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403(b) ANNUITY PLANS - EXEMPT OR NOT?

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Section 541(c)(2) of the Bankruptcy Code

A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.

Section 403(b)(7) of the Internal Revenue Code

(7) Custodial accounts for regulated investment company stock.

(A) For purposes of this title, amounts paid by an employer described in paragraph (1)(A) to a custodial account which satisfies the requirements of section 401(f)(2) shall be treated as amounts contributed by him for an annuity contract for his employee if--

- (i) the amounts are to be invested in regulated investment company stock to be held in that custodial account, and
- (ii) under the custodial account no such amounts may be paid or made available to any distributee before the employee dies, attains age 59 1/2, has a severance from employment, becomes disabled (within the meaning of section 72(m)(7)), or in the case of contributions made pursuant to a salary reduction agreement (within the meaning of section 3121(a)(1)(D)), encounters financial hardship.

(B) For purposes of this title, a custodial account which satisfies the requirements of section 401(f)(2) shall be treated as an organization described in section 401(a) solely for purposes of subchapter F and subtitle F with respect to amounts received by it (and income from investment thereof).

(C) For purposes of this paragraph, the term "regulated investment company" means a domestic corporation which is a regulated investment company within the meaning of section 851(a) [Internal Revenue Code].

Section 1103 of the Labor Code

(a) Except as provided in subsection (b), all assets of an employee benefit plan shall be held in trust by one or more trustees...

(b) The requirements of subsection (a) of this section shall not apply--

(5) to a contract established and maintained under section 403(b) of the Internal Revenue Code of 1986 [26 USCS § 403(b)] to the extent that the assets of the contract are held in one or more custodial accounts pursuant to section 403(b)(7) of such Code [26 USCS § 403(b)(7)].

Section 34-55-10-2(b)(6) of the Indiana Code

(6) An interest, whether vested or not, that the judgment debtor has in a retirement plan to the extent of:

(A) contributions, or portions of contributions, that were made to the retirement plan:

- (i) by or on behalf of the debtor; and
- (ii) which were not subject to federal income taxation to the debtor at the time of the contribution;

(B) earnings on contributions made under clause (A) that are not subject to federal income taxation at the time of the judgment; and

(C) roll-overs of contributions made under clause (A) that are not subject to federal income taxation at the time of the judgment.

Introduction

Section 541(c)(2) of the Bankruptcy Code creates an exception to the general rule found in section 541(a), that all property interests of the debtor must be turned over to the trustee for the benefit of the creditors. In general, the inquiry under section 541(c)(2) has three parts: “First, does the debtor have a beneficial interest in a trust? Second, is there a restriction on the transfer of that interest? Third, is the restriction enforceable under nonbankruptcy law?” *In re Wilcox*, 233 F.3d 899, 904 (6th Cir. 2000).

The leading case on the interpretation of section 541(c)(2) with respect to retirement plans, is *Patterson v. Shumate*, 504 U.S. 753 (1992), in which the Supreme Court held that the “debtor’s interest in an ERISA-qualified plan is excluded from the property of the bankruptcy estate.” *Patterson*, 504 U.S. at 765. The Court had concluded that the anti-alienation clause required for ERISA qualification constituted a restriction on transfer enforceable under “applicable nonbankruptcy law” within the meaning of section 541(c)(2). However, there are many tax sheltered annuity arrangements that are not subject to ERISA’s anti-alienation or trust requirements which are included in the debtor’s bankruptcy estate.

Is a 403(b) annuity plan included in the Bankruptcy estate?

The Sixth Circuit recently addressed this issue in *In re Adams*, 302 B.R. 535 (BAP 6th Cir. 2003). In this case, the debtors both had interest in separate retirement plans that were qualified 403(b) tax-sheltered annuity plans, which did not have anti-alienation language. The BAP reversed the Bankruptcy Court’s decision, and held that this type of annuity plan is not excluded from the Bankruptcy estate under section 541(c)(2). In coming to its conclusion, the BAP focused on the first part of the section 541(c)(2) inquiry, whether the debtor has a beneficial interest in a trust.

Generally, ERISA requires that all assets of an employee benefit plan be held in trust. 29 U.S.C. § 1103(a). Therefore, if a pension plan is subject to or governed by, ERISA, then it usually complies with ERISA’s trust requirements as well as satisfying the trust requirement of section 541(c)(2). *Adams*, 302 B.R. at 542. However, ERISA specifically exempts section 403(b) annuity plans from the ERISA trust requirements. 29 U.S.C. § 1103(b)(5). The following is illustrative as to why section 403(b) annuity plans are excluded from the ERISA trust requirements:

Since 1942, and long before the enactment of ERISA, there has been a tax statute, in one form or another, that allowed employees of certain charitable organizations to defer income under a tax-sheltered annuity arrangement. Revenue Act of 1942, ch. 619 § 162, 56 stat. 798 (codified as amended in scattered sections of 26 U.S.C.). Section 403(b) of the Internal Revenue Code was added by Congress in 1958 in order to restrict the amount of compensation deferrable under such annuity arrangements, since some charitable employers were ‘paying selected employees all, or almost all, of their compensation in the form of annuities.’ H.R.Rep. No. 775, 85th Cong., 1st Sess. 15, 16 (1957). Section 403(b) continued the deferral, but provided a formula for limiting the

amount deferred according to the employee's compensation length of service. No trust was required or employed as a part of these tax-sheltered annuity arrangements.

It stands to reason that when ERISA was first proposed as a comprehensive piece of legislation to govern pension plans in the United States, the insurance companies, having done a good business selling retirement annuities to charitable organizations, wished to keep that business. Since insurance companies are in the business of selling contracts, not acting as trustees, it was necessary for them to obtain an exception from ERISA's general rule that plan assets were to be held in trusts. In effect, the previous practice of the insurance companies was grandfathered in.

Adams, 302 B.R. at 542-3.

The BAP determined that the purchase of an annuity "creates the relationship of debtor/creditor not trustee/beneficiary, and '[a] debt is not a trust.'" Adams, 302 B.R. at 541. The debtors, on the other hand, had argued that "any ERISA-qualified plan must be a trust." Adams 302 B.R. at 541. The BAP stated that there is nothing in ERISA or the Internal Revenue Code that "mandates the conclusion that these plans involve trusts." *Id.*

Further, the BAP notes that under section 401(a) of the Internal Revenue Code, a "qualified trust is (a) a trust that features (b) employer/employee contributions for the benefit of an employee and (c) an anti-alienation provision." Adams, 302 B.R. at 542. In addition, for the purposes of the Internal Revenue Code, section 401(f) "allows certain custodial accounts or annuities having the (b) and (c) features, but not being trusts, to be treated as qualified trusts." *Id.* The BAP emphasizes that this "special treatment" is expressly limited to the Internal Revenue Code, and does not apply at all to the Bankruptcy Code. *Id.*

The dissent in Adams had argued that "§ 541(c) of the Bankruptcy Code and § 1056(d)(1) of ERISA (requiring pension plans to contain anti-alienation clauses) are in conflict and that ERISA should prevail." *Id.* at 545. However, the majority in Adams disagreed, and found no conflict between the statutes because they can be applied without interfering with each other. *Id.* The BAP explained that "ERISA requires that most pension plans contain an anti-alienation clause, but it does not purport to describe the legal effects of such a clause under all circumstances." *Id.* In addition, the Bankruptcy Code specifically provides that a debtor's interest in property becomes property of the estate "notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law... that restricts or conditions transfer of such interest by the debtor..." *Id.* Further, the BAP stated that the "Bankruptcy Code contains a provision that acts as a kind of enzyme within the medium of the Bankruptcy Code: it undoes all anti-alienation clauses except those appurtenant to trusts." *Id.* In sum, the decision in Adams said that it was not self-evident that the debtor's plans constituted a "trust," which is critical for finding that the plan was excluded from the bankruptcy estate.

Exactly how do you determine whether a debtor's interest in a retirement plan should be excluded from the bankruptcy estate under section 541(c)(2)? If a debtor is seeking for the plan to be excluded "on the theory that ERISA is the applicable nonbankruptcy law, the threshold question that must be addressed is whether the plan at issue is an employee pension benefit plan

subject to Title I of ERISA and its anti-alienation and trust requirements.” 40-APR Tenn. B.J. 25, 27.

A “pension, profit sharing, 401(k), stock bonus or employee stock ownership plan that is subject to Title I of ERISA will be required to contain an anti-alienation provision, and generally be required to hold its assets in a trust.” *Id.* However, “many tax sheltered annuity arrangements will not be subject to Title I of ERISA and its anti-alienation and trust requirements,” regardless of whether they satisfy all requirements and are “qualified” under section 403(b) of the Internal Revenue Code. *Id.* In this situation, the annuity plan would not be excluded from the bankruptcy estate under section 541(c)(2).

Do any other exemptions apply to a 403(b) annuity plan?

While the Seventh Circuit has yet to address this issue, even if the Indiana courts determined that the section 403(b) annuity plans are included in the bankruptcy estate, a debtor should still be able to claim the full value as exempt under Indiana Code § 34-55-10-2(b)(6). Section 403(b) contributions used to purchase annuity contracts are excluded from the gross income of the debtor, and because these plans are not subject to income taxation at the time of the contribution, the debtor would be able to claim a 403(b) annuity plan as exempt.