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Subject: **Tax Court Rules That IRS Lien on Participant's Interest in Qualified Plan Survives Bankruptcy Discharge**

Major References: [*Wadleigh v. Comm'r, T.C. Memo. 134 T.C. No. 14 \(2010\)*](#)

Prior AALU Washington Reports: 92-12; 05-62; 05-42; 04-35

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THE CONCLUSION OF THIS WASHINGTON REPORT.**

The Tax Court, in Wadleigh v. Comm'r, T.C. Memo, 134 T.C. __ No. 14 (2010), ruled that the Internal Revenue Service's lien on a participant's interest in a qualified plan survived the bankruptcy discharge of Federal tax liability when the qualified plan was excluded from the bankruptcy estate. (See generally our Bulletins Nos. 92-12; 05-62; 05-42; 04-35.)

In *Wadleigh*, in 2002, the IRS assessed the taxpayer, a participant in the Honeywell Pension Plan, and his wife, both residents of California, for failing to pay income tax for the 2001 tax year. Sometime in 2005, the Wadleighs filed a voluntary chapter 7 bankruptcy petition. When the bankruptcy case was discharged later that year, the debt relating to the 2001 income tax liability was included in the discharge.

At the time of the bankruptcy petition, the taxpayer was fully vested in his pension, but the pension was not yet in payout status since his right to monthly pension payments did not mature until November 1, 2007. Because the pension plan is a qualified plan and subject to ERISA, he indicated in his bankruptcy filing that it was excluded from the bankruptcy estate under Federal bankruptcy law.

In 2007, following the discharge, the Service notified the taxpayer of its intent to levy on his pension income in order to collect the unpaid tax liability from the 2001 tax year. In response, he

requested a hearing to appeal the tax. In his appeal, the taxpayer argued, among other things, that, because the IRS was not entitled to his interest in the pension plan at the time of the bankruptcy petition, the IRS could not attach a lien. Additionally, he argued that the liability for the unpaid 2001 income tax was discharged in bankruptcy. The IRS Appeals Office sustained the levy, and the taxpayer filed a petition with the Tax Court to review the Appeals Office's determination.

The Tax Court ruled that the Revenue Service could attach a lien to the taxpayer's interest in the plan and that the lien survived the bankruptcy discharge. When a bankruptcy court enters a discharge order in a bankruptcy proceeding, the debtor is discharged from personal liability for all dischargeable debts; however, liens and other secured interests can survive bankruptcy. Following bankruptcy discharge, tax liens generally remain attached to property existing at the time of the bankruptcy that was exempted by the petitioner, abandoned by the bankruptcy trustee, or excluded from the bankruptcy estate by applicable law.

The Tax Court ruled that the tax lien on the taxpayer's pension plan interest arose by operation of law once he failed to pay the assessed tax liability after receiving a notice and demand of payment, notwithstanding the fact that the IRS never perfected the lien by properly recording it, and regardless of the fact that the IRS was not entitled to payouts from the pension plan at the time of the bankruptcy (since the taxpayer's right to payments did not mature until 2007). Furthermore, the Tax Court ruled that, although the discharge in bankruptcy relieved him of personal liability for the tax debt, it did not release the IRS lien against his interest in the pension plan, which had been "excluded" from the bankruptcy estate. As a result, the IRS could enforce a levy of his interest in the pension plan once his benefit under the pension was in payout status.

One interesting aspect to this case concerns the classification of the pension plan interest as either "exempted" or "excluded," and how this classification affects the relevance of whether the IRS perfected the lien on the taxpayer's interest in the pension plan by filing a valid notice of Federal tax lien ("NFTL"). Although the failure to file the NFTL did not prove fatal to the Service's position in *Wadleigh*, the Court noted that, in order for an IRS lien to survive bankruptcy with respect to "exempted" property, the IRS would have had to file a NFTL. In *Wadleigh*, the Revenue Service ruled that the pension plan was "excluded" from the estate, rather than "exempted." As a result, the NFTL was not necessary for the lien to survive. However, a question arises because qualified pension plans are listed in the Bankruptcy Code as both an exclusion and an exemption.

Generally, "exclusions" are not included in the bankruptcy estate, whereas "exemptions" are part of the bankruptcy estate but are not used to pay off the outstanding debt of the bankruptcy petitioner. Once an item is judged to be excluded from the bankruptcy estate, there is no need to address the question of whether it is exempt. It is not entirely clear from case law whether or not exclusions are mandatory or permissive. However, the U.S. Court of Appeals for the Ninth Circuit, to which this case ultimately will be appealable, has held that the exclusion of a qualified pension plan from a bankruptcy estate is within the discretion of the petitioner, rather than required by law. Further, a Federal tax lien does not survive bankruptcy discharge with respect to "exempted" property unless a NFTL has been filed prior to the bankruptcy filing. In light of this background, it is reasonable to ask (although there is no current definitive answer) if bankruptcy petitioners in the Ninth Circuit should "exclude" or "exempt" their qualified plans, particularly if a NFTL has not been filed by the IRS.

Any AALU member who wishes to obtain a copy of *Wadleigh v. Comm'r* may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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