PERSONAL FINANCIAL PLANNING

Protect your clients' assets from creditors.

Is Your Retirement Plan Really Safe?

BY RICHARD A. NAEGELE AND MARK P. ALTIERI

EXECUTIVE SUMMARY

- **BENEFITS IN TAX-QUALIFIED RETIREMENT PLANS** generally are protected from the creditors of plan participants and insulated from claims in bankruptcy.
- **PLANS NOT PROTECTED FROM CREDITORS** are those that cover only the business owner and/or the owner's spouse and section 403(b) tax-sheltered annuity plans whose assets are held in custodial accounts rather than in trusts.
- **RETIREMENT PLAN ASSETS ARE MARITAL ASSETS** subject to division in divorce or attachment for child support by a qualified domestic relations order.
- **RETIREMENT PLAN ASSETS MAY BE SUBJECT TO** attachment by federal tax levies, judgments and fines imposed in federal criminal actions. Treasury regulations provide that plan benefits are subject to attachment by the IRS.

RICHARD A. NAEGELE, JD, is an attorney and shareholder at Wickens, Herzer, Panza, Cook and Batista in Avon, Ohio. His e-mail address is rnaegele@wickenslaw.com. MARK P. ALTIERI, CPA/PFS, JD, is an associate professor of accounting at Kent State University and special tax counsel to Wickens, Herzer, Panza, Cook and Batista. His e-mail address is maltieri@wickenslaw.com.

Could your retirement fund be at risk? Could a simple adjustment or two shield it? A landmark ruling by the Supreme Court in 2004 and decisions by lower courts and the IRS have changed the protection offered to taxpayers on assets they hold in tax-qualified retirement plans.

As a larger-than-ever percentage of Americans approach retirement, CPAs must be aware of these new decisions—and their potential repercussions on the $12 trillion the public has invested in retirement funds. This article discusses the 2004 *Yates* v. *Hendon* case—the second most important case in history with regard to the protection of retirement assets (after the landmark *Patterson* v. *Shumate* case)—and other recent rulings on the subject, and provides CPAs with guidance on how to

protect their own and their clients' 401(k)s and other retirement plan assets from creditors.

Value of Assets in Retirement Savings

Between 1975 and 1999, the total value of assets set aside in pensions, 401(k) plans and IRAs increased to more than $12 trillion from $400 billion.

Source: National Bureau of Economic Research, www.nber.org, 2004.

ANTI-ALIENATION PROVISIONS

The point of retirement plans, of course, is to provide taxpayers with a financial cushion in their old age. To that end, the anti-alienation provisions of the Employee Retirement Income Security Act (ERISA) section 206(d) and IRC section 401(a)(13) have protected tax-qualified retirement plans from the claims of creditors of plan participants and their beneficiaries, with three major exceptions.

First, qualified domestic relations orders (QDROs) were exempted under IRC section 414(p) and ERISA section 206(d)(3). Thus, retirement plan assets have been considered a marital asset subject to division in divorce and attachment for child support.

Second, the IRS staked a claim to assets held in retirement plans. Federal tax levies and judgments were exempted from ERISA protection under Treasury regulations section 1.401(a)-13(b).

Third, under IRC section 401(a)(13)(C) and ERISA section 206(d)(4), criminal or civil judgments, consent decrees and settlement agreements offset retirement benefits when the plan participants committed fiduciary violations or crimes against the plan. (For more on protections afforded retirement plans, see "What About State Laws?" below.)

What About State Laws?

Neither ERISA nor IRS protections apply to assets held under individual retirement arrangements (including SEPs and SIMPLE IRAs), government plans, or most church plans. IRAs are protected from creditors in many states by law, based on the IRA owner/participant's state of residency.

But ERISA provisions supersede state laws relating to employer-sponsored employee benefit plans. The ERISA anti-alienation and preemption provisions combine to protect ERISA-covered employee benefit plans from state attachment and garnishment laws.

Aside from these exceptions, however, funds deposited in retirement plans were safe from creditors. In the past couple of years, however, the courts and the IRS took a second look at their historic protections. In 2003 and 2004 the IRS in effect added a fourth exception by broadly construing the tax-lien exemption to encompass federal

criminal penalties. In private letter rulings 200342007 and 200426027, the service said "the general anti-alienation rule of IRC section 401(a)(13) does not preclude a court's garnishing the account balance of a fined participant in a qualified pension plan in order to collect a fine imposed in a federal criminal action." The IRS cited favorably three recent federal district court cases that concluded that ERISA plans were subject to garnishment to satisfy criminal fines under the Federal Debt Collection Procedures Act of 1977 (FDCPA). (Also see *United States* v. *Tyson*; *United States* v. *Clark*; *United States* v. *Rice*.)

The FDCPA provides that "an order of restitution…is a lien in favor of the United States on all property of the person fined as if the liability of the person fined were liability for a tax assessed under the Internal Revenue Code…." The IRS accepted the reasoning of the courts that retirement funds fell within the exception to the anti-alienation provision listed in Treasury regulations section 1.401(a)-13(b)(2)(ii) for "collection by the United States on a judgment resulting from an unpaid tax assessment."

Case Citations

These cases are listed in the order of their appearance in the article.

- *United States* v. *Tyson*, no. 02-X-73808 (E.D. Mich. April 9, 2003).
- *United States* v. *Clark*, no. 02-X-74872 (E.D. Mich. June 11, 2003).
- *United States* v. *Rice*, 196 FSupp. 1196 (N.D. Okla. 2002).
- *Patterson* v. *Shumate*, 112 S. Ct. 2242 (1992).
- *In Raymond B. Yates, M.D., P.C. Profit Sharing Plan* v. *Hendon, Trustee,* 124 S. Ct. 1330 (March 2, 2004).
- *In re Yates,* 287 F3d 521 (6th Cir. 2002).
- *In re Witwer,* 148 B.R. 930 (Dec., 1992, Cal.).
- *In re Lane,* 149 B.R. 760 (Jan., 1993, N.Y.).
- *In re Hall,* 151 B.R. 412 (Feb., 1993, Michigan).
- *In re Watson,* 192 B.R. 238 (Feb., 1998, Nevada), affd. 22 EBC 1091 (9th Cir. 1998).
- *Lowenschuss* v. *Selnick*, 117 F3d 673 (9th Cir. 1999).
- *McCaferty* v. *McCaferty*, no. 95-3919 (6th Cir. 1996).
- *Erb* v. *Erb*, 75 Ohio St. 3d 18 (1996).
- *Rhiel* v. *Adams*, no. 03-8011, 203 Fed. App. 0006P (6th Cir. 2003).
- *Hoult* v. *Hoult*, 373 F3d 47 (1st Cir. 2004), cert. denied, U.S. S. Ct. (2004).

RETIREMENT ASSETS IN BANKRUPTCY

The historic U.S. Supreme Court ruling that has protected retirement plan assets for the past 12 years is *Patterson* v. *Shumate*. In it the court resolved a split among the U.S. Circuit Courts of Appeals by holding that ERISA's prohibition against the assignment or alienation of pension plan benefits was a restriction on the transfer of a debtor's beneficial interest in a trust that was enforceable under applicable nonbankruptcy law. Thus, a debtor's interest in an ERISA pension plan was excluded from the bankruptcy estate and not subject to attachment by creditors.

In 2004 the Supreme Court issued another significant ruling, *Raymond B. Yates, M.D., P.C. Profit Sharing Plan* v. *Hendon, Trustee*, that reversed the previous decision of the U.S. Sixth Circuit Court of Appeals in *In re Yates*. The Sixth Circuit had said Dr. Yates, as a sole shareholder, was not an "employee" for purposes of

ERISA and, therefore, was not entitled to ERISA creditor protection; the Supreme Court rejected the position that a working owner could not rank as both "employer" and "employee." The Supreme Court held that the working owner of a business (here, the sole shareholder and president of a professional corporation) could qualify as a "participant" in a pension plan covered by ERISA if the plan included one or more employees other than the business owner and his or her spouse. This owner, in common with other employees, qualifies for the protections ERISA affords plan participants and is governed by the rights and remedies ERISA specifies.

Planning tip. CPAs should review their own and their clients' retirement plans to ensure they include nonowner employees as well as owners and their spouses, so that the assets of business owners and their spouses are protected from creditors in case of bankruptcy.

OWNER-ONLY PLANS ARE AT RISK

Since *Patterson*, several U.S. bankruptcy courts have ruled that assets in a retirement plan that benefits only the business owner (and or the sole owner's spouse) may be attached by creditors if the owner goes bankrupt. The bankruptcy courts have held ERISA is meant to benefit common-law employees, while a sole owner is an employer. (See *In re Witwer, In re Lane, In re Hall, In re Watson*.) Thus, a retirement plan that covers only the owners of a business may be attached by the bankruptcy creditors of the owner/plan participant.

Department of Labor regulations also provide that a husband and wife who solely own a corporation are not employees for retirement plan purposes and that a plan that covers only partners or sole proprietors is not protected under Title I of ERISA. However, a plan that includes one or more common-law employees (in addition to the owners) is protected, making ERISA protections applicable to all participants.

In *Yates* v. *Hendon*, the U.S. Supreme Court noted that the Department of Labor interprets the Code of Federal Regulations to mean that the statutory term *employee benefit plan* does not include one whose only participants are the owner or his or her spouse, but does include plans that cover one or more common-law employee, in addition to the self-employed individuals. The Supreme Court said "this agency view merits the Judiciary's respectful consideration."

In *Lowenschuss* v. *Selnick*, the U.S. Ninth Circuit Court of Appeals held that an ERISA-qualified employee pension benefit plan could lose its ERISA status for bankruptcy purposes if nonowner participants left and it covered only the owner-employee at the time of the bankruptcy filing. The court also said section 541(c) of the Bankruptcy Code invalidated certain nonbankruptcy state law protections for retirement benefits.

Planning tip. A retirement plan can lose its creditor protection if it does not benefit nonowner employees. It is important for CPAs to ensure that plans always contain benefits for nonowner employees to protect plan assets from creditors.

BANKRUPTCY AND QDROs

The U.S. Sixth Circuit Court of Appeals in 1996 in *McCaferty* v. *McCaferty* ruled that pension benefits awarded to a participant's former spouse under a qualified domestic relations order before the participant filed for bankruptcy didn't qualify for bankruptcy protection and must be paid to the former spouse. The court held that the divorce decree created a "constructive trust" to protect the interest awarded to the former spouse in the pension plan even though the divorce decree did not use the words *constructive trust.*

The Sixth Circuit opinion was consistent with the earlier 1996 ruling of the Ohio Supreme Court in *Erb* v. *Erb*, which said the spouse's property interest in the participant's pension was not part of the bankruptcy estate.

403(b) PLANS MAY NOT BE PROTECTED

The United States Sixth Circuit Court of Appeals held in 2003 in *Rhiel* v. *Adams* that only assets held "in a trust" could be excluded from bankruptcy by section 541(c)(2) of the Bankruptcy Act. Earlier, the bankruptcy court for the Southern District of Ohio had held that IRC section 403(b) plans (for the husband and wife) were "ERISA-qualified" as defined by the Supreme Court in *Patterson* v. *Shumate* and were not the property of the bankruptcy estate. The Sixth Circuit reversed that decision and remanded the case for further proceedings, saying the debtors had not shown that section 541(c)(2) "in a trust" language had been satisfied. The Sixth Circuit said that only assets of an ERISA plan held in a trust would be excluded from the bankruptcy estate and that assets in a custodial account could not be excluded.

Planning tip. If your clients are employees of public schools or tax-exempt organizations and participate in a 403(b) plan with a custodial account, their retirement plan benefits may not be protected from creditors. Investigate whether it's possible to transfer the assets to a 403(b) plan with a trust account to obtain creditor protection.

RESOURCES

AICPA Resources

CPE

- Financial Issues of Aging, a self-study course (# 731781JA).
- High-Powered Tax Planning Strategies for Your Best Clients, a self-study course (# 731652JA).
- Qualified Benefit Plans: Taxation and Administration for Small to Mid-Sized Companies, a self-study course (# 731900JA).
- Qualified Retirement Plans—401(k), Keogh, SEP, Simple…Does Your Plan Still Meet Your Needs?, a self-study course (# 731870JA).
- Tax, Health Care and Asset Protection for Aging Clients, a self-study course (# 732076JA).

Web site

www.360financialliteracy.org, AICPA's 360 Degrees of Financial Literacy, offers information on personal finance topics including retirement plans.

Other Resources

1. www.benefitslink.com, Benefits Link, offers compliance information and tools for employee benefit plan sponsors, providers and participants.
2. www.dol.gov/ebsa, Employee Benefits Security Administration, gives compliance information.

DISTRIBUTED BENEFITS NOT SAFE

The U.S. First Circuit Court of Appeals held in the *Hoult* v. *Hoult* case of 2004 that the anti-alienation provisions of ERISA and the Internal Revenue Code don't protect pension benefits that already have been removed from retirement plans and distributed to plan participants or beneficiaries.

Planning tip. Advise clients facing possible bankruptcy to withdraw only the minimum required annual distributions from their retirement plans to shield the balance from creditors.

PRACTICAL TIPS TO REMEMBER

1. Make sure retirement plans include nonowner employees as well as owners and their spouses so that assets of business owners and their spouses are protected from creditors in case of bankruptcy.
2. Consider transferring assets of employees of public schools and tax-exempt organizations to 403(b) plans with trust accounts.
3. Advise clients facing possible bankruptcy to withdraw only the minimum required annual distributions from their retirement plans to shield the balance from creditors.

BEWARE OF THE RISKS

The rights of retirement plan participants to ward off creditors of all types are formidable, and ERISA's anti-alienation protections are extensive. Still, some details have changed under recent rulings by the courts and the IRS, and CPAs need to stay current to protect their own retirement plans and those of their clients.