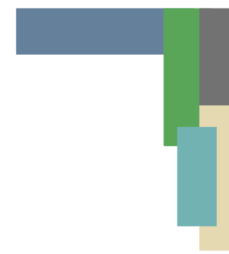

Important Information **Plan Administration and Operation** **June 2005 (Rev. 2/14)**

Bankruptcy Reform Act Includes Pension Provisions

WHO'S AFFECTED The new law affects sponsors of and participants in qualified defined benefit and defined contribution plans, including 401(k) plans. It also affects 403(b) plans and programs and governmental section 457(b) plans, as well as holders of individual retirement accounts and annuities (IRAs).

BACKGROUND AND SUMMARY On April 20, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. In general, this legislation will make it harder for debtors to be excused from their debts in bankruptcy. However, it also makes significant changes in the pension area for both individual debtors and bankrupt employers, by:

- Extending protection for individuals in bankruptcy to non-ERISA 403(b) programs, governmental plans, non-electing church plans, section 457 plans, and IRAs;
- Requiring retirement plans to establish their tax-favored status in order for participant benefits and accounts to qualify for bankruptcy protection;
- Clarifying that outstanding participant loans will remain in effect for participants who declare bankruptcy; and
- Providing additional protection for the retirement benefits of employees of bankrupt employers.

In general, the new rules are effective for bankruptcy petitions filed after October 16, 2005.

ACTION AND NEXT STEPS None of these new provisions will require plan amendments. In fact, they should simplify plan administration by removing earlier disjoints between the Bankruptcy Code, the Internal Revenue Code and, where applicable, ERISA. However, plan sponsors should review the information in this publication to familiarize themselves with the new rules. If you have questions about the application of any of these provisions to your plan or program, please contact your Prudential Retirement representative for assistance.

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Prior Law

In general, the federal Bankruptcy Code has provided that an individual's bankruptcy estate includes all of the debtor's rights to, or interests in, any type of asset. However, it permitted individuals to exclude certain assets from the estate and protect those assets from claims of their creditors. One of these exclusions was for property that is subject to "restriction on transfer under applicable non-bankruptcy law."

At the same time, both ERISA and the Internal Revenue Code contain anti-alienation provisions. These provisions prohibit the involuntary payment of a participant's benefit to anyone other than the participant. As a result, they would appear to protect a participant's accrued benefit in either a qualified plan or an ERISA 403(b) plan from the claims of either his creditors or the sponsoring employer's creditors.

In the early 1990's, the Circuit Courts were split on the issue of whether a debtor's qualified plan benefits were includable in his bankruptcy estate. Four Circuits held that the ERISA anti-alienation provision was a non-bankruptcy law transfer restriction that made qualified plan benefits excludable from the estate. Four other Circuits looked to whether the plan was considered a "spendthrift trust" under state law.

In 1992, the U.S. Supreme Court held (in *Patterson v. Shumate)* that the ERISA anti-alienation provision does protect certain retirement plan assets from creditors during an individual's bankruptcy. However, the Court did not express an opinion about benefits in pay status, the treatment of outstanding participant loans, or arrangements not covered by ERISA (e.g., non-ERISA 403(b) programs, section 457 plans, and IRAs).

Just this year, the U.S. Supreme Court ruled (in *Rousey v. Jacoway*) that IRA assets are similarly protected in bankruptcy situations. However, many observers felt that this protection was not complete for IRA holders with large amounts in their IRAs.

Protection for Individuals in Bankruptcy

Closely following the *Rousey v. Jacoway* decision, Congress passed this major revision of the Bankruptcy Code. The new law extends unlimited protection to assets in non-ERISA 403(b) programs, governmental plans, non-electing church plans, and section 457 plans, as well as to plans covered by ERISA.

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The new law also extends protection to both traditional IRAs and Roth IRAs, to a maximum of $1 million in contributions. This $1 million limit does not include amounts rolled over from eligible plans and related earnings, and may be increased in the future. The bankruptcy court also has the discretionary power to increase the $1 million limit "if the interests of justice so require." All amounts rolled over from eligible plans are fully protected, as are all assets held in a Simplified Employee Pension plan (SEP) or SIMPLE IRA.

Establishing Tax-Favored Status

To qualify for this protection, the debtor must demonstrate that the retirement plan assets are held in a plan that is exempt from federal income taxation. Assets held in a qualified defined benefit or defined contribution plan will satisfy this requirement if the plan has a favorable determination letter in effect as of the date of the filing of the bankruptcy petition. If the plan does not have a favorable determination letter (e.g., a qualified prototype or volume submitter plan, 403(b) plan or program, section 457 plan, or IRA), the debtor must demonstrate that neither a court nor the IRS has made an adverse determination on the fund's tax-exempt status, and either (1) the fund is in substantial compliance with applicable Internal Revenue Code requirements, or (2) the debtor is not materially responsible for any failure of the fund to be in compliance.

Outstanding Participant Loans

Under prior law, it was not unusual for the Bankruptcy Court to order a debtor either to reduce the amount of the repayments being made on a loan from the plan or to stop making repayments altogether. Unfortunately, the result of such actions was usually a default on the loan and a deemed distribution that was then immediately taxable to the participant.

The new law specifies that plan loans made to a participant before he files for bankruptcy protection will not be automatically discharged. If the individual is still employed, his employer may continue withholding loan repayments from his wages. In addition, a bankrupt individual's reorganization plan cannot materially modify the loan's terms.

As a practical matter, this protects retirement plan loans up to $50,000 and allows the participant to continue making loan repayments to avoid defaulting on the loan and incurring additional tax liability.

Protection for Employees of Bankrupt Employers

In addition to participant assets being protected in personal bankruptcy situations, contributions are protected when plan sponsors file for bankruptcy. Amounts withheld from wages (on a pre-tax or post-tax basis) as retirement plan contributions are now protected from claims of the employer's creditors even if they have not yet been deposited in a separate trust fund. This protection extends to employee contributions for qualified defined benefit and defined contribution plans, governmental plans, non-electing church plans, public section 457 plans, and section 403(b) plans and programs.

Unsecured claims for unpaid contributions owed to retirement plans are considered high-priority claims that must be paid before the claims of general unsecured creditors. Effective for cases filed after April 20, 2005, the new law increased the limit on these high-priority claims from $4,295 to

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$10,000 times the number of covered participants. It also extends the coverage period to include unpaid amounts due up to 180 days before the filing for bankruptcy (up from 90 days).

The new law also provides that if a debtor is a plan administrator of an employee benefit plan at the time of bankruptcy, the debtor must continue to perform its duties as the plan administrator during bankruptcy, unless the bankruptcy trustee assumes these obligations. This requirement is designed to limit the number of "orphan" plans resulting from employer bankruptcies.

Next Steps

Except as noted above, the changes made by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 will apply to bankruptcy filings made on or after October 17, 2005.

None of these new provisions require plan amendments. However, plan sponsors should familiarize themselves with these rules and make any changes to plan administration procedures that may be needed. For example, you may want to assemble a package of documentation to help a participant demonstrate that your plan or program's assets are exempt from federal taxation. This package could be simply a copy of the plan's IRS Determination Letter, if your plan has one. If you sponsor a 403(b) plan or program, or section 457 plan, you should consider preparing a statement attesting to the fact that the IRS has not made any adverse determination on the tax-exempt status of the plan or program and it is in substantial compliance with applicable Internal Revenue Code requirements. If you are a qualified plan sponsor and are relying on a document provider's Opinion Letter or Advisory Letter, you should include a copy of that letter with a statement signed by the Plan Administrator attesting to the fact that the IRS has not made an adverse determination on the plan's tax-exempt status and it is in substantial compliance with applicable Internal Revenue Code requirements.

If you have questions about the application of any of these provisions to your plan or program, please contact your Prudential Retirement representative for assistance.

Pension Analyst by Prudential Retirement
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