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MEMORANDUM FOR DISTRICT COUNSEL, VIRGINIA-WEST VIRGINIA

FROM: Gary D. Gray
Assistant Chief Counsel (General Litigation)

SUBJECT: Pensions as Property of the Bankruptcy Estate

By memorandum dated July 16, 1996 (digested in GL Bulletin No. 431), we took the position that the bankruptcy court's opinion in In re Lyons, 148 B.R. 88 (Bankr. D.D.C. 1992) is legally unsound and, therefore, should not be followed. We understand that several District Counsel offices, as well as the Tax Division of the Department of Justice, have questioned whether our position is correct. By memorandum dated August 28, 1997, you requested that we reconsider our position.

## ISSUE

Whether the Internal Revenue Service's (Service) claim in bankruptcy is secured by the debtor's interest in an ERISA-qualified plan or other interest generally subject to a restriction on transfer enforceable under nonbankruptcy law.

## CONCLUSION

As discussed below, we have reconsidered our position and have concluded that the holding of the Bankruptcy Court for the District of Columbia (Judge Teel) in Lyons is correct. We believe that the debtor's interest in ERISA-qualified pension plans and similar interests are property of the bankruptcy estate under section 541 of the Bankruptcy Code, but only for the benefit of the Service. Therefore, under section 506 of the Bankruptcy Code, the Service's claim is secured to the extent of the value of such interests.

## DISCUSSION

Section 541(a)(1) provides that property of the bankruptcy estate consists of all legal or equitable interests of the debtor in property as of the commencement of the case, except as provided in section 541(b) and (c)(2). Section 541(c)(1) further provides that the debtor's interest in property becomes property of the bankruptcy estate under section 541(a), notwithstanding any restrictions on transfer, except as provided by section 541(c)(2). Section 541(c)(2) provides:

> A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.

In Patterson vs. Shumate, 504 U.S. 753 (1992), the Supreme Court was presented with the question whether the debtor's interest in an employer pension plan that contained the anti-alienation provision required by Title I of the Employee Retirement Income Security Act of 1974 (ERISA) 1/ was included or excluded from the bankruptcy estate under section 541. 2/ The Court held that the term "applicable nonbankruptcy law" in section 541(c)(2) was not limited to state law (and thus included ERISA and other federal law) and that the anti-alienation provision required for qualification under Title I of ERISA was enforceable under applicable nonbankruptcy law. 3/ The Court concluded that under section 541(c)(2) the debtor's interest in the pension plan was excluded from the bankruptcy estate. 504 U.S. at 760.

Under ERISA and federal tax law, anti-alienation provisions enforceable under ERISA against creditors generally are not enforceable against the Service. See, e.g., Travelers Insurance Co. v. Ratterman, 96-1 U.S.T.C. ¶ 50,143 (S.D. Ohio 1996) (while ERISA prevents ordinary creditors from attaching pension payments, courts have unanimously held that a federal tax lien or levy may be imposed on ERISA-qualified pension plans); Ameritrust Co., N.A. v. Derakhshan, 830 F. Supp. 406 (N.D. Ohio 1993) (rejecting the assertion of the taxpayer's former spouse that a qualified domestic relations order is the only exception to ERISA's anti-alienation provisions, the district court held that the Service may levy on funds in a taxpayer's individual retirement account (IRA) and Keogh account); In re Jacobs, 147 B.R. 106 (Bankr. W.D. Pa. 1992)

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1/ Section 206(d)(1) of ERISA provides: "Each pension plan shall provide that benefits provided under the plan may not be assigned or alienated." 29 U.S.C. § 1056(d)(1).

2/ Patterson did not involve bankruptcy claims of the Service. The Chapter 7 trustee was seeking to include in the bankruptcy estate the debtor's interest in the qualified plan.

3/ In finding that the phrase "applicable nonbankruptcy law" referred to "any relevant nonbankruptcy law, including federal law such as ERISA," the Court looked to the plain language of section 541(c)(2). 504 U.S. at 757-759. The Court went on to find that (1) the plan contained restrictions on transfer and (2) the restrictions on transfer were enforceable, because a plan participant, fiduciary, or beneficiary, or the Department of Labor could bring a civil action to enjoin any act which violated the terms of the plan or ERISA. 504 U.S. at 760.

(bankruptcy court held that federal tax lien may attach to the taxpayer's ERISA-qualified pension); In re Reed, 127 B.R. 244 (Bankr. D. Haw. 1991) (ERISA anti-alienation provisions do not preclude enforcing a federal tax lien or collection on a judgment resulting from an unpaid tax liability); see also Shanbaum v. United States, 32 F.3d 180 (5th Cir. 1994) (Fifth Circuit stated in dictum that a taxpayer's pension benefits under an ERISA-qualified plan are subject to levy despite the ERISA anti-alienation provision). Because Patterson did not involve a claim of the Service, it did not address the effect of a plan restriction on transfers that is not enforceable against a particular creditor, such as the Service. That question was addressed in Lyons:

> [T]he pension plans' provisions are not, within the language of § 541(c)(2), "enforceable under applicable nonbankruptcy law" with respect to the IRS. Under § 541(c)(1) the debtor's pension rights thus remain property of the estate and under § 506(a) the IRS has an allowed claim against the pension rights to the extent of their value.

148 B.R. at 94. 4/

The court noted that its interpretation was "compelled" by the plain language of section 541(c)(2), as well as policy considerations:

> Outside bankruptcy, the IRS would have an enforceable lien against the debtor's vested right to receive a future stream of pension income despite spendthrift 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.

148 B.R. at 93. As you point out, this same policy consideration–replicating within bankruptcy the result that would occur outside bankruptcy–was also recognized by the Supreme Court, which stated that the Patterson decision "ensures that the treatment of pension benefits will not vary based on the beneficiary's bankruptcy status." 504 U.S. at 764.

Judge Teel revisited this issue in In re Jones, 206 B.R. 614 (Bankr. D.D.C. 1997), a case concerning whether a Thrift Savings Plan (TSP) account is property of the

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4/ Lyons involved plans under the Teachers Insurance and Annuity Association (TIAA)/College Retirement Equities Fund (CREF). In footnote 6 of the opinion, Judge Teel left undecided whether the result of the case would be different if the plans at issue were ERISA-qualified plans, rather than merely TIAA/CREF plans. However, based on the case law cited above, holding that ERISA's anti-alienation provision does not bar federal tax collection, we believe that the reasoning of Lyons is equally applicable to ERISA plans.

bankruptcy estate. 5/ Jones recognized the unique position of the United States as a creditor in bankruptcy:

> A TSP account becomes property of the estate only to the extent that the account is not beyond the reach of creditors outside bankruptcy. ... Accordingly, as regards state-created statutory liens, a TSP account would not be property of the estate and, accordingly, 11 U.S.C. § 506(a) would be inapplicable to such liens. [footnote omitted.]
>
> Nevertheless, as this court has held on slightly different facts, the 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 the purposes of other creditors' claims. [Footnote omitted.]

206 B.R. at 621.

We believe that the disparate treatment of the Service and other creditors under section 541 is entirely appropriate and, as you noted in your memorandum, occurs elsewhere in the Bankruptcy Code. We agree with your conclusion that the treatment of property held by tenants by the entireties under section 522 offers a good analogy to the treatment of ERISA-qualified plans under section 541. Section 522(b)(2)(B) refers to nonbankruptcy law and gives effect to the requirements of such law, resulting in property being in the bankruptcy estate for (and to the benefit of) certain creditors, but not others. Similarly, section 541 draws on nonbankruptcy law that should be given effect in bankruptcy.

Not following Lyons leads to results that are straightforward: ERISA-qualified plans and similar interests are excluded from the bankruptcy estate with respect to the Service and all other creditors. Because they are not property of the estate, they cannot be used in determining the value of the Service's secured claim. On the other hand, to the extent that the Service has a lien that survives the bankruptcy, it can pursue collection outside bankruptcy. However, given the statutory framework of sections 541 and 506 and the Supreme Court's reasoning in Patterson discussed above, upon reconsideration we now believe that the holding in Lyons is correct. The wording of each section, on its face, supports the court's reasoning. In addition, there is nothing in

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5/ Like ERISA-qualified plans, TSP accounts are generally protected from alienation provision. Funds held in the Thrift Savings Fund "may not be assigned or alienated and are not subject to execution, levy attachment, garnishment or other legal process." 5 U.S.C. § 8437(e)(2).

the legislative history that would call for a different result. Similarly, there is no case law contrary to Lyons. 6/

In your memorandum, you stated that following Lyons has advantages in Chapter 13 cases. [redacted]

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6/ In fact, there have not been many cases on this issue since Lyons and Jones were decided. There is one case, In re Persky, 98-2 U.S.T.C. ¶ 50,786, that has distinguished Jones. The court in Persky held that an interest in a spendthrift trust was not property of the bankruptcy estate, and, therefore, the Service's claim was not secured to the extent of the interest in the trust. The debtors cited Jones, asserting that the Service's claim was secured under section 506 to the extent of its prepetition lien on the trust. The court found that the debtors' reliance on Jones was misplaced because, unlike Jones and Lyons, the parties stipulated that the interest was excluded from the bankruptcy estate. Because of the parties' stipulation, the court did not have to address the section 541 issue. Several other cases have concluded that the Service's claim is secured to the extent of the debtor's interest in an ERISA-qualified plan, and therefore seemingly lend support to Lyons. However, these cases are not particularly strong support for Lyons because while they reach the same result regarding the determination of the Service's secured claim, they, unlike Lyons, did so after holding that ERISA-qualified plans are excluded from the bankruptcy estate.

[redacted]

[redacted] 7/ [redacted]

8/ [redacted]

Because, under Lyons, ERISA-qualified plans are property of the bankruptcy estate only for the purposes of the Service's claims, we believe that the property should be abandoned by the trustee. In a Chapter 7 case, the trustee is required to collect, liquidate, and distribute the property of the bankruptcy estate "as expeditiously as is compatible with the best interests of parties in interest." B.C. § 704(a). In accordance with this obligation, section 554 provides for the abandonment of property "if it is not needed by the estate and its retention serves no purpose in effectuating the goals of

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7/ [redacted]

8/ [redacted]

the Bankruptcy Code." 9/ 5 Collier on Bankruptcy ¶ 554.01. See, e.g., In re MCI, Inc., 151 B.R. 103 (E.D. Mich. 1992)(Chapter 7 trustees have a duty not to administer property that will not generate funds for unsecured claimants). In In re Groves, 120 B.R. 956 (Bankr. N.D. Ill. 1990), a pre-Patterson case 10/ not involving the Service, the bankruptcy court found that the debtor's interest in a state retirement plan was property of the estate that could only be sold for the benefit of the creditors or abandoned. In a post-Patterson/Lyons world, there is no benefit to the other creditors in selling the interest, so it should be abandoned.

If you have questions or comments regarding the foregoing, please contact Branch 1 at (202) 622-3610.

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9/ Specifically, section 554 provides that the trustee, after notice and a hearing, may abandon property of the bankruptcy estate that is burdensome to or of inconsequential value and benefit to the estate. B.C. § 554(a). Alternatively, a party in interest can request that the bankruptcy court, on the same grounds, order the trustee to abandon the property. B.C. § 554(b).

10/ The court in In re Groves adopted the pre-Patterson position that a number of courts had taken. It concluded that the exception under section 541(c)(2) applied only to spendthrift trusts under state law. 120 B.R. at 960.