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EXCLUSIONS FROM THE BANKRUPTCY ESTATE: EDUCATION SAVINGS ACCOUNTS & EMPLOYEE BENEFIT PLANS

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A CLE Presentation

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§ 541. Property of the estate

(b) Property of the estate does not include –

(5) funds placed in an education individual retirement account (as defined in section 530(b)(1) of the Internal Revenue Code of 1986) not later than 365 days before the date of the filing of the petition in a case under this title, but--

(A) only if the designated beneficiary of such account was a child, stepchild, grandchild, or stepgrandchild of the debtor for the taxable year for which funds were placed in such account;

(B) only to the extent that such funds--

(i) are not pledged or promised to any entity in connection with any extension of credit; and

(ii) are not excess contributions (as described in section 4973(e) of the Internal Revenue Code of 1986); and

(C) in the case of funds placed in all such accounts having the same designated beneficiary not earlier than 720 days nor later than 365 days before such date, only so much of such funds as does not exceed \$5,475;

(6) funds used to purchase a tuition credit or certificate or contributed to an account in accordance with section 529(b)(1)(A) of the Internal Revenue Code of 1986 under a qualified State tuition program (as defined in section 529(b)(1) of such Code) not later than 365 days before the date of the filing of the petition in a case under this title, but--

(A) only if the designated beneficiary of the amounts paid or contributed to such tuition program was a child, stepchild, grandchild, or stepgrandchild of the debtor for the taxable year for which funds were paid or contributed;

(B) with respect to the aggregate amount paid or contributed to such program having the same designated beneficiary, only so much of such amount as does not exceed the total contributions permitted under section 529(b)(7) of such Code with respect to such beneficiary, as adjusted beginning on the date of the filing of the petition in a case under this title by the annual increase or decrease (rounded to the nearest tenth of 1 percent) in the education expenditure category of the Consumer Price Index prepared by the Department of Labor; and

(C) in the case of funds paid or contributed to such program having the same designated beneficiary not earlier than 720 days nor later than 365 days before such date, only so much of such funds as does not exceed \$5,475;

(7) any amount--

(A) withheld by an employer from the wages of employees for payment as contributions--

(i) to--

(I) an employee benefit plan that is subject to title I of the Employee Retirement Income Security Act of 1974 or under an employee benefit plan which is a governmental plan under section 414(d) of the Internal Revenue Code of 1986;

(II) a deferred compensation plan under section 457 of the Internal Revenue Code of 1986; or

(III) a tax-deferred annuity under section 403(b) of the Internal Revenue Code of 1986;

except that such amount under this subparagraph shall not constitute disposable income as defined in section 1325(b)(2); or

(ii) to a health insurance plan regulated by State law whether or not subject to such title; or

(B) received by an employer from employees for payment as contributions--

(i) to--

(I) an employee benefit plan that is subject to title I of the Employee Retirement Income Security Act of 1974 or under an employee benefit plan which is a governmental plan under section 414(d) of the Internal Revenue Code of 1986;

(II) a deferred compensation plan under section 457 of the Internal Revenue Code of 1986; or

(III) a tax-deferred annuity under section 403(b) of the Internal Revenue Code of 1986;

except that such amount under this subparagraph shall not constitute disposable income, as defined in section 1325(b)(2); or

(ii) to a health insurance plan regulated by State law whether or not subject to such title;

Introduction

A bankruptcy estate generally consists of “all legal or equitable interests of the debtor in property as of the commencement of the case.” 11 U.S.C. § 541(a). Section 541(b) of the Bankruptcy Code delineates property which is to be excluded from the estate. One of the few new benefits afforded to bankruptcy debtors in the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”) was the addition of an exclusion from the bankruptcy estate of certain education savings accounts under §§ 541(b)(5) and (6), and employee benefit funds under § 541(b)(7). *Bankr. Exemption Manual* § 2:23 (2007).

Education Savings Accounts: Sections 541(b)(5) and (6)

Education IRAs § 541(b)(5)

Debtors are explicitly allowed to exclude certain types of education savings accounts from the bankruptcy estate under §§ 541(b)(5) and (6). Section 541(b)(5) excludes funds placed in an education IRA within 365 days prior to the filing of the bankruptcy petition. The education IRAs under this section must fall in to the category defined by IRC § 530(b)(1), and the funds cannot be pledged to an entity in connection to an extension of credit or be in excess of contributions under IRC § 4973(e). 11 U.S.C.A. § 541(b)(5)(B). The designated beneficiary of the education IRA must be the debtor's child, stepchild, grandchild, or stepgrandchild for the taxable year in which the funds were placed in to the account. 11 U.S.C.A. § 541(b)(5)(A). Section 541(e) adopts a relatively broad view of "child" for the purposes of both § 541(b)(5)(A) and (6)(A) to include legally adopted children or foster children of the debtor. 11 U.S.C.A. § 541(e). Section 541(b)(5)(C) excludes funds placed in an education IRA more than 720 days prior to filing the bankruptcy petition, but the account must have the same designated beneficiary and the amount cannot exceed \$5,475. 11 U.S.C. § 541(b)(5)(C). Section 541(b)(5) includes exclusion of "Coverdell" education savings accounts, "meaning a trust created or organized in the United States exclusively for the purpose of paying the qualified education expenses of an individual who is the designated beneficiary of the trust." Lawrence R. Ahern, III, 13 Am. Bankr. Inst. L. Rev. 585, 606 (2005).

Qualified Tuition Programs § 541(b)(6)

Section 541(b)(6) excludes funds used by the debtor to purchase tuition credit or a certificate under a qualified State tuition program within 365 days of the filing date of the bankruptcy petition. These programs are generally referred to as "qualified tuition programs," and are programs "established and maintained by a State or agency or instrumentality thereof or by 1 or more eligible educational institutions," under which tuition credits for a beneficiary may be purchased. Lawrence R. Ahern, III, 13 Am. Bankr. Inst. L. Rev. 585, 606 (2005). This must be done in accordance with IRC § 529(b)(1), and the beneficiary of the amounts paid or contributed

to the tuition program must be the debtor's child, stepchild, grandchild, or stepgrandchild for the taxable year the funds were paid or contributed. 11 U.S.C.A. § 541(b)(6)(A). For purposes of this section, "child" also includes the debtor's legally adopted children or foster children. 11 U.S.C.A. § 541(e).

The total amount paid or contributed to the same beneficiary's program by the debtor cannot exceed the total contributions permitted under IRC § 529(b)(7). 11 U.S.C.A. § 541(b)(6)(B). The amount of contributions allowed under IRC § 529(b)(7) is to be adjusted beginning on the date the petition is filed by the annual increase or decrease (rounded to the nearest tenth of 1 percent) in the education expenditure category of the Department of Labor's Consumer Price Index. 11 U.S.C.A. § 541(b)(6)(B). Section 541(b)(6)(C) excludes funds placed in the same beneficiary's program more than 720 days prior to filing the bankruptcy petition, but the amount cannot exceed \$5,475.

In order for a debtor to exclude an education account under § 541(b)(5) and (6), the debtor is required under § 521(c) to file with the court a record of any interest the debtor has in an education individual retirement account or under a qualified State tuition program. *Bankr. Exemption Manual* § 2:23 (2007).

BAPCPA & Exclusion of Education Savings Accounts

Since the enactment of BAPCPA in 2005, there has been a significant drop off in the number of cases dealing with litigable issues relating to the exclusion of education savings accounts from bankruptcy estates. The majority of case law in this area involves exclusion issues in cases filed prior to October 17, 2005, before §§ 541(b)(5) and (6) were enacted. See *In re Addison*, 368 B.R. 791, 794 (8th Cir.2007); *In re Quakenbush*, 339 B.R. 845 (Bkrtcy.S.D.N.Y.2006). Issues involving pre-BAPCPA cases in this area often arose because there had previously been no explicit provisions in the bankruptcy code for the exclusion of education savings accounts.

The unambiguous statutory language and high degree of specificity used by Congress in drafting the two sections have helped to clarify many of the previous issues for the courts. Although §§ 541(b)(5) and (6) take a broad approach to the exclusion of education funds, it is

likely issues such as debtors' pre-bankruptcy planning and conveyance of assets in to these education accounts to protect them from distribution will eventually arise.

Employee Benefit Plans: Section 541(b)(7)

Debtors are explicitly allowed to exclude certain types of employee benefit plans from the bankruptcy estate under § 541(b)(7). Section 541(b)(7)(A) excludes any amount *withheld* by an employer from the wages of employees for contributions to an employee benefit plan under title I of the Employee Retirement Income Security Act of 1974 or IRC § 414(d), a deferred compensation plan under IRC § 457, or a tax-deferred annuity under § 403(b). 11 U.S.C. § 541(b)(7)(A)(i). Contributions under this section do not constitute disposable income as defined in § 1325(b)(2) of the Bankruptcy Code. 11 U.S.C. § 541(b)(7)(A)(i). Also excluded under this section are employer contributions to a health insurance plan regulated by State law. 11 U.S.C. § 541(b)(7)(A)(ii).

Section 541(b)(7)(B) excludes any amount *received* by an employer from employees for contributions to an employee benefit plan that is subject to title I of the employee of the Employee Retirement Income Security Act of 1974 or IRC § 414(d), a deferred compensation plan under IRC § 457, or a tax-deferred annuity under § 403(b). 11 U.S.C. § 541(b)(7)(B)(i). Contributions under this section do not constitute disposable income as defined in § 1325(b)(2) of the Bankruptcy Code. 11 U.S.C. § 541(b)(7)(B)(i). Also excluded under this section are employer contributions to a health insurance plan regulated by State law. 11 U.S.C. § 541(b)(7)(B)(ii).

The exclusions from the bankruptcy estate under § 541(b)(7) “include ERISA employee benefit plans and other types of benefit plans or tax-sheltered trusts or plans referred to in specific Internal Revenue Code sections.” Lawrence R. Ahern, III, 13 Am. Bankr. Inst. L. Rev. 585, 606 (2005). Section 541(b)(7)(A)(i)(I) refers to “governmental plans” for retirement which are established and maintained by the United States, or any State or political subdivision of a State. *Id.* at 607. Section 541(b)(7)(A)(i)(II) refers to “eligible deferred compensation plans” which are established and maintained by an eligible employer. *Id.* Section 541(b)(7)(A)(i)(III) refers to “qualified annuity plans” which are purchased for employees by certain employers that generally

include charitable, religious, scientific, literary, public safety, or educational corporations and organizations. *Id.*

Two Main Categories of Employee Benefit Plans: IRC §§ 403(b) & 401(k)

Since the addition of § 541(b)(7) by BAPCPA, several issues have emerged regarding the two main categories of employee benefit plans under this section: IRC § 403(b) tax-deferred annuities and IRC § 401(k) plans. A “403(b) plan is analogous to a 401(k) plan, but it is for employees of nonprofit organizations.” *In re Heffernan*, 242 B.R. 812, 818 n.2 (Bankr.D.Conn. 1999). Section 541(b)(7) treats loan repayments and contributions to qualified § 401(k) retirement accounts, deferred compensation plans, and ERISA-qualified savings plans in the same was as § 403(b) plans.

The unambiguous language of § 541(b)(7) has thus far resulted in few cases directly addressing the parameters of exclusion of IRC § 403(b) accounts from property of the bankruptcy estate. *In re Leahy*, 370 B.R. 620, 623 (Bankr.D.Vt. 2007). Although this code section is broad, its clear language has led courts to consistently exclude IRC § 403(b) from the bankruptcy estate as long as the contributions are within the permissible contribution limits. *In re Leahy*, 370 B.R. 620, 623 (Bankr.D.Vt. 2007). Similarly, courts have uniformly held that 401(k) plans, ERISA-qualified savings plans, and deferred compensation plans are to be excluded from the bankruptcy estate under § 541(b)(7) as long as the contributions are within the permissible contribution limits. *In re Leahy*, 370 B.R. 620, 623-24 (Bankr.D.Vt. 2007); *In re Nowlin*, 366 B.R. 670, 675 (Bankr.S.D.Tex.2007)(amounts withheld from debtor's wages as contribution to ERISA qualified employee benefit plan do not constitute “property of the estate” under § 541(b)(7)); *In re Njuguna*, 357 B.R. 689 (Bankr.D.N.H.2006).

Post-BAPCPA Issues § 541(b)(7)

There have been two contexts in which cases involving exclusion of employee benefit plans under § 541(b)(7) have arisen. The first involves motions to dismiss chapter 7 cases based upon alleged abuse of the bankruptcy process pursuant to § 707(b). *In re Leahy*, 370 B.R. 620, 623 (Bankr.D.Vt. 2007). Although no case has thus far disallowed exclusion of an employee

benefit plan falling within the parameters of § 541(b)(7) from the estate, at least one court has taken in to consideration the debtor's ability to continue to fund his 401(k) plan along with other factors in deciding to dismiss the case under § 707(b)(3)(B). *In re Zaporski*, 366 B.R. 758, 773-74 (Bankr.E.D.Mich. 2007).

The second context involves objections to confirmation of chapter 13 plans where the question is whether contributions to a qualified § 401(k) plan, an ERISA-qualified savings plan, or a deferred compensation plan are properly excluded in calculating disposable income, under § 1325(b)(2). *Leahy*, 370 B.R. at 623. However, courts have uniformly held that contributions to such plans should not be included in disposable income due to the explicit language in §§ 541(b)(7)(A)(i) and (B)(i). *Id.*

Several cases and commentators have remarked on the broad sweep of § 541(b)(7). *Id.* at 625. In *Devilliers*, “the trustee maintained that the court must set the level of contributions allowed a 401(k) plan under a necessary and reasonable standard.” *Id.* The court rejected the trustee’s position, reasoning that “[a]s excluded income, the contributions are not a deduction because they were never included in the first instance.” *In re Devilliers*, 358 B.R.849, 864 (Bankr.E.D.La.2007). “Although § 1325(b)(2) contemplates, as a general premise, that reasonably necessary expenses for the support and care of the debtor and his dependents are the only deductions allowed, the more specific provisions of § 541(b)(7) control over the general.” *Id.* at 865; see *Gaddis v. U.S.*, 381 F.3d 444, 469 (5th Cir.2004). Therefore, since mandatory or voluntary contributions to qualified retirement plans are not property of the bankruptcy estate, they are also not to be considered when calculating projected disposable income for purposes of Chapter 13 plan confirmation. *Id.* at 864; see also *In re Braulick*, 360 B.R. 327 (Bankr.D.Mont.2006)(any plan contributions withheld by Chapter 13 debtor's employer or paid by debtor to the employer for debtor's Montana Deferred Compensation Plan, which were in employer's hands at the time of debtors' bankruptcy filing and had not yet been remitted to the plan, did not constitute property of debtors' bankruptcy estate or disposable income); *In re Njuguna*, 357 B.R. 689 (Bankr.D.N.H. 2006)(Chapter 13 debtor's contributions to her 401(k) employee retirement plan, not being included in “property of the estate,” were not subject to being

considered for any part of Chapter 13 plan; debtor's failure to increase her monthly contributions to proposed plan by amount equal to her monthly 401(k) contribution did not cause her proposed plan to violate "projected disposable income" requirement).

The court in *Devilliers* also rejected the trustee's arguments based on policy reasons, stating that unlike §§ 707(b)(2) and 1325(b)(2) or (3), § 541(7) does not contain a requirement that contributions to retirement accounts be "reasonable or necessary." *Devilliers*, 358 B.R. at 865. Instead, the court opined that Congress had determined contributions to a qualified retirement account are reasonable and necessary by their very nature. *Id.* Therefore, retirement contributions under § 541(b)(7) become part of a debtor's fresh start by providing for eventual retirement. *Id.*