Creditor Protection for Retirement Accounts: ERISA, the Supreme Court, and the Bankruptcy Act of 2005
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Executive Summary

- The Bankruptcy Abuse Protection and Consumer Protection Act of 2005 (BAPCPA), signed into law on April 20, 2005, and effective on October 17, 2005, has substantially increased and simplified bankruptcy creditor protection for retirement accounts.
- SEP (Simplified Employee Pension) IRAs, SIMPLE (Savings Incentive Match Plan for Employees of Small Employers) IRAs, and all defined-benefit and defined-contribution employer retirement plans now receive unlimited creditor protection in bankruptcy, regardless of whether the plan is subject to ERISA.
- Distributions from all defined-benefit and defined-contribution employer retirement plans fully retain creditor protection if they are rolled over to an IRA, obviating the "need" to keep assets in ERISA plans for bankruptcy creditor protection.
- Traditional and Roth IRAs will be subject to creditors to the extent that accounts exceed $1 million, excluding any amounts attributable to rollovers from qualified plans. Since the IRA contribution limit has been so low for decades, it is unlikely that any individuals will actually be subject to this limit in the foreseeable future.
- IRA protection, at least to the extent of $1 million, now applies regardless of the state in which the debtor files for bankruptcy, apparently overriding (favorably) the recent Rousey v. Jacoway Supreme Court case.
- Employer retirement plan protection (including SEP and SIMPLE IRAs, and non-ERISA retirement plans such as individual 401(k)s) now receive unlimited creditor protection during bankruptcy, regardless of ERISA.
- Financial planners will need to re-educate themselves on the new rules of bankruptcy creditor protection as opposed to the old rules of ERISA protection, state-specific IRA protection, and the Rousey v. Jacoway Supreme Court case.

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On April 20, 2005, President Bush signed the Bankruptcy Abuse Protection and Consumer Protection Act of 2005 (BAPCPA), which will become effective on October 17, 2005. Although the primary focus of the law was to make "abuse" of bankruptcy protection more difficult for debtors who have the capacity to pay, BAPCPA simultaneously increased, in some cases substantially, the creditor protection available to retirement accounts for those who declare bankruptcy.

Before implementation of the Bankruptcy Act, the protection of retirement accounts from creditors during bankruptcy has been subject to multiple rules depending on the type of account and the applicable state. Employer retirement plans have received creditor protection due to the Employer Retirement Income Security Act of 1974 (ERISA), but only a limited number of retirement account types are actually subject to ERISA.

For non-ERISA-protected plans, protection has varied by state. The extent of relief for debtors with retirement accounts would depend on which bankruptcy protections applied for a particular debtor's state. Protection varied from unlimited in some states to none in others, and practitioners often had difficulty keeping track of which states applied which protections.

BAPCPA has simplified retirement account creditor protection by eliminating much of the differentiation among types of plans and bankruptcy jurisdictions. To understand what has changed, though, it is important to first
basics of how assets can be protected in bankruptcy.

**Basics of Asset Protection in Bankruptcy**

Fundamentally, there are two ways that an asset can be protected from distribution among creditors of the bankruptcy estate in a bankruptcy proceeding:

1. **Excluded** from the bankruptcy estate
2. **Exempted** from the bankruptcy estate

**Exclusion.** A debtor's "bankruptcy estate" is considered to be "all legal or equitable interest of the debtor in property"¹—in a bankruptcy proceeding, these assets are divided among the creditors. But if an asset is not considered to be part of the bankruptcy estate in the first place (that is, it is "excluded from" the bankruptcy estate), then it cannot be among the assets that creditors divide. Most commonly, asset-protection-by-exclusion means ensuring that the individual debtor does not own the asset from the start—for example, when a highly at-risk professional titles assets in his or her spouse's name. But many restrictions apply in bankruptcy law to ensure that individuals do not inappropriately or fraudulently transfer assets to others in an attempt to exclude them from the bankruptcy estate and defeat known creditors.

**Exemption.** Certain statutes provide exemptions for specific debtor assets, thereby making them unavailable to creditors and allowing them to remain the property of the debtor. When an asset meets the requirements for being exempted, even though it is property the debtor owns (that is, it is not excluded), the asset is removed from the bankruptcy estate. For example, in many instances an individual's residence is exempted from the bankruptcy estate—and consequently safely remains the property of the debtor, sometimes despite a substantial value—under so-called "homestead exemption" rules that may apply.²

Technically, though, there actually are two distinct sets of exemptions (that is, lists of exempted assets) that may apply to a debtor (as slightly modified under BAPCPA):

1. Federal exemptions³
2. State exemptions, plus a short add-on list of still-applicable federal exemptions⁴

By default, all states use the federal exemptions, but states have the opportunity to "opt out" of the federal exemptions and instead design their own list of exemptions that will be applicable to debtors domiciled in their state.⁵ Many states have, in fact, opted out and used their own exemptions instead (with the few federal add-ons that still apply), while other states actually provide debtors the choice between using the federal exemptions or the state's own exemptions. Only a few states have entirely declined the opt-out process and instead use just the federal exemptions.

Debtors who have the choice between federal or state-plus-add-on exemptions evaluate the list of protected assets under both, and attempt to select the one that will provide the most protection for their particular composition of assets. In some instances, debtors may attempt to change their domicile, particularly if they fear potential litigation, to have the opportunity to use the "favorable" exemption lists that exist in some states.⁶

**Understanding ERISA Protection**

The Employee Retirement Income Security Act of 1974 (ERISA), applicable to employer retirement plans including all types of defined benefit plans, 401(k)s, 403(b)s, profit-sharing, and money-purchase, plans, states that retirement benefits under an employer plan "may not be assigned or alienated."⁷ This is important because, in defining what is or is not included in the bankruptcy estate itself, federal law states that "a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law"⁸ (author's emphasis) is not part of the debtor's bankruptcy estate.
In 1992, the U.S. Supreme Court declared in the case of *Patterson v. Shumate* that the ERISA "anti-alienation" rules do, in fact, constitute an enforceable non-bankruptcy law restriction on transfer of a debtor's assets held in trust, thereby causing employer retirement plan assets subject to ERISA (and its anti-alienation clause) to be excluded from the debtor's bankruptcy estate. In essence, the effect of ERISA, and the Supreme Court's interpretation of it, was to entirely protect ERISA-based employer retirement plans by excluding a debtor's account value from consideration in bankruptcy.

Notably, this protection applied only to ERISA-plan assets—if a retirement plan was not subject to ERISA, it was not excluded or protected. The most common plans not subject to ERISA (and thus not receiving the ERISA-based protection) were traditional, Roth, SEP, and SIMPLE IRAs, and retirement plans for self-employed business owners (for example, individual 401(k)s) where a failure to have any non-owner "employees" meant that ERISA's employee-oriented protections would not apply.

**IRAs and the Supreme Court**

Many states that opted out of the federal exemptions have included IRA accounts in their list of state exemptions, thereby providing partial or full (depending on the state's exact rules) creditor protection for IRAs. But in states that use the federal exemptions or grant creditors the right to choose federal (instead of state) exemptions, IRAs have been troublesome.

The issue is that under the federal exemption list, the right to receive "a payment under a stock bonus, pension, profit-sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service"9 (author's emphasis) is considered an exempt asset "to the extent reasonably necessary for support of the debtor and his/her dependents."10 Yet courts across the country have differed in their interpretations of whether IRAs would be eligible for exemption under these provisions.

In the recent case of *Rousey v. Jacoway*, decided on April 4, 2005, the Supreme Court resolved differences of interpretation in the lower courts by definitively confirming that IRAs are a "similar plan," and that the age-related penalty restrictions applicable to IRAs means that the right to receive payments from IRAs are "on account of age." Consequently, the court ruled that IRAs should be protected from creditors, subject to the limitation that they would be exempted only to the extent of the "reasonably necessary" provisions. This ruling meant that debtors' IRAs would be protected from creditors, to the extent reasonably necessary for support, for any debtor subject to the federal exemptions (that is, debtors in states that granted the choice between state or federal where the debtor chose the federal exemptions, or debtors in states that had not opted out of the federal exemptions). But those debtors subject to state-plus-add-on exemptions would still need to look to the state-specific treatment of IRAs, since the Supreme Court interpretation affected only the application of federal exemptions and those debtors subject to them.

**Retirement Account Protection Before BAPCPA**

Leading up to BAPCPA, creditor protection under the above guidelines had led to a confusing array of potential rules that might apply to protect retirement accounts, depending on the particular type of retirement account and the debtor's state of domicile (since domicile would determine which state's provisions would apply).

Employer plans subject to ERISA received creditor protection by virtue of the fact that they could be excluded from the bankruptcy estate. Consequently, many individuals in high-liability-risk professions were careful to accumulate and retain money in ERISA retirement plans, and were hesitant to roll the money over to potentially unprotected IRAs.

Before *Rousey v. Jacoway*, IRAs themselves were sometimes at least partially exempt from creditors, but only in
cases were the debtor's state of domicile had opted out of the federal exemptions and had included IRA protection as an explicit state exemption. States that still used federal exemptions, or gave debtors the choice, provided no creditor protection for IRAs before the Rousey decision, although the Supreme Court decision changed this to provide exemption to the extent "reasonably necessary" for those using federal bankruptcy exemptions.

BAPCPA's passage put an end to much of this differentiation between ERISA retirement plans and IRAs, and greatly simplified the determination of retirement account creditor protection among various states.

**Basic Retirement Account Rules Under BAPCPA**

Under the new rules of BAPCPA, virtually all types of retirement accounts are now exempt assets in bankruptcy proceedings. This was accomplished by adding a provision creating a new exemption for "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under Sections 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code." This exhaustive list of sections applicable to tax-deferred retirement plans that will now be exempt covers 401(k)s, 403(b)s, profit-sharing and money purchase plans, IRAs (including SEP and SIMPLE plans), as well as defined-benefit plans. But nonqualified annuities, although tax-deferred and ostensibly for retirement, will not be protected under these provisions since the applicable Section 72 is not listed (although qualified annuities will still be protected under the applicable IRA or qualified plan section, and nonqualified annuities may still otherwise be protected under state law).

To greatly aid simplification for debtors, the provisions exempting retirement plans of all types were added to the existing code twice—once in the list of federal exemptions, and again as one of the add-ons applicable to all states that opt out for their own state exemptions. Consequently, this blanket protection for all types of retirement accounts applies regardless of whether the debtor is eligible (or required) to use the federal or state exemptions—because the relevant protection was added in each applicable section of the law, it should apply in either case.

**The 'Catch' for IRAs**

Unfortunately, although BAPCPA has created an exemption for all types of retirement plans, the exemption for those plans is not unlimited in all cases. The catch is that, in the case of Roth and traditional IRAs, the maximum amount of the exemption is limited to an aggregate IRA account value of $1 million (adjusted every three years for inflation). SEP and SIMPLE IRAs, along with all other types of non-IRA retirement accounts such as 401(k)s and 403(b)s, are not included in determining the $1 million limit—it applies only to traditional and Roth IRAs.

In addition, this $1 million limitation does not include any amounts held in an IRA that are attributable to eligible rollover contributions (and subsequent rollover growth). Eligible rollover contributions are those that occur under a series of explicitly listed Internal Revenue Code rollover provisions; the end result is that rollovers from any qualified employer retirement plan will qualify, but IRA-to-IRA rollovers will not.

But it is notable that rollovers from other protected IRAs not subject to the $1 million limitation (that is, SEP and SIMPLE IRAs) appear not to be eligible rollovers (because such rollovers are completed under a code section that is not listed as a "protected" eligible rollover). Consequently, a rollover from a SEP or SIMPLE IRA to a traditional IRA would appear to forfeit unlimited protection and potentially subject the assets to the $1 million aggregate traditional and Roth IRA protection cap.

The good news is that, in the foreseeable future, the $1 million limitation is not likely to apply to many taxpayers. Forgoing the issue of rollovers from SEP and SIMPLE IRAs, the only type of IRA account balances that would apparently be subject are those attributable to annual individual contributions. At maximum annual contributions over the past two decades of only $2,000 (up until IRA contributions limits were increased in 2002), an investor
would have had to achieve rather phenomenal growth to actually accumulate more than $1 million solely attributable to such contributions.

In addition, BAPCPA's changes allow for the courts to increase the $1 million IRA exemption limit in cases where it is in the "interests of justice" to do so. It remains for the courts to actually apply this provision of the law to show what might actually constitute such a need, but Congress made flexibility available to the courts if they are inclined to use it.

Implications for Financial Planners

BAPCPA's sweeping changes will require financial planners to re-structure how they think about retirement account creditor protection for clients after BAPCPA's October 17 effective date.

The issue of whether assets should be held in an ERISA plan will be substantially less relevant; although technically ERISA could still remove applicable retirement accounts from the bankruptcy estate, the point is moot since such an asset would be fully exempt under BAPCPA anyway. But BAPCPA goes further than ERISA protection ever did by granting creditor protection to rollovers from qualified retirement plans, thereby removing the prior necessity to keep employer retirement accounts in their ERISA-protected accounts merely for protection during bankruptcy. Thanks to BAPCPA, there is less of a need to advise clients to retain qualified retirement plan assets in their employer's plan—minimal protection is lost by completing an IRA rollover, as long as debtors can prove the asset was rolled over from an employer retirement plan.

But it is important to note that ERISA protection may still provide clients with protection from other nonbankruptcy-related claims that IRAs will not (unless otherwise protected under state law). In addition, advisors should realize that a client might actually need to file for bankruptcy to protect an IRA from creditors. On the other hand, if a client's other assets or income might be treated unfavorably during bankruptcy in the client's domicile, this might not necessarily be a desirable course of action. Consequently, clients at high risk ultimately should still consult with an attorney familiar with bankruptcy laws in the applicable state, particularly if there are substantial nonretirement assets of concern.

Beyond ERISA, BAPCPA also essentially overwrote the "new" protection that Rousey v. Jacoway created (apparently making it one of the shortest Supreme Court precedents in history, since BAPCPA was signed into law a mere 16 days after the Rousey decision). Although a debtor theoretically could still attempt to exempt an IRA account under the "to the extent reasonably necessary" provisions of bankruptcy law, the fact that "reasonably necessary" is generally construed as only enough to maintain basic subsistence means that BAPCPA's $1 million IRA exemption limit will likely be more favorable in all situations. Even in situations where a debtor might prove that the "reasonably necessary" need is actually larger than the $1 million limit, BAPCPA's "in the interests of justice" clause might still come into play to provide the same increased protection. In the end, this means that financial planners probably no longer need to worry about the Rousey decision—BAPCPA's sweeping provisions and highly protected rules should prove more applicable and favorable for virtually all client situations.

The bottom line for financial planners is that there are three basic rules necessary to remember (see Table 1):

1. Traditional and Roth IRAs are exempt up to $1 million
2. SEP and SIMPLE IRAs are exempt for an unlimited amount (but rollovers from them to other IRAs fall under #1 above)
3. All other types of tax-deferred retirement accounts, or rollovers from them now held in IRAs, are exempt for an unlimited amount

Tips for Financial Planners

Although the provisions of BAPCPA are substantially simplified and straightforward, a few practice points and
cautionary notes should be borne in mind.

First of all, although rollovers from qualified retirement plans into IRAs are exempt, it appears that rollovers from SEP or SIMPLE IRAs are not (because those rollovers do not occur under one of the listed "protected" rollover Internal Revenue Code provisions). Consequently, planners should be cautious about consolidating SEP or SIMPLE accounts into regular rollover IRAs if the aggregate account balance may exceed $1 million and the client is concerned about creditor protection.

Planners should also advise clients to keep records that document rollovers from employer retirement plans, to ensure the ability to track which IRA account assets are attributable to unlimited-protection eligible rollover contributions. In fact, for clients who are concerned about creditor protection and have large IRA balances at risk it may be wise to keep such assets in separate rollover IRA accounts (even though there is really no longer any tax reason to keep assets separate for clients born after 193617). This will facilitate the ease of tracking and proving which IRA assets are attributable to protected rollover contributions and growth thereon, and may provide clients the opportunity to choose to make regular spending withdrawals for consumption from limited-protection IRAs first and unlimited-protection IRAs last.

For planners interested in more aggressive strategies, strict interpretation of the provisions regarding the $1 million limitation on IRA protection offers additional opportunities. Since the new BAPCPA exemption that defines the $1 million IRA limit explicitly states that the limitation applies only for assets in individual retirement accounts "other than a simplified employee pension [SEP-IRA]Éor a simple retirement account [SIMPLE IRA]"18 (author's emphasis), it appears that clients might seek to avoid application of the IRA limitation by rolling over traditional IRAs into SEP IRAs. (Note: This option would not work for Roth IRAs or SIMPLE IRAs, both of which can only be rolled into other accounts of the identical type.)

Alternatively, since the $1 million IRA exemption cap in the new BAPCPA exemption explicitly applies only to "individual retirement accounts described in section 408 [traditional/rollover IRA] or 408A [Roth IRA],"19 it appears that clients might roll over at-risk IRA assets into any other type of fully-protected defined-contribution employer retirement plan where the plan document will allow rollovers (most commonly a 401(k) or profit-sharing plan20), to avoid application of the cap. Since such accounts are not IRAs, the newly rolled-over assets apparently would not be subject to the $1 million limit when held in an employer retirement plan, despite the fact that they happened to be received from an IRA.

Although these types of aggressive strategies based on "literal" interpretations may not have been originally anticipated by Congress, it will ultimately be up to the courts to legally interpret the provisions of BAPCPA to decide how these rules will apply.

**Remaining Issues**

The discussion here focuses on explicit provisions of the Bankruptcy Abuse Protection and Consumer Protection Act of 2005, which provide fairly straightforward indications of how they will apply in potential client situations. But various nuances will bring forth additional questions for more complicated client situations, which over time will be clarified with some combination of additional regulations, potential legislative clarification from Congress, and litigation between creditors and debtors that develops a body of case law interpreting BAPCPA's provisions.

A few potential complications already becoming clear, of which planners should be aware, include:

- If an IRA with protected "eligible rollover contributions" from a qualified retirement plan is itself rolled over into another IRA, does the previous protected rollover treatment persist, even though an IRA-to-IRA rollover yields no protection?
- If the owner of an IRA with protected eligible rollover contributions dies, and the spouse elects to roll over
the account to a new account in his or her name, does the protected rollover treatment persist?

- What if a debtor files for bankruptcy using state exemptions, and the applicable state exemption provides unlimited IRA creditor protection, while the state-plus-add-on provision that will still apply under BAPCPA secures only a $1 million exemption? Which limit will apply—does the state's unlimited amount supersede the $1 million limitation, or vice versa?
- What situations might constitute a reason to exceed the $1 million limitation in the "interests of justice?"
- If an IRA is rolled over into a qualified employer retirement plan, and then subsequently is rolled back into an IRA, is the original IRA balance formerly subject to the $1 million limitation still at risk, or is it "laundered" clean by passing through the employer retirement plan?

**Summary**

As with all new laws that substantively change old rules, the new BAPCPA provisions applicable to retirement account protection will become clearer with time as they are applied and tested in actual bankruptcy cases.

Nonetheless, despite the fact that the dust has not yet settled entirely, BAPCPA clearly marks the start of a new, clearer, simpler paradigm for retirement account creditor protection. The long-standing and highly significant differentiation between ERISA and non-ERISA retirement accounts is far less problematic (although qualified retirement plans are still modestly more favorable under BAPCPA without the $1 million limitation), and the dizzying former state-by-state variability of IRA creditor protection has been tremendously simplified with far more uniform rules.

Although the existing ERISA-protection and *Rousey* decision will still apply to bankruptcies until BAPCPA's effective date of October 17, 2005, planners need to start now to re-learn how retirement assets can be protected from creditors under the new rules and to plan for their clients accordingly.

**Endnotes**

1. 11 United States Code (USC) Sec. 541(a)(1).
2. Notably, some types of exemption protections were adjusted under BAPCPA to better protect creditors from debtors trying to take advantage of the exemption rules.
3. 11 USC Sec. 522(d).
4. 11 USC Sec. 522(b)(3) after BAPCPA amendments; 11 USC Sec. 522(b)(2) prior to BAPCPA.
5. 11 USC Sec. 522(b).
6. However, the ability of debtors to make domicile changes in pursuit of more favorable exemptions has been substantially limited by other BAPCPA provisions, which requires an individual to live in a state for 730 days (instead of 180 days under prior law) to apply its bankruptcy exemptions.
7. ERISA Sec. 206(d)(1); 29 USC Sec. 1056(d)(1).
8. 11 USC Sec. 541(c)(2).
10. 11 USC Sec. 522(d)(10)(E).
11. BAPCPA Sec. 224; 11 USC Sec. 522(b)(3)(C); 11 USC Sec. 522(d)(12).
12. 11 USC Sec. 522(n).
13. 11 USC Sec. 104(b).
14. 11 USC 522(n); Protected rollovers are rollover contributions that occur under IRC Sections 402(c), 402(e)(6), 403(a)(4), 403(a)(5), and 403(b)(8).
15. SEP and SIMPLE IRA rollovers occur under IRC Section 408(d)(3), equally applicable to any/all types of IRA-to-IRA rollovers. IRC Section 408(d)(3) is not one of the "protected" rollover sections named under BAPCPA's new 11 USC 522(n).
16. IRA contribution limits were increased under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).
17. Since the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), there is no longer a need to separately maintain so-called "conduit IRAs" to allow future rollovers to employer retirement plans.

18. 11 USC Sec. 522(n).
19. Ibid.
20. Allowable since rollover provisions to and from qualified plans were broadened under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).