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Bankruptcy -- What Can I Protect?

Many people considering bankruptcy share a common misconception - that a bankruptcy trustee has the power to reach all of a debtor's assets. If you are considering bankruptcy, it is important to understand that certain assets are protectable, within certain limitations. This includes assets such as retirement plans, IRA's, and qualified tuition plans. Following are some general guidelines to assist in pre-bankruptcy planning.

Bankruptcy Overview

Most individuals file either a Chapter 7 (liquidation) or Chapter 13 (reorganization) bankruptcy. Under Chapter 7, the trustee exercises legal control over most of your bankruptcy estate. The bankruptcy estate is all property that you own on the date the petition is filed. Certain property is exempt - meaning that you are permitted to retain it, whereas other property is liquidated to pay creditors. Chapter 7 ends with a discharge of all the debts that you are entitled to discharge.

Likewise, under Chapter 13 certain property is exempt. However, creditors are paid off over time - either three or five years -- depending on which plan is approved. A bankruptcy trustee oversees the payment process. In essence, you adhere to a court approved budget. Any disposable income over and above the budget is paid to the trustee. In turn, the trustee pays creditors covered under your plan. At the end of the plan, your debts are wiped clean, unless they are non-dischargeable.

Non-dischargeable debts include such things as back taxes or unfiled taxes, child and spousal support, other court imposed judgments, and student loans. Debts incurred by fraudulent acts, such as concealing assets, are also non-dischargeable.

California's Exemption System

Certain property may be retained by a debtor and is called "exempt". California recognizes two exemption systems, and allows a debtor to select from one or the other (not both). This enables greater flexibility, depending on what you own and want to retain. Some assets are exempt under either system, meaning that you will keep them. Which assets fit within this category?

1. Retirement Plans

Most retirement plans are exempt, including:

- pensions (private and public employees),
- traditional and Roth IRA's,
- Keogh plans,
- tax exempt retirement accounts, including 401 (k)s, 403 (b)s, 408's and 408A's, 457's,
- profit sharing and money purchase plans,
- SEP and SIMPLE IRA's and defined benefit plans,
- ERISA qualified benefits needed for support.

Note however, that the exemption on both traditional and Roth IRA's is capped at \$1,171,650 per person. This limitation does not apply to rollovers or earnings on rollovers.

2. Qualified Tuition Programs and Educational Savings Accounts

Qualified tuition programs (529 Plans) and Coverdell Educational Savings Accounts (which are broader than 529 Plans) are not included in the bankruptcy estate and thus exempt *provided that they fall within these restrictions*:

- The beneficiary is a child, stepchild, grandchild, step grandchild and (sometimes) a foster child.
- Timing:
 - If the funds were deposited more than two years before filing, they are fully excluded.
 - If the funds were deposited between one and two years before filing, \$5,475.00 is excluded.
 - If deposited less than one year before filing, the funds may not be excluded.

Conclusion

Pre-bankruptcy planning can enable a debtor to maximize contributions to these types of assets, as long as any limitations or restrictions are honored. Further, it is critical to understand it is never necessary to liquidate protectable assets (such as IRA's or 401(k) accounts) to pay off creditors. Don't be deceived - these are assets that can be legitimately shielded.