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

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I. COMMUNITY PROPERTY

A. General Issues

There are eight community property jurisdictions in the United States—two of which are among the three most populous states in the country, California and Texas.[1] Although some politicians believe that

1. *See* J. Thomas Oldham, *Conflict of Laws and Marital Property Rights*, 39 BAYLOR L. REV. 1255, 1258 (1987). The eight community property jurisdictions are as follows: Louisiana, Texas, New Mexico, Arizona, Nevada, California, Washington, and Idaho. *See* ARIZ. REV. STAT. ANN. § 25-211 (2008); CAL. FAM. CODE § 760 (West 2004); IDAHO CODE ANN. § 32-906 (2003); LA. CIV. CODE ANN. art. 2338 (2008); NEV. REV. STAT. ANN. §125.150 (West 2007); N.M. STAT. ANN. § 40-3-12 (West

community property statutes were enacted as a tax avoidance device, most of the community property jurisdictions trace their community property statutes to old Spanish law.[2] Most states define "community property" by defining what is not community property.[3] Generally, community property is all property acquired during marriage except property acquired by gift, devise, or descent.[4]

1. Why Common Law Lawyers Should Care

The United States is now, and has been for a considerable period of time, a mobile society. Persons from community property jurisdictions often relocate to common law states, bringing with them considerable community property. The character of community property is not magically transmuted into something other than community property by relocation to a common law jurisdiction.[5] In fact, clients may desire to retain the community character of certain property.[6] Further, even if not advisable, changing the character of community property could affect existing property rights.[7]

2. Comparing the Law Among Community Property Jurisdictions

Lawyers in statutory jurisdictions often mistakenly believe that community property laws are uniform across the various community property jurisdictions. In reality, there are several key differences between the various community property jurisdictions.

a. Income from Separate Property

In Texas, Idaho, Wisconsin, and Louisiana, income from separate property constitutes community property.[8] In all other community property

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2008); TEX. FAM. CODE ANN. § 3.002 (Vernon 2006); WASH. REV. CODE ANN. § 26.16.030 (West 2005). Additionally, Alaska and Wisconsin have adopted property systems very similar to community property systems. *See* ALASKA STAT. § 34.77.090 (2008) (adopting an "opt-in" community property system—designed primarily to achieve a new basis at death—which may be treated as community property for federal tax purposes); WIS. STAT. ANN. §§ 766.001-766.97 (West 2007) (adopting the Uniform Marital Property Act, which essentially creates a community property system).

2. *See* J. Wesley Cochran, *It Takes Two to Tango!: Problems with Community Property Ownership of Copyrights and Patents in Texas*, 58 BAYLOR L. REV. 407, 412 n.13 (2006).

3. *See* Michael McAuley, *The Wanting of Community Property*, 20 TUL. EUR. & CIV. L.F. 57, 61 (2005).

4. *See* BLACK'S LAW DICTIONARY 297 (8th ed. 2004).

5. *See* J. Thomas Oldham, *What If the Beckhams Move to L.A. and Divorce? Marital Property Rights of Mobile Spouses When They Divorce in the United States*, 42 FAM. L.Q. 263, 266 (2008).

6. *See* Oldham, *supra* note 1, at 1279.

7. *Id*.

8. *See* Internal Revenue Service, Internal Revenue Manual Part 25.18.1.2.13, *available at* http://www.irs.gov/irm/part25/ch13s01.html [hereinafter IRS, Internal Revenue Manual].

jurisdictions, such income is treated as separate property.[9] Income, however, is to be distinguished from mere changes in form of the property which do not alter the property's essential character.[10] For example, dividends from IBM stock are income, but proceeds from 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.[11] Furthermore, assuming that the proceeds can be traced into a purchase of Dell stock, the Dell stock is separate property.[12]

Assume Jane rolls over her qualified plan into an Individual Retirement Account (IRA) prior to marrying John and makes no further contributions to the IRA during her marriage.[13] In California, any earnings during the marriage would be separate property, so the IRA remains 100% separate property.[14] In Texas, the answer is not so clear.[15] In Texas, if the income of the IRA (i) stays in the IRA and (ii) is treated as marital property, then part of the IRA is converted into community property.[16]

b. Inception of Title vs. Proportional Determination

The point at which the character of property is determined also differs from jurisdiction to jurisdiction. Texas follows the inception of title rule.[17] Under the inception of title rule, the character of property is determined at the time of its acquisition and is unchanged by future events.[18] California, however, adopted a proportional consideration rule.[19] Under California's proportional consideration rule, the character of property obtained prior to marriage is subject to change after marriage.[20]

For example, assume Jane acquires title to real property prior to marrying John. Further, assume that payments on the mortgage to the property are made during their marriage from community funds. In California, a portion of the property would become community property.[21] In Texas, however, the property would remain the separate property of the

9. *See id*.
10. *See* 26 U.S.C. §§ 72, 1221(2008); Internal Revenue Service, Topic 409 Capital Gains and Losses, *available at* http://www.irs.gov/taxtopics/tc409.html [hereinafter IRS, Topic 409].
11. *See* 26 U.S.C. §§ 72, 1221; IRS, Topic 409, *supra* note 10.
12. *See generally* IRS, Topic 409, *supra* note 10.
13. *See* IRS, Internal Revenue Manual, *supra* note 8. Because the individual rolled her qualified plan into her IRA prior to marriage, the IRA is separate property. *Id.*
14. *Id.*
15. *See id*.
16. *See* discussion *infra* Part I.2.b.
17. Cochran, *supra* note 2, at 414.
18. *See id*.
19. *See* CAL. FAM. CODE § 2640 (West 2005).
20. *See id*.
21. *See id*.

acquiring spouse, Jane.[22] John would only have a right to reimbursement.[23] Thus, contributions to an IRA after marriage would create community property in California based upon a proportion of the contributions. Such contributions, however, would merely give rise to a right of recovery in Texas—assuming the spouse was not the beneficiary—if such contribution was a fraud on the community.[24]

c. Management of Property

Jurisdictions also differ on how community property should be managed. California requires the consent of both spouses in managing community property.[25] Texas, however, determines the right to manage the community property largely based upon in whose name the property is registered.[26] The Texas management scheme also allows the managerial spouse to dispose of property subject to that spouse's sole management during the managerial spouse's life without the consent of the other spouse, except when such disposition would constitute a fraud on the community.[27]

d. Disposition of Community Property at Death

In all community property jurisdictions, title is irrelevant in determining the character and, thus, ownership of community property.[28] Rather, each spouse has the power to dispose of only his or her one-half of the community property at death.[29] Life insurance and retirement benefits, however, are handled separately because the owner of a life insurance policy or retirement benefits has a contractual right to dispose of the asset as the owner wishes.[30] Nonetheless, if the non-owner or non-participant spouse dies first, then the participating spouse has the right to dispose of her community one-half interest, subject to preemption of that right under the Employee Retirement Income Security Act (ERISA).[31]

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22. Cochran, *supra* note 2, at 414.
23. *See id*.
24. A discussion of the fraud on the community doctrine is well beyond the scope of this paper.
25. *See* CAL. FAM. CODE § 761(a) (West 2004).
26. *See* TEX. FAM. CODE ANN. § 3.004(a) (Vernon 2006).
27. *See id*. § 3.102(a); Osuna v. Quintana, 993 S.W.2d 201, 207 (Tex. App.—Corpus Christi 1999, no pet.).
28. *See* NIHARA K. CHOUDRI, THE COMPLETE GUIDE TO DIVORCE LAW 14 (Citadel Press 2004).
29. *See id*.
30. Strom v. Goldman, Sachs & Co., 202 F.3d 138, 142 (2d Cir. 1999).
31. Julie McDaniel Dallison, *Disappearing Interests: ERISA Impliedly Preempts the Predeceasing Nonemployee Spouse's Community Property Interest in the Employee's Retirement*, 49 BAYLOR L. REV. 477, 504 (1997).

3. IRC Provisions

Two provisions of the Internal Revenue Code (IRC) apply directly to the issue of community property in IRAs: (1) section 408(d)(6) of the IRC, which allows division of IRAs upon divorce, and (2) section 408(g) of the IRC, which states that section 408 "shall be applied without regard to any community property laws."[32] Although the scope of section 408(g) is unclear, it is clear 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.[33]

B. ERISA Preemption and Qualified Plans: The Supreme Court's Decision in Boggs v. Boggs

The United States Supreme Court has held that ERISA preempts community property law with respect to the power of a non-participant spouse to dispose of her community interest in the ERISA plan if she predeceases the plan participant.[34] In *Boggs v. Boggs*, the Supreme Court clearly states that ERISA preempts state community property law as to undistributed benefits; however, the Court's decision also raises several new questions.[35]

1. Overview of Boggs

In determining whether ERISA preempts state community property law, the majority states that the issue before the Court is not the technical construction of the "relate to" language of ERISA's preemption clause.[36] Rather, the issue before the Court deals with the overarching purpose of ERISA—to provide for the retirement of the participant and the participant's spouse—and whether ERISA has preempted state community property law to the extent that it occupies the entire field.[37]

The Court concludes that allowing state community property law to permit a non-participant spouse to dispose of one-half of the plan's assets deprives the participant of the use of those assets for the participant's retirement.[38] Thus, the Court holds that ERISA preempts community

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32. I.R.C. § 408(d)(6), (g) (2008).

33. *See id*. § 408(g).

34. *See* Boggs v. Boggs, 520 U.S. 833, 848 (1997). *Boggs* will only control, however, if a plan is subject to Title I of ERISA, which can be difficult to determine. *See In re* Schlein, 8 F.3d 745, 749-50 (11th Cir. 1993).

35. *Boggs*, 520 U.S. at 848.

36. *Id*. at 839-41.

37. *Id*.

38. *Id*. at 834-35.

property law with respect to the power of a non-participant spouse to dispose of her community interest in the ERISA plan if she predeceases the plan participant.[39] The dissent argues that the majority's holding deprives Dorothy Boggs, Issac Boggs's first wife, of her share of the plan benefits.[40] The dissent also applies and extensively analyzes the "relate to" test under ERISA, which, as prior cases have demonstrated, can be applied to reach whatever result is desired.[41]

2. Facts

Isaac Boggs, a Louisiana resident, was married to Dorothy Boggs, and he worked for South Central Bell for thirty years of their marriage.[42] Dorothy died in 1979.[43] In her will, Dorothy left Issac one-third of her estate along with a lifetime usufruct in the remaining two-thirds of her estate.[44] Dorothy left the "naked ownership" of the remaining two-thirds of her estate to her three sons.[45] At the time of Dorothy's death, Isaac had an interest in three types of retirement benefits: (i) a joint and survivor retirement annuity; (ii) an Employee Stock Ownership Plan (ESOP); and (iii) a profit sharing plan.[46] Dorothy's interest in these plans was valued at approximately $22,000 in her "succession," which is referred to as an "inventory" in most jurisdictions.[47] In 1980, Isaac married Sandra.[48] He retired in 1985.[49] Upon retirement, Issac began receiving benefits from his retirement plans.[50] He received a monthly annuity payment, shares of stock under his ESOP, and a lump sum payment from his profit sharing plan, which he converted into an IRA.[51] Isaac died in 1989 without making any withdrawals from the IRA.[52]

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39. *Id*. at 848. While preemption may result in allowing the participant to determine the devolution of all the plan benefits, this appears to be congruent with the purpose of ERISA.

40. *Id*. at 868 (Breyer, J., dissenting). What she was, in fact, "deprived of" was the ability to dispose of half of her husband's retirement to his detriment.

41. *Id*. at 855-84. In analyzing *Boggs*, it is also important to keep in mind that Issac's sons could have demanded an accounting during his life, while he was receiving benefits from the retirement plan, rather than waiting until after their father had died to file their action. *See id*. at 837 (majority opinion).

42. *Id*. at 836.

43. *Id*.

44. *Id*. A lifetime usufruct is generally equivalent to a common law life estate. *Id*.

45. *Id*. at 836-37. A "naked ownership" is generally equivalent to a common law remainder interest. *Id*. at 856 (Breyer, J., dissenting).

46. *Id*. at 836 (majority opinion).

47. *Id*. at 837.

48. *Id*. at 836.

49. *Id*.

50. *Id*.

51. *Id*.

52. *Id*. Although the opinion is unclear, it is presumed that Sandra was the beneficiary of the IRA. *See id*. at 837-38.

After Issac's death, two of Issac and Dorothy's sons 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."[53] Sandra filed an action in federal court seeking a declaration that ERISA preempted community property laws.[54] She lost in both the federal district court and the Fifth Circuit.[55] The United States Supreme Court granted certiorari because of the conflict between the Fifth Circuit's decision in *Boggs* and the Ninth Circuit's decision in *Ablamis v. Roper*.[56]

3. The Decision

a. The New Preemption Test

After acknowledging that its decision would also affect claims in non-community property jurisdictions, the Court stated a very broad preemption test and apparently adopted a new standard for determining whether ERISA preempted state law:

> 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 . . . ." 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*.[57]

Thus, it appears that the majority in *Boggs* is holding that community property laws must yield to ERISA when community property laws affect a

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53. *Id*. at 837.

54. *Id*.

55. *Id*. at 837-38. Circuit Judge Jacques Wiener, joined by five of his colleagues, wrote an articulate dissent to the court's refusal to grant an *en banc* rehearing. Boggs v. Boggs, 89 F.3d 1169, 1170 (5th Cir. 1996) (Wiener, J., dissenting).

56. *Boggs*, 520 U.S. at 839. It took the Ninth Circuit fifteen months to write its opinion in *Ablamis,* and it took the Fifth Circuit eighteen months to write its opinion in *Boggs*. *See* Ablamis v. Roper, 937 F.2d 1450 (9th Cir. 1991); Boggs v. Boggs, 82 F.3d 90 (5th Cir. 1996). The Supreme Court also noted that this case was important in that it affected, at the time, approximately eighty million people who resided in community property states, with over $1 trillion in qualified plan benefits. *Boggs*, 520 U.S. at 840. The Court further noted that it had already taken two other cases involving federal preemption under ERISA during the same term as *Boggs*. *Id*. at 839.

57. *Id*. at 841(quoting 29 U.S.C. § 1144(a)(2006)) (emphasis added).

field that Congress has appropriated for a federal purpose to carry out a uniform federal scheme.[58]

In deciding whether ERISA preempts community property laws, the Court examined several provisions of ERISA and determined that the purpose of ERISA is to protect the interests of both participants and beneficiaries.[59] The Court also examined the purpose of qualified domestic relations orders (QDRO), qualified pre-retirement survivor annuities (QPSA), and qualified joint and survivor annuities (QJSA) provisions in relation to the rights of non-participant spouses under the Retirement Equity Act (REA).[60] In holding that ERISA preempts community property law with respect to the power of a non-participant spouse to dispose of her community interest in the ERISA plan if she predeceases the plan participant, the Court pointed to the QPSA, QJSA, and QDRO provisions and ERISA's silence regarding the rights of non-participant spouses:

> 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 nonparticipant spouse to control pension plan benefits by testamentary transfer provides powerful support for the conclusion that the right does not exist.[61]

b. ERISA Protects Only Participants and Beneficiaries

The Court holds that the sons have no claim under ERISA for a share of their father's retirement benefits because they were neither participants nor beneficiaries under the plan.[62] The sons, relying on pre-REA case law, argued that ERISA does not preempt spousal community property interests in pension benefits.[63] The Court, however, rejected this argument holding that the result would not be proper under ERISA.[64]

Additionally, the Court stated that the anti-alienation provisions of section 1056(d)(1) of ERISA give "specific and powerful reinforcement" to the preemption argument.[65] The Court held that Dorothy's attempted testamentary transfer of her interests in Issac's retirement benefits was a prohibited "assignment or alienation" in violation of section 1056(d)(1).[66]

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58. *See id*.
59. *Id*. at 840-41.
60. *Id*. at 842-48.
61. *Id*. at 847-48.
62. *Id*. at 848.
63. *Id*. at 848-49. This argument was made by the Estate Planning, Probate and Trust Law Section of the State Bar of California in an amicus brief supporting the sons. *Id*.
64. *Id*. at 850-51.
65. *Id*. at 851.
66. *Id*.

An "assignment or alienation" has been defined as "'[a]ny direct or indirect arrangement whereby a party acquires from a participant or beneficiary' an interest enforceable against a plan to 'all or any part of a plan benefit payment which is, or may become, payable to the participant or beneficiary.'"[67] Under Louisiana law, community property interests are enforceable against a plan.[68] Thus, if Dorothy is a participant by virtue of her community property interest, then the mere fact that the respondents' rights might be enforceable against payments to be received violates the anti-alienation provision.[69]

Accordingly, if the sons were allowed to bring a claim under ERISA for a share of Issac's retirement benefits, "they would have acquired . . . an interest in Issac's pension plan at the expense of plan participants and beneficiaries."[70] If permitted, the sons would cause a diversion of substantial benefits under the plan to testamentary recipients, depleting the benefits intended to protect beneficiaries and participants of the plan: "Retirement benefits and the income stream provided for by ERISA-regulated plans would be disrupted in the name of protecting a nonparticipant spouses' successors over plan participants and beneficiaries."[71]

c. *Accounting by NPS's Beneficiaries Not Available*

The Court then addresses the sons' argument that the suit is simply for an accounting and in no way affects the plan.[72] In addressing this issue, the Court looks to its decision in *Free v. Bland*, which involved Texas community property law.[73] In *Free*, federal regulations required that U.S. Savings Bonds, which were community property, pass to the surviving spouse as co-owner upon the death of a spouse.[74] Texas community property law, at that time, did not recognize joint tenancy in community property.[75] Conceding that federal law preempted state law, the state court required that the deceased wife's heirs be reimbursed for the loss of community interest in the bonds.[76] The Supreme Court, finding that the wife's beneficiary should not be able to affect property interests indirectly

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67. *Id*. (citing 26 C.F.R. § 1.401(a)-13(c)(1)(ii)(2007)).

68. *Id*.

69. *See id*. at 851-52; 29 U.S.C. § 1056(d)(1)(2006). I am not sure that the Court's logic is especially sound because there is still a question as to whether Dorothy's beneficiaries could enforce the rights against the plan. However, should they not have that right if Dorothy was a participant by virtue of the community property law?

70. *Boggs*, 520 U.S. at 851-52.

71. *Id*. at 852-53.

72. *Id*. at 853.

73. *Id*.

74. Free v. Bland, 369 U.S. 663, 670 (1966).

75. *Id*. at 664.

76. *Id*. at 663.

that he could not affect directly, stated that, "[v]iewed realistically, the State has rendered the award of title [under federal law] meaningless."[77] Accordingly, the Court held that a plan participant cannot be forced to render an accounting.[78]

The *Boggs* Court then notes 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.[79] Returning to an earlier theme as to the purpose of ERISA, the Court notes that ERISA is "for the living."[80] 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."[81]

d. The Dissent

As pointed out above, the dissent seems to perceive this case as one in which Sandra, the second wife of ten years, is taking something away from Dorothy, the first wife of thirty-six years.[82] 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."[83] The facts, however, are that Sandra received only a usufruct, with the three sons 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.[84]

The dissent strongly emphasizes 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.[85] While citing *Ingersoll-Rand Co. v. McClendon*,[86] the dissent misses the application of this case to the issue in *Boggs*.[87] *McClendon* involved a suit for wrongful discharge.[88] The plaintiff alleged that he was discharged to

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77. *Id*. at 669.

78. *Boggs*, 520 U.S. at 853.

79. *Id*. at 853-54. In a somewhat gratuitous, but realistic point, the Court states: "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." *Id*. at 853.

80. *Id*. at 854.

81. *Id*.

82. *Id*. at 856 (Breyer, J., dissenting).

83. *Id*. at 857.

84. *Id*. at 836-37 (majority opinion).

85. *Id*. at 862 (Breyer, J., dissenting).

86. Ingersoll-Rand Co. v. McClendon, 498 U.S. 133, 133 (1990).

87. *Boggs*, 520 U.S. at 861-62 (Breyer, J., dissenting).

88. *McClendon*, 498 U.S. at 133.

prevent his pension benefits from vesting.[89] The Supreme Court of Texas found that this action was not preempted by ERISA because the suit was a tort action against the company and was not a suit against the plan.[90] The United States Supreme Court found that ERISA provided a remedy for wrongful discharge to prevent benefits from vesting.[91] The Court also held that without the existence of the plan, the plaintiff would have no cause of action and that the wrongful discharge "related to" the plan.[92]

The dissent continues, "[t]he lawsuit before us concerns benefits that the fund has already distributed; it asks not the fund, but others, for a subsequent accounting."[93] 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.[94] This differs from determining the value of a party's interest after it has been determined what that interest is.

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

> Contrary to the majority's suggestion, Dorothy's children are not the equivalent of plan "participants" or "beneficiaries," any more than would be a grocery store, a bank, an IRA, 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).[95]

With regard to the first sentence of the above quotation, it is my reading of the majority opinion that the children are 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

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89. *Id*. Ironically, the plaintiff had worked sufficient hours in the year of his discharge to cause his benefits to vest. *Id*. at 136.

90. *Id*. at 134.

91. *Id*.

92. *Id*.

93. Boggs v. Boggs, 520 U.S. 833, 862 (1997) (Breyer, J., dissenting).

94. *Id*. at 836 (majority opinion).

95. *Id*. at 862 (Breyer, J., dissenting).

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. Congress, however, has specifically directed the division on divorce and has not specifically directed that the non-participant spouse may dispose of an interest in the participant's plan, even in a community property state.[96]

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.[97]

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.[98] Inexplicably, the dissent proclaims that ERISA does not "restrict what Isaac can do with his pension funds after his death."[99] This is precisely the focus of REA.[100]

In dealing with the argument that Dorothy's transfer violates the anti-alienation clause "or some more general ERISA purpose," the dissent notes, "[t]his argument . . . is beside the point, however, for the state-law action here seeks an accounting that will take place after the deaths of *both* Dorothy and Isaac."[101] There is no reason that the action had to be delayed until after Isaac's death if Dorothy 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 preempted, 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 their dad with the claim that they had an interest in what he perceived to be his assets.

96. *Id*.
97. *Id*. at 864.
98. *Id*. at 843 (majority opinion).
99. *Id*. at 865 (Breyer, J., dissenting).
100. *Id*. at 843 (majority opinion).
101. *Id*. at 865 (Breyer, J., dissenting).

However, there is no legal impediment to seeking an accounting before his death.[102]

"I do not understand," says Justice Breyer, "why or how ERISA could be concerned about Dorothy's creation of a will, which affected the retirement assets only after Isaac received them."[103] 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 a suit for an accounting is not prohibited once the benefits have been distributed to the participant or the participant's beneficiary.[104] 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, then could her beneficiaries not demand her portion of the benefits which Isaac could take but chose not to take?

Noting that Congress specifically authorized the transfer of pension benefits to a divorced non-participant, Justice Breyer asks, "[w]hy then, one might ask, would Congress object to court orders that transfer benefits to a former spouse after her death?"[105] 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.[106] Justice Breyer goes on to note that Dorothy 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.[107] 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.[108] This proposition is directly adverse to the Court's holding of *Free*.[109] 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 estate that might be used to satisfy the heirs of the non-participant spouse.[110]

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102. *See* 26 U.S.C. § 691(a) (2004).

103. *Boggs*, 520 U.S. at 865 (Breyer, J., dissenting).

104. *See id*.

105. *Id*. at 868.

106. *See id.* at 836-38 (majority opinion). As one of my client's reminded me, "You never saw a hearse with a luggage rack."

107. *Id*. (Breyer, J., dissenting).

108. *Id*. at 871.

109. *See* discussion *supra* Part I.B.3.c.

110. *Boggs*, 520 U.S. at 872-73 (Breyer, J., dissenting).

This argument, however, ignores the reality that participants would, in effect, be forced to purchase the benefits Congress set aside for them under ERISA.

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

> In sum, an annuity goes to Sandra, a surviving spouse; but otherwise Dorothy would remain free not only to have, but to bequeath, her share of the marital estate to her children. This reading of the relevant statutory provisions and purposes protects 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.[111]

This appears to be a straight forward formula; however, it 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 permitting a non-participant or non-beneficiary to bring a state accounting action and the ensuing issues tracing the couple's community property over the past ten years.[112]

4. The Remaining Problems

While *Boggs* answers the preemption issue in general, the opinion does not make clear the scope of preemption. Nor does it deal at all with reporting issues on the federal estate tax return.

a. Reporting Issue and Inclusion in Gross Estate

After *Boggs*, what is to be reported on the federal estate tax return of the predeceasing non-participant spouse? Because 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.[113] Thus, the non-participant's interest should not be included in the gross estate but should be disclosed on the return. But what if the

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111. *Id*. at 873.

112. *See id.* at 873-74. Although a "taking" argument was also raised in oral argument, that argument does not appear in either the majority opinion or the dissenting opinion until the penultimate paragraph of the dissent, and then it only appears in a footnote comparing two cases. *Id*. Evidently, the Court did not want to go down the slippery slope of taking by preemption in view of the argument that REA itself may well have been a taking. *See id.*

113. *See* Treas. Regs. § 20.2033-1(a) (1963) (noting that federal government bonds which are exempt from income tax are not necessarily exempt from the estate tax because "such tax is an excise on the transfer of property at death and is not a tax on the property transferred").

participant dies first? Is 100% of the benefits included in the participant's estate? If no interest is to be reported on the non-participant's return, then the answer should be yes. In recent years, the Treasury Department has indicated that it is strongly considering promulgating this position—no inclusion of plan benefits on the non-participant's spouse's return, but 100% inclusion on the participant's return if the participant predeceases the non-participant. The Treasury Department, however, has not formally adopted this position.[114]

Is this entire question as to the non-participant spouse's interest purely 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. The non-participant's interest, however, is a classic terminable interest.[115] Yet, the IRS has not been disallowing non-participants from taking a marital deduction under these circumstances. Further, section 2056(b)(7)(C) of the IRC has been amended to state "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 ensure that the non-participant's interest, if passing to the participant, qualifies for the marital deduction.[116] While Congress considered deleting this language from section 2056(b)(7)(C) in light of *Boggs*, the language remained after it was decided that there may still be situations in which this problem exists, such as when dealing with section 403(b) plans and individual retirement annuities.[117] The committee reports were expected to definitively state that section 2056(b)(7)(C) is not intended to override the Court's decision in *Boggs*, but no such provision was inserted.[118]

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114. Additionally, the inclusion or non-inclusion of plan benefits on federal tax returns will affect percentage tests such as those in §§ 6166 and 2032A.

115. I.R.C. § 2039(c)(1986), *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1852(e)(1). Prior to its repeal by the Tax Reform Act of 1986, § 2039(c) provided that any interest of a non-participant spouse in a retirement plan that 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. *Id*. 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, "[h]owever, 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." Sen. Rep. to 1986 Act § 1853(e).

No such provision was enacted, however, and no subsequent amendments to the IRC corrects this oversight, except the Technical and Miscellaneous Revenue Act's amendment to §2056(b)(7), which is limited to joint and survivor annuities. I.R.C. § 2056(b)(7) (2000).

116. I.R.C. § 2056(b)(7)(C).

117. *See id.*

118. *See id.*

b. Application to IRAs

Whether the *Boggs* opinion applies to an interest rolled over to an IRA before the death of the non-participant spouse remains uncertain. While the Court speaks in terms of "undistributed" benefits, it is not 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 nonparticipant spouse to obtain a devisable community property interest in benefits paid out during the existence of the community between the participant and that spouse.[119]

Further, the Court, concludes its opinion with the following 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."[120]

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

One viewpoint is that the essential character of the property as community property within the plan is unchanged, and what was preempted by ERISA was only the non-participant spouse's ability to dispose of the assets at such spouse's death.[121] 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, however, that the assets in the plan are compensation and, thus, once out of the plan, are community property.

Another argument is that the community character of the property itself is preempted. Thus, when classic community property analysis is applied, if the asset was not community property inside the plan, then it cannot suddenly "transmute," absent an agreement in those states that permit such agreements, to community property. In other words, if it was not community property inside the plan, then how can it be community property when it comes out of the plan? Moreover, even if the assets were distributed outright, rather than in an IRA, this logic would apply so long as the proceeds can be traced.

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119. Boggs v. Boggs, 520 U.S. 833, 845 (1997).
120. *Id*. at 854.
121. I suspect that this is the majority viewpoint of community property lawyers.

While a literal reading of the statutes and *Boggs* might favor the construction that distributions from the plan are not community property, the treatment of the distributed property as community property is more likely to occur. One argument is that the federal purpose has been satisfied once the assets are distributed. The response to this argument is that the same policy should apply whether the assets are in the plan or not. The more persuasive argument, however, is that because IRAs are not covered by ERISA, 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, Idaho, Wisconsin, and Louisiana.[122] This includes assets distributed to a rollover IRA unless section 408(g) of the IRC applies.[123] 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 the couple could establish two IRAs.[124]

c. Application to section 403(b) Plans

A subset of this problem is the treatment of government plans, church plans, and section 403(b) of the IRC plans. ERISA provides in section 514(a) that "the provisions of this subchapter and subchapter III of this chapter shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan described in section 1003(a) and not exempt under section 1003(b) of this title."[125]

While church plans and governmental plans are clearly exempt under section 4(b) of ERISA, it is not clear whether section 403(b) of the IRC plans are included under section 4(a) of ERISA.[126] Because this is the only preemption language in ERISA, these plans may not to be covered by *Boggs*. The majority in *Boggs*, however, apparently did not rely on section 514(a) of ERISA but rather on either traditional field preemption, conflict preemption, or both.[127] So the question remains whether *Boggs* applies to government plans or section 403(b) of the IRC plans.

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122. *See* IRS, Internal Revenue Manual *supra* note 8.

123. I.R.C. § 408(g) ("This section shall be applied without regard to any community property laws.").

124. This belief has been confirmed by a staff member of the Treasury department who was responsible for drafting this provision.

125. 29 U.S.C. § 1144 (2006).

126. Michael R. Maryn, *What's New in Employee Benefits: A Summary of Current Cases and Other Developments*, SM079 ALI-ABA 1, 45-46 (2007).

127. *See id*. at 150-51.

5. Conclusion

Boggs has now clarified that assets within a qualified plan are not subject to community property laws.[128] The Court in *Boggs*, however, did not address how its decision affects non-participants' interest in plan benefits for federal estate and gift tax purposes. More importantly, the Court did not state whether the assets, once distributed, are community property, and the Court did not state the precise scope and breadth of ERISA's preemption of state community property laws.

C. Community Property Issues at Death

1. Basic Assumption

Non-rollover IRAs are clearly community property.[129] Except in extremely unusual circumstances, however, such IRAs are generally not large enough to generate serious tax issues.[130] Therefore, the following discussion assumes a rollover IRA and that the rollover is community property, notwithstanding the uncertainty of such characterization by *Boggs*.

2. Non-Participant Spouse Issues

It is clear that the IRA is community property and that the non-participant spouse has an interest in that IRA.[131] The participant's spouse, however, may predecease the participant causing various issues to arise if they are not dealt with beforehand.

a. Gift in Will to Participant

It seems well settled that the non-participant spouse can leave the non-participant spouse's interest in the participant's IRA to the participant by will.[132] This resolves any issues as to treatment of the beneficiary because the participant becomes the only one with any interest in the IRA. It is doubtful that a gift to a qualified terminable interest property trust would accomplish the same thing, even if the participant is the trustee.

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128. Boggs v. Boggs, 520 U.S. 833, 839 (1997).
129. Allard v. Frech, 754 S.W.2d 111, 114 (Tex. 1988).
130. *See id*.
131. *See id*.
132. *Id*.

b. Gift to Non- Participants

It also follows from the holding in *Allard v. Frech* that someone other than the participant can be the beneficiary of the non-participant spouse's interest.[133] If someone other than the spouse is the beneficiary, then there are many problems for which few answers exist. One would think that there would be clear authority as to the taxation of distributions to the non-participant spouse's beneficiaries other than the participant, but, unfortunately, there are not.

3. IRS Private Letter Ruling 8040101

The only direct authority dealing with the passage of an IRA at death is a 1980 private letter ruling, PLR 8040101.[134] In PLR 8040101, the IRS ruled that the non-participant spouse's community interest was transferable to the non-participant spouse's beneficiaries and that the distribution was taxable to the beneficiaries.[135] Even though PLR 8040101 has not been challenged, it is not the law because, according to statutory directive, private letter rulings are not precedent and do not bind the IRS.[136] The ruling also fails to answer serious questions as to the non-participant spouse's beneficiaries: Can they take distributions over their life expectancy? Over the participant's life expectancy? Under the five year rule? Or only as a lump sum? Additionally, although the section 72(t) penalty should not apply because the interest was acquired at death, PLR 8040101 provides no real answer on whether the penalty actually applies or not.

4. Indirect Contradictory Authority

In *Bunney v. Commissioner*, an IRA was divided in a divorce settlement as permitted by section 408(d)(6) of the IRC.[137] However, instead of delivering one-half of the IRA account to his wife, the husband withdrew money from the IRA and delivered part of those funds to his wife.[138] The court held that the amount withdrawn was taxable on the husband's return and that the amount withdrawn was subject to the section 72(t) penalty.[139] In analyzing the case, the court discussed section 408(g) of the IRC and determined that the designation of the distribution as

133. *See id*. at 113-14.
134. *See* I.R.S. Priv. Ltr. Rul. 80-40-101 (July 15, 1980).
135. *Id*.
136. *See id*.
137. Bunney v. Commissioner, 114 T.C. 259, 260 (2000).
138. *Id*.
139. *Id*. at 264-65.

community property was irrelevant—it was nonetheless taxable to the husband-distributee.[140] While there is language indicating that the Tax Court would treat payment to the non-participant spouse's beneficiaries the same way, this issue was not before the court. In PLR 9439020, the IRS recognized the community character of an IRA but stated that a distribution of the non-participant spouse's interest to someone other than the owner may be a prohibited transaction under section 4975 of the IRC.[141]

5. A Recent Example of How to Plan (Or Perhaps Not)

In PLR 200826039, issued April 2, 2008, the decedent, a participant in two qualified plans, had not reached his required beginning date.[142] The decedent's wife was the executor and testamentary trustee under his will and was named as beneficiary in her capacity as trustee.[143] The will provided that if the decedent's wife had an ownership interest in the qualified plans, then such interest was to be paid to her to the extent that it did not pass to her under the beneficiary designation.[144] The balance of the interest would then pass to the Bypass Trust, over which the decedent's wife had power to make distributions of income and principal for health, support, and maintenance.[145] The IRS ruled that the community property interest passed to the decedent's wife under the provisions of the will and that the community property interest was eligible for a rollover to her IRA.[146] Further, in keeping with the IRS's very liberal attitude concerning rollovers when the spouse, as fiduciary, has discretion as to distributions to a beneficiary spouse, the IRS ruled that the interest passing to the Bypass Trust could be distributed to the spouse and that the spouse could choose to roll the interest over to her IRA.[147]

Under the analysis of *Boggs*, there appears to be a serious question as to whether the decedent's wife had an ownership interest in the qualified plan at all. However, that seemed to be of no concern to the IRS, which raises the question of whether *Boggs* has any application in the absence of a dispute regarding the rights of a non-participant spouse. If the decedent names his spouse as a beneficiary with the power to disclaim, then the same result is achieved much more easily and directly.

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140. *Id*. at 262.

141. *See* I.R.S. Priv. Ltr. Rul. 94-39-020 (Sept. 30, 1994) (treating a division of community property IRAs so that half was distributed to an IRA in the non-participant spouse's name as a distribution taxable to the participant).

142. I.R.S. Priv. Ltr. Rul. 08-26-039 (Apr. 2, 2008).

143. *Id*.

144. *Id*.

145. *See id*.

146. *Id*.

147. *Id*.

D. Aggregate Versus Individual Asset Theory

The aggregate and individual asset theories are the 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.[148] California has enacted a statutory resolution adopting the aggregate theory.[149] 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 to dispose of by the non-participant spouse to allow the entire IRA to be allocated to the IRA owner.[150]

1. Written Agreement Between Spouses

Section 100 of the California Probate Code provides as follows:

> (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.[151]

Thus, by written agreement, the spouses can allow the executor of the predeceased spouse to divide the community property on an aggregate as opposed to an undivided asset by asset basis.[152]

2. Trust as Written Agreement

Section 104.5 of the California Probate Code provides that a transfer of community property to a revocable trust is presumed to be an agreement under section 100 and that those "assets retain their character *in the aggregate* for purposes of any division provided by the trust."[153]

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148. *See* 24 CAL. JUR. 3D *Decedent's Estates* § 4 (2008).
149. *See* CAL PROB. CODE § 100 (West 2002).
150. *See id*.
151. *Id*.
152. *See id*.
153. *Id*. § 104.5 (emphasis added).

3. Does This Work in Other Jurisdictions?

As many questions as California's solution raises, there is no statutory authority in other jurisdictions that supports this approach. However, there appears to be very good arguments if this type of solution is available in revocable trusts in other states. After all, a joint revocable trust is an agreement between spouses. There are some conceptual difficulties because the IRA is not actually contributed to the trust, but the argument that the beneficiary designation is sufficient seems reasonable. Further, 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.

II. CREDITOR'S RIGHTS

A. BAPCPA

The Bankruptcy Abuse Prevention and Creditor Protection Act (BAPCPA) contains retirement benefit provisions, creating several new exemptions, which apparently override state law exemptions.[154] The BAPCPA significantly liberalizes the protection of qualified plans, IRAs, and other non-qualified plans by providing exemptions from the bankruptcy estate.[155] These protections, however, are available only in the context of a bankruptcy proceeding and do not affect the rights of creditors in other contexts.[156]

1. Governing Law Prior to BAPCPA

a. Patterson v. Shumate

After many years of wrangling over the status of qualified plans in bankruptcy proceedings, in *Patterson v. Shumate*, the United States Supreme Court finally determined which plans were subject to the anti-alienation clause of ERISA.[157] The Court decided that ERISA was "applicable nonbankruptcy law," and, thus, retirement plans were excluded from the bankruptcy estate.[158] Some lower courts have tried to limit the applicability of this case by holding that the plan in question did not meet

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154. *See* Bankruptcy Abuse Prevention and Creditor Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005) [hereinafter BAPCPA].

155. *See generally id*. (amending title II of the United States Code).

156. *Id*.

157. 29 U.S.C. § 1056(d)(1) (2000); Patterson v. Shumate, 504 U.S. 753 (1992).

158. *See Patterson*, 504 U.S. at 755.

the qualifications of ERISA and the IRC.[159] The *Shumate* holding, however, does not apply to situations in which the business owner and the business owner's spouse are the only participants of the plan.[160]

b. Rousey v. Jacoway

On April 4, 2005, the United States Supreme Court issued its opinion in *Rousey v. Jacoway*, which resolved a conflict among the circuit courts as to whether the exemption from the bankruptcy estate in section 522(d)(10)(E) of the Bankruptcy Code applied to IRAs.[161] Section 522(d)(10)(E) 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 . . . ."[162]

There are several things that should be noted about the section 522(d)(10)(E) exemption. First, it is available only if the debtor chooses to not claim state law exemptions, which are much more liberal in many cases.[163] Second, the exemption is limited to the amount necessary for the support of the debtor.[164] Third, although it remains in the Bankruptcy Code, its efficacy is somewhat questionable because it is effectively overridden for all practical purposes by the new exemption in section 522(d)(12) added by BAPCPA.[165]

The Court determined that the rollover IRA was similar to the types of plans enumerated in the section 522(d)(10)(E) exemption because the plans in each case "provide income that substitutes for wages earned as salary or hourly compensation."[166] Further, the Court determined that the 10% early withdrawal penalty was substantial, and, thus, distributions were made on account of age, unlike those from a simple savings account, which could be accessed penalty free and without regard to age.[167] The Court engaged in further analysis to support its conclusion, but in light of the BAPCPA, the continuing importance of this opinion is questionable. The court stated in dictum that "although a debtor's interest . . . [in an IRA] could not be excluded under [section] 541(c)(2) . . . that interest could nevertheless be exempted under [section] 522(d)(10)(E)."[168]

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159. *See In re* Pederson, 155 B.R. 750, 756-57 (Bankr. S.D. Iowa 1993).
160. *See* Yates v. Hendon, 541 U.S. 1, 2-3 (2004).
161. Rousey v. Jacoway, 544 U.S. 320, 320 (2005).
162. 11 U.S.C. § 522(d)(10)(E) (2006).
163. *See id*. § 522(b)(2)-(d)(10).
164. *See id*. § 522(b)(2).
165. *Rousey*, 544 U.S. at 321.
166. *See* BAPCPA, *supra* note 154.
167. *See id*. (noting that they need not decide whether a lesser penalty would be substantial).
168. Patterson v. Shumate, 504 U.S. 753, 762-63 (1992).

2. BAPCPA Benefits Exempted Under State Exemption Election

Under the BAPCPA, section 522(b)(1) of the Bankruptcy Code allows debtors to elect between federal exemptions under section 522(b)(2) and state law exemptions under section 522(b)(3).[169] Section 522(b)(3) lists three exemptions conjunctively.[170] If the state exemptions are elected, then section 522(b)(3)(A) exempts property that is exempt under federal law other than under section 522(d) and state or local law of the debtor's domicile.[171] Section 522(b)(3)(B) retains the existing exemption for joint tenancy and tenancy by the entirety property, and section 522(b)(3)(C) exempts "retirement funds" to the extent those funds are in an account that is exempt from taxation under the following sections of the IRC: (i) section 401, including a qualified pension, profit sharing or employee stock bonus plan established by an employer for the exclusive benefit of the employees; (ii) section 403, including qualified annuity plans established by an employer for an employee; (iii) section 408, including IRAs; (iv) section 408A, including Roth IRAs; (v) section 414, including retirement plans for controlled groups; (vi) section 457, including eligible deferred compensation plans maintained by an eligible employer for an eligible employee; or (vii) section 501(a), including retirement plans by qualified charities.[172]

a. Additional Exemption

Apparently, because section 522(b)(3) of the Bankruptcy Code is written in the conjunctive, a debtor claiming state law exemptions would have available the greater of the section 522(b)(3)(C) exemptions or the exemption of qualified plans and IRAs under state law.[173] There does not appear to be any sort of preemption of state law, which the legislature could have easily included. Thus, if a debtor chooses to elect state exemptions and the state law provides little or no shelter for retirement benefits, then the federal exemption would protect the plans.[174]

b. Based on Tax Qualification

While the Supreme Court based the exclusion provided under *Patterson v. Shumate* on the application of Title I of ERISA, Congress based the section 522(b)(3)(C) exemption only on tax qualification under

169. *See* BAPCPA, *supra* note 154.
170. 11 U.S.C. § 522(b)(3) (2006).
171. *Id*. § 522(b)(3)(A)-(C).
172. 26 U.S.C. §§ 401, 403, 408, 408A, 414, 457 (2000).
173. *See id*. 11 U.S.C. § 522(b)(3).
174. *See id*. § 522.

the sections enumerated in the IRC.[175] The BAPCPA provides a method for determining whether the plans meet the qualifications of those sections.[176]

Section 522(b)(4)(A) presumes that plans which receive a favorable determination under section 7805 of the IRC, which determination is still in effect at the date of filing the bankruptcy petition, are exempt under sections 522(b)(3)(C) and (d)(12).[177]

Section 522(b)(4)(B) provides that even if there is no favorable determination under section 7805 of the IRC, "those funds are exempt from the estate if the debtor demonstrates that no prior determination to the contrary has been made by a court or the Internal Revenue Service; and the retirement fund is in substantial compliance with the . . . Internal Revenue Code of 1986; or . . . the debtor is not materially responsible for that failure."[178] As a result, a plan that has not received a favorable determination will still be exempt if it meets the other requirements of section 522(b)(4)(B), while a plan that has received favorable determination is entitled only to a presumption.[179] Section 522(b)(4)(C) provides that a direct trustee-to-trustee transfer will not cause a loss of the section 522(b)(3)(C) exemption or the section 522(d)(12) exemption.[180] Section 522(b)(4)(D) states that a qualified rollover will not cause a loss of the exemption.[181]

3. The New Federal Exemption

A new exemption is created if the federal exemptions are elected.[182] This exemption is identical to the section 522(b)(3)(C) exemption and applies to retirement funds "to the extent that those funds . . . [are] exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986."[183]

With the addition of this paragraph, it is difficult to understand the need for the exemption in section 522(d)(10)(E) of the Bankruptcy Code, which was the subject of *Rousey v. Jacoway*.[184] Even with the $1,000,000 limitation on the exemption for non-rollover IRAs and Roth IRAs, the relief under the section 522(d)(12) exemption appears to be much more liberal than the section 522(d)(10)(E) exemption, which imposes a "need of the

175. *Id*. § 522(b)(3)(c); *see* Patterson v. Shumate, 504 U.S. 753, 753 (1992).
176. *See* 11 U.S.C. § 522(b)(4).
177. *See id*. § 522(b)(3)(C), (b)(4)(A), (d)(12); *see* 26 U.S.C. § 7805 (2000).
178. *See* 11 U.S.C. §522(b)(4)(B).
179. *Id*.
180. § 522(b)(4)(C).
181. § 522(b)(4)(D).
182. *See* § 522(d)(12).
183. *See* § 522(b)(3)(C).
184. *See id*. § 522(d)(10)(E); *see* Rousey v. Jacoway, 544 U.S. 320 (2005).

debtor" requirement. For that reason, the latter section becomes unnecessary.[185]

4. *Limitation on Exemptions*

The blanket exemptions which sections 522(b)(3)(C) and (d)(12) of the Bankruptcy Code appear to grant, are subject to a limitation in section 522(n), which reads:

> 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 account under section 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), 403(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.[186]

a. *Plans Affected by the Limitation*

The $1,000,000 limitation is apparently designed to apply to plans other than employer plans and to rollovers from employer plans to IRAs, such as to individually established IRAs and Roth IRAs.[187] A rollover consists of a distribution to the participant followed by a contribution within sixty days to another tax exempt plan.[188] Without the rollover provisions, the initial distribution would be taxable to the participant irrespective of what the participant did with the money.[189] The exemption for a rollover is defined by reference to specific IRC sections.[190] These sections do not include rollovers from one IRA to another under section 408(d)(3) of the IRC.[191] As a result, an IRA rolled over to another IRA will be subject to the $1,000,000 limitation, while a rollover from an employer plan to an IRA would not be.[192] 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. Because the limitation applies only to rollovers, the issue of an IRA to IRA rollover can be avoided using a trustee-to-trustee transfer, which, unlike a rollover, is not treated as a

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185. *Compare* § 522(d)(12), *with* § 522(d)(10)(E).
186. *Id*. § 522(n) (emphasis added).
187. *See id*.
188. *Id*. § 522(b)(4)(D).
189. *See id*.
190. *Id*.
191. 26 U.S.C. § 408(d)(3) (2000).
192. *See* 11 U.S.C. § 522(b)(4)(D); *see also* 26 U.S.C. § 408(d)(3).

distribution.[193] This technique, however, cannot exempt an IRA originally subject to the limitation.[194]

b. Applicability to State Law Exemptions

If state law exemptions are elected and provide unlimited exemptions for IRAs, then a question arises as to whether the highlighted language in section 522(n) of the Bankruptcy Code applies only to the section 522(b)(3)(C) exemption or whether it also applies to limit the state law exemptions under section 522(b)(3)(A).[195] Arguably, section 522(b)(3)(C) exemptions are the assets "exempted under this section," and state law exemptions are therefore not subject to section 522(n).[196] After all, as previously noted, these exemptions are written in the conjunctive. Conversely, the phrase could be interpreted as applying to all of section 522; however, given the effect of the limitation, this question would appear more academic than real, unless the IRA contains an explosive asset.[197]

c. Applicability to Federal Exemptions

The limitation clearly applies to the section 522(d)(12) exemption and presumably to the section 522(d)(10)(E) exemption also.[198]

d. 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.

i. Adjusted for Inflation

The amount of the limitation is adjusted for inflation under section 104 of the Bankruptcy Code.[199] Given the affect of the limitation 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

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193. Rev. Rul. 78-406, 1978-2 C.B. 157.
194. *Id*.
195. Santo Bisignano, Jr. et al., *Watch Your Assets! An Estate Planner's Guide to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*. SM022 ALI-ABA 149, 186 (2006).
196. *Id*.
197. *Id*.
198. *Id*.
199. *Id*.

inflation.[200] For example, a person who began making maximum contributions thirty years ago would have contributed less than $70,000 to the IRA. It would take an amount greater than a 15% compound annual return for that person to accumulate $1,000,000.

ii. Commingled IRAs

However, if an IRA is commingled, then the question arises as to whether tracing is 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? Although the act provides no answer, it would certainly be worth a try.

e. Discretionary Increase in the Limitation Amount

It is mystifying under what circumstances the "interests of justice" would require an increase in the limitation amount.[201] Perhaps this could refer to a situation in which a rollover IRA is taken out of the safe harbor provision because of its contributions.[202] If it could be shown that the contributory portions, including earnings on that portion, were less than $1,000,000, then there would arguably be a reason to raise the limitation. To the extent possible, rollover IRAs and contributory IRAs should be kept separate.

5. 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 section 522(b)(3)(C) or (d)(12) exemption.[203]

a. Spousal Rollovers

Nevertheless, there are still some important unanswered questions. Is a spousal rollover under Treasury Regulation sections 1.408-8, A-5 subject to the section 522(n) limitation?[204] 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 was an unlimited exemption.[205] If the spousal

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

201. *Id*.

202. *Id*. at 186-87.

203. 11 U.S.C. § 522(b)(4)(C)-(D) (2006); Bisignano, *supra* note 195, at 187.

204. 11 U.S.C. § 522(n).

205. *See* § 522(b), (n).

rollover is from an IRA which is not a rollover, then it should be subject to the same $1,000,000 limitation.[206] This is consistent with the treatment of an inherited IRA which should retain its exemption from the section 522(n) limitation because there has been no change other than the distributee.[207]

b. Inherited IRAs

The BAPCPA leaves open the issue of an inherited IRA, or 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 section 522(b)(3)(C) and (d)(12) exemption if the beneficiary has adjudicated a bankruptcy?[208] The statute makes no distinction with respect to the beneficiary, but at least one commentator has raised the issue whether such funds are assets which are described as exempt or "retirement funds" in the hands of the beneficiary.[209]

Many, but not all states, have statutes exempting IRAs from claims of creditors.[210] 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 issue becomes important not only in state law proceedings, but also in bankruptcy. As previously noted, because state law exemptions are available in the context of bankruptcy proceeding, the need to resort to the BAPCPA only arises when the state law exemptions fail to provide protection.[211] Nevertheless, several new bankruptcy cases have cast doubt upon the efficacy of state law protection for a beneficiary's interest in inherited IRAs.[212] One of these cases is an unpublished Texas case which discusses and analyzes many of the other cases.[213]

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206. *See* § 522(n).

207. *See id*.

208. § 522(b)(3)(c).

209. *See* Gideon Rothschild, *Protecting Retirement Plans*, June 2002, http://mosessinger.com/articles/files/protecting.htm.

210. *See* Chris Riser, *Asset Protection State-by-State*, May 2007, http://www.assetprotectionbook.com/s1_asset_protection_state_resources.htm.

211. *See* 11 U.S.C. § 522.

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

213. *In re* Jabroe, 365 B.R. 717 (Bankr. S.D. Tex. 2007).

B. Construction of State Statutes

1. *In re* Jabroe

Section 42.0021 of the Texas Property Code exempts a debtor's interest in an IRA when 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 of 1986."[214] Many state statutes granting exemptions to IRAs rely on Internal Revenue Code qualification as the linchpin for such exemption.[215] 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.[216] Among these differences are the inability of the beneficiary to: (i) contribute to the IRA; (ii) rollover the IRA to another plan; and (iii) wait until age 70-1/2 before being required to take distributions.[217] While these are valid distinctions, there is a serious question as to whether these distributions prevent the inherited IRA from qualifying as such "under the applicable provisions of the Internal Revenue Code."[218] In fact, the IRC still treats the inherited IRA as tax-deferred and subject to the required minimum distribution rules, assuming that the required beginning date is December 31 of the year following the year of the participant's death.[219]

2. *In re* McClelland

Due to the fact that Idaho is a community property state, both spouses in *In re McClelland* filed.[220] Mrs. McClelland was the sole beneficiary of her aunt's IRA.[221] After transferring IRA custodians, Mrs. McClelland annuitized the IRA.[222] She claimed the IRA was exempt, but the trustee in

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214. *Id*. at 720.

215. *See* Riser, *supra* note 210.

216. *Jabroe*, 365 B.R. at 721-23.

217. *Id*. at 721.

218. *Id*. at 718.

219. *Id*. at 724. One of the more amazing facets of *Jabroe* is that the debtor argued that section 829 of the Pension Protection Act, dealing with non-spousal rollovers, indicated that the IRA was exempt, but he failed to argue the exemption for IRAs in bankruptcy that section 522(b)(3)(C) created by the Bankruptcy Abuse Prevention and Creditor Protection Act of 2005, which was effective a year before the bankruptcy filing. 11 U.S.C. § 522(b)(3)(C) (2006). 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 section[s] . . . 408 . . . of the Internal Revenue Code of 1986." *Id*. Some commentators have suggested that inherited IRAs are not "retirement funds," and this argument would be consistent with the reasoning in Jabroe and similar cases. *See id.*; *see generally Jabroe*, 365 B.R. at 720-25.

220. *In re* McClelland, No. 07-40300, 2008 WL 89901, at *1 (Bankr. D. Idaho Jan. 7, 2008).

221. *Id*.

222. *Id*.

bankruptcy objected.[223] The court cited section 11-604A of the Idaho Code, which reads in relevant part as follows:

> (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:
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> . . .
>
> (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.[224]

The court decided that "the [l]egislature painted with a broad brush" in creating this exemption.[225] Looking at the policy to protect "retirement income" for any citizen of Idaho, the court refused to engraft a requirement that the exempt person be the participant or owner.[226] Then, by looking to the broad definition of an "employee benefit plan," the court determined that Mrs. McClelland's aunt's "account was an 'employee benefit plan' for purposes of [section 11-604A of the] Idaho Code."[227]

The court acknowledged the adverse decisions in other jurisdictions while simultaneously relying on the fact that the Idaho statute includes section 408 plans.[228] In many of the other decisions, the courts went to great lengths to explain why an inherited IRA was not a section 408 plan,

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223. *Id*.
224. *Id*. at *2-3 (citing IDAHO CODE ANN. § 11-604A (2008)) (emphasis added).
225. *Id*. at *3.
226. *See id*. (noting the holding and rationale of the court).
227. *Id*. at *3.
228. *See id*. at *4 (comparing the several other bankruptcy court decisions as inherited IRAs).

primarily because the beneficiary could not contribute to the inherited IRA.[229]

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.[230] The assistant manager informed Mrs. McClelland that she would have to pay income tax on the entire IRA and would be subject to a penalty for early withdrawal.[231] Despite the described adverse tax effects, Mrs. McClelland insisted on withdrawal, but Westmark refused to give her the funds.[232] As a result, Mrs. McClelland established an account at another institution styled "Debra J. McClelland ABO Carol Morrow."[233] In that account, she purchased the annuity.[234]

To compound matters, the court noted that the advice concerning the early withdrawal penalty was erroneous. The court stated:

> The rules pertaining to distribution upon the death of an IRA owner are set out in 26 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 [the] 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).[235]

C. 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. Pay Benefits to a Spendthrift Trust

Protection may be provided by paying such benefits to a spendthrift trust, which meets the requirements of a designated beneficiary.[236] The trust should be excluded from the bankruptcy estate under section 541(c) of the Bankruptcy Code, and reliance on exemption for inherited IRAs is

229. *See id*.
230. *Id*. at *1.
231. *Id*.
232. *Id*.
233. *Id*. at *2.
234. *Id*.
235. *Id*.
236. *See In re* Reagan, 741 F.2d 95, 97 (5th Cir. 1984).

unnecessary.[237] The trust, however, cannot be a conduit trust, or creditors will be allowed to reach the amounts that are required to be distributed to the beneficiary.[238] This, of course, raises all of the difficulties in assuring that the primary beneficiary is a designated beneficiary and the measuring life. If the trust is a support trust, then amounts paid to the beneficiary are subject to claims of creditors.[239] Thus, the trust should include a facility of payments clause.[240] Some commentators have suggested that a subtrust under a traditional spendthrift trust may not work.[241] These commentators suggest that a separate trust should receive the benefits.

2. Use a Trusteed IRA

Instead of a custodial IRA with a trust as beneficiary, the IRA itself can be a trust.[242] This avoids complying with all the rules of qualifying a trust as beneficiary, but it does not avoid the rules surrounding the determination of whether there is a designated beneficiary who is the measuring life. Again, a conduit trust cannot be used.[243] However, 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. It can nevertheless be accomplished and should be considered.

3. Some Policy Thoughts

Most believed that state exemption statutes extended to inherited IRAs, and it may well be that the state courts would reach such a result.[244] However, the policy argument in protecting IRAs is that creditors should not be allowed to reach the retirement benefits of an owner.[245] However, these funds are clearly not set aside for the retirement of the beneficiary. Because of their ability to cash out, which over 75% do, they are therefore 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, then the owner can use a spendthrift trust or trusteed IRA.

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237. *See* 11 U.S.C. § 541(c)(2) (2006).

238. Jean T. Adams, *Working with Retirement Benefits in Estate Planning for Family Business Owner*, 2007 A.L.I.-A.B.A. CONTINUING LEGAL EDOC. 893, 909.

239. 76 AM. JUR 2D *Trusts* § 110 (2005).

240. *In re* Keeler's Estate, 3 A.2d 413, 415-16 (Pa. 1939).

241. *But see* Doug H. Moy, Living Trusts 131 (2003).

242. Kathleen R. Sherby & Bryan Cave, *Now that You Have It-What Do You Do With it? : Hot Topics in Planning Estate Disposition of Qualified Plans and IRAs*, 2007 A.L.I.-A.B.A. CONTINUING LEGAL EDUC. 981, 1055-56.

243. Adams, *supra* note 85, at 909.

244. *See* Christopher R. Hoyt, *Family and Charitable Estate Planning With Retirement Plan Accounts*, 2006 A.L.I.-A.B.A. CONTINUING LEGAL EDUC. 309, 378, n. 37.

245. John E. Sullivan III, *Gutting the Rule Against Self-Settled Trusts: How the New Delaware Trust Law Competes with Offshore Trusts*, 23 DEL. J. CORP. L. 423, 431-32 (1998).