Written By:
Dustin I. Nichols
Partner

Heather Kocer
Attorney

Gambling with Retirement Funds - Loans v. Withdrawals

A properly *designed* private retirement plan is not enough to capture the exemption protection of CCP § 704.115; the plan must also be principally or primarily *used* for retirement purposes. However, the statute does not provide any rules regarding the administration of the plan which, if followed, would ensure the validity of the exemption. Instead, whether a plan is *used* for retirement purposes is a question of fact that is assessed by the courts based on the totality of the circumstances of each particular case. Thus, absent a comprehensive command of the intricate interworking of case law, an act by a plan participant of taking a loan from the plan prior to retirement is like gambling with the statutory exemption since the exemption protection is lost if the court considers the loan to be more like a withdrawal thereby resulting in a finding that the funds were *used* for a nonretirement purpose.

Rather than playing a game of chance when taking loans from a plan, it is best to minimize the risk of loss by strictly adhering to the holdings of various courts that have addressed this issue. In the case of *In re Bloom ((9th Cir. 1988) 839 F.2d 1376, 1379)*, Bloom's interest in the plans was approximately $475,000, however, she took a number of loans from the plan totaling nearly $300,000 with accrued interest in exchange for unsecured promissory notes. Thus, at the time of filing for bankruptcy, a significant portion of the plans assets were Bloom's unsecured promissory notes. Despite such action, the court held that Bloom's plans were not so abused as to lose their retirement purpose based on four circumstances. "First, Bloom followed the procedures set out in the Trust Agreement for obtaining loans. Second, Bloom was charged a reasonable rate of interest on the loans. Third, she regularly made the interest payments due, over a period of several years. […] Fourth, there is no indication that Bloom used the plans to hide otherwise ineligible assets from bankruptcy administration […]." The court, however, did note that the "plans' unsecured loans to Bloom may well have been imprudent", but "[a] poorly, even imprudently, invested plan may still be designed and used for retirement purposes."

In reaching its decision, the court contrasted the facts of Bloom with its ruling in the case of *In re Daniel ((9th Cir. 1985) 771 F.2d 1352, 1357–1358)*. In *Daniel*, the court held that the plan was not principally used for retirement purposes based on its consideration of two transactions. In the first transaction, Daniel made an unsecured loan to himself in the amount of $75,000 to purchase a house. This loan was substantially equal to his interest in the plan, was only secured by his interest in the plan, he never made interest or principal payments, and he rolled over the loan when it became due. The second transaction consisted of Daniel contributing all of the corporation's available cash ($39,000) to the plan two weeks before filing bankruptcy. Viewed together, the court noted that, "the plan essentially operated to meet debtor's short-term personal needs by lending money or shielding and hiding funds from creditors."

Thus, at a minimum, if a plan participant wants to loan himself or herself money, plan procedures must be followed, the participant must be charged a reasonable rate of interest, timely and continuous payments must be made, and there should be no evidence of an attempt to hide assets. And, in an effort to double down on the bet for exemption protection, the plan participant should never be the trustee since the odds always favor the plan participant who does not control the plan assets.

And, even if a loan survives the scrutiny of the court and does not negate the retirement purpose of the plan, it is critical that plan participants understand that funds loaned from the plan are not exempt. The statutory exemption only applies to funds held, controlled, or in the process of distribution *"for the payment of benefits."* As explained by the court in the case of *In re Friedman ((B.A.P. 9th Cir. 1998) 220 B.R. 670, 672)*, "the payment to debtor was not a 'payment of benefits.' Instead, the payment was a loan from the plan. The funds loaned are not exempt under CCP section 704.115(d), as they were not CCP section 704.115(b) funds."

California residents have been dealt the best hand to protect their retirement assets: exemption protection under CCP § 704.115(b). This statutory exemption protection for private retirement plans, if properly *designed* and *used* for retirement purposes, can ensure California residents never walk away empty-handed no matter how many times they find themselves staring at a losing hand.