

# EXEMPTIONS—PRESERVING A DEBTOR'S ASSETS

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When confronted with a client who has severe financial problems, one of the first questions to be addressed is what assets can be protected from creditors and retained in the event that a bankruptcy is filed. Which of an individual debtor's assets are potentially exempt is equally important to a creditor in determining what assets will remain available to satisfy a judgment. Exemptions are available under both federal and Virginia law. Pursuant to *Virginia Code* § 34-3.1, Virginia has "opted out" from the standard federal exemptions contained in Section 522 of the *Bankruptcy Code* (11 U.S.C. § 522). Thus, a debtor in Virginia must look

to other federal exemptions and the Virginia exemptions for protection.

## Tenants by the Entireties

While not titled as an "exemption," the ability to hold property as tenants by the entireties is perhaps the exemption of greatest value to Virginia residents. Property held as tenants by the entireties is subject only to the joint debts of a husband and wife. Typically, husband and wife own a house on which there is joint debt secured by a deed of trust, that has significant equity above the amount of the deed of trust. The husband has incurred significant debt as the result of a failed

business. While other assets owned by the husband, including his future earnings, may be subject to creditor process, the house is protected from sale by the husband's creditors. Any judgment against the husband does not constitute a lien against the house.

This exemption is only available to husband and wife while they are married. Once the couple is divorced, the exemption is extinguished and the creditor of one spouse can collect against one-half of the value of the property. Following the example above, a judgment against the husband would become a lien upon the

home immediately upon a divorce. If one spouse is deemed liable for the debts of the other spouse pursuant to the doctrine of necessities, that debt will be joint debt that can be a lien against property held as tenants by the entirety.<sup>1</sup> Both real and personal property can be held as tenants by the entirety.<sup>2</sup>

However, with personal property, it must be “manifest” that the property is intended to be owned in a tenancy by the entirety.<sup>3</sup> It is not necessary to use the magic “tenant by the entirety” language so long as the owners are described as husband and wife and take the personal property with right of survivorship.<sup>4</sup> The law of the state in which property is located, rather than the state of residence of the husband and wife, determines whether tenants by the entirety property is exempt.<sup>5</sup> The exemption for entirety property is also contained in § 522(b)(2)(B) of the Bankruptcy Code (11 U.S.C. § 522(b)(2)(B)).

Pursuant to 11 U.S.C. § 363(h), a bankruptcy trustee is permitted to sell entirety property if certain conditions exist. However, the trustee cannot sell entirety property if the proceeds will go only to separate unsecured creditors of the husband and the wife.<sup>6</sup> In *Bunker*, two married couples filed joint Chapter 7 petitions. In both cases, their only joint debt was the mortgage on their homes. Both couples had significant equity in their homes. The debtors claimed the equity as exempt, and the trustee challenged their exemptions. The Fourth Circuit held, despite the fact that one of the couples had their cases substantively consolidated because they had intermingled their finances, the equity in the homes to be totally exempt from individual creditors under Virginia law.<sup>7</sup>

Recently, the United States Supreme Court held that a federal tax lien against one spouse could be enforced against property held in a tenancy by the entirety. *United States v. Craft*, 535 U.S. 274 (2002). The implications of *Craft* are still being worked

out in the lower courts, but the decision should not affect the sanctity of tenants by the entirety exemptions as to other debts.<sup>8</sup>

## Retirement Plans

Virginia’s exemption for retirement plans is found at *Virginia Code* § 34-34. In theory, calculating the exemption for retirement plans is simple. Every individual is entitled to exempt from creditor process an amount in their retirement plans which will permit them to receive an annual benefit of \$17,500.<sup>9</sup> To determine the amount of the exemption the table in Section 34-34 (C) must be consulted for a factor related to the age of the person claiming the exemption. This factor is multiplied by \$17,500 to arrive at the total exemption. For example, a fifty-five year-old is entitled to exempt \$57,669.50 in a retirement plan (\$17,500 x 3.2954). It is important to remember that contributions made in the current fiscal year of the retirement plan and the prior two years do not qualify for the exemption.<sup>10</sup>

Section 34-34 defines “retirement plan” as “a plan, account, or arrangement that is intended to satisfy the requirements of” *Internal Revenue Code (IRC)* sections “401, 403(a), 403(b), 408, 408A, 409 (as in effect prior to repeal by United States P.L. 98-369) or § 457.”<sup>11</sup> The section establishes that “If an individual has an interest in

alienation provisions, is treated as being fully-exempt from creditor attack. Amounts in ERISA-qualified retirement plans are not treated as being a part of the bankruptcy estate created by § 541 of the *Bankruptcy Code*. Thus, the exemption available under an ERISA-qualified plan—even though it is defined as a retirement plan by § 34-34—is not determined by § 34-34. Rather, all amounts in any ERISA-qualified retirement plan are fully exempt. Thus, the § 34-34 exemption usually applies to IRAs (IRC § 408) and Roth IRAs (IRC § 408A).

For several years, in the Eastern District of Virginia, there was a split of authority in the bankruptcy courts located over whether an individual who owns an IRA and a 401(k) could treat the amounts in the 401(k) plan as fully-exempt under *Patterson* and apply the full § 34-34 exemption to the IRA. Earlier this year, Judge Robert G. Doumar of the District Court for the Eastern District of Virginia addressed the issue and held that the amount of the 401(k) plan must be taken into account in determining the amount of the § 34-34 exemption.

In *Abbate*, the court reasoned that ERISA did not preempt Virginia’s exemption statutes regarding retirement plans.<sup>13</sup> Therefore, although a 401(k) plan is not part of the bankruptcy estate, it is a “retire-

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more than one retirement plan, the limitation [creating the annual benefit of \$17,500] shall be applied as if all such retirement plans constituted a single plan.”<sup>12</sup> However, under *Patterson v. Shumate*, 504 U.S. 753 (1992), a debtor’s interest in an ERISA-qualified retirement plan, such as a 401(k) plan, due to its anti-

ment plan” within the meaning of the Virginia exemption statute. Mr. Abbate had a 401(k) worth \$50,000 and two IRAs worth \$8,200. The amount of Mr. Abbate’s § 34-34 exemption was \$21,532. Judge Doumar decided that the amount of the 401(k) account must first be applied to the § 34-34 exemption amount to determine if

there was any remaining exemption amount for the IRAs. Since the amount in Mr. Abbate's 401(k) exceeded his exemption amount, there was no exemption amount available to protect the IRAs. Thus, Mr. Abbate could not exempt any of the funds in his IRA accounts.<sup>14</sup>

Subsection (H) of § 34-34 should not be overlooked. The first sentence of § 34-34(H) fully exempts plans established under IRC §§ 408 and 408 A (IRAs and Roth IRAs) "to the same extent as that permitted under federal law for a qualified plan established pursuant to § 401 of the [IRC]." However, the second sentence of § 34-34(H) provides that this exemption is not available to "an individual who claims an exemption under federal law for any retirement plan established under § 401 . . . of the Internal Revenue Code . . . ." If an individual has an IRA and does not have a 401(k) account, then the IRA account is fully-exempt regardless of the amount of that IRA. This achieves the same result as the individual who has a 401(k) account that is fully exempt pursuant to *Patterson*, regardless of the amount of the 401(k) account. However, if an individual has an IRA account and a 401(k) account plan, then the IRA is presumably subject to the limitations in § 34-34, assuming that any exemption is available after the amount of the 401(k) is applied to the exemption amount as directed by *Abbate*. The individual then has a small 401(k) account and

retirement plan and a \$200,000 IRA would be able to exempt only \$47,669.50 of the IRA. If that same person did not have the § 401 retirement account, all of the \$200,000 in the IRA would be exempt. This inequity is amplified because many retirement plan documents may make it difficult to terminate participation in a § 401 plan.

The language in the second sentence of § 34-34(H), which denies the full exemption of IRAs if "an individual claims an exemption under federal law for any retirement plan . . ." is problematic. As appears from *Patterson*, an individual does not have to claim an exemption under federal law to obtain protection from creditors for amounts in an ERISA-qualified retirement plan. Those amounts are protected by the anti-alienation provisions of the plan without further action by the individual. While an individual may benefit from the anti-alienation provision in an ERISA-qualified plan, it is not clear that such individual claims an exemption under federal law. It does not appear that this issue was raised in *Abbate*.

### Homestead Exemption

The homestead exemption is Virginia's primary statutory exemption. It is established by *Virginia Code* § 34-4. Every householder is permitted to exempt \$5,000 in property and an additional \$500 for each dependent. *Virginia Code* § 34-1 defines a

exemption of \$11,000. Assuming their house is worth \$165,000.00, and is subject to a deed of trust with a balance due of \$158,000.00, they can exempt the \$7,000 of equity in the house and use the remaining \$4,000 to protect money in their checking account or value in a car.

In order to claim the exemption for real property, the householder must file a homestead deed in the city or county where the land is located. If the real property is located outside of Virginia, the homestead deed must be filed in the city or county in which the householder resides.<sup>15</sup> In order to claim the exemption for personal property, the householder must file a homestead deed, in the city or county where he or she resides.<sup>16</sup> Form homestead deeds for real property and personal property appear in *Virginia Code Ann.* §§ 34-6 (real property) and 34-14 (personal property). To be effective against a trustee in bankruptcy, a homestead deed must be filed not later than 5 days after the initial date of the meeting of creditors in the bankruptcy case.<sup>17</sup> If the original creditors' meeting is continued, the homestead deed still must be filed within 5 days of the date of the original meeting.<sup>18</sup> A person may waive his or her homestead exemption in writing in the instrument that creates the debt.<sup>19</sup> Section 34-22 sets out language sufficient to make a waiver of the homestead exemption effective. However, § 522(e) of the *Bankruptcy Code* (11 U.S.C. § 522(e)) renders such waivers ineffective in bankruptcy. Further, none of the exemptions of Title 34 apply to creditors collecting secured debts.<sup>20</sup>

Also, none of the exemptions apply to debts for the purchase price of property or to spousal or child support obligations.<sup>21</sup>

### Poor Debtor Exemptions

Under the so-called "poor debtor's exemptions" established by *Virginia Code* § 34-26, every resident is permitted to exempt certain miscellaneous items without filing

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a large IRA account. In this situation, IRAs will be subject to the § 34-34 exemption limit. However, if the individual did not have the 401(k) account, IRAs would be fully-exempt. For example, a fifty-five-year-old with a \$10,000 account in a § 401

householder as a resident of Virginia. This exemption can be claimed against equity in real property or against personal property (cash, checking accounts, cars, etc.). For example, a husband and wife with two children has a total homestead

a homestead deed. The “poor debtor exemptions” are available to every resident of Virginia regardless of the existence of any other assets.<sup>22</sup> The major exemptions here include the exemption for tools of the trade, which permits someone to exempt, up to \$10,000 in value, “[t]ools, books, instruments, implements, equipment and machines, including motor vehicles, vessels and aircraft, which are necessary for use in the course of the householder’s occupation or trade.”<sup>23</sup> Also of importance is an exemption of \$2,000 in a motor vehicle.<sup>24</sup> A security interest on personal property claimed to be exempt under the “tools of the trade” exemption or the motor vehicle exemption takes priority over the claimed exemption. A debtor may also exempt “[f]amily portraits and family heirlooms not to exceed \$5,000 in value.”<sup>25</sup> A debtor’s wedding and engagement rings are exempt without regard to value.<sup>26</sup>

Finally, with the exception of statutory liens, all causes of action for personal injury or wrongful death are exempt from creditor process.<sup>27</sup>

## Other Exemptions

There are a number of other exemptions created by Virginia and federal law. Few of these exemptions are likely to be applicable to many clients. However, for reference, a list of these exemptions is attached.

## Conclusion

While Virginia’s exemptions are parsimonious compared with those of Florida or Texas, in many instances their proper use can protect most of your client’s assets. Counsel should pay particular attention to evaluating the types and values of any retirement accounts and should review the *Virginia Code* carefully to insure that homestead deeds are properly filed. 🏡

### Federal Exemptions

Federal Civil Service Retirement Benefits—5 USC § 8346.



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Armed Forces Personnel and Survivors—Deposits by Overseas Personnel—10 USC § 1035; Retirement Annuities—10 USC § 1440; Military Survivor Benefits and Annuities; 10 USC § 1450.

Seventy-Five Percent of Disposable Earnings or the Amount by which Disposable Earnings for a Week Do Not Exceed 30 times the Federal Minimum Hourly Wage—15 USC § 1673.

Benefits and Annuities Payable to Survivors of Foreign Service Employees—22 USC § 4060(c).

Annuities to Survivors of Federal Judges—28 USC § 376(n).

Black Lung Benefits—30 USC § 931(b)(2)(f) & 932(a) (through reference to 33 USC § 916).

Benefits to Widows of Lighthouse Service Personnel—33 USC § 775.

Longshoremen and Harbor Workers Compensation and Benefits—33 USC § 916.

Veterans’ Benefits—38 USC § 5301.

Social Security and Supplemental Security Income—42 USC § 407.

Compensation for Injuries or Death Resulting from a War Risk Hazard—42 USC § 1717.

Retirement and Supplement Annuities Pursuant to the Railroad Retirement Act—45 USC § 231m.

Railroad Unemployment Benefits—45 USC § 352(e).

Seaman’s, Master’s or Fisherman’s Wages—46 USC § 11109.

Seaman’s Clothing—46 USC § 11110.

### Virginia Exemptions

Growing Crops—*Va. Code Ann.* § 8.01-489.

Compensation for Victims of Crime—*Va. Code Ann.* § 19.2-368.12.

Prepaid Tuition Contracts and Savings Trust Agreements—*Va. Code Ann.* § 23-38.81F.

Property of Disabled [more than 40%] Veterans (an additional \$2,000 homestead exemption)—*Va. Code Ann.* § 34-4.1.

Cemetery or Burial Lots or Funds—*Va. Code Ann.* §§ 34-26 & 38.2-4021.

Certain Farm Implements of Persons Actually Engaged in Agriculture—*Va. Code Ann.* § 34-27.

Seventy-Five Percent of Disposable Earnings For One Week or the Amount by which Disposable Earnings for a Week Do Not Exceed 30 Times the Federal Minimum Hourly Wage—*Va. Code Ann.* § 34-29.

Spendthrift Trust Property—*Va. Code Ann.* §§ 38.2-3118, 38.2-3119 & 55-19.

Proceeds from Industrial Sick Benefits Insurance—*Va. Code Ann.* § 38.2-3549.

Fraternal Benefit Society Benefits—*Va. Code Ann.* § 38.2-4118.

Benefits Accrued or Accruing from the Virginia Supplemental Retirement System—*Va. Code Ann.* § 51.1-124.4.

Pre-need Funeral Trust Property—*Va. Code Ann.* § 54.1-2823.

Approved Assignments of Salary and Wages (for the benefit of creditors)—*Va. Code Ann.* § 55-165.

**Exemptions** *continued on page 29*

**Exemptions** *continued from page 25*

Unemployment Compensation Benefits—*Va. Code Ann.* § 60.2-600.

Public Assistance Payments—*Va. Code Ann.* § 63.2-506.

Family Allowance for Surviving Spouse and Minor Children—*Va. Code Ann.* § 64.1151.1 (priority over all other claims against the estate).

Exempt Property of a Decedent's Estate—*Va. Code Ann.* § 64.1-151.2 (\$15,000.00; priority over all other claims against the estate).

Homestead Allowance from Decedent's Estate—*Va. Code Ann.* § 64.1151.3 (\$15,000.00; priority over all other claims against the estate).

Workers' Compensation Benefits—*Va. Code Ann.* § 65.2-531.

Endnotes:

- 1 *Virginia Code Ann.* §55-37.
- 2 *Virginia Code Ann.* § 55-20.2.
- 3 *See Wolfe v. Sprouse*, 183 B.R. 739 (W.D. Va. 1995), *aff'd*, 91 F.3d 133 (4th Cir. 1996) (promissory notes); *Va. Code Ann.* §§ 55-20 to -21.
- 4 *In re Potter*, 274 B.R. 224 (*Bankr.* E.D. Va. 2002).
- 5 *In re McNeilly*, 249 B.R. 576 (1st Cir. BAP 2000); *In re Anselmi*, 52 B.R. 479 (*Bankr. D. Wyo* 1985) (trusts and shares of stock); *In re Gillette*, 248 B.R. 845 (*Bankr. M.D. Fla.* 1999) (bank accounts).
- 6 *See In re Bunker*, 312 F.3d 145 (4th Cir. 2002).
- 7 *See id.* at 154-55.
- 8 *See In re Greathouse*, 295 B.R. 562 (*Bankr. D. Md.* 2003) (The trustee could not use hypothetical lien rights of IRS created by *Craft* to proceed against entireties property in the absence of tax debt).
- 9 *See Virginia Code Ann.* § 34-34(B) & (C).
- 10 *Va. Code Ann.* § 34-34(D).
- 11 *Virginia Code Ann.* § 34-34(A).
- 12 *Virginia Code Ann.* § 34-34(C).
- 13 *See id.* at 70.
- 14 *See id.* at 71.
- 15 *Virginia Code Ann.* § 34-6.
- 16 *Virginia Code Ann.* § 34-14.
- 17 *Virginia Code Ann.* § 34-17.
- 18 *See Smoot v. Wolfe*, 271 B.R. 115 (W.D. Va. 2001).
- 19 *Virginia Code Ann.* § 34-22.
- 20 *See Wal-Mart Stores, Inc. v. Carpenter*, 252 B. R. 905 (E.D. Va. 2000), *aff'd*, 36 Fed. App. 80 (4th Cir. 2002); *Virginia Code Ann.* § 34-1 (exemptions of Title 34 are from "creditor process" and "creditor process" is defined as methods of collecting unsecured debts).
- 21 *Virginia Code Ann.* § 34-5.
- 22 *See Davis v. Maloney*, 243 Va. 500, 416 S.E.2d 232 (1992).
- 23 *Virginia Code Ann.* § 34-26(7).
- 24 *Virginia Code Ann.* § 34-26(8).
- 25 *Virginia Code Ann.* § 34-26.
- 26 *Virginia Code Ann.* § 34-26(1a).
- 27 *Virginia Code Ann.* § 34-28.1.