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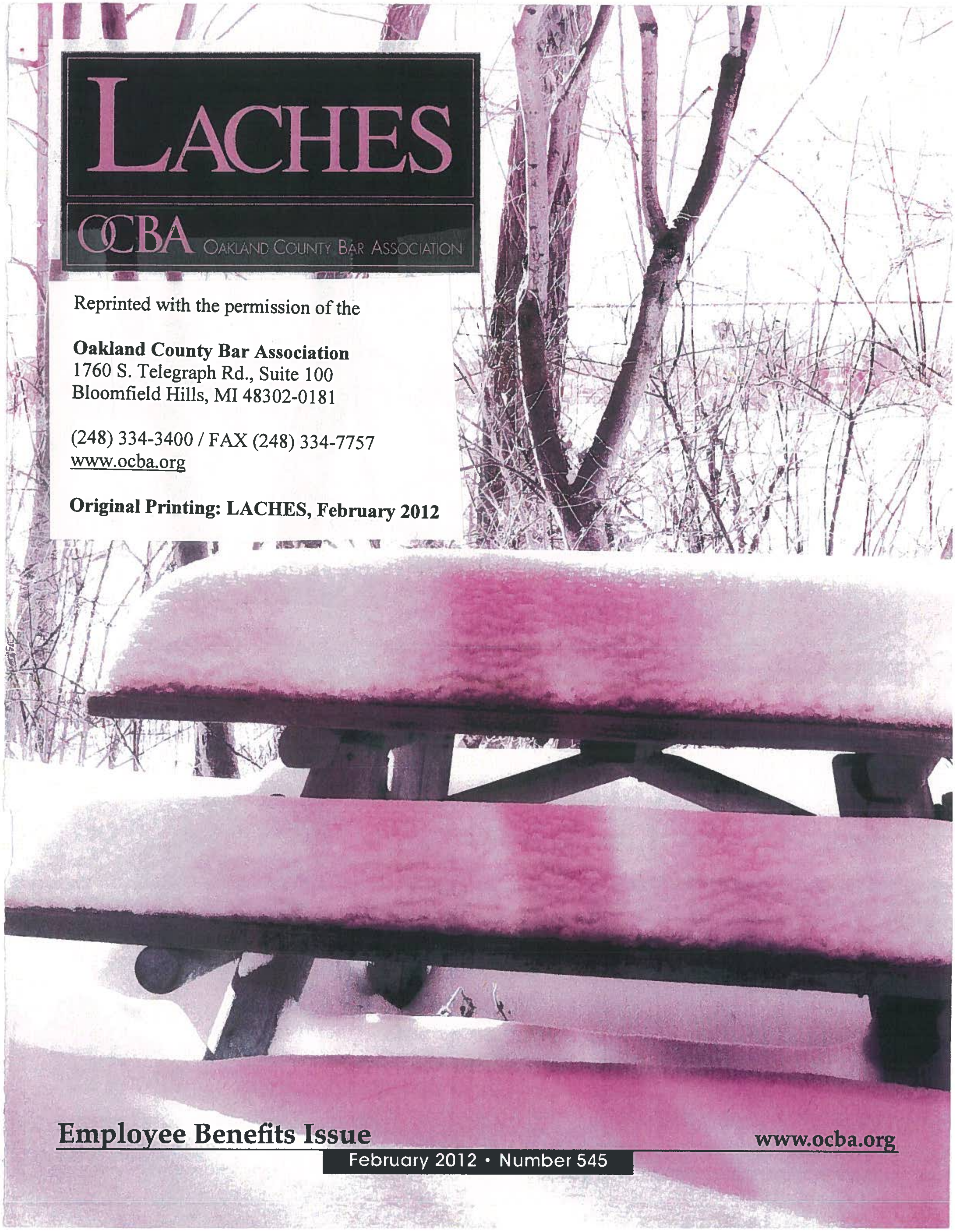

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Feature Article

"But I Thought My IRA Was Protected From My Creditors"

by Kalman G. Goren

Only an Ebenezer Scrooge[1] wakes up thinking, "How can I avoid my creditors?" But the question often comes up when clients are concerned about their real or possible liabilities. A quick glance at the Michigan statutes[2] would lead one to believe that payments made from an Individual Retirement Account/Individual Retirement Annuity ("IRA") to the original account owner or beneficiary, as well as benefits paid by tax-qualified retirement plans, are beyond the reach of judgment creditors. The only statutory exceptions would appear to be court orders for divorce or separate maintenance, child support arrearage, or contributions to the IRA that exceed the Internal Revenue Code ("IRC") Section 408 deductible amount – $5,000 for 2012 (plus the "catch-up contribution" of $1,000 for those who attain age 50 or older in a particular year).[3] The Michigan statute even appears to go so far as to protect rollovers of "tax-exempt retirement plans" from claims of creditors.[4]

This section initially appears to exempt interests in retirement plans that are "qualified" under IRC Section 401. Creditor protection for 403(b) annuities depends on whether there are employer contributions from a non-profit employer.[5] Essentially, the Michigan creditor protection of 403(b) annuities applies only to 403(b) annuities that are subject to ERISA, such as employer contributions that are made by a non-profit (not a governmental employer) tax-exempt entity. The exemption would also appear to apply to debtors who file for creditor protection as permitted by 11 U.S.C. 522(b)(2) – participants in plans that are tax-exempt under IRC 401, 403, 408, 408A ("Roth IRAs"), 414 (multiple-employer plans but not collectively bargained multi-employer plans), 457 (deferred-compensation plans of state and local governments and tax-exempt organizations) or 501(a) (tax-exempt organizations).

One could even conclude that the double negative in M.C.L.A. 600.6023(1)(k)(iii), cited in Footnote 4, means that a "rollover from a tax-qualified pension or profit-sharing ... or other plan that is qualified under 401 of the Internal Revenue Code of 1986, or an annuity contract under Section 403(b) of the Internal Revenue Code of 1986" is protected from creditors' claims.

Again, a quick review might lead one to conclude that even the payments to the account holder or their beneficiaries are protected from claims of creditors. But this is an area where state statutes and federal bankruptcy laws intersect and even collide.[6]

Before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)[7], debtors who wanted to exempt their IRAs and the right to receive payments from their IRAs either used the federal exemption in 11 U.S.C. 522(d)(10)(E) or, in states like Michigan that opted out of the federal exemption process, looked to statutes like M.C.L.A. 600.6023(1)(k).

Enter the U.S. Supreme Court, in *Rousey v. Jacoway*,[8] holding that IRAs were "similar plans" within the meaning of 11 U.S. 522(d)(10(E). This is important in order to exempt the right to receive payments from IRAs from creditors under the federal exemption statute. The logic was that the right to receive payment because of or "on account of their age" was within the meaning of the exemption provided by the Bankruptcy Code.

But the Michigan courts seem to be reading a different statute. The first question a judgment creditor has is, can I garnish the judgment debtor's IRA? The 2011 Michigan Court of Appeals decision in *Macatawa Bank v. Wipperfurth*[9] held, in dicta, that Michiganders can have their IRA garnished so long as the account's *situs* is within the state's boundaries. This was dicta, because the defendants, while once Michiganders, now resided in Florida. The court held the plaintiff could not garnish the defendants' IRAs, even though they were initially established when the defendants lived in Michigan. The court did answer a question that has never been asked before – what law controls the interpretation of an IRA where the IRA provides that it is subject to the laws of the sponsor's "principal place of business," e.g., Massachusetts for Fidelity Investments. The defendants were initially Michigan residents. The plaintiff was a Michigan-based bank with a judgment against the defendants. Rather than transferring the judgment to the Florida courts under a procedure comparable to Michigan General Court Rule 2.112(G), the plaintiff attempted to garnish the IRAs that had been established when defendants were Michigan

The Bankruptcy Abuse Prevention and Creditor Protection Act ("BAPCPA") was enacted in 2005, expanded a debtor's ability to exempt certain assets from the bankruptcy filing. These can be used in lieu of or in addition to state law exemptions, even if the state exemptions are elected. BAPCPA permits states to "opt-out" of federal exemptions and requires their residents use only exemptions provided by state law. Michigan has not "opted-out." The Michigan exemption is in MCL 600.6023(1)(k). Michigan also has a bankruptcy-specific exemption in MCL 600.5451 that was held to be unconstitutional by the Sixth Circuit Bankruptcy Appellate Panel in the case of In re Schafer, 2011 FED App. 0003P (6th Cir).

residents. The Court of Appeals did not follow the rule that applies to bank accounts – that funds in a bank account "are 'located' wherever they are available for withdrawal."[10] The court did cite MCL 600.4011(1) as providing authority to garnish "personal property" of a person, regardless of whether the defendant is subject to Michigan personal jurisdiction[11] or if the obligor is subject to Michigan jurisdiction.[12] Ultimately, they concluded that the IRA could not be garnished.

Even better is the Court of Appeals decision on November 1, 2011, in *Vinyl Tech Window Systems vs. Valley Lawn Maintenance Company, Pamela Blodgett and William Blodgett*.[13] Here the defendants were convicted of five criminal counts of embezzlement, resulting in entry of a judgment of $1.7M against them and sentenced to five-year prison terms. Defendant Pamela Blodgett had been the plaintiff's comptroller, with access to the company's finances. She embezzled funds from the plaintiff and deposited them in her husband's business account. The plaintiff's attempts to collect on its judgment were futile. It brought a motion to liquidate the defendants' IRAs. The defendants asserted the IRA funds were exempt from collection under MCL 600. 6023(1)(k). The trial court granted the motion to liquidate the accounts, holding:

> There is no legal basis for protecting Defendants' multiple Individual Retirement Funds (hereafter referred to as IRAs). Plaintiff has established that these IRAs were created with partial proceeds of partial lump sum pension distributions elected upon Defendant William Blodgett's early retirement, and as such these funds are not protected from execution on this judgment which was entered for breach of fiduciary duties, fraud and embezzlement. IRAs are specifically excepted from ERISA's anti-alienation provision. Selflube, Inc v JJMT, 278 Mich App 298, 316 (2008); 29 USC § 1051[6]. Further, ERISA also preempted any Michigan law with regard to the IRAs. Lampkins v Golden, 28 Fed.APPx. 409 (6th Cir. 2002) [unpublished].[14]
>
> Lastly, this Court finds that any protection afforded the IRAs has been lost by Defendants Blodgetts' self dealing and disregard for this Court's orders. [Footnotes omitted].

In a footnote, the circuit court (trial court) made the following factual findings:

> Plaintiff has provided evidence that defendants cashed out an AT&T 401 account worth $100,000 and transferred the bulk of those funds to a Florida trust. Additionally, over $400,000 which Plaintiff states was located though [sic] Advance Capital Management, Inc. and was neither an AT&T SSP nor during the pertinent time period, a protected pension, had been placed through a Self Directed IRA Trust into several IRAs.

While the author does not disagree with the result, the court has overextended its precedence and is ignoring its statutory authority in order to obtain an equitable result. M.C.L.A. 600.6023(1)(k) specifically exempts payments or distributions from garnishment or other attempts at collection.

While mentioned by the *Vinyl Tech* court, the protection of rollovers from tax-exempt retirement plans from claims of creditors should be the next area of serious court challenge. To qualify as a rollover, the IRA must be tax-exempt. The IRS has a procedure to obtain an advanced determination that the form of a "retirement" plan is tax-exempt, so long as the plan, in operation, does not violate any of the arcane rules of the IRC.[15] Other than the initial submission of the IRA form to the IRS for approval by its sponsor, there is no IRS procedure to establish the tax-qualified status of an IRA in operation. This could become an active area of collection attempts. IRC 4975 (c)(3) exempts IRA owners and beneficiaries from the IRC 4975 15 percent/100 percent excise tax on self-dealing or other prohibited transactions.

If the IRA owner (debtor) engages in a "prohibited transaction" with the IRA, such as borrows or pledges the IRA as security for a loan, the IRA loses its tax-qualified status as of the first day of the year in which the "prohibited transaction" occurred.[16] This is a "self-policed" area – it is up to taxpayers to report they engaged in a prohibited transaction. But it could become an area where creditors could question what has occurred in the past. Said another way, once the debtor has engaged in a prohibited transaction, the IRA loses its tax-qualified status. What may turn out to be even more important, it loses its creditor protection – a double whammy to a debtor having creditor issues – debtor's prison may start to look reasonable.

Another judicial exception to the "creditor protection" of tax-qualified plans is the need of the state under the State Correctional Facility Reimbursement Act (SCFRA).[17] Here there has been litigation between the state and incarcerated defendants over an inmate's receipt of retirement plan benefits while incarcerated. Obviously, at that point, they are not in the then-current workforce of their former employer. They may be entitled to a distribution from their former employer's retirement plan. SCFRA prohibits them from having bank accounts outside of the prison system. The fight in this arena is under ERISA and whether the requirement that the Michigan prison warden notify incarcerated prisoner's retirement plans that the prisoner's retirement plan benefits be sent to the prisoner's institutional account. The end result of this being that payments are garnished to reimburse the state for the prisoner's care. This has all of the appearances of a prohibited alienation or assignment under ERISA Section 206(d)(1).[18] But it may be a situation of form over substance. The Sixth Circuit Court of Appeals held in *DaimlerChrysler Corp. vs. Cox*[19] that orders and notices redirecting benefit payments to a prisoner's institutional account encumbered benefit payments before they left plan control and were therefore pre-empted by ERISA's anti-alienation provision. What is interesting about this case is the contrary earlier (unmentioned) result reached by the Michigan Supreme Court in *State Treasurer vs. Abbott*.[20] In a 5-4 opinion, the Michigan Supreme Court held that: (1)

the trial court's order was not an assignment or alienation of the prisoner's pension benefits and thus did not violate ERISA's anti-alienation provisions; (2) ERISA did not protect pension proceeds that a prisoner received once they were in his prison "bank account" and, thus, the state could garnish those funds to the extent permitted by SCFRA.

This remains a fertile area for ongoing litigation. What would appear to be a clear reading of the statute is anything but. Courts will reach a result that does not appear to be in compliance with the statute but may, in the end, be equitable.

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Footnotes

1 cf. Charles Dickens "A Christmas Carol."

2 MCL 600.6023(1)(k) exempts "an individual retirement account or individual retirement annuity as defined in Section 408 or 408a of the Internal Revenue Code of 1986 and the payments or distributions from such an account or annuity. This exemption applies to the operation of the Federal Bankruptcy Code as permitted by Section 522(b)(2) of Title 11 of the United States Code, 11 U.S.C. 522(b)(2).

3 Internal Revenue Code of 1986, as amended, Section 219(b)(5)(A) and (B).

4 M.C.L.A. 600.6023(1)(k)(iii). This may be a good reason to have a current "Favorable Determination Letter" for the particular plan or be a "word for word adopter" of a Volume Submitter or Prototype Plan, i.e., a letter from the IRS that tells the employer that the plan provisions meet the current requirements of Internal Revenue Code Section 401(a).

5 M.C.L.A. 600.6023(1) refers to annuity contracts under Code Section 403(b) that are subject to the Employee Income Security Act of 1974, Public Law 93-406, 88 Stat. 829, i.e., ERISA – which only applies to employer contributions to employee annuities where the employer is tax-exempt under IRC Section 501(c)(3). To be tax-exempt under Section 501(c)(3), an organization must be organized and operated exclusively for exempt purposes set forth in Section 501(c)(3), and none of its earnings may inure to any private shareholder or individual. In addition, it may not be an action organization, meaning that it may not attempt to influence legislation as a substantial part of its activities and it may not participate in any campaign activity for or against political candidates. Organizations described in Section 501(c)(3) are commonly referred to as *charitable organizations*. Organizations described in Section 501(c)(3), other than testing for public safety organizations, are eligible to receive tax-deductible contributions in accordance with Code Section 170. A governmental plan is not subject to ERISA. A public school teacher's 403(b) plan is not subject to ERISA because, as a public school, it is deemed to be a governmental political subdivision of the state.

6 cf. *State Treasurer vs. Abbott*, 468 Mich. 143, 660 N. W. 2d 714 (2003) where the Michigan Supreme Court upheld the state treasurer's action under the State Correctional Facility Reimbursement Act (SCFRA), MCL 800.401 *et. seq.* seeking to recover the costs of the defendant's prison confinement by having the defendant's monthly pension payments deposited to his prison account rather than his credit union, essentially using the monthly pension check to pay for his prison upkeep. (And notwithstanding what would otherwise appear to be a clear prohibition of payments or distributions from ERISA-qualified plans as set out in MCL 600.6023(1)(l) and the anti-alienation provisions of ERISA Section 206(d)(1).

7 Pub. L. No. 109-8, 224, 119 Stat. 23, 64 (2005).

8 544 U.S. 320, 125 S. Ct 1561, 161 L.Ed.2d 563, 53 C.B.C.2d 181 (2005).

9 Published November 8, 2011, Docket No. 300451.

10 Unpublished opinion of the U.S. District Court for the Eastern District of Michigan in *Acme Contracting, Ltd vs. Toltest, Inc.* issued October 3, 2008, affirmed as to award of damages by the Sixth Circuit Court of Appeals on March 24, 2010, but remanded "for further proceedings on the very limited issue of the calculation of quantum meruit damages."

11 MCLA 600.4011(1)(a) authorizing garnishment "if the third person is subject to the judicial jurisdiction of the state and the personal property to be applied is within the boundaries of this state."

12 MCLA 600.4011(1)(b) authorizing garnishment "if an obligation is owed to the person against whom the claim is asserted if the obligor is subject to the judicial jurisdiction of the state."

13 Unpublished November 1, 2011, *per curiam* decision proving again that when your client attempts to hide assets, judges will find a way to "do justice."

14 There are bankruptcy cases in accord with *Lampkins* (*In re John E. Diguilio, Debtor*, 303 BR 144, 12/04/2003, United States Bankruptcy Court, N.D. Ohio Eastern Division) and cases that seem to be contrary to it in that they have permitted the debtor to elect state law exemptions without finding pre-emption to be an obstacle (*In re Dantone*, 167 BR 67, 1993 WL 657277, 7/15/1993, U. S. Bankruptcy Court, N. D. Mississippi; and *LaBarge v. Mehra*, 166 BR 393, 01/25/1994, U. S. Bankruptcy Court, E.D. Missouri, E.D.). Outside of Michigan, many commentators think the case is wrong. *Lampkins* fails to distinguish between the SEP ("simplified employee plan") and the IRA that held the benefits under the plan. Here the court is relying on the unpublished opinion in *Lampkins* for the proposition that the IRA can be reached by creditors. This is stretching the *Lampkins* opinion even beyond what it dealt with. Much like the defendants in *Vinyl Tech*, the court was offended by the defendant's behavior and attempts to defraud his creditor. In *Lampkins*, Golden was a licensed attorney who attempted to impose as many obstacles on the plaintiff, his former secretary of more than 20 years, from collecting on her retirement benefits. This included borrowing the assets of the Plan (a prohibited transaction), moving the assets into an SEP-IRA and attempting to avoid paying the plaintiff because the IRA was beyond the reach of creditors.

15 cf Rev Proc 2011-6 for the procedures to apply for an advance determination of the tax-qualified status of a retirement plan – note this can be done every five to six years, depending on the type of retirement plan document the employer implements. This is an annual IRS publication, which by the time this article is published, should be issued for 2012 as Rev. Proc 2012-6.

16 cf. IRC 408(e)(4) and 4975.

17 MCL 800.401 et. seq.

18 29 U.S.C. 1056(d)(1).

19 447 F. 3d 967 (2006).

20 468 Mich. 143, 660 N.W.2d 714 (2003).