCP Section 704.115(e) where 55-year-old physician who worked approximately 80-90 hours per week could save for his retirement out of his estimated \$250,000 annual income).

<sup>16</sup> In re Moffat, 119 B. R. 201 (9<sup>th</sup> Cir. BAP 1990), aff’d, 959 F2d 740 (9<sup>th</sup> Cir. 1992) (practicing orthodontist did not need annuity for support).

<sup>17</sup> 28 Cal. App. 4th 8, 33 Cal. Rptr. 2d 283 (1994).

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the assets being used for long-term retirement purposes; and (vi) whether the debtor exercised such control over the plan so as to show a non-retirement purpose.<sup>18</sup>

Accordingly, while California does not provide for a clear cut definition, it appears that private retirement plans are broadly defined as plans intended to provide for the debtor's retirement.

Nonqualified plans garner additional protection from the fact that the underlying trust is often spendthrift in nature. Which means that the plan will contain its own anti-alienation provision. Thus, the Ninth Circuit held that the assets of a nonqualified plan were protected in bankruptcy under the California spendthrift statute due to the plan's spendthrift clause.<sup>19</sup>

While the spendthrift trust affords beneficiaries strong protection from creditors, it is subject to the prohibition against self-settled trusts. Because retirement plans are frequently established by employees for their own benefit, it would seem that the self-settled trust rules may apply.

In the Ninth Circuit, the prohibition against self-settled trusts has been modified so that such trusts have an enforceable spendthrift clause if: (i) the employer, rather than the participant, makes all contributions, even if such contributions result in a voluntary reduction of future wages, and (ii) the participant is not entitled to receive the contributions except indirectly as distributions from the retirement plan.<sup>20</sup> Thus, the less access the beneficiary has to plan assets, the more likely the plan will be treated as a valid spendthrift trust

In carving out this exception to the self-settled trust rules, Ninth Circuit noted the great value our society places on providing for retirement of individuals, and deemed that such value overrides the public policy reasons behind the self-settled trust rules.

It would appear that the protection carved out by the Ninth Circuit to spendthrift nonqualified plans would apply even to plans established by closely held businesses for the benefit of owner-employees, so long as the entity and not the owner-employee makes contributions to the plan.

Clients seeking protection for their retirement plans should always roll-over their IRA to other types of plans. Additionally, converting to an ERISA qualified plans should also be considered, as ERISA plans are immune from fraudulent transfer challenges.

Frequently, financial advisors recommend to their client to roll their 401(k) and other ERISA-qualified plans into IRAs. In a recent decision, a California appellate court held that under the California tracing statute, monies rolled from a fully exempt retirement plan to an IRA remains fully exempt from creditor claims. The rollover is treated as just another distribution from a fully exempt plan and remains exempt so long as it is segregated from other assets.<sup>21</sup>

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<sup>18</sup> In re Anderson, 249 F. 3d 1170, 1176 (9<sup>th</sup> Cir. 2001); Schwartzman v. Wilshinsky, 50 Cal. App. 4th, 619, 629, 57 Cal. Rptr. 2d 790 (1996).

<sup>19</sup> In re Atwood, 259 B. R. 158, 161–162 (9<sup>th</sup> Cir. BAP 2001).

<sup>20</sup> In re Kincaid, 917 F. 2d 1168 (9<sup>th</sup> Cir. 1990).

<sup>21</sup> McMullen v. Haycock, -- Cal. Rptr. 3d – (Feb. 13, 2007).