THE RETIREMENT PLAN EXEMPTION

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I. The Statute

A. California Code of Civil Procedure § 704.115 establishes an exemption for the assets of a "private retirement plan". The definition of a private retirement plan and the operative exemption provision are set forth below:

> (a) As used in this section, "private retirement plan" means:
>
> (1) Private retirement plans, including, but not limited to, union retirement plans.
>
> (2) Profit-sharing plans designed and used for retirement purposes.
>
> (3) Self-employed retirement plans and individual retirement annuities or accounts provided for in the Internal Revenue Code of 1986, as amended, including individual retirement accounts qualified under Section 408 or 408A of that code, 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.
>
> (b) 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.

B. The statute provides an unlimited exemption for plans which fall under either of the first two categories; §704.115(b); and for distributions from those plans; §704.115(d).

C. The "self-employed" plan exemption, the third identified type of plan, is extremely limited:

1. The plan must qualify under ERISA; §704.115(a)(3); see, <u>In re Rogers</u>, 222 B.R. 348 (Bkrtcy. C.D.Cal. 1998); and

2. The plan is exempt only to the extent "necessary to provide for the support of the judgment debtor"; §704.115(e).

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[1] Any useful information about trusts presented in the final section – but not my errors on the subject – can be attributed to the assistance of Benjamin Berk of Lillick & Charles.

a) Objective rather than subjective test. In re Moffat, 104 B.R. 255 (Bkrtcy. C.D. Cal. 1989); *aff'd* 119 B.R. 201 (BAP 9th Cir. 1990); *aff'd* 959 F.2d. 740 (9th Cir. 1992).

b) When used by Congress, this standard refers to subsistence rather than lifestyle maintenance. In re Velis, 123 B.R. 497 (D.N.J. 1991), *aff'd in part and rev'd in part*, Velis v. Kardanis, 949 F.2d. 78 (3rd Cir. 1991).

D. As a consequence, for insolvency planning purposes it is important that the plan be characterized as a "private retirement plan" or a "profit sharing plan", but not as a "self employed retirement plan".

E. The statute provides no description or explanation of the contours of a "private retirement plan". Rogers, supra, 222 B.R. at 351 (characterizing the exemption as "vague and undefined". Case law, however, has been expansive in its determination of what constitutes a "private retirement plan" (a "Plan").

II. **The Essential Requirement:** "Designed and used for a retirement purpose."

A. "The dispositive inquiry under the California statute is whether the plan was designed and used for retirement purposes." Yaesu Electronics Corp. v. Tamara, 28 Cal.App.4 8, 14; 33 Cal.Rptr.2d 283 (1994); quoted with approval in Schwartzman v. Wilshinsky, 50 Cal.App.4 618, 628; 57 Cal.Rptr.2d 790, 796.

B. *Compare*: In In re Daniel, 771 F.2d 1352 (9th Cir. 1985), *cert. den*. 475 U.S. 1016 (1986) the Ninth Circuit rejected the exemption where the debtor had borrowed the contents of his duly established retirement plan to fund the down payment on his home and failed to make any payments until shortly before his bankruptcy filing, when he repaid $40,000 and asserted the exemption. The Ninth Circuit held that his conduct in dealing with the plan suggested that the plan was not used for retirement purposes. Borrowing substantially all of the value of the plan is generally identified as a basis for denying the exemption. In re (Cathy Lee) Crosby, 162 B.R. 276, 285 (Bankr. C.D. Cal. 1993).

C. This single element is the touchstone of all of the case law, and hence the critical element in a planning context.

III. **There are few other significant restrictions on the retirement plan exemptions.**

A. ***Single Person Plan Tolerated:*** In Cheng, the Ninth Circuit squarely held that the "Private Retirement Plan" unlimited exemption was available where the sole beneficiary of the $1.8 million plan was also the sole shareholder of the corporation and the trustee of the plan, squarely rejecting the argument that the plan should be analyzed as a "self-employed retirement plan", and the exemption thereby limited to a "necessary for the support" standard.

1. The Ninth Circuit acknowledged the findings of the trial court to the effect that "otherwise stated, the plan operated more like a tax-favored savings account for Dr. Cheng than like a negotiated arms'-length pension and retirement system for the benefit of many people" and recognized that "the legislative history indicates that the policy behind the statute was to limit the exemption for plans that are controlled by one person."

2. The Ninth Circuit nonetheless ruled that the language of the statute was clear and the Bankruptcy Court was powerless to deny Dr. Cheng his $1.8 million private retirement plan exemption.

3. And see In re Witwer, 148 B.R. 930, 939 (Bankr. C.D. Cal. 1992) *aff'd* without opinion, 163 B.R. 614 (BAP 9th Cir. 1993), complaining that the unlimited exemption available for private retirement plans "may be an invitation for debtors to engage in pre-petition exemption planning. Solely in anticipation of putting assets beyond the reach of creditors…," but concluding that the language of the statute is mandatory.

4. Although this authority appears strong, it should be treated with care; it is not clear that a state court would necessarily adopt so expensive a view; *see,* analysis in Schwartzman .

5. And see, Rogers, supra, 222 B.R. at 351, noting that the exemption does "not include exclusively self-funded plans unlsee they qualify through a professional corporate entity."

B. ***Plan Need Not Be ERISA Qualified:*** Witwer, 148 B.R. at 939; In re Acosta, 182 B.R. 561, 566 (Dist. Ct. N.D. Cal. 1994); b*ut see*, Cheng, 943 F.2d at 116 (9th Cir. 1991) (relying on identification of the plan as a "corporate plan" under the Internal Revenue Code as the basis for determining that the plan was a "Private Retirement Plan" under the California statute).

C. ***Control Over Plan:*** "Whether or not the debtor exercises control over the plan is irrelevant to the exemption." Witwer, supra, 148 B.R. at 939; Cheng, 943 B.R. at 116; and see, In re Vigghiany, 74 B.R. 61 (Bankr. S.D.

Cal. 1987) (ability to withdraw funds from IRA before retirement did not destroy the exemption

D. ***Imprudent Investments:*** In many of the cases, the plan beneficiary borrowed money from the plan or caused the plan to invest in speculative real estate, and the challenge was raised that the plan was not "designed and used for retirement purposes" because the investments were such as would not be made by a prudent trustee of a retirement plan.

1. In general, the courts have rejected this attempted limitation on the retirement exemption, ruling that "it is inappropriate to hold the debtor to the prudent investor standard. A poorly, even imprudently, invested plan may still be designed and used for retirement purposes. That is enough to satisfy the… exemption." In re Bloom, 839 F.2d 1376, 1379 (9th Cir. 1988);

2. *See also*, Crosby, 162 B.R. at 284 (approving as exempt a retirement plan the assets of which were $60,000 of cash, a 50% interest in a partnership which owns raw land on St. Croix, stock in a closely-held corporation and $200,000 of promissory notes payable by the plan beneficiary and her parents).

3. *But see* Daniel, 771 F.2d. at 1358, looking to the choice of plan investments as evidence that the plan was not used for retirement purposes, and denying the exemption. "Thus, the plan essentially operated to meet debtor's short-term personal needs by lending money or shielding and hiding funds from creditors. Moreover, the debtor has failed to show how his transactions with the plan, by virtue of his role as trustee, were in furtherance of legitimate long-term retirement purposes."

4. Likewise, in Yaesu, the plan gave numerous gifts and the beneficiary testified that it was designed so as to leave assets to his children; the court concluded that the plan was not designed and intended for retirement purposes, even though it qualified for tax deferral purposes.

IV. Context:

A. ***Documentation Is One of the Most Significant Factors:*** The courts have found that compliance with trust agreement procedures respecting loans and similar matters supported the claim of exemption. See, Witwer, 148 B.R. at 940; Crosby, 162 B.R. at 284; Bloom, 839 F.2d at 1379; *contrast* In re Philips, 218 B.R. 520, 522 (Dist. Ct. N.D. Cal. 1998) (noting that "the 'informal retirement plan' was never reduced to writing and funds were used for a variety of purposes, none related directly to retirement" and denying the exemption.); In re Smith 2000 W.L. 1099794 (9th Cir. 2000) (debtor's assertions that a real estate family limited partnership was a retirement plan rejected; debtor must "offer more than merely his illusory intentions and dictionary definitions to satisfy the courts that the property was acquired as part of his private retirement plan. Such instantiation of the purported plan is required to prevent an abuse of this exemption.")

B. ***Construction:*** "The exemption statute should be construed, so far as practicable, to the benefit of the judgment debtor." Schwartzman, 57 Cal.Rptr.2d at 797; Cheng, 943 F.2d at 1116.

C. ***Burden of Proof:*** The creditor or trustee has the burden of disproving a claim of exemption. Crosby, 162 B.R. at 283.

V. An appropriate plan:

A. General Considerations

1. It is probably important that the sponsoring entity be different from the debtor / beneficiary, so as to avoid any potential of a "self-employed retirement plan" characterization.

2. Often, the objective will be to permit the beneficiary (prospective debtor) to contribute his assets to the plan (as opposed to the sponsoring entity being the principal funding source.)

3. Using a model which already exists will leave the plan "looking like" an ordinary plan, and thereby reduce the risks of litigation.

B. Using the "Employee Retirement Trust" model.

1. Some employers will compensate and bind highly compensated employees by making contributions to a retirement trust on their behalf. Structures which are designed for highly compensated employees often do not rely on obtain ERISA-based tax benefits.

a) There are two leading models: the "Rabbi trust", in which the contributions are not taxed to the employee until ultimate disbursement but remain available to attachment by the employer's creditors until disbursement as well, and the "secular trust" in which the contributions are treated as income to the employee when made.

b) A secular ("grantor") trust is generally treated as the same as the beneficiary for tax purposes: while third part contributions to the trust are treated as taxable income to the beneficiary, transfers between the beneficiary and the trust generally are not taxable events.

2. A secular trust may prove effective for insolvency planning purposes because it contemplates employee contributions to the trust.

   a) It is important to avoid characterization as an employer funded grantor trust, which can have adverse tax consequences. See, IRC §402(b).

   b) As a consequence, the beneficiary of a secular trust can and should contribute his own assets to the Plan. Kroll, 385-3rd Tax Management Portfolios, "Deferred Compensation Arrangements" A-30 (8) ("The key to favorable tax treatment is to establish a trust in which the employee truly is the grantor. The IRS focuses on whether the contributions were after-tax employee money and were not incidental compared to employer contributions. The standard applied is that the total employee contributions must exceed employer contributions as of any date.")

   c) In the ordinary case, insolvency planning is intended to shield assets which are already owned by the beneficiary by placing the assets in an exempt vehicle, such as the trust.

3. Using an employer/employee vehicle gives rise to the risk that the vehicle will be required to comply with ERISA (or rather, some portion of ERISA), thereby creating unwanted complications.

   a) There is an exemption where the employer has only a single employee/shareholder, because a single shareholder/employee is not treated as "employee" for ERISA purposes. DOL Reg. Section 2510.3-(c)(1).

   b) Where the employer is likely to have multiple employees, however, it will be important to evaluate whether establishment of the retirement trust gives rise to ERISA consequences.

C. A "free standing" retirement trust?

1. Conceptually, an alternative would be a free-standing retirement trust in which the sponsoring entity has no necessary connection with the beneficiary, but would provide retirement trust creation, administration and maintenance.

2. Such a trust would necessarily avoid ERISA issues.

3. To the extent that it was considered "abnormal", however, it might be challenged as a "exemption shelter" and face increased risks of litigation.

Relevant Cases

In re Acosta, 182 B.R. 561, 566 (Dist. Ct. N.D. Cal. 1994).

In re Bloom, 839 F.2d 1376, 1379 (9th Cir. 1988);

In re Cheng, 943 F.2d 114, 116 (9th Cir. 1991)

In re (Cathy Lee) Crosby, 162 B.R. 276, 284 (Bankr. C.D. Cal. 1993)

In re Daniel, 771 F.2d 1352 (9th Cir. 1985), *cert. den.* 475 U.S. 1016 (1986)

In re Philips, 218 B.R. 520 (Dist. Ct., N.D. Cal. 1998)

Schwartzman v. Wilshinsky, 50 Cal.App.4th 618, 628; 57 Cal.Rptr.2d 790, 796. (Cal. App. 2d. Dist. 1996)

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Yaesu Electronics Corp. v. Tamara, 28 Cal.App.4 8, 14; 33 Cal.Rptr.2d 283 (1994)