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CREDITORS' RIGHTS Tax Qualified Plans and IRAs

By Mark P.Altieri and Richard A. Maegele

In Brief

Keeping a Retirement Safe from Creditors

Most CPAs are generally aware of the fact that a participant's accrued benefit or account balance in a qualified retirement plan is well insulated from attack by that participant's creditors. Whether the creditor is asserting rights as a general creditor, insolvency creditor, or bankruptcy creditor, ERISA's anti-alienation protections are extensive. CPAs may be unaware of the significant chinks in the armor, particularly owner-only plans and IRAs, which are not protected by ERISA.

Recent developments under state law have provided ERISA-like protections to IRA owners. If a plan benefits only self-employed owners in a Keogh plan or shareholders/ employees in a corporate plan (where ERISA protections are inapplicable), tax advisors should consider transitioning plan assets to IRAs.

Under ERISA and IRC regulations, a participant's accrued benefit or account balance in a qualified retirement plan is generally insulated from attack by creditors. However, this protection is not absolute, and there are significant exceptions in the area of owner-only plans and IRAs, which are affected by evolving state law. CPAs representing creditors or bankrupt individuals should be aware of the existing guidance in order to best represent a client's interest.

ERISA and IRC Anti-Alienation Provisions

ERISA. Title I of ERISA provides that a pension plan shall provide that benefits under the plan may not be assigned or alienated; in other words, the plan must provide a contractual "anti-alienation" clause [ERISA section 206(d), 29 USC section 1056(d)(1)].

In order for the anti-alienation clause to be effective, the underlying plan must constitute a "pension plan," which is defined by ERISA as any "plan, fund or program which ... provides retirement income to employees" [ERISA section 3(2)(A)]. An ERISA pension plan, therefore, generally encompasses pension, profit sharing, and section 401(k) plans. A plan that does not benefit any common-law employee is not an ERISA pension plan. This may apply in the case of Keogh plans or corporate plans in which only the owners participate (see below).

Internal Revenue Code. Buttressing ERISA, the IRC provides that "a trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that benefits provided under the plan may not be assigned or alienated" [IRC section 401(a)(13)(A)].

The Treasury Regulations provide that "under [IRC] section 401(a)(13), a trust will not be qualified unless the plan of which the trust is a part provides that benefits provided under the plan may not be anticipated, assigned (either at law or in equity), alienated, or subject to attachment, garnishment, levy, execution or other legal or equitable process" [Treasury Regulations section 1.401(a)-13(b)(1)]. A retirement plan will not, therefore, be considered qualified unless it precludes both voluntary and involuntary assignments.

Neither ERISA nor IRC protections apply to assets held under individual retirement arrangements, simplified employee pension plans, government plans, or most church plans [ERISA sections 4(b) and 201; IRC section 401(a) and DOL Regulations section 2510.3-2(d)].

Exceptions. There are a number of exceptions to the ERISA and IRC anti-alienation provisions:

? Qualified domestic relations orders, as defined in IRC section 414(p) [IRC section 401(a)(13)(B), ERISA section 206(d)(3)]

? Up to 10% of any benefit in pay status may be voluntarily and revocably assigned or alienated [IRC section 401(a)(13)(A), Regulations section 1.401(a)-13(d)(1), ERISA section 206(d)(2)].

? A participant may direct the plan to pay a benefit to a third party if the direction is revocable and the third party files acknowledgment of lack of enforceability [Regulations section 1.401(a)-13(e)].

? Federal tax levies and judgments are exempted. IRC section 401(a)(13) provides that plan benefits are subject to attachment by the IRS in common-law and community property states [Regulations section 1.401(a)-13(b). See also *in re: Vermande*, 94 TNT 190-9 (Bankr. N.D. Ind. 1994); *Gregory v. United States*, 96-2 USTC P 50, 478 (D.C. Mich. 1996); *McIntyre v. United States*, 86 A.F.T.R. 2d 2000-5348 (9th Cir. 2000)]. Note, however, that the IRS has issued a field service advice memorandum (FSA 199930039) advising that a retirement plan does not have to honor an IRS levy for taxes to the extent that the taxpayer is not entitled to an immediate distribution of benefits from the plan (See also IRS Chief Counsel Advisory 200032004). The logic of the general exemption is that ERISA may not be construed so as to alter, amend, modify, or supersede any U.S. law [ERISA section 514(d)]. Thus, under this "savings clause," the IRS tax levy authority is deemed to override ERISA's anti-alienation rule [*U.S. v. Sawf*, 74 F. 3d 119 (6th Cir. 1996)].

? Criminal or civil judgments, consent decrees, and settlement agreements may permit the offset of a participant's benefits under a plan and order the participant to pay the plan due to a fiduciary violation or criminal activity [IRC section 401(a)(13)(C); ERISA section 206(d)(4)]. If the participant is married when the plan benefits are offset and if the survivor annuity provisions of ERISA section 205 or IRC section 401(a)(11) apply to distributions under the plan, the participant's spouse must consent in writing to the offset. An exception to such spousal consent exists where the spouse is also involved in the fiduciary violation or crime or where the spouse retains the right to receive the survivor annuity.

ERISA preemption. The ERISA anti-alienation provisions are given force by the preemption provisions also contained in ERISA. Section 514(a) provides that the provisions of ERISA supersede state laws insofar as such laws relate to employee benefit plans. The ERISA anti-alienation and preemption provisions combine to make state attachment and garnishment laws inapplicable to an individual's benefits under an employee benefit plan (an ERISA pension plan).

Supreme Court acknowledgment outside of bankruptcy. The U.S. Supreme Court has held that the ERISA anti-alienation provisions are extremely broad. In *Guidry v. Sheet Metal Workers National Pension Fund* [110 S. Ct. 680 (1990)], the Court held that ERISA prevented a federal court from imposing a "constructive trust" on pension benefits payable to a former union official convicted of embezzling more than $377,000 from the union: "Section 206(d) reflects a congressional policy choice, a decision to safeguard a stream of income for pensioners (and their dependents, who may be, and perhaps usually are, blameless), even if that decision prevents others from securing relief for the wrongs done them" [110 S. Ct. at 687].

General creditors of the sponsoring employer. The general creditors of a corporation or other sponsoring employer cannot reach the assets contained in that employer's qualified retirement plan. The statutory rationale is that a qualified retirement plan is established for the exclusive benefit of the employees and their beneficiaries [IRC section 401(a)(1), Treasury Regulations section 1.401-1(b)]. Furthermore, the terms of the trust must be such as to make it impossible, prior to the satisfaction of all liabilities to the employees and their beneficiaries, for any part of the funds to be diverted to purposes other than the exclusive benefit of the employees and their beneficiaries [IRC section 401(a)(2); Treasury

Regulations section 1.401-2]. Since the employer does not have any significant rights with respect to the trust assets, its creditors have no rights either.

The Bankruptcy Code

Statutory guidelines. The Bankruptcy Code provides generally for inclusion of all legal or equitable interests in the bankruptcy estate of the debtor. A bankruptcy estate is generally comprised of all the debtor's property, except as noted by Bankruptcy Code section 541(c)(2): "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title." Thus, to the extent the interest of a debtor in a trust contains a restriction on transfer which is enforceable under "applicable non-bankruptcy law," such an interest is not within the definition of property for purposes of bankruptcy.

Patterson v. Shumate. In 1992, the U.S. Supreme 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 is a restriction on the transfer of a debtor's beneficial interest in a trust that is enforceable under applicable non-bankruptcy law. Thus, a debtor's interest in an ERISA pension plan is excluded from the bankruptcy estate and not subject to attachment by creditors' claims [*Patterson v. Shumate,* 112 S. Ct. 2242 (1992)].

The Supreme Court stated that Bankruptcy Code section 541(c)(2) "encompasses any relevant non-bankruptcy law, including federal law such as ERISA." The Court also noted that its decision ensures that treatment of pension benefits will not vary because of a beneficiary's bankruptcy status and gives full effect to ERISA's goal of protecting pension benefits.

Post-Patterson law has noted that significant participant control does not negate the enforceability of the applicable plan's nonalienation provisions. A nonalienation clause in a section 401(k) plan has prevented a debtor's interest in the plan from being includable in the bankruptcy estate, even where the participant had the right under the plan to an immediate distribution of benefits [*Manufacturers Bank & Trust Co. v. Holst,* 197 B.R. 856 (N.D. Ia. 1996)].

If the underlying plan is not an ERISA pension plan (see below), the participant may still exempt the plan benefits from the bankruptcy estate to the extent reasonably necessary for the support of the debtor and any dependent of the debtor [11 USC section 522(d)(10)]. This is not a reliable alternative because the "reasonably necessary for support of debtor" criteria are strict, similar to the standard addressed below in the IRA analysis [See also *In re: Robert Harshbarger*, 66 F. 3d 775 (6th Cir. 1995)].

Impact of bankruptcy on a qualified domestic relations order. The U.S. Sixth Circuit Court of Appeals ruled that pension benefits awarded to a participant's former spouse before the participant filed for bankruptcy do not constitute property of the participant's bankruptcy estate and, therefore, the debtor cannot discharge the payment obligation *[McCafferty v. McCafferty,* 96 F. 3d 192 (6th Cir. 95-3919, 9/18/96)]. The Sixth Circuit held that the divorce decree created a constructive trust to protect the interest awarded to the alternate payee/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 Ohio Supreme Court's ruling in *Erb v. Erb* [75 Ohio St. 3d 18 (1996)] that the wife's property interest in the husband's pension would be neither part of the husband's bankruptcy estate nor subject to its jurisdiction.

Owner-Only Plans

Since *Patterson*, several U.S. bankruptcy courts have ruled that assets in a sole proprietor's retirement plan may be attached by creditors when the sole proprietor goes bankrupt, holding that a pension plan that benefits only the owner of a small business is not ERISA-qualified. ERISA is meant to benefit common-law employees, the courts have noted, whereas a sole proprietor is an employer. Thus, it is possible for a retirement plan that covers only the owners of a business to be attached by their bankruptcy creditors.

Department of Labor (DOL) regulations provide that a husband and wife that solely own a corporation are not employees for retirement plan purposes. The DOL regulations further provide that a plan that covers only partners or a sole proprietor is not covered under Title I of ERISA. However, a plan under which one or more common-law employees (in addition to the owners) are participants will be covered under Title I and ERISA protections will apply to all participants [29 CFR section 2510.3-3(b), (c)(1)]. Thus, inclusion of one or more nonowner employees transforms a non-ERISA plan into an ERISA-qualified plan and thereby protects all the plan assets (including the owners') from the claims of creditors.

As noted in the opinion of several courts, only plans that include nonowner employees as plan participants are entitled to the ERISA protection from creditors' claims and exclusion from bankruptcy [*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., 1996, Nevada), affd. 22 EBC 1091 (9th Cir., December 1998)]. If a plan files an IRS Form 5500-EZ, indicating that the plan covers only the owner and the owner's spouse, it is at risk of being included in the participant's bankruptcy estate and attached by creditors in bankruptcy.

IRAs and State Law

Although ERISA plans are exempt from creditors' claims, no such exemption is available for IRAs, which are not subject to ERISA protections [*Smith v. Winter Park Software, Inc.,* 504 So.2d 523 (Fla. 1987)]. Courts have summarized the law by holding that there is no federal exemption from garnishment for IRAs and that ERISA section 201(d) specifically excludes IRAs from anti-alienation protection.

IRAs, however, are often exempted by state law; therefore, IRAs are not protected in a state without an exemption [See ERISA sections 4(b) and 201, IRC section 401(a), 29 CFR section 2510.3-2(d)]. IRAs are not usually classified as spendthrift trusts under most state laws. As such, they are considered property of the bankruptcy estate unless specifically exempted under state law [See *In re: Martin*, 102 B.R. 639 (Bankr. E.D. Tenn. 1989); *In re: Felts*, 114 B.R. 131 (Bankr. W.D. Tex. 1990); and *In re: Horath,* 116 B.R. 835 (Bankr. M.D. Fla. 1990)]. In *Schlein v. Mills* [8 F. 3d 745 (11th Cir. 1993)], the court held that ERISA does not preempt state exemptions for simplified employee pension (SEP) and IRA assets that are enacted pursuant to the express authority bestowed on states under the Bankruptcy Code.

Trends in State Law

The relatively recent (yet representative) evolution of IRA protection under state law is best understood by exploring the examples of old and current law in Ohio and New York (see the Exhibit begining on page 27).

Ohio law before March 22, 1999. Ohio Revised Code (ORC) section 2329.66(A)(10)(c) provided that a person domiciled in Ohio could hold a pension benefit exempt from execution, garnishment, attachment, or sale to satisfy a judgment or order. However, the person's right to receive payment under any IRA or Keogh plan was exempt only to the extent reasonably necessary for the support of the person and any dependents.

In *Mid-America Fed. S&L Ass'n* [94 Ohio App. 3d 521 (1994)], the judgment debtor attempted to exempt his interest in the plan pursuant to ORC section 2329.66(A)(10)(c). Applying the factors established by the case law, the court determined that no portion of the judgment debtor's interest was subject to exemption. The judgment debtor was 57 years old, had various health problems, substantial debts, and no retirement income other than the funds in the Keogh plan, which were approximately $127,000.

In re: Metzner [157 B.R. 332 (Bankr. N.D. Ohio 1993)] epitomizes the vagaries of Ohio's old exemption statute. The bankruptcy court determined that only one half of a $7,000 IRA was subject to exemption as being reasonably necessary for the debtor's support. The debtor was in his mid-40s, earned a weekly income of $268, and was about to lose his job due to an expected closing of his employer's business. The court reasoned that the debtor had never made any withdrawals from the account and had been able to maintain his sustenance by other means.

Ohio law after March 22, 1999. ORC section 2329.66(A)(10)(c) was recently amended to specifically exempt IRAs, Roth IRAs, and Education IRAs from execution, garnishment, attachment, or sale to satisfy a judgment or order. SEPs and SIMPLE IRAs are not protected under Ohio law. Assets rolled over from an SEP or SIMPLE into a rollover IRA would, however, be entitled to protection from creditor claims under these provisions.

There are exceptions to this positive new development. Portions of the otherwise protected IRA that are deposited for the purpose of evading the payment of any debt continue to be subject to execution, garnishment, attachment, or sale to satisfy a judgment creditor. Moreover, the entire IRA is still subject to a court order to withhold money from those assets to pay child support. Additionally, the new law relocates the statutory location but does not change the previous-law standards for holding Keogh plan assets exempt from attachment only "to the extent reasonably necessary for the support of the person and any of the person's dependents" [ORC section 2329.66(A)(10)(d)].

New York law. Prior to the amendment of section 5205(c)(2) of the New York Civil Procedure Laws and Rules (NYCPLR), generally effective September 1, 1994, IRAs were held to be included in the bankruptcy estate of the debtor. This was the case whether or not the IRA was part of an SEP plan [*In re: Kramer Bankrupt* 128 B.R. 707 (E.D. N.Y. 1991); *In re: Mann* 134 B.R. 710 (E.D. N.Y. 1991); *In re: Taft* 184 B.R. 189 (E.D. N.Y. 1995)]. The New York statute and case law interpreting section 5205(c) prior to its amendment did exempt an IRA from the bankruptcy estate to the extent it was attributable to funds rolled over to the IRA from other retirement plans qualified under IRC section 401 [*In re: Modansky* 159 B.R. 139 (S.D. N.Y. 1993)].

The revisions to NYCPLR section 5205(c)(2) have been interpreted broadly by the courts. The court in *Pauk v. Pauk* [648 NYS 2d 134 (1996)] noted that IRAs established by a New York settler are entirely exempt from attachment to satisfy a money judgment irrespective of whether the IRA funds were derived from rollovers, exempt retirement plans, or funds directly traceable to the judgment debtor. Therefore, a former wife could not garnish funds in her ex-husband's IRA to satisfy an attorney's fee awarded by the local divorce court. Similarly, the court in *In re: Dubroff* [119 F. 3d 75 (2nd Cir. 1997)] stated that a Chapter 7 debtor could claim complete exemption for his IRA pursuant to NYCPLR section 5205(c)(2).

Planning under current state law. A very problematic area has developed in the case of an otherwise qualified ERISA plan that constitutes an owner-only plan under the earlier pension plan analysis. This situation requires the tax advisor to provide appropriate counsel to New York, Ohio, or similarly situated clients with an owner-only plan. If creditor protection is a priority, a proper course of action would be to either 1) extend the plan to benefit nonowner employees, thus removing the plan from the owner-only, Form 5500-EZ category or 2) transition the owner-only plan assets into an IRA.

Note that, generally, pre-1998 state IRA exemption statutes make reference to IRC section 408. Roth IRAs, defined by IRC section 408A, may not be covered by state exemptions.

Pending Legislation

Note that legislation currently pending in Congress (S.625, the Bankruptcy Reform Bill) could impose a limit of $1 million or less on the amount of qualified plan and IRA assets that would be exempt from a bankruptcy estate.

Mark P. Altieri, JD, LLM, CPA*, is an associate professor of accounting at Kent State University and* ***Richard A. Naegele, JD****, is a shareholder in the law firm of Wichens, Herzer, Panza, Cook & Batista.*
