A Review of Changes to California Retirement Exemptions after AB2837

CALIFORNIA LAWYERS ASSOCIATION

Presenters:



Honorable Meredith Jury | Sherrie Boutwell | Dustin I. Nichols

Program Moderator: Michael N. Nicastro

CCP Section 704.115

- Under CCP 704.115, although the law is not completely clear, in our view, California law recognizes the following categories for retirement plans:
  - Fully exempt plans (no means test applies to distributions):
  - Partially exempt plans (means test applies to distributions):
- Under CCP 704.115, fully protected plans are not subject to creditors' claims: (a) assets held in the plan , (b) assets distributed from the plan and (c) death benefits paid from the plan.
  - However, under the California exemptions, many retirement plans (and all IRAs, unless the Haycock exception applies) are now subject to a means test for plan benefits that have been distributed.
- CCP 704.115 is available inside and outside of Bankruptcy Cases

New Law: AB 2837

AB 2837 was signed into law on September 24, 2024 by the Governor Gavin Newson and became effective on January 1, 2025.

AB 2837 makes certain changes to the California Enforcement Judgment Law ("EJL"), including changes to CCP § 704.115.

The Private Retirement Trust is governed by CCP § 704.115, however, the changes made to the statute relate to certain tax-qualified retirement plans and DO NOT impact the exemption protection of qualified or non-qualified plans that meet the requirements of a Private Retirement Trust.

Changes to CCP § 704.115

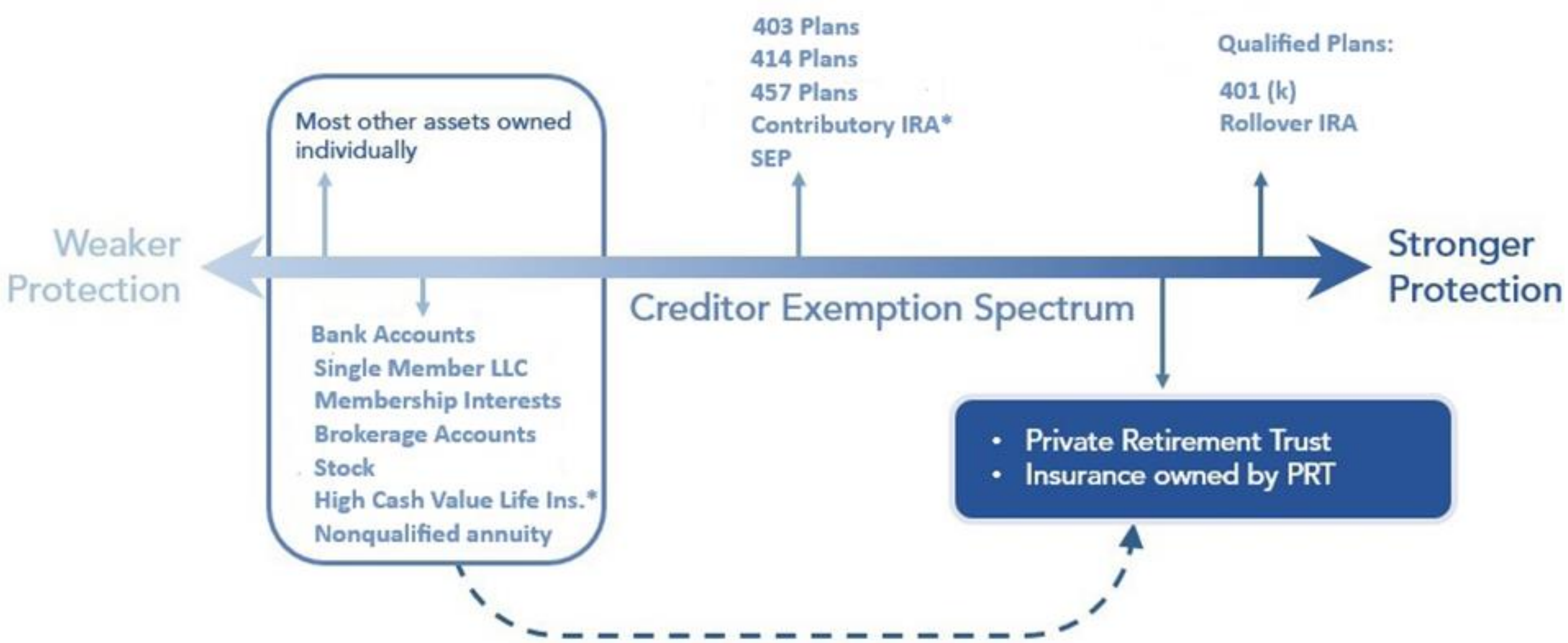
- Prior to AB 2837, traceable distributions from tax qualified plans under Sections 403, 414, or 457 of the Internal Revenue Code of 1986, as amended were exempt.
- Effective January 1, 2025, certain tax qualified retirement plans will become subject to the “Means Test” of CCP § 704.115(e).
- The “Means Test” provides that the amounts in tax qualified plans and IRAs are exempt <u>only to the extent necessary to provide for support of the judgment debtor</u> when the judgment debtor retires and for the support of the spouse and dependents of the judgment debtor, <u>taking into account all resources</u> that are likely to be available for the support of the judgment debtor when the judgment debtor retires.

Changes to CCP § 704.115 (continued)

- The "Means Test" is applied at the time money is distributed from the plan, which means that trust anti-alienation provisions still protect money in tax qualified plans while the money remains in the plan and distributions should not be subject to the means test.
- The Private Retirement Trust provides the trifecta of retirement exemption protection for California residents *(protection of the assets in the plan, distributions from the plan, and the death benefit)*.
- After AB 2837, bankruptcy may provide better protection for select tax qualified plans than California law. However, bankruptcy is not an option for all clients.

Private Retirement Plan Exemption: CCP § 704.115(b)

- “[a]ll 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.”
- Traceable distributions that are exempt and not subject to means test.



For informational and educational purposes only.

ERISA

- Under the 1992 US Supreme Court case Patterson v. Shumate (504 U.S. 753 (1992)), “ERISA Qualified” plans are exempt from a debtor’s bankruptcy estate and are not subject to attachment while assets are held in the plan.
- Whether a qualified retirement plan is subject to ERISA depends on whether there are any common law employees in the plan (other than the owner and spouse) and whether the plan is a pension plan under ERISA.
- Retirement plans can move in and out of ERISA status depending on the facts and circumstances. For example, if a plan covers only the owner and spouse, it is not subject to ERISA. But if the spouse’s divorce, it is. Likewise, if an employer covers a common law employee, it is subject to ERISA, but if that employee leaves and takes their benefits out of the plan leaving only the company owner, now it is not.
- Not all plans that provide deferred compensation qualify as “pension” plans. To be a pension plan, the plan has to be designed to provide benefits after termination of employment. So, a bonus plan may end up providing some retirement benefit, but if it is designed to provide benefits primarily during employment, it is not a pension plan. And even a pension plan under ERISA can fail to meet the tax code’s qualification requirements, although it is not clear that this means the plan is subject to claims of creditors. Purposely overfunding a plan in excess of the tax code’s limitations will limit protection from creditors. See Cunning v. Rucker (In re Rucker), 570 F.3d 1155 (9th Cir. 2009). Merely having an overfunded plan that was properly funded all along should not.
- In California, an “ERISA compliant” plan is not subject to attachment, even outside of a bankruptcy. See: Coastline Jx Holdings LLC v. Bennett, 80 Cal.App.5th 985, 296 Cal.Rptr.3d 437 (App. 4th Dist. 2022).

Plans that are subject to the means test:

- "Self-employed" plans (which is a term that used to be relevant under federal tax law but is not defined under either state or federal law);
- Non-profit, church and governmental plans (under Code Sections 403, 457 and 414);
- Non-qualified plans that do not qualify as "private retirement plans"; and
- All IRAs and IRA based plans (unless the Haycock exception applies).

IMPERFECT PLANS

- If a plan does not have its own favorable letter from the IRS, it can still be exempt if the debtor can prove that:
  - no prior determination to the contrary has been made by a court or the Internal Revenue Service <u>and</u> *the retirement fund is in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986 (emphasis added)*; or
  - if the retirement fund fails to be in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986, the debtor is not materially responsible for that failure.

What is the Haycock Exemption?

Private pension funds that are exempt from execution by creditors do not lose their exempt status when rolled over into an IRA. *McMullen v. Haycock* (Cal. Ct. App., 2nd Dist., No. B187748, Feb. 13, 2007)

Creation of a PRT

CCP § 704.115(a) doesn't define a PRT – Case law provides guidance:

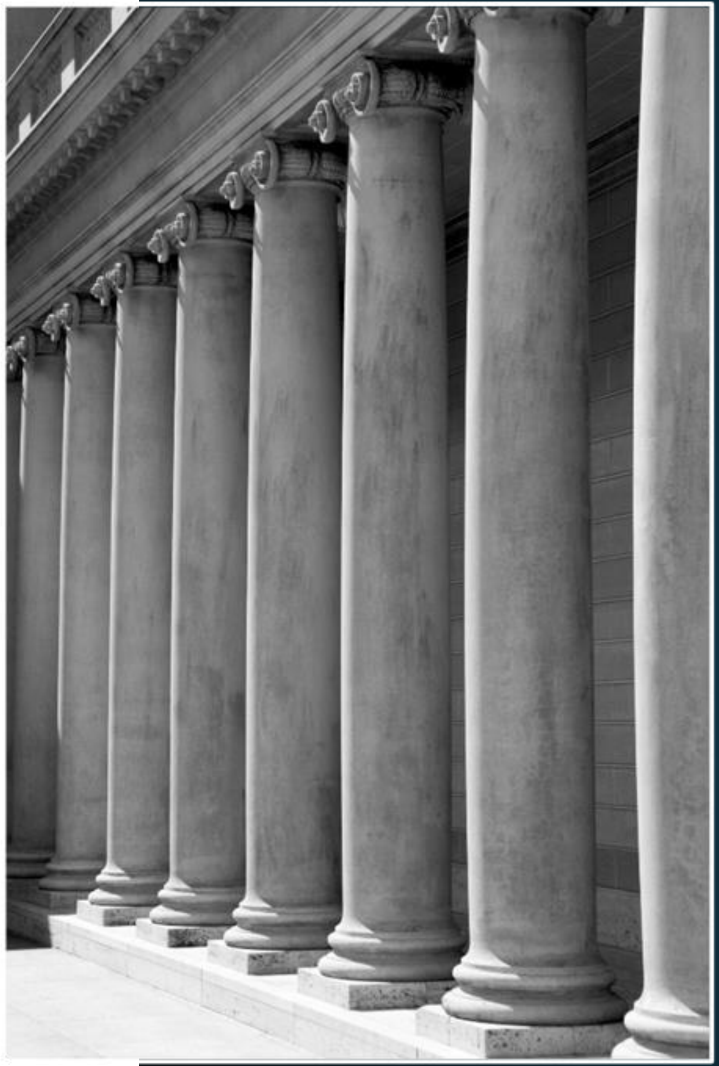
- A Private Retirement Plan (one per Company)
- A Private Retirement Trust to hold the retirement assets (one per Employee)
- PRT must be sponsored by an Employer Company
- Managed by an independent trustee or custodian
- To provide retirement benefits "only" to an employed person
- Plan can be ERISA qualified or not qualified
    - Retirement plan documentation whether qualified or non-qualified
    - Schedule or formula of payments to be made to the Plan by employee or employer or both
    - Schedule or formula of payments to participant at retirement

Purpose of the PRT Exemption

- The purpose of the PRT is to protect a debtor from his or her creditors and his or her lifestyle through retirement

- The PRT allows Californians to convert their “exposed” personal assets to “exempt” private retirement assets by enhancing (using in advance) their California exemption

- To be construed in a light most favorable to a debtor (In re Dudley, (9th Cir. 2001) 249 F.3d 1170)



Additional PRT Features

- 100% exempt *if designed* and *used* for retirement purposes and held by the plan or distributed from the plan
    - Exception Creditors: IRS & judgments for child, family, and spousal support

O'Brien v. AMBS Diagnostics, LLC – Totality of the Circumstances: 5 Factors

Debtor's subjective intent in designing and using the plan

Chronology or timing of the creation of the plan in relation to other events

Degree of control the debtor maintains over contributions, management, administration, and use of funds in the plan or account

Whether the debtor violated or complied with Internal Revenue Service (IRS) rules or the plan's rules in contributing to the plan

If the debtor withdraws money from the plan or account, whether those funds were used for retirement or a nonretirement purpose

Exemptions Claimed in Bankruptcy Cases

- An ERISA-qualified pension plan as an asset is excluded from the bankruptcy estate. *Patterson v Shumate*, 504 U.S. 753 (1992), which recognized that the anti-alienation provision in the pension plan met the requirements of Section 541(c)(2) so the plan assets are excluded from the estate. No dollar limit. No means test. Since this asset is excluded from the estate, appreciation accrues to the plan/debtor, not the estate.
- If the fund protected by this exemption is an IRA, the amount exempted is capped by 522(n) which states "For assets in [IRAs]…the aggregate value of such assets exempted under this section [522]… shall not exceed $1,711,975 [as adjusted recently for inflation] in a case filed by a debtor who is an individual, *except that such amount may be increased if the interests of justice so require."* (emphasis added)
- Post-petition distributions after filing Chapter 7 not property of the estate.

Exemptions Claimed in Bankruptcy Cases

- Section 522(b)(3)(C) applies even in an opt-out state such as California. *In re Hamlin*, 465 B.R. 863, 870-71 (9th Cir. BAP 2012); 4 Collier on Bankruptcy ¶ 522.10[09] (16th ed. 2015).
  - 4003(c) should apply to federal claimed exemptions and then burden of proof is on objector (where Courts may find that 4003 is outweighed by state law applied to state exemptions
- Generally, inherited IRA's are not exempt, except where inherited by a spouse and retained as a retirement account
  - *See* 26 U.S.C. (d)(3)(C)(2); I*n re Kelly,* 2023 Bankr. LEXIS 974, 72 Bankr. Ct. Dec. 119, 2023 WL 2903988; In re Pacheco, 537 B.R. at 938-39

11 U.S.C. §522(b)(3)(C) and §522(d)(12).

At least one appellate court has held that a plan that is not in substantial compliance with the tax qualification requirements but can still be corrected under the IRS's voluntary compliance program called "EPCRS" (which Congress expanded in 2022) can still be exempt. See Gladwell v. Reinhart (In re Reinhart), 477 Fed. Appx. 510, 52 EBC 2793 (10th Cir. 2012).

Bankruptcy law provides its own protection for IRAs, with a dollar cap on the aggregate amount held in contributory IRA plans other than SEPs and SIMPLE plans (currently $1,711,975) and cap does not include funds rolled over from 401(k) with no limit on rollover amounts held in an IRA. 11 U.S.C. Section 522(n).

DISCLAIMER

The information provided during this program does not constitute legal advice. In addition, this program only provides a summary of certain complex and always evolving laws and regulations. Attendees should consult their legal counsel for guidance on the application and implementation of the many federal and state laws that impact employee benefit plans and the private retirement plans, including the topics discussed during this program.

THANK YOU.

Questions?