SELECTED PROBLEMS IN PLANNING WITH RETIREMENT BENEFITS: COMMUNITY PROPERTY ISSUES AND CREDITOR'S RIGHTS

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COMMUNITY PROPERTY

I. GENERAL ISSUES – There are eight community property jurisdictions in the United States[1], two of which (California and Texas) are among the three most populous states in the country. Most of the community property jurisdictions trace their beginnings to the Spanish law (and were not created, as some in Washington believe) as a tax avoidance device.

A. **WHY COMMON LAW LAWYERS SHOULD CARE**. The United States is now, and has ben for a considerable period of time, a mobile society. Persons from community property jurisdictions may relocate in common law states, bringing with them considerable community property. The character of such property is not magically transmuted into something other than community property, and it may be desirable to retain the community character of certain property. Even if not advisable, a change could affect already established property rights.

B. **DIFFERENCES AND SIMILARITIES AMONG JURISDICTIONS**. There is a tendency among lawyers in statutory jurisdictions to believe that community property laws are uniform among the various jurisdictions. Comparing Texas and California law is instructive in this regard.

1. **Definitions**. As a generally applicable definition, most states define community property by defining what is not community property. Community property is all property acquired during marriage except that acquired by gift, devise or descent.

2. **Income from Separate Property.** In Texas and Idaho, income from separate property is community property. In all other jurisdictions, such income is separate property.

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[1] Louisiana, Texas, New Mexico, Arizona, Nevada, California, Washington and Idaho. Wisconsin has adopted the Uniform Marital Property Act which essentially creates a community property system, and Alaska has an "opt-in" community property system (designed primarily to achieve a new basis at death) which may or may not be treated as community property for federal tax purposes.

Income is to be distinguished from mere changes in form of the property which do not alter its essential character. Thus, for example, dividends from IBM stock are income, but proceeds of a sale of IBM stock, even if there is a gain on such sale, are treated as separate property which has mutated from stock to cash. Furthermore, assuming that the proceeds can be traced into a purchase of Dell stock, the Dell stock is separate property. Assume that a spouse rolls over her qualified plan into an IRA prior to marriage, and makes no further contributions to the IRA during the marriage. In California, any earnings during marriage would also be separate property so that the IRA remains 100% separate property. In Texas, the answer is not so clear. If income of the IRA stays in the IRA *and* is treated as marital property, the IRA is now part community.[2]

3. **Inception of Title vs. Proportional Determination.** Texas follows the inception of title rule which means that the character of property is determined at the time of its acquisition, and is unchanged by future events. California adopts a proportional consideration rule, so that the character of property may well change after marriage. For example, assume one spouse acquires title to real property prior to marriage, and payments on the mortgage are made after marriage from community funds. In Texas, the property would remain the separate property of the acquiring spouse (subject to a right of reimbursement), but in California, a portion of the property would become community property. Contributions to an IRA after marriage would create community property in California based upon a proportion of the contributions, while in Texas, such contributions would give rise to a right of recovery (assuming the spouse was not the beneficiary) if such contribution was a fraud on the community.[3]

4. **Management of Property.** California requires the consent of both spouses in managing community property, whereas Texas determines the right to manage largely

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[2]See discussion below.

[3]A discussion of the fraud on the community doctrine is well beyond the scope of this paper.

based upon in whose name the property is registered. The Texas management scheme also allows the managerial spouse to dispose of property subject to that spouse's sole management during life without the consent of the other spouse, except where such disposition would constitute a fraud on the community.

5. **Disposition at Death.** In all community property jurisdictions, title is irrelevant in determining character, and thus ownership. Each spouse has the power to dispose only of his or her one half of the community property at death, except such property as life insurance or retirement benefits, which are subject to a contractual right in the owner to dispose of the asset. If the non-owner or non-participant spouse (NPS) dies first, then that spouse has the right to dispose of his or her community one-half interest, subject to ERISA preemption of that right.

C. **IRC PROVISIONS.** Two provisions of the Internal Revenue Code apply directly to the issue of community property in IRAs. The first of these is §408(d)(6), which allows division of IRAs upon divorce. The second is §408(g) which states:"This section will be applied without regard to community property laws." Although the scope of this section is very unclear, it is clear to the author that it cannot be read literally, and is probably best interpreted as simply preventing double contributions to an IRA in community property states based upon the fact that earnings from personal services are community property.

II. ERISA PREEMPTION AND QUALIFIED PLANS.

The United States Supreme Court has held that ERISA preempts community property law with respect to, among other things, the power of the NPS to dispose of his community interest in the ERISA plan if he predeceases the participant. *Boggs v. Boggs,* 520 U.S. 833 (1997). [4]

[4] It is sometimes difficult to determine whether a plan is subject to Title I of ERISA or not.

A. **OVERVIEW OF *BOGGS.*** While *Boggs*, clearly states that ERISA pre-preempts state community property law as to undistributed benefits, it raises several new questions. In answering the pre-emption issue, the 5-4 majority openly stated that the issue to be resolved was **not** a technical construction of the "relate to" language of ERISA's preemption language. Rather, the majority emphasized that the overarching purpose of ERISA is a statute designed to provide primarily for the retirement of the participant and the participant's spouse and that the federal statute has pre-empted state property law and occupies the entire field.[5] Allowing state community property law to permit the non-participant spouse to dispose of one-half of the plan assets deprives the participant of the use of those assets for his or her retirement. While it may also result in allowing the participant to determine the devolution of all the plan benefits, that is a price that Congress decided was necessary to carry out the purpose of the statute. In the balancing of the equities, it seems that this is the proper balance. As noted in more detail below, the dissent spends a lot of time analyzing and applying the "relate to" test, which, as prior cases have demonstrated, can be applied to reach whatever result is desired. The dissent also seems to believe that Dorothy Boggs (the first wife) has somehow been deprived of her share of the plan benefits. What she was, in fact, "deprived of" was the ability to dispose of half of her husband's retirement to his detriment. It is important to keep in mind in analyzing *Boggs* that while the sons waited until after their father was dead to file their action, they could have demanded an accounting during his life *while he was receiving benefits from the retirement plan.*

B. **FACTS.** The relevant facts in *Boggs* are somewhat complex. Isaac Boggs, a Louisiana resident, was married to Dorothy Boggs and he worked for Southern Bell Telephone for

[5]This design can be seen in the tax effects of qualified plans. The participant is normally required to begin taking distributions at 70-½ (with certain limited exceptions added by the Jobs Protection Act). At the participant's death, the property can pass to the spouse virtually tax free, and, in most cases, the spouse can start a new life expectancy calculation. At the death of the spouse, when the property passes to the next generation, the combination of income taxes and estate taxes results in the next generation receiving only 20% to 30% of the gross value of the plan, even with the best of planning.

36 years of their marriage. Dorothy died in 1979, and her will left one-third of her estate to Isaac and gave him a usufruct interest in the other 2/3, in which 2/3 their three sons had the "naked ownership."[6] At the time of Dorothy's death, Isaac had an interest in three types of retirement benefits -- a joint and survivor retirement annuity, an ESOP, and a profit sharing plan. Dorothy's interest in these plans was valued at approximately $22,000 in her "succession" (an "inventory" in the rest of the United States). In 1980, Isaac married Sandra. He retired in 1985. At that time he began drawing his retirement annuity, took the shares of the ESOP and rolled the profit sharing plan into an IRA. Isaac died in 1989, having made no withdrawals from the IRA.[7]

Two of the sons then filed an action for an accounting in state court requesting a judgment awarding them an interest in "the IRA; the ESOP shares of AT&T stock; the monthly annuity payments received by Isaac during his retirement; and Sandra's survivor annuity payments both received and payable." 520_ U.S. at 834 (1997). Sandra filed an action in the federal court seeking a declaration that ERISA pre-empted community property laws. She lost in both the District Court and the Fifth Circuit.[8] The Supreme Court granted *certiorari* because of the conflict between the Fifth Circuit in *Boggs* and the Ninth Circuit in *Ablamis v. Roper,* 937 F.2d 1450 (1991).[9]

C. **THE DECISION.** The Court noted first that the case was important in that it affected (over ten years ago) 80 million residents of community property states with over $1 trillion dollars in qualified plan benefits.

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[6]A usufruct interest is roughly equivalent to a common law life estate, and the naked ownership is roughly equivalent to a remainder interest.

[7]Although the opinion is unclear, it is presumed that Sandra was the beneficiary of the IRA.

[8]Judge Jacques Weiner, joined by five of his colleagues, wrote an articulate dissent to the Court's refusal to grant an *en banc* rehearing. 89 F.3d 1169 (1996).

[9]It took the Ninth Circuit 15 months to write *Ablamis,* and it took the Fifth Circuit 18 months to write *Boggs*.

1. **<u>The New Pre-Emption Test</u>.** The Court begins its analysis by noting that it had already taken two other cases involving federal pre-emption during the same term as *Boggs*. After announcing that its decision would also affect claims in non-community property jurisdictions, the Court stated its very broad pre-emption test, which apparently adopts a new standard for applying pre-emption in ERISA related cases:

> ERISA's express pre-emption clause states that the Act "shall supersede any and all state laws insofar as they may now or hereafter relate to any employee benefit plan...." §1144(a). We can begin, and in this case end, the analysis by simply asking if state law conflicts with the provisions of ERISA or operates to frustrate its objects. We hold that there is a conflict, which suffices to resolve the case. **We need not inquire whether the statutory phrase "relate to" provides further and additional support for the pre-emption claim**. (emphasis added.)

Id., at 833.

Thus, it would appear that the majority in *Boggs* is holding that it is necessary for community property laws to yield to ERISA where the effect of community property laws is to affect a field which Congress has appropriated for a federal purpose to carry out a uniform federal scheme.

`In deciding whether Congress has pre-empted the field, the Court examined several provisions of ERISA, and determined that the purpose of the statute is to protect the interests of participants and beneficiaries; *e.g.,* ERISA §§ 1001(c), 1104(a)(1), 1103(c)(1), and 1108(a)(2). Further, the Court examines QDROs and the QPSA and QJSA provisions in analyzing the rights that REA gave to a nonparticipant spouse.

The surviving spouse annuity and QDRO provisions, which acknowledge and protect specific pension plan community property interests, give rise to the strong implication that other community property claims are not consistent with the statutory scheme. ERISA's silence with respect to the right of a non-participant spouse to control pension plan benefits by testamentary transfer provides powerful support for the conclusion that the right does not exist.

520 US, at 834.

2. **ERISA Protects Only Participants and Beneficiaries.** The Court then goes on to find that the sons are neither participants nor beneficiaries and rejects the argument that pre-REA case law in divorce indicates that ERISA did not pre-empt community property interests.[10] Additionally, the anti-alienation provisions of ERISA §1056(d)(1) give "specific and powerful reinforcement" to the pre-emption argument. Dorothy's attempted testamentary transfer is the prohibited assignment or alienation. Citing Treas. Regs. §1.401(a)-13(c)(1)(ii) which defines an assignment or alienation as including an interest acquired from a beneficiary or participant and "enforceable against the plan in, or to, all or any part of a plan benefit payment which is, or may become, payable to the participant or beneficiary." (emphasis added.)

Under Louisiana Law community property interests are enforceable against a plan (Citation omitted.) If respondents' claims were allowed to succeed they would have acquired, as of 1980, an interest in Isaac's pension plan at the expense of plan participants and beneficiaries.

[10]This argument was made in an *amicus* brief by the Estate Planning, Probate and Trust Law Section of the State Bar of California supporting Respondent.

520 U.S. at 852.

Thus, if Dorothy is a participant, by virtue of her community property interest, then the mere fact that the respondents' right might be enforceable against payments to be received violates the anti-alienation provision. I am not sure that the logic is especially sound, since there is still the question as to whether Dorothy's beneficiaries could enforce the rights against the plan. (But should they not have that right if Dorothy was a participant by virtue of the community property law?)

The Court returns to its premise that ERISA is designed to protect beneficiaries and participants. Respondents would cause a diversion of substantial benefits to testamentary recipients. "Retirement benefits and the income stream provided for by ERISA-regulated plans would be disrupted in the name of protecting a nonparticipant spouse's successors over plan participants and beneficiaries." 520 U.S. at 852.

3. Accounting by NPS's Beneficiaries Not Available. The Court then goes on to reach what ought to be an obvious response to respondents' argument that the suit is simply one for an accounting, and in no way affects the plan. *Free v. Bland,* 369 U.S. 663 (1966), involved Texas community property law. In that case, federal regulations required that U.S. Savings Bonds, which were community property, pass to the surviving spouse as co-owner. Texas community property law, at that time, did not recognize joint tenancy in community property. Conceding that federal law pre-empted, the state court required that the deceased wife's heirs had to be reimbursed for the loss of community interest in the bonds. The Supreme Court, finding that the wife's beneficiary should not be able to affect property interests indirectly that he could not affect directly, stated, "Viewed realistically, the State has rendered the award of title [under federal law] meaningless." *Id.,* at 669.

The *Boggs* Court then went on to note that whether the interest of Dorothy's beneficiaries is enforced against the plan or against the recipient of the benefits, the result is the same.[11] Returning to an earlier theme as to the purpose of ERISA, the Court notes that "ERISA is for the living." In summary, the Court says:

> It does not matter that respondents have sought to enforce their rights only after the retirement benefits have been distributed since their asserted rights are based on the theory that they had an interest in the undistributed plan benefits. Their state-law claims are pre-empted.

520 U.S. at 854.

D. **The Dissent**. As pointed out above, the dissent seems to perceive this case as one in which Sandra, a second wife of ten years, is taking something away from Dorothy, the first wife of thirty-six years. The dissent notes that Sandra is asking "the court to say that the shares of stock, the cash, and the annuity payments were entirely hers." 520 U.S. at 857. However, the facts are that Sandra received only a usufruct, with the three children receiving the naked ownership and that the suit by the respondents also asked for an accounting of the benefits received by Isaac during his life.

The dissent emphasizes strongly that this is not a lawsuit against a fund and speculates that the law of Louisiana would not allow such a suit and that this suit does not change the basic duties of a plan fiduciary. While citing *Ingersoll-Rand Co. v. McClendon,* 498 U.S. 133 (1990), the dissent misses the application of this case to the issue in *Boggs.* That case involved a suit for wrongful

[11] In a somewhat gratuitous, but realistic point, the Court says: "If the couple had lived in several states, the accounting could entail complex, expensive, and time-consuming litigation. Congress could not have intended that pension benefits from pension plans would be given to accountants and attorneys for this purpose." 520 U.S. at 853. Actually, the accounting litigation in this case promised to meet the three prong test of "complex, expensive, and time consuming."

discharge. The plaintiff alleged that he was discharged to prevent his pension benefits from vesting,[12] and the Supreme Court of Texas found that this action was not pre-empted by ERISA since the suit was a tort action against the company and was not a suit against the plan. The United States Supreme Court found that ERISA provided a remedy for wrongful discharge to prevent benefits from vesting and that without the existence of the plan, there would be no cause of action and that the wrongful discharge "related to" the plan.

The dissent continues, "The lawsuit before us concerns benefits that the fund has already been distributed; it asks not the fund, but others, for a subsequent accounting." *Id.,* at 862. What this approach ignores is that the funds were **not** distributed at the death of Dorothy Boggs, which is the relevant time for determining the rights of the parties. This differs from determining the value of the interest of a party after it has been determined what that interest is.

In one of the more enigmatic statements in the opinion, the dissent notes:

> Contrary to the majority's suggestion, Dorothy's children are not the equivalent of plan "participants" or "beneficiaries" see §§1002(7), 1002(8), any more than would be a grocery store, a bank, an IRA account, or any other recipient of funds that have emerged from a pension plan in the form of a distributed benefit, and no one here claims the contrary. Moreover, the children here are seeking an accounting only after the plan participant has died. But even were that not so, any threat the children's lawsuit could pose to plan administration is far less than that posed by the division of plan assets upon separation or divorce, which is allowed under §1056(d).

Id., at 862.

[12]Ironically, the plaintiff had worked sufficient hours in the year of his discharge to cause his benefits to vest.

With regard to the first sentence of that quotation, it is my reading of the majority opinion that the central point in one of their arguments is that the children are, indeed, neither "participants" nor "beneficiaries." Comparing the sons' request for an accounting and distribution of assets (whether directly traceable to plan assets or not), to the voluntary decision by a participant or beneficiary to spend (grocery store) or save (bank account or IRA) is misguided at best and specious at worst. No one has suggested that plan assets, once distributed to the appropriate distributee, should not be controlled by that distributee. In the community property context, the issue is the character of the property. The final sentence of the quotation also misses the point. It may be true that division on divorce is more burdensome to plan administration than an accounting action not involving a plan. However, Congress has specifically directed the division on divorce, and has <u>not</u> specifically directed that the non-participant spouse may dispose of an interest in the participant's plan, even in a community property state.

The dissent rejects the majority's reliance on ERISA's anti-alienation provision:

> The anti-alienation provision is designed to prevent plan beneficiaries from prematurely divesting themselves of the funds they will need for retirement, not to prevent application of the property laws that define the legal interest in those funds. One cannot find frustration of an "anti-alienation" purpose simply in the state law's definition of property.

Id., at 864. But, as the majority points out, it is not entirely logical that REA prohibits the participant from disposing of his or her interest in derogation of the rights of the non-participant, but Congress did not intend to afford similar protection to the participant. Inexplicably, the dissent proclaims that ERISA does not "restrict what Isaac can do with his pension funds after his death." That is precisely the focus of REA.

In dealing with the argument that Dorothy's transfer violates the anti-alienation clause "or some more general ERISA purpose," the dissent notes, "This argument...is beside the point, however, for the state law action here seeks an accounting that will take place after the death of *both* Dorothy and Isaac." (emphasis in original). *Id.,* at 865. There is no reason that the action had to be delayed until after Isaac's death if Dorothy indeed had an ownership interest in the plan by virtue of Louisiana's community property law. Why could the children not have challenged Isaac to account for the distributions of plan assets in excess of his usufruct interest? And surely, the legal principle is not changed had she not given Isaac a usufruct interest. In that context it becomes much more clear that, if community property law is not pre-empted, Dorothy's beneficiaries would have had a right to require an accounting as soon as any funds were distributed. In all probability, the reality is that the children were unwilling to confront dad with the claim that they had an interest in what he perceived to be his assets. However, there is no legal impediment to seeking an accounting before his death.

"I do not understand," says Justice Breyer,[13] "why or how ERISA could be concerned about Dorothy's creation of a will, which affected the retirement assets only after Isaac received them." *Id.,* at 865. This argument perforce proceeds from the proposition that ERISA prohibits suits against the plan to force distribution of benefits of the non-participant spouse's interest to her beneficiaries, but that a suit for an accounting is not prohibited once the benefits have been distributed to the participant or the participant's beneficiary. How is this possible? Dorothy either had a community interest at her death or she did not. This problem can be illustrated by an example. Suppose Isaac had become entitled to an in-service distribution under the terms of the plan, and Dorothy's will had devised her interest in the plan only to the children. If she had a devisable interest, could her beneficiaries not demand her portion of the benefits which Isaac could take but chose not to take?

[13]And I agree with him with respect to this opinion.

Noting that Congress specifically authorized the transfer of pension benefits to a divorced non-participant, Justice Breyer asks, "Why then, one might ask, would Congress object to court orders that transfer benefits ***to*** a former spouse after her death?" *(emphasis added.) Id.,* at 868. I could be mistaken, but I do not think the transfer which Justice Breyer seeks to authorize is **to** Dorothy, but rather **by** Dorothy. This is a distinction with a difference, because Dorothy is not deprived of any benefits during her life.[14] Justice Breyer goes on to note that she could have acquired her share of the pension benefits in a divorce and then she would be free to dispose of them at her death. Of course, the possibility also exists that she could live until those benefits were consumed, and then they would have fulfilled the announced Congressional purpose of REA in providing for the non-participant spouse.

The dissent's next argument is that Louisiana law might provide that the sons' interest does not have to be satisfied out of the pension benefits, but could be satisfied by other assets in Isaac's probate estate. This proposition flies directly in the face of the holding of *Free v. Bland, supra.* The balance of the dissent is devoted to the proposition that Congress in ERISA had no interest in dealing with other property of the community which might be used to satisfy the heirs of the non-participant spouse. This ignores the reality that it in effect forces the participant to purchase that which Congress set aside to him.

In attempting to make their result appear to be equitable to Sandra, the dissent says:

> In sum, an annuity goes to Sandra, a surviving spouse; but otherwise Dorothy would remain free not only to have,[15] but to bequeath, her share of the marital estate to her children. This reading of the relevant statutory provisions and purposes protects

[14]As one of my client's reminded me, "You never saw a hearse with a luggage rack."

[15]I suppose here the dissent is speaking existentially.

> Sandra, limits ERISA's interference with basic state property and family law, and minimizes the extent to which ERISA would interfere with Dorothy's pre-existing property.

Id, at 873. This seems to be a nice, neat formulation, but ignores the complexity of the reality. Sandra is protected only as to the annuity, but all of Isaac's probate estate may go to his children. It takes only a brief moment of consideration to foresee the expense and complexity of the state accounting action and the tracing problems over ten years.[16]

E. **The Remaining Problems**. While Boggs answers the pre-emption issue in general, the opinion does not make clear the scope of pre-emption. Nor does it deal at all with reporting issues on the federal estate tax return.

1. **Reporting Issue and Inclusion in Gross Estate**. The latter issue will be dealt with first, since it more easily lends itself to some concrete approaches if not concrete answers. After *Boggs,* what is to be reported on the federal estate tax return of the predeceasing non-participant spouse? Since the federal estate tax is an excise tax on the privilege of transferring property, it would seem that if the non-participant has no right to transfer, then there is nothing to report on the return.[17] My present view is that the non-participant's interest should not be included in the gross estate, but should be disclosed on the return. A more interesting issue is presented if the participant dies first. Is 100% included in the participant's estate? Logically, it should be if no interest is to be reported on

[16]Although a "taking" argument was raised in oral argument, that argument does not appear in either opinion until the penultimate paragraph of the dissent, and then only under a "Cf." to two cases. Evidently, the Court did not want to go down the slippery slope of taking by pre-emption in view of the argument that REA itself may well have been a taking.

[17]*See* Treas. Regs. §20.2033-1(a) which, while noting that federal government bonds which are exempt from income tax are not necessarily exempt from the estate tax, state, "...since such tax is an excise on the transfer of property at death and is not a tax on the property transferred."

the non-participant's return. In recent conversations, Treasury has indicated that it is strongly considering promulgating a position that comports with the above -- No inclusion on the non-participant's spouse's return but 100% inclusion on the participant's return. However, Treasury has never provided such guidance.

Additionally, the inclusion or non-inclusion will affect percentage tests such as §6166, 2032A, *etc.*

Is this entire question as to the non-participant spouse's interest academic? After all, even if the non-participant's interest is included in the gross estate, surely it qualifies for the marital deduction because it "passes" by operation of law to the participant. But the non-participant's interest is a classic terminable interest.[18] Even if true, the Service has not been disallowing the marital deduction in a case like this. IRC §2056(b)(7)(C) was amended by inserting the parenthetical phrase "(or in the case of an interest in an annuity arising under the community property laws of a State, included in the gross estate of the decedent under section 2033)" to make clear that the non-participant's interest, if passing to the participant, qualifies for the marital deduction. While some consideration was given to deleting this provision from the Bill in light of *Boggs,* it was decided that there may still be situations in which this problem exists; *e.g.*, §403(b) plans and individual retirement annuities. The committee reports were to make clear that this section is not intended to override *Boggs,* but no such provision was inserted.

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[18]IRC § 2039(c), prior to its repeal by the Tax Reform Act of 1986, provided that any interest of a non-participant spouse in a retirement plan, which interest was obtained solely as a result of community property law, was not includable in the estate of the non-employee spouse upon such spouse's death. The result of the repeal of this section prior to *Boggs* was thought to be that the one-half community interest of the non-employee spouse is includable in that spouse's estate if the non-participant spouse predeceases the participant. The Senate explanation of the repeal states, "However, the bill clarifies that, if a transfer is made to an employee spouse by a non-employee spouse in a community property state, the amount transferred is eligible for the unlimited marital deduction (§§2056 and 2523)." No such provision was to be found anywhere in the statutes and no subsequent tax law (of which there have been many) corrects this oversight, except TAMRA's amendment to §2056(b)(7) which is limited to joint and survivor annuities.

2. **Application to IRAs.** It is still uncertain whether the *Boggs* opinion would apply to an interest rolled over to an IRA before the death of the non-participant spouse. While the opinion talks in terms of "undistributed" benefits, it is not at all clear that such benefits suddenly transmute to community property upon distribution. In fact, the Court itself specifically declines to deal with this issue:

> Both parties agree that the ERISA benefits at issue here were paid after Dorothy's death, and thus this case does not present the question whether ERISA would permit a non-participant spouse to obtain a devisable community interest in benefits paid out during the existence of the community between the participant and that spouse.

Boggs, 520 U.S. at 845. Further, the Court, as noted earlier, concludes its opinion with this comment:

> It does not matter that respondents have sought to enforce their rights only after the retirement benefits have been distributed **since their asserted rights are based on the theory that they *had* an interest in the undistributed pension plan benefits.** (emphasis added)

Id., at 854.

The Court could arguably be saying that if the benefits can be traced to the qualified plan, the non-participant never had a community interest in those assets and thus one could not suddenly arise. The result depends upon the view taken of the meaning of "pre-empted."

One viewpoint (and I suspect that this is the one of majority of community property lawyers) is that the essential character of the property as community property inside the plan is unchanged, and that what was pre-empted was only the non-participant spouse's ability to dispose of the assets at such spouse's death. Thus, when the assets emerge from the plan, they are community property freed of the restriction on the non-participant spouse's right to transfer. An argument has also been made, though I do not believe it to be valid, that the assets in the plan are compensation, and thus, once out of the plan, are community property.

The other argument, somewhat supported by the above quoted language from the Supreme Court's opinion, is that the community character of the property itself is pre-empted. Thus, when classic community property analysis is applied, if the asset was not community property inside the plan, it cannot suddenly "transmute" (absent an agreement in those states which permit such agreements) to community property. In other words, If it was not community property inside the plan, how can it be community property when it comes out of the plan? And this would seem to apply even if the assets were distributed outright (rather than in an IRA) so long as the proceeds can be traced.

While a literal reading of the statutes and *Boggs* might favor the construction that distributions from the plan are <u>not</u> community property, the result is likely to be that the distributed property will be treated as community property. One argument is that the federal purpose has been satisfied once the assets are distributed. The response to that is that the same policy should apply whether the assets are in the plan or not. The more persuasive argument, however, comes after some reflection. Since IRAs are not covered by ERISA, then the character of property, once distributed (whether in an IRA or not) is a state law question. The state courts are very likely to protect the state community property law, and to hold that the assets, outside the plan, are community property.

Of course, even if the assets themselves are not community property, the earnings on the assets, will be community property in Texas and Idaho. This would include assets distributed to a rollover IRA unless IRC §408(g)[19] applies. I have long believed that the purpose of this income tax section is to prevent couples in a community property state from double-dipping, by attributing one-half the earnings of the working spouse to the non-working spouse so that two IRAs could be established. (This belief has been confirmed by one Treasury staffer who was responsible for drafting this provision.) However, counsel for the petitioner in *Boggs* believes that the scope of the section is much broader.

3. **Application to §403(b) Plans.** A subset of this problem is the treatment of government plans, church plans and Code §403(b) plans. ERISA provides in §514(a):

> ...[T]he provisions of this title and title IV shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan described in section 4(a) and not exempt under section 4(b).

While church plans and governmental plans are clearly exempt under ERISA §4(b), it is not clear whether Code §403(b) plans are included under ERISA §4(a). Since this is the only preemption language in ERISA, these plans may not to be covered by *Boggs.* However, the majority apparently did not rely on ERISA §514(a), but rather on traditional field and/or perhaps conflict pre-emption. So the question remains whether *Boggs* applies to government plans or Code §403(b) plans.

F. **Conclusion.** *Boggs* has now clarified that assets inside a qualified plan are not subject to community property laws. It has left unanswered the question as to how to deal with that interest for federal estate and gift tax purposes. More importantly, it has not explicitly answered the question as to whether the assets, once distributed, are community property and as to the precise

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[19] §408(g) states: "This section will be applied without regard to community property laws."

scope and breadth of ERISA's preemption.

III. COMMUNITY PROPERTY ISSUES AT DEATH

A. **Basic Assumption.** Non-rollover IRAs are clearly community property, but except in extremely unusual circumstances, such IRAs are not generally large enough to generate serious tax issues. Therefore, the following discussion assumes a rollover IRA, and also assumes that the rollover is community property, the uncertainty of such characterization of *Boggs* notwithstanding.

B. **Non-Participant Spouse Issues.** The participant's spouse may predecease the participant, in which case problems may arise if this situation is not dealt with. It is clear that the IRA is community property and that the NPS has an interest in that IRA.

1. **Gift in Will to Participant.** It seems well settled that the NPS can leave the NPS's interest in the participant's IRA to the participant by Will. *Allard v. Frech*, 754 S.W.2d 111 (Tex. 1988), *cert. den*. 488 U.S. 1006, 109 S.Ct. 788 (1989). This resolves any issues as to treatment of the beneficiary since the participant becomes the only one with any interest in the IRA. It is doubtful that a gift to a QTIP trust would accomplish the same thing even if the participant is the trustee.

2. **Gift to Other than Participant**. It also follows from the holding in *Allard*, that someone other than the participant can be the beneficiary of the NPS's interest. If someone other than the spouse is the beneficiary, then there are many problems and few answers. One would think that there would be clear authority as to the taxation of distributions to the NPS's beneficiaries other than the participant.

C. **PL8040101.** The only direct authority dealing with the passage of an IRA at death is a

1980 private letter ruling, PLR 8040101 (7/15/1980). In that PLR, the Service ruled that the NPS's community interest was transferable to the NPS's beneficiaries and that the distribution was taxable to the beneficiaries. Even though that PLR has stood a long time without challenge, it cannot be fairly assumed that it is the law, if only because of the statutory directive that PLRs are not precedent and do not bind the Service. The ruling does not answer serious questions as to the NPS's beneficiaries: Can they take distributions over their life expectancy, over the participant's life expectancy, under the 5 year rule, or only as a lump sum. Additionally, the §72(t) penalty should not apply because the interest was acquired at death, but there is no real answer.

D. **Indirect Contradictory Authority.** In *Bunney v. Commissioner,* 114 T.C. 259 (2000), an IRA was divided in a divorce settlement as permitted by Code §408(d)(6). However, instead of delivering one-half of the IRA account to his wife, husband withdrew money and delivered part of that to his wife. The court held that the amount withdrawn was taxable on husband's return (and subject to the §72(t) penalty). In analyzing the case, the court discussed Code §408(g) and determined that the fact that the distribution was community property made no difference – it was nonetheless taxable to the husband-distributee. While there is language indicating that the Tax Court would treat payment to the NPS's beneficiaries the same way, they were not faced with such issue directly. In PLR 9439020, the IRS recognized the community character of an IRA, but stated that a distribution of the NPS's interest to other than the owner, may be a prohibited transaction under IRC §4975(c). *See also* PLR 199937055 treating a division of community property IRAs so that half was distributed to an IRA in NPS's name as a distribution taxable to the participant.

E. **A Recent Example of How to Plan (Or Perhaps Not).** In PLR 200826039 (6/27/2008), the decedent, a participant in two qualified plans, had not reached his RBD. His wife was the executor and testamentary trustee under his Will and was named as beneficiary in her capacity as trustee. The will provided that if Wife had an ownership interest in the qualified plans, then such interest was to be paid to her to the extent it did not pass to her under the beneficiary designation, and the balance was to pass to the Bypass Trust, over which wife had power to make distributions of income and principal for health support and maintenance. The Service ruled that the wife had a community property interest which passed to her under the provisions of the Will and was eligible for a rollover to her IRA. Further, in keeping with the Service's very liberal attitude concerning rollovers where the spouse as fiduciary has discretion as to distributions to spouse as beneficiary, the Service ruled that the interest passing to the Bypass Trust could be distributed to the spouse and rolled over to her IRA. <u>INSERT CITES HERE.</u>

1. **Some Unanswered Questions.** Under the analysis of *Boggs,* there would seem to be a serious question as to whether the wife had an ownership interest in the qualified plan. However, that seemed to be of no concern to the IRS, raising the question as to whether *Boggs* has any application in the absence of a dispute as to the rights of the NPS.

2. **Why Make It so Hard?** Decedent could have named his spouse as beneficiary with a power to disclaim and achieved the same result much more easily and directly.

IV. AGGREGATE VERSUS INDIVIDUAL ASSET THEORY. There are two basic theories in dealing with community property. In the aggregate approach, the community is treated as a collection of assets in which each spouse owns an undivided interest in the whole without regard to owning interests in each individual asset. California has adopted a statutory resolution adopting the aggregate theory. This solution assumes that there is sufficient community property outside the IRA so that, in a non-prorata distribution of the community, there are sufficient assets that may be disposed of by the NPS to allow the entire IRA to be allocated to the IRA owner.

A. **Written Agreement Between Spouses.** California Probate Code §100 provides:

(a) Upon the death of a married person, one-half of the community property belongs to the surviving spouse and the other half belongs to the decedent.

(b) Notwithstanding subdivision (a), a husband and wife may agree in writing to divide their community property on the basis of a non pro rata division of the aggregate value of the community property or on the basis of a division of each individual item or asset of community property, or partly on each basis. Nothing in this subdivision shall be construed to require this written agreement in order to permit or recognize a non pro rata division of community property.

Thus, the spouses, by written agreement can allow the executor of the predeceased spouse to divide the community to be divided on an aggregate as opposed to an undivided asset by asset basis. (The last sentence allowing a non-prorata distribution in the absence of an agreement is a bit confusing.)

B. **Trust as Written Agreement.** Cal. Prob. C. §104.5, provides that a transfer of community property to a revocable trust is presumed to be an agreement under §100 and that those assets retain their character *in the aggregate* for purposes of any division provided in the trust.

C. **Does This Work in Other Jurisdictions?** As many questions as California's solution raises, there is no statutory authority in other jurisdictions which would support this approach. However, there would appear to be very good arguments if this type of solution was available in revocable trusts in other states. After all, a joint revocable trust is an agreement between spouses. There are some conceptual difficulties sine the IRA is not actually contributed to the trust, but the argument that the beneficiary designation us sufficient seems reasonable. And, if the spouses in community property states can alter the system as between separate and community property, the spouses should be able to agree as to the aggregate disposition of assets.

CREDITOR'S RIGHTS

I. **BAPCPA**. The Bankruptcy Abuse Prevention and Creditor Protection Act ("BAPCPA") contains provisions relating to retirement benefits, creating several new exemptions which apparently override state law exemptions, even if such exemptions are elected, as well as providing new federal exemptions. It provides a huge liberalization in the protection of qualified plans, IRAs and some non-qualified plans by providing ***exemptions*** from the bankruptcy estate. As a reminder, it should be noted that **this protection is available only in the context of a bankruptcy proceeding, and does not affect the rights of creditors in other contexts.**

A. **Governing Law Prior to BAPCPA.**

1. ***Patterson v. Shumate.***[20] After many years of wrangling over the status of qualified plans in bankruptcy, the Supreme Court finally settled the issue as to plans which were subject to the anti-alienation clause of ERISA.[21] The Supreme Court decided that ERISA was "applicable non-bankruptcy law,"[22] and thus retirement plans were *excluded*

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[20] 504 U.S. 753 (1992).

[21] 29 U.S.C. §1056(d)(1) [ERISA §206(d)(1)]

[22] Bankruptcy Code §541(c)(2). "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title."

from the bankruptcy estate. Some lower courts have tried to limit the applicability of this case by considering whether the plan in question met the qualifications of ERISA and the Internal Revenue Code. This case does not apply to situations in which the business owner and the business owner's spouse were the only participants in the plan.

2. ***Rousey v. Jacoway*.** On April 4, 2005, the Supreme Court issued its opinion in *Rousey v. Jacoway,* opinion by Mr. Justice Thomas. In that case, the Court resolved a conflict among the circuit courts as to whether the exemption from the bankruptcy estate in 11 U.S.C. §522(d)(10)(E) [the "(d)(10)(E) exemption"] applied to IRAs. The (d)(10)(E) exemption provides an exemption for:

> a payment under a stock bonus, pension, profit-sharing, annuity, **or similar plan or contract on account of** illness, disability, death, **age** or length of service, **to the extent reasonably necessary for the support of the debtor** and any dependent of the debtor.... (emphasis added)

There are several things which should be noted about this exemption. First, it is available only if the debtor does not claim state law exemptions, which are much more liberal in many cases. Second, the exemption is limited to the amount necessary for the support of the debtor. Third, although it remains in the Bankruptcy Code, its efficacy is somewhat questionable in that it is effectively overridden for all practical purposes by the new exemption in §522(d)(12) added by BAPCPA.

The Court decided that an IRA[23] was similar to the types of plans enumerated in

[23] The IRA in this case was a rollover, but I do not think that is relevant.

§522(d)(10)(E) in that in each case the plan "provide[s] income that substitutes for wages earned as salary or compensation." Further, the Court determined that the 10% early withdrawal penalty was not insubstantial (noting that they need not decide whether a lesser penalty would be) and thus distributions were made on account of age, unlike those from a simple savings account which could be accessed penalty free without regard to age. The Court engaged in further analysis to support its conclusion, but in light of BAPCPA, the continuing importance of this opinion is questionable.[24]

B. **BAPCPA Benefits Exempted Under State Exemption Election.** Under BAPCPA, §522(b)(1) allows debtors to elect between federal exemptions under §522(b)(2) and state law exemptions under §522(b)(3). There are three exemptions in §522(b)(3), and they are listed in the **conjunctive**. If the state exemptions are elected, §522(b)(3)(A) exempts property that is exempt under federal law other than under §522(d) and state or local law of the debtor's domicile, §522(b)(3)(B) retains the existing exemption for joint tenancy and tenancy by the entirety property, **and** §522(b)(3)(C) exempts "retirement funds" to the extent those funds are in a fund or account that is exempt from taxation under sections 401 [a qualified pension, profit sharing or employee stock bonus plan established by an employer for the exclusive benefit of the employees], 403 [qualified annuity plans established by an employer for an employee], 408 [IRA], 408A [Roth IRA], 414 [retirement plans for controlled groups], 457 [eligible deferred compensation plans maintained by an eligible employer for an eligible employee], or 501(a) [retirement plans by qualified charities] of the Internal Revenue Code."

1. **Apparently Additional Exemption.** It would seem that because §522(b)(3) is written in the conjunctive, that a debtor claiming state law exemptions would have

[24] In *Patterson v. Shumate, supra*, the Court had stated in dictum: "Although a debtor's interest [in an IRA] could not be excluded under §541(c)(2)..., that interest could nevertheless be exempted under §522(d)(10)(E)." *Id*, *762-763.*

available to the debtor the greater of the (3)(C) exemption or the exemption of qualified plans and IRAs under state law. There does not appear to be any sort of preemption of state law, which could easily have been done. Thus, if a debtor elects state exemptions, and the state law provides little or no shelter for retirement benefits, the federal exemption would protect the plans.

a. **Based on Tax Qualification.** While the exclusion provided under *Patterson v. Shumate* was based on the application of ERISA, Title I, the (3)(C) exemption is based only on tax qualification under the enumerated sections of the Internal Revenue Code. BAPCPA also provides a method for determining whether the plans meet the qualifications of those sections.[25]

(1) Subsection (A) creates a presumption that plans which have received a favorable determination under IRC §7805, which determination is still in effect at the date of filing the bankruptcy petition, are exempt under §§522(b)(3)(C) and 522(d)(12).

(2) Subsection (B) provides that, even if there is no favorable determination under §7805, those funds **are** exempt if the debtor demonstrates that (x) no prior determination to the contrary has been made by a court or the IRS, and (y) the retirement fund is in substantial compliance with the IRC, or (z) if not in substantial compliance, the debtor is not materially responsible for that failure. Note, curiously

25 Bankruptcy Code §522(b)(4).

enough, that in the case of a plan which has not received a favorable determination, such plan **will** still be exempt if it meets the other requirements of (B), while a plan that has a received a favorable determination is only entitled to a presumption.

(3) Subsection (C) provides that direct trustee to trustee transfers will not cause a loss of the (b)(3)(C) or (d)(12) exemption (discussed below).

(4) Subsection (D) states that a qualified rollover will not cause a loss of the exemption.

C. **New Federal Exemption.**[26] A new exemption is created if the federal exemptions are elected. This exemption is identical to the §522(b)(3)(C) exemption and applies to:

> (12) Retirement funds to the extent that those funds are exempt from taxation under sections 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.

With the addition of this paragraph, it is difficult to understand the need for the §522(d)(10)(E) exemption, which was the subject of *Rousey v. Jacoway, supra*. Even with the $1,000,000 limitation on the exemption for non-rollover IRAs and Roth IRAs (discussed below), the relief under (d)(12) would seem to be so much more liberal than the "need of the debtor" requirement in the (d)(10)(E) exemption that the latter section is unnecessary.

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26 Bankruptcy Code §522(d)(12).

D. **Limitation on Exemptions.**[27] The blanket exemptions which (3)(C) and (d)(12) would appear to grant, are subject to a limitation which reads:

> (n) For assets in individual retirement accounts described in section 408 or 408A...other than a simplified employee pension under 408(k)...or a simple retirement plan under 408(p)..., the aggregate value of such assets **exempted under this section**, without regard to amounts attributable to rollover contributions under section 402(c), 402(e)(6), 303(a)(4), 403(a)(5) and 403(b)(8)...and earnings thereon, shall not exceed $1,000,000 in a case filed by a debtor who is an individual, except that such amount may be increased if the interests of justice so require. (Emphasis added).

1. **Plans Affected by Limitation**. The $1,000,000 limitation is apparently designed to apply to other than employer plans and rollovers from employer plans to IRAs; *i.e.,* to individually established IRAs and Roth IRAs. A rollover consists of a distribution to the participant followed by a contribution within 60 days to another tax exempt plan. Without the rollover provisions, the initial distribution would be taxable to the participant irrespective of what the participant did with the money. The exemption for a rollover is defined by reference to specific Internal Revenue Code sections, which sections do not include rollovers from one IRA to another under IRC §408(d)(3). The apparent result of this is that an IRA rolled over to another IRA will be subject to the $1,000,0000 limitation, while a rollover from an employer plan to an IRA would not. This should not be the case if the funds in the original IRA were rolled over from an employer plan and thus were exempt from the limitation in the original IRA. Note that limitation applies only to rollovers, and the issue of an IRA to IRA rollover can be

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27 Bankruptcy Code §522(n).

avoided by the use of a trustee to trustee transfer, which, unlike a rollover, is not treated as a distribution.[28] However, this technique cannot exempt an IRA originally subject to the limitation.

2. **Applicability to State Law Exemptions.** If state law exemptions are elected and provide unlimited exemptions for IRAs, a question arises whether the highlighted language in §522(n), *supra,* applies only to the (3)(C) exemption or whether it also applies to limit the state law exemptions under (3)(A). Certainly there is an argument that the (3)(C) exemptions are the assets "exempted under this section" and that the state law exemptions are not limited since the exemptions, as pointed out earlier, are in the conjunctive. On the other hand, the phrase may be interpreted as applying to all of §522. However, given the effect of the limitation, this question would appear more academic than real, unless the IRA contains an "explosive" asset.

3. **Applicability to Federal Exemptions.** The limitation clearly applies to the (d)(12) exemption (and presumably, [but who cares?] to the (d)(10(E) exemption also.)

4. **Application of Limitation**. In the real world, this limitation would appear to have little effect, except in the event that a rollover IRA is commingled with a non-rollover IRA.

a. **Adjusted for Inflation.** The amount of the limitation is adjusted for inflation under Bankruptcy Code §104. Given the limitations on contributions to IRAs and Roth IRAs, it is almost mathematically impossible to accumulate more than $1,000,000 in an individually established IRA, particularly given the increase in the limitation due to inflation.[29] A person who began making

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28 Rev. Rul. 78-406, 1978-2 C.B.

29 As in every case, there are exceptions that prove the rule. Occasionally, an IRA will invest in an asset which skyrockets in value, and, in that case, the conventional IRA could exceed the $1,000,000 limit.

maximum contributions 30 years ago would have contributed less than $70,000 to the IRA. It would have taken greater than a 15% compound annual return to reach $1 million.

b. **<u>IRAs Are Commingled</u>**. If the IRA is a commingled IRA, is tracing available to segregate the rollover portion (and its earnings) from the non-rollover portion so that the limitation does not somehow get exceeded by the rollover portion? There is no answer to this in the Act, but certainly it would be worth a try.

5. **<u>Discretionary Increase in Amount of Limitation</u>.** It is most mystifying under what circumstances the "interests of justice" would require an increase in that amount. Perhaps this could refer to a situation in which a rollover IRA also has contributions, therefore taking it out of the safe harbor. If it could be shown that the contributory portions (including earnings on that portion) were less than $1,000,000, then arguably there would be a reason to raise the limitation. Obviously, to the extent possible, rollover IRAs and contributory IRAs should be kept separate.

E. **Rollovers and Trustee to Trustee Transfers.** As a general rule, neither the transfer from one exempt plan to another nor a qualified rollover distribution will cause a loss of the (3)(C) or (d)(12) exemption.[30]

1. **<u>Spousal Rollovers</u>.** There are still (surprise!) some important questions left. Is a spousal rollover under Treas. Regs. §1.408-8, A-5 subject to the §522(n) limitation? The better argument is that it should not be if the account from which it is rolled over was protected as a rollover or a plan for which there is an unlimited exemption. If the spousal rollover is from an IRA which is not a rollover, it should be subject to the same $1,000,000 limitation. This would,

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[30] Bankruptcy Code §§522(b)(4)(C) and (D).

it seems be consistent with the treatment as an inherited IRA which should retain its exemption from the §522(n) limitation because there has been no change other than the distributee.

2. **Inherited IRAs.** As discussed below, BAPCPA leaves open the issue of an inherited IRA, one in which the beneficiary of the IRA is not the spouse or the spouse does not elect to treat the IRA as his or her own. For purposes of this discussion, this would also include a non-spousal rollover from a qualified plan. In that case, does this asset still enjoy the (3)(C) and (d)(12) exemption if the beneficiary is adjudicated a bankrupt? The statute makes no distinction with respect to the beneficiary, but at least one commentator has raised the issue as to whether such funds are "retirement funds" (the asset which is described as exempt) in the hands of the beneficiary.

II. INHERITED IRAS.

Many, but not all states, have statutes exempting IRAs from claims of creditors.[31] While it is clear that such protection extends to the IRA owner and the IRA owner's spouse, it is not clear whether such statutes extend to inherited IRAs. This is important not only in state law proceedings, but also in bankruptcy. As, noted above, state law exemptions are available in bankruptcy and only if they fail is there need to resort to BAPCPA. Several new bankruptcy cases have cast doubt upon the efficacy of such state law protection for a beneficiary's interest in inherited IRAs.[32] One of these cases is an unpublished Texas case which discusses and analyzes many of the other cases. *In re Jabroe,* 2007 WL 987314 (Bkrtcy. S.D. Tex. 2007).

A. CONSTRUCTION OF STATE STATUTES.

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[31]Some states provide total protection for IRAs, while other states limit the protection. For a table of state laws see http://www.assetprotectionbook.com/s1_asset_protection_state_resources.htm.

[32]*See In re Navarre*, 332 B.R. 24 (M. D. Ala. 2004); *In re Greenfield,* 289 B.R. 146 (S.D. Cal. 2003); *In re Taylor*, 2006 W.L. 1275400 (Bkrtcy. C.D. Ill. 2006); *In re Sims*, 241 B.R. 467 (N.D. Okla. 1999); *In re Kirchen*, 344 B.R. 918 (E.D. Wisc. 2006).

1. ***In re Jabroe.*** Texas Property Code §42.0021 exempts a debtor's interest in an IRA with the following language: "[A] person's right to the assets held in . . . any individual retirement account . . . is exempt from attachment, execution, and seizure for the satisfaction of debts unless the plan, contract, or account does not qualify under the applicable provisions of the Internal Revenue Code." Many state statutes granting exemptions to IRAs rely on Internal Revenue Code qualification as the linchpin for such exemption. The *Jabroe* court, as well as the other courts considering this issue, focused on the differences between an inherited IRA and a participant or spousal IRA. Among these are the inability of the beneficiary (1) to contribute to the IRA, (2) to rollover the IRA to another plan, and (3) to wait until 70-1/2 before being required to take distributions. While these are valid distinctions, there is a serious question whether they prevent the inherited IRA from qualifying as such "under the applicable provisions of the Internal Revenue Code." In fact, the Code still treats the inherited IRA as tax deferred and subject to the RMD rules (albeit that the required beginning date is December 31 of the year following the year of the participant's death).[33]

2. ***In re McClelland***. *McClelland* , 2008 WL 89901 (Idaho Bankruptcy Court). Idaho is a community property state so that both spouses filed. Mrs. McClelland was the sole named beneficiary of her aunt's IRA. After transferring IRA custodians, Mrs. McClelland annuitized the IRA. (*See* discussion of amusing facts below.) She claimed the IRA as exempt, and the Trustee in bankruptcy objected. The Court construed Idaho Code §11-604A, which reads in relevant part as follows:

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One of the more amazing facets of *Jabroe* is that the debtor argued that §829 of the Pension Protection Act (dealing with non-spousal rollovers) indicated that the IRA was exempt, he failed to argue the exemption for IRAs in bankruptcy §522(b)(3)(C) created by the Bankruptcy Abuse Prevention and Creditor Protection Act of 2005 (effective a year before the bankruptcy filing). However, the language of that section exempts "retirement funds to the extent those funds are in a fund or account that is exempt from taxation under sections...408...of the Internal Revenue Code." Some commentators have suggested that inherited IRAs are not "retirement funds" and that argument would be consistent with the reasoning in *Jabroe* and similar cases.

(1) It is the policy of the state of Idaho to ensure the well-being of its citizens by protecting *retirement income* to which they are or may become entitled....

(3) The right of *a person* to a pension, annuity, or retirement allowance or disability allowance, or death benefits, or any optional benefit, or any other right accrued or accruing to any citizen of the state of Idaho under any employee benefit plan, and any fund created by the benefit plan or arrangement, shall be exempt from execution, attachment, garnishment, seizure, or any other levy by or under any legal process whatever....(4) For the purposes of this section, the term "employee benefit plan" means: ...

(b) Any plan or arrangement, whether funded by a trust, an annuity contract, an insurance contract, or an individual account, that is described in sections 401(a), 403(a), 403(b), *408*, 408A or 457 of the Internal Revenue Code of 1986, as amended, or section 409 of the Internal Revenue Code as in effect before January 1, 1984....

(5) An employee benefit plan shall be deemed to be a spendthrift trust, regardless of the source of funds, the relationship between the beneficiary and the trustee or custodian of the plan, or the ability of the debtor to withdraw, borrow, or otherwise become entitled to benefits from the plan before retirement. (Emphasis added.)

a. The court decided that "the Legislature painted with a broad brush" in creating this exemption. Looking at the policy to protect "retirement income" for any citizen of Idaho, the court refused to engraft a requirement that the person exempt be the participant or owner. Then, looking to the broad definition of "employee benefit plan", the court determined that Mrs. McClelland's aunt's "account was an 'employee benefit plan' for purposes of Idaho Code §11-604A."

The court acknowledged the adverse decisions in other jurisdictions, while simultaneously relying on the fact that the Idaho statute include §408 plans. In many of the other decisions, the courts had gone to great lengths to explain why an inherited IRA was not a §408 plan, primarily because the beneficiary could not contribute to it.

b. **<u>The Facts – Saved by Bad Advice</u>** After her aunt's death, Mrs. McClelland contacted Westmark Credit Union (the custodian) and requested a complete distribution of the IRA to set up "a separate savings account." The assistant manager informed Mrs. McClelland that she would have to pay income tax on the entire IRA <u>and would be subject to a penalty for early withdrawal</u>! Despite the described adverse tax effects, Westmark 'refused' to give her the funds. So, Mrs. McClelland established an account in another institution styled "Debra J. McClelland ABO Carol Morrow." In that account she purchased the annuity.

To compound matters, the court noted that the advice concerning the early withdrawal penalty was erroneous, and then continued:

> The rules pertaining to distribution upon the death of an IRA owner are set out in C.F.R. 1.408-2. Under these regulations, the entire balance of the IRA ""must, within 5 years after [Carol Morrow's] death ... be distributed or applied to the purchase of an immediate annuity for [the] beneficiary ... which will be payable for the life of such beneficiary ... and which annuity contract will be immediately distributed to such beneficiary." 26 C.F.R. 1.408-2(b)(7)(i). If a beneficiary elects to purchase an annuity in accordance with these rules, the entire balance will not be included in gross income of the beneficiary upon distribution, but rather will be taxed as distributions are received by the beneficiary in accordance with section 1.408-4(e). *Id*

B. **SOME SUGGESTED SOLUTIONS.** If asset protection planning for subsequent beneficiaries is an important consideration, then there are some steps that can be taken to attempt to provide protection.

1. **<u>Pay Benefits to a Spendthrift Trust</u>**. Protection may be provided by paying such benefits to a spendthrift trust which meets the requirements of a DB. The trust should be excluded from the bankruptcy estate under 11 USC §541(c), and reliance on exemption for inherited IRAs is unnecessary. The trust cannot be a conduit trust or creditors will be allowed to reach the amounts that are required to be distributed to the beneficiary. This, of course, raises all of the difficulties in assuring that the primary beneficiary is a DB and the measuring life. If the trust is a support trust, amounts paid to the beneficiary are subject to claims of creditors. Thus a facility of payments clause should be used. Some commentators have suggested that a subtrust under a traditional spendthrift trust may not work (although the authors are not certain why). They advocate a separate trust to receive the benefits.

2. **<u>Use a Trusteed IRA</u>.** Instead of a custodial IRA with a trust as beneficiary, the IRA itself can be a trust. This avoids complying with all the rules of qualifying a trust as beneficiary, but does not avoid the rules surrounding determination of whether there is a designated beneficiary and who is the measuring life. Again, a conduit trust cannot be used. Trusteed IRAs are not very common, and persuading a corporate fiduciary to allow the participant to alter the terms of their trust may not be easy, but it can be done, and should be considered.

C. **<u>Some Policy Thoughts</u>.** Most believed that state exemption statutes extended to inherited IRAs, and it may well be that the state courts would reach such a result. However, the policy argument in protecting IRAs is that creditors should not be allowed to reach retirement benefits of an owner or the NPS. However, these funds are clearly not set aside for the retirement of the beneficiary, and are, because of the ability to cash out (which over 75% do) no different than a bank account. Even though this is a particularly difficult asset with which to deal, if the owner wishes to protect those benefits, the owner can use a spendthrift trust or trusteed IRA.