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FEDERAL TAX LIENS AND THE DEBTOR'S PENSION PLAN

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A CLE Presentation

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The Internal Revenue Service has a secured claim in bankruptcy only if the claim is secured by a lien on “property in which the estate has an interest” and only “to the extent of the value of such creditor’s interest in the estate’s interest in such property.” 11 USC § 506(a). However, property of the estate has been broadly interpreted to include “all legal or equitable interests of the debtor in property as of the commencement of the case.” 11 USC § 541(a)(1).

Similarly, restrictions or conditions on transfer of property are generally ineffective to prevent inclusion of such property in the Bankruptcy Estate. 11 USC § 541(c)(1). An exception to this general rule provides that a **“restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title.”** 11 USC § 541(c)(2). Accordingly, to the extent a debtor’s interest in property is subject to such enforceable non-bankruptcy transfer restrictions, the interest is not property of the estate.

It was within this framework that the Supreme Court examined the includability/excludability of pension plans under § 541 in its famous decision Patterson v. Shumate, 504 U.S. 753 (1992). The Supreme Court held that “applicable non-bankruptcy law” is not limited to state law and that an ERISA mandated anti-alienation provision satisfies the literal terms of § 541(c)(2). Id. at 759-60. The Court’s ruling was based on the “plain language” of the statute (id. at 757) and also based on several policy considerations. Among these was the fact that the Court’s interpretation of § 541(c)(2) “ensures that the treatment of pension benefits will not vary based on the beneficiary’s bankruptcy status...[and] minimizes the possibility that creditors will engage in strategic manipulation of the bankruptcy laws in order to gain access to otherwise inaccessible funds. Id. at 764.

Although heralded as a victory for debtors and a protection to their golden years investment, the decision actually created for many debtors the antithesis of the Court’s strong policy consideration, i.e., the uniform treatment of pension benefits without regard to the beneficiary’s bankruptcy status. In the eight years since the decision, debtors have been faced with a myriad of collection practices by the IRS based solely upon the particular practices of the district in which the debtor filed bankruptcy.

In aggressive districts, the IRS pursued collection against debtor’s pension plans either during or immediately after the debtor’s bankruptcy as the Notice of Federal Tax Lien was collectible “in rem” from excluded or exempt property and was unaffected by the debtor’s “in personam” discharge. In passive or overburdened districts, the IRS usually ignored the pension plan within the bankruptcy as excluded property and released the “in rem” lien on all dischargeable tax debts as being too burdensome to pursue.

Still yet in other districts, such as locally, and when counsels for debtors were wise enough to think about debtor’s pension plans post-bankruptcy, a variety of deals were struck to value the debtor’s interest presently within a Chapter 11 or Chapter 13 Plan (especially if debtor was not yet fully vested or the pension was going to grow in value during the bankruptcy) and to pay that value within the Plan in exchange for a lien release upon Plan completion. In Chapter 7 proceedings, sharp counsel would quickly value and buy an “in rem” release of the tax lien on the pension plan as soon as the No Asset Order was entered and while the IRS’s bankruptcy unit still had control of the situation.

Because Patterson did not involve a claim of the IRS, it did not address the effect of plan restrictions on transfer that are not enforceable against a particular creditor such as the IRS. That situation was identified and decided by the Honorable Judge Teel just months after the Supreme Court’s opinion in Patterson. However, his decision In re Lyons, 148 B.R. 88 (Bankr. D.D.C. 1992) has been largely ignored, distinguished, or avoided by the courts until April 2000 when the IRS issued Memorandum Advice that it was reversing its prior position on Lyons, agreeing that its holding was correct, and advising that it would be followed by the IRS.

The issue presented in Lyons was whether the claim of the IRS was secured by the debtor’s interest in certain retirement annuities. In light of the Supreme Court’s holding that “applicable non-bankruptcy law” encompassed any relevant law, including Federal law, the Court in Lyons applied a two-pronged analysis to determine whether the annuities were excluded from the estate (and thus from the value of the secured claim) under § 541(c)(2). The Court first determined that the anti-alienation

provisions of the annuity contracts were enforceable against ordinary creditors under State spend thrift trust law. The Court then addressed whether these transfer restrictions were effective against the IRS. Just as ERISA was held to be a source of applicable non-bankruptcy law in Patterson, the Court in Lyons found that “Federal tax lien law is also applicable non-bankruptcy law.” Id. at 93.

The Court concluded that the anti-alienation provisions of the annuity contracts were not enforceable against the IRS under applicable non-bankruptcy law. Therefore, the Court held that “to the extent the IRS can reach the debtor’s [pension] rights, they are property of the estate under § 541.” Id. at 93. Accordingly, under 11 USC 506(a), the IRS had a secured claim to the extent to the value of the debtor’s pension rights, i.e., the present value of the future cash flows. Id. at 94.

Like the Supreme Court’s decision in Patterson, the Lyons holding was based on the “plain language” of § 542(c)(2). Id. at 93. The Court also cited its policy rationale:

Outside bankruptcy, the IRS would have an enforceable lien against the debtor’s vested right to receive a future stream of pension income despite spend thrift provisions in the pension plans. There is no evidence that in enacting § 541(c)(2) Congress intended the intervention of bankruptcy to alter the IRS’s powers as a tax creditor. Id. at 93.

Note that the concern expressed here echoes the policy consideration identified by the Supreme Court in Patterson, i.e., the uniform treatment of pension benefits without regard to the beneficiary’s bankruptcy status.

The Lyons decision was subsequently affirmed by the same Judge in In re Jones, 206 B.R. 614 (Bankr. D.D.C. 1997). In Jones, Judge Teel held that a thrift savings plan account was property of the estate to the extent of the Federal tax lien and, therefore, the IRS was secured with respect to the debtor’s interest in her TSP account. The Court found that because the transfer restrictions are not effective against Federal tax liens, the Debtor’s “technical” property of the estate argument loses its foundational premise.

[T]he TSP account would in effect have a split personality by remaining property of the estate for purposes of federal tax claims even though it is not property of the estate for purposes of other creditors’ claims. Id. at 621.

Most other cases decided since Lyons neither support nor rebut the Lyons rationale but fail to address it directly. However in In re Persky, 82 A.F.T.R. 2d 6664 (E.D. Pa. 1998) the Court declined to follow the Lyons and Jones rationale. The Court stated in a footnote that there is nothing in Lyons which “supports the reasoning of the Jones Court that property excluded from the estate by the Bankruptcy Code has a ‘split personality’ and is nonetheless property of the estate for purposes of a Federal tax lien.” Id. at 6669 note 9.

However, the Persky decision is odd for several reasons. First the Court’s attempts to distinguish Lyons from Jones are clearly erroneous. Both of Judge Teel’s opinions show the same holding: that the debtor’s interest in a beneficial trust otherwise excluded from the bankruptcy estate under 11 USC § 541(c)(2) **is** property of the estate to the extent that a creditor can reach the interest outside a bankruptcy. If “applicable non-bankruptcy law” cannot prevent transfer, such as in the case of a Federal tax lien that attaches regardless of anti-alienation provisions, the exception of § 541(c)(2) does not apply and the interest becomes property of the estate under § 541(a). In addition, whether a debtor’s interest in a beneficial trust is property of the estate is a question of law, but the Court relied upon the stipulation of the parties that the beneficial interest was not property of the estate under Patterson.

Accordingly, for the past eight years decisions within some circuits followed Lyons while the rest of the country and the IRS generally followed the rationale in Patterson; and district by district deals existed. In April 2000, the IRS issued a Memorandum Advice nationwide reversing its position on Lyons. The IRS recognized the “split personality” character of pension funds secured by Notices of Federal Tax Lien and agreed that the Lyons rationale replicated within bankruptcy the result that would occur outside

bankruptcy, consistent with the strong policy consideration sought by the Supreme Court in Patterson. The disparate treatment between the IRS and other creditors within § 541 was found to be appropriate and consistent with many other provisions elsewhere in the Bankruptcy Code. Thus, following Lyons creates a uniform treatment of all debtors and is particularly valuable to Chapter 11 and Chapter 13 debtors.

Accordingly, it now becomes extremely incumbent upon debtor's counsel to identify and value a debtor's interest in a pension, retirement, or thrift savings plan at the onset of a bankruptcy proceeding where the IRS holds a Notice of Federal Tax Lien. This will involve both identifying debtor's contributions to the pension plan as well as valuing debtor's vested interest in the future pension stream actuarially.

It has been suggested that this position in Lyons might create potential issues for decision if a trustee sought to avoid the IRS's lien as allowed under § 724(b) for the benefit of priority creditors. However, since the "value" included within property of the estate is only for the limited purposes of valuing the IRS's secured claim, but not property the estate for the purposes of satisfying the claims of other creditors, this issue appears unlikely to arise. The Chapter 7 Trustee will most likely abandon any interest in a pension plan as secured by the IRS and as excluded property as to all other creditors; thus it would provide no liquidation interest for the benefit of the estate.

Accordingly, adoption of the Lyons rationale should prove beneficial from the IRS's standpoint, and most often the debtor's too. It is much preferable to allow the debtor to pay the value of his interest in the pension plan through monthly plan payments than to cause an invasion of the debtor's retirement system with its attending tax ramifications and depletion of retirement years benefits.