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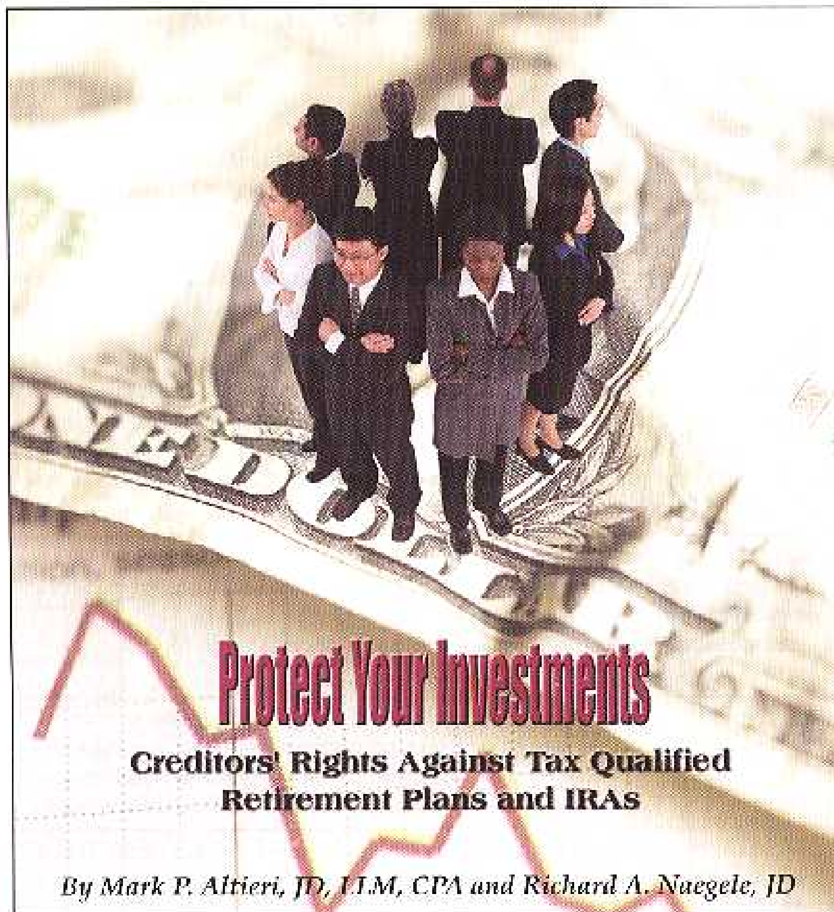

Protect Your Investments

Creditors' Rights Against Tax Qualified Retirement Plans and IRAs

By Mark P. Altieri, JD, LLM, CPA and Richard A. Naegele, JD

Overview

For the last few years, accountants, lawyers and other tax practitioners in the qualified plan area have felt somewhat assured of the state of the law addressed in this article. However, the recent 6th Circuit opinions of *Lampkins v. Golden* and *In re: Yates*, which will be analyzed later, have caused consternation among pension practitioners. Accountants, lawyers and other tax practitioners have been compelled to question whether the legal insulation of IRA owners against creditors has been dealt a blow because of *Lampkins* in Tennessee and other 6th Circuit jurisdictions. As detailed in this article, the authors are not of this opinion. The impact of *Yates* on owner-participant plans may prove to be more problematic.

Many tax practitioners are aware of the fact that a participant's accrued benefit or account balance in a qualified retirement plan is insulated from attack by that participant's creditors. Whether the creditor is asserting rights as a general creditor, insolvency creditor or bankruptcy creditor, Employee Retirement Income Security Act's (ERISA) anti-alienation protections are extensive. However, tax practitioners may be unaware that significant chinks in the armor exist, particularly in owner-only plans and IRAs, which are not protected by ERISA. This article will attempt to identify these chinks in the armor. An interesting dichotomy as to the treatment of SIMPLE and simplified employee pension (SEP) IRAs both in and outside of bankruptcy will also be analyzed.

Anti-Alienation Provisions

ERISA. Title I of ERISA provides that a pension plan shall require that benefits under the plan may not be assigned or alienated. In other words, the plan must provide a contractual "anti-alienation" clause.[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 ... is established or maintained by an employer that provides a retirement income to employees."[2] An ERISA pension plan, therefore, generally encompasses pension, profit-sharing and section 401(k) plans. As detailed below, the position of the Department of Labor (DOL) is that the phrase also encompasses a SEP IRA. A plan that does not benefit any common-law employee is not an ERISA pension plan. As discussed below, this certainly applies to non-SEP and non-SIMPLE IRAs and may apply in the case of Keogh plans or corporate plans in which only the owners participate.

Internal Revenue Code (IRC). Buttressing ERISA with regard to tax qualified plans, 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."[3]

Neither the ERISA nor IRC anti-alienation protections apply to assets held under non-qualified deferred compensation arrangements, government plans, church plans or any IRA arrangement described under IRC Section 408 [which, as detailed below, has been held to include not only general owner-established and maintained IRAs, but also employer-established SEP and SIMPLE IRAs under IRC Sections 408(k) and (p)].[4] There are a number of exceptions to the general ERISA and IRC anti-alienation provisions.[5]

ERISA Pre-emption. The ERISA anti-alienation provisions are given force by the pre-emption provisions also contained in ERISA. ERISA Section

514(a) provides that the provisions of ERISA supersede state laws insomuch as such laws relate to employee benefit plans. The ERISA anti-alienation and pre-emption provisions generally combine to make state attachment and garnishment laws inapplicable to an individual's benefits under an ERISA pension plan.

A dichotomy exists with regard to SEP and SIMPLE IRAs. These employer-established and maintained IRA arrangements are deemed for that reason to constitute ERISA pension plans. Despite that characterization, such arrangements are not protected under the ERISA anti-alienation provisions as noted above. As addressed in the discussion about the *Lampkins* case, this dichotomy is at the core of that court's opinion that state law protections for SEP IRAs are pre-empted by ERISA.

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. Such 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.[6] The Supreme Court stated that Bankruptcy Code Section 541(c)(2) encompasses relevant non-bankruptcy law such as ERISA.

SEP and SIMPLE IRAs — A Fascinating Dichotomy. A SEP IRA is an arrangement maintained by an employer and put into place for the benefit of its employees. A SIMPLE IRA is also an arrangement that is established and maintained by an employer for the benefit of its employees.

Recall that an ERISA pension plan is any "plan, fund or program which is established or maintained by an employer ... that provides retirement income to employees."[7] Although contributions under both SEP and SIMPLE IRAs are immediately allocated among the individually owned IRAs of the participating employees, practitioners have long conceded the fact that such arrangements fit the definition of an ERISA pension plan due to the employer involvement in the arrangement. The Department of Labor has categorically taken the position that SEP and SIMPLE IRAs are constituent parts of an ERISA plan.[8] The DOL does gratuitously provide an abbreviated compliance scheme for SEPs under Part 1 of Title 1 of ERISA.[9] The 10th Circuit has also acknowledged the status of a SEP IRA arrangement as an ERISA pension plan.[10]

Despite the SEP and SIMPLE IRA arrangements constituting ERISA plans, as noted earlier,[11] such arrangements are excluded from the anti-alienation protections of ERISA.[12] The referenced exclusion from ERISA anti-alienation protection extends to any arrangement described under IRC Section 408 (covering IRAs). The 6th and 11th Circuits have determined that the ERISA anti-alienation exclusion of IRC Section 408 extends to SEPs and SIMPLEs described under IRC Sections 408(k) and (p).[13]

What does all of this mean for a SEP or SIMPLE IRA? The answer depends on whether the creditor's rights are being asserted in or outside of bankruptcy. Outside of bankruptcy, the SEP or SIMPLE IRA does indeed find itself between the proverbial rock and a hard place. Simply put, as an ERISA pension plan, any state law that attempts to protect the wealth accumulated in such IRA is pre-empted. However, an ERISA plan described in 29 USC 1051(6), it is not afforded ERISA's general anti-alienation protection from creditors' claims.[14]

What if the SEP or SIMPLE IRA are attempted to be attached in a bankruptcy proceeding? The referenced[15] and heavily cited *Schlein* case provides the proper analysis of state law protection of a SEP or SIMPLE IRA becoming viable in a bankruptcy again. The 11th Circuit in *Schlein* noted that a SEP IRA is indeed an ERISA plan and, as such, related state law would normally be pre-empted under ERISA. However, the court noted that the ERISA pre-emption "saving clause" needs to be analyzed in a bankruptcy proceeding. This saving clause notes that "nothing in this subchapter shall be construed to alter, amend, modify, invalidate, impair or supercede any law of the United States."[16]

With regard to state law interaction with the savings clause, the court concluded that any state law incorporated into a federal bankruptcy proceeding under federal bankruptcy law would be saved from ERISA pre-emption. The court noted that state law that imposed a "restriction on the transfer of the beneficial interest of a debtor in a trust that is enforceable under applicable non-bankruptcy law" could be exempted under the Bankruptcy Code Section 541(c)(2) as interpreted by the Supreme Court in the

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Patterson case.[17] More specifically, the *Schlein* court focused on the "opt out" allowance in the bankruptcy code.[18] Therefore, the federal bankruptcy law allows states to fashion individualized exemptions that would be applicable in a federal bankruptcy proceeding affecting a resident of that state. The court then concluded that since Florida law clearly protected the SEP IRA wealth in a federal bankruptcy proceeding, the federal bankruptcy law incorporated that state law allowance and the federal bankruptcy law, as so adapted, was saved from ERISA preemption.

The Tennessee practitioner should note the similarity between applicable Tennessee law and the Florida statutes analyzed in the *Schlein* case. The referenced opt-out provision in Florida law found that Section 222.20 of the Florida statutes is virtually identical to Section 26-2-112 of the Tennessee code. Likewise, the exemption for individual retirement accounts and other qualified plan assets found at Section 222.21(2) of the Florida statutes is substantively the same as Section 26-2-105(b) of the Tennessee code.

Thus, Tennessee law appears to exempt SEP and SIMPLE IRA assets from attachment in a federal bankruptcy proceeding.

Owner Only Plans

Since *Patterson*, several U.S. bankruptcy courts have ruled that assets in a sole proprietor's Keogh retirement plan may be attached by creditors when the sole proprietor goes bankrupt, holding that a plan that benefits only the owner of a small business is not "ERISA-qualified." As is fundamental in the definition of an ERISA pension plan,[19] ERISA is meant to benefit common-law employees. As the courts have noted, a sole proprietor is an employer. Thus, it is distinctly possible for a retirement plan that covers only the owners of a proprietorship to be attached by the bankruptcy creditors.

What if the business is incorporated? DOL regulations provide that a husband and wife who solely own a corporation are not deemed employees for retirement plan purposes. The DOL regulations further provide that a plan that covers only partners or only 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.[20]

Thus, inclusion of one or more non-owner employees transforms a non-ERISA plan into an ERISA qualified plan. Thereby, protecting all the plan assets (including the owners') from the claims of creditors.[21] 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.

To what extent the recent 6th Circuit opinion, *In re: Yates*, throws a monkey wrench into this long-accepted scenario is the topic of the next section.

Assets of Sole Shareholder/Sole Proprietor May be at New Risk- *In re: Yates*. The Court of Appeals for the 6th Circuit recently held in *In re: Yates* that ERISA creditor protection may not be available for the sole owner of a multiple participant plan.[22] Dr. Yates was the sole shareholder of Raymond B. Yates, M.D., P.C., which maintained a qualified profit-sharing/pension plan. Four participants were in the plan, Yates and three other unrelated employees. Dr. Yates owed approximately $50,000 to the plan and, three weeks before an involuntary bankruptcy petition was filed against him, he repaid the loan. The creditors in bankruptcy sought to have the loan repayment set aside as a voidable preference. Dr. Yates asserted ERISA creditor protection.

Citing *Fugarino v. Hartford Life Insurance*,[23] that a sole shareholder is not an employee for purposes of ERISA, the 6th Circuit held that Dr. Yates had no standing under ERISA to assert its creditor protection. The 6th Circuit, therefore, upheld the rulings of the bankruptcy court and the district court that the trustee in bankruptcy was entitled to have the loan repayment set aside. This increased the amount of money available for creditors.

The attorneys for Dr. Yates argued that the *Fugarino* decision is contradicted by the case law of eight other circuits and DOL Advisory Opinions. Nonetheless, the bad facts and perceived overreaching of Dr. Yates may have influenced the court to reach the conclusion that there was a voidable preference under the bankruptcy law.

Taking the logic of the 6th Circuit opinion in *In re: Yates* to its extreme, Dr. Yates' creditors may be able to attach the entire profit-sharing/pension account, not merely the $50,000 preferential payment. Similarly, the retirement accounts of all similarly situated proprietors and sole shareholders could be at risk in the 6th Circuit.

IRAs and State Law

Although ERISA plans are generally exempt from creditor's claims, no such exemption is available for IRAs, which are not subject to ERISA protections. 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.[24] As has been noted,[25] SEP and SIMPLE IRAs, as well as general IRAs, lack this federal law protection.

However, "regular" (non-SEP and non-SIMPLE) IRAs are not subject to ERISA pre-emption because they are not ERISA pension plans.[26] These regular IRAs are often protected from attachment under state law. Therefore, regular IRAs are not protected in a state without a specific state law exemption.[27] 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.[28]

Tennessee Law. The Tennessee Code Section 26-2-105(b) exempts all IRAs under IRC Section 408 from attachment (as well as exempting other tax-qualified retirement assets). Thus, regular IRA assets are protected from attachment [except pursuant to a qualified domestic relations order under Section 26-2-105(c)] under Tennessee law. Again, recall that, if the IRA is part of a SEP or SIMPLE IRA arrangement, the earlier analysis of such IRAs being attachable in or out of bankruptcy needs to be reviewed.

Lampkins vs. Golden

Tax practitioners in the 6th Circuit have taken note of a somewhat vague decision by the 6th Circuit Court of Appeals in *Lampkins v. Golden*.[29] Some practitioners fear that *Lampkins* may have opened the door for a creditor assault on all IRAs. We are not of that opinion and feel that a steady interpretation of *Lampkins* conforms with the above-described accepted law.

The plaintiff, Deborah Lampkins, was employed as the secretary of Robert Golden, a Michigan lawyer, and a participant in a profit-sharing and pension plan his wholly-owned corporation sponsored. Lampkins first successfully brought suit against Golden to compel him to pay Lampkins on her termination of employment her accrued benefits under the terms of the plans. In addition to winning summary judgment against Golden in district court, Golden was also fined by the court.

After Golden refused to pay all judgments on the basis that he had no assets or income, Lampkins discovered that Golden had a sufficient amount of wealth within a SEP IRA. Lampkins then moved to garnish the SEP IRA, and the district court (in a magistrate's report) ordered summary judgment in her favor. Golden then appealed the case to the 6th Circuit.

The 6th Circuit clearly was in no mood to entertain Golden's plea (he was representing himself *pro se*). The court could have quickly disposed of the matter by deeming the SEP IRA a fully attachable non-qualified plan since Golden had engaged in significant prohibited borrowing from the SEP IRA. Instead, the court rather brusquely (and with little citation to supporting case law) addressed the issues raised in the pleadings, which resulted in an ambiguous ERISA holding.

The court quickly disposed of Golden's first argument that his SEP IRA was protected from attachment via ERISA's anti-alienation provisions. As we have noted earlier,[30] a Section 408(p) SEP IRA is not afforded protection under those anti-alienation provisions.

Golden then claimed protection under Michigan law, which he contended shielded any IRC Section 408 IRA arrangement from attachment. The court proceeded to dismiss this argument on the basis of ERISA pre-emption. The court simply noted (presuming, *ipso facto*, that a SEP IRA is an ERISA pension plan) that the Michigan statute related to an ERISA plan and was, therefore, pre-empted by the federal law.

The underlying Michigan law,[31] affords exemption only as an extension of federal bankruptcy law under the "opt-out" provisions analyzed earlier.[32] The *Lampkins* case did not involve a claim in bankruptcy. Therefore, the analysis of state law protection afforded a SEP IRA in a bankruptcy proceeding did not pertain. Although the court did not address this point in an analytical way, the *Lampkins* decision was a correct one with respect to a SEP IRA and followed the law that we analyzed earlier. Simply, Golden's SEP IRA did constitute an ERISA pension plan. As such, outside of bankruptcy, ERISA pre-empted any related state law that might have been called upon to protect those SEP IRA assets. Furthermore, despite constituting an ERISA plan, the SEP IRA assets were not protected by ERISA's anti-alienation protections.

Note: *The authors have been advised that the legal distinctions made in this article relative to* Lampkins *are not being followed by some bankruptcy courts in the 6th Circuit. Rather, some bankruptcy trustees are summarily including all (SEP, SIMPLE and general) IRA assets in the bankruptcy estate based on, in our opinion, an overly expansive interpretation of* Lampkins.

Planning Considerations

Under ERISA and treasury 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. Tax practitioners representing creditors or bankrupt individuals should be aware of the existing statutory and case law in order to best represent a client's interest.

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 adviser to provide appropriate counsel to Tennessee and other similarly situated clients with an owner-only plan. If creditor protection is a priority, a proper

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course of action would be to either (1) extend the plan to benefit non-owner employees, thus removing the plan from the owner-only, Form 5500-EZ category or (2) transition the owner-only plan assets into an IRA. As noted above, however, the 6th Circuit opinions in *In re: Yates* and *Lampkins* call into question whether qualified plans covering sole shareholders and other non-owner participants are protected (*Yates*) and whether IRAs are protected at all (*Lampkins*).

Recent developments under state law have provided ERISA-like protections to IRA owners in most states. If benefits are provided only to self-employed owners in a Keogh plan or shareholders/employees in a corporate plan (where ERISA protections are inapplicable), tax advisers should consider transitioning plan assets to rollover IRAs (presuming our interpretation of the scope of *Lampkins* is correct). Depending on the perceived scope and evolution of the *Yates* decision, such a course of action may also be advisable as to the accrued benefits or account balances of owners/participants of plans with non-owner participants as soon as a distribution is permitted from the plan.

If our interpretation of the scope of *Lampkins* and Tennessee law is correct, owners of IRAs that are created under SEP or SIMPLE IRAs should transition that wealth to a rollover IRA as soon as the primary IRA is funded. At that point, the rollover IRA owner can assert that the new IRA is no longer a constituent part of an ERISA plan. Thereafter, it is not subject to ERISA pre-emption, and the new IRA is entitled to protection from creditor claims (in or out of bankruptcy) under Tennessee law. ■

References

1. *ERISA Section 206(d), 29 USC Section 1056(d)(1).*
2. *ERISA Section 3(2)(A), 29 USC Section 1002(2)(A).*
3. *IRC Section 401(a)(13)(A).*
4. *ERISA Sections 4(b) and 201; IRC Section 401(a); DOL Regulations Section 2510.3-2(d).*
5. *IRC Section 401(a)(13); ERISA Sections 206(d) and 514(d), Treasury Regulations Section 1.401(a)-13.*
6. Patterson vs. Shumate, *112 S. Ct. 2242 (1992).*
7. *Text at endnote 2.*
8. *See the preamble to DOL Regulations Section 2520.104-48, 45 Fed. Reg. 24866 (4/11/80).*
9. *DOL Regulation Section 2520.104-49.*
10. Garratt vs. Walker, *164F 3d 1249 10th Cir. 1998.*
11. *Text at endnote 4.*
12. *29 USC Section 1051(6).*
13. In re: Schlein, *8F. 3d 745 (11th Cir. 1993).* Lampkins v. Golden *2002-1 U.S.T.C. P 50,000 216, 27 B.B.C. 1587 (6th Cir. 2002).*
14. *Endnote 13.*
15. *Endnote 13.*
16. *ERISA Section 514(d), 29 USC Section 1144(d).*
17. *8F. 3d at 751.*
18. *11 USC Section 522(b).*
19. *Text at endnote 2.*
20. *29 CFR Section 2510.3-3(b), (C)(1)*
21. 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 Circuit, Dec. 1998).*
22. In re: Yates, *287 F.3d 521 (6th Circuit, 2002), rehg. denied 2002 U.S. App. LEXIS 12550 (June 20, 2002).*
23. *969 F.2d 178 (6th Circuit, 1992)*
24. Smith vs. Winter Park Software, Inc., *504 So. 2d 523 (Fla., 1987).*
25. *Text at endnote 13.*
26. *Text at endnote 8.*
27. *See ERISA Sections 4(b) and 201, IRC Section 401(a), 29 CFR Section 2510.3-2(d).*
28. See In re: Martin, *102 B.R. 639 (Bankr. E.D. Tenn., 1989);* In re: Felts, *114 B.R. 131 (Bankr. W.D., Texas, 1990); and* In re: Horath, *116 B.R. 835 (Bankr. M.D. Fla., 1990).*
29. *2002 U.S. App. Lexis 900; 27 E.B.C. 1587 (6th Circuit 2002).*
30. *Text at endnote 13.*
31. *Michigan Comp. Laws Ann. Section 600-6023(k).*
32. *Text at endnote 18.*

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