

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 12-6130

In re JAMES L. DALEY, JR., Debtor,

JAMES L. DALEY, JR.,

Appellant,

v.

ANN MOSTOLLER, TRUSTEE,

Appellee.

Appeal from the United States District Court
for the Eastern District of Tennessee
Case No. 3:11-CV-565

**BRIEF OF *AMICUS CURIAE* SECURITIES INDUSTRY AND FINANCIAL
MARKETS ASSOCIATION IN SUPPORT OF DEBTOR-APPELLANT
AND IN SUPPORT OF REVERSAL**

Melanie Franco Nussdorf
Eric G. Serron
STEPTOE & JOHNSON LLP
1330 Connecticut Ave., NW
Washington, DC 20036
(202)429-3000

Ira D. Hammerman
Kevin Carroll
SECURITIES INDUSTRY AND
FINANCIAL MARKETS ASSOC.
1101 New York Ave., NW
Washington, DC 20005
(202) 962-7382

Attorneys for Amicus Curiae
Securities Industry and Financial Markets Association

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STATEMENT OF COMPLIANCE WITH RULE 29

This brief is submitted pursuant to Federal Rule of Appellate Procedure 29. No party's counsel authored this brief in whole or in part. No party or party's counsel contributed money that was intended to fund preparing or submitting this brief. No person—other than the Securities Industry and Financial Markets Association (SIFMA), its members, or its counsel—contributed money that was intended to fund preparing or submitting this brief. All parties to this case have consented to the filing of this brief.

INTEREST OF AMICUS CURIAE

The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). More information about SIFMA is available at www.sifma.org.

SIFMA and its members have a strong interest in this appeal. Millions of Americans rely on Individual Retirement Accounts (IRAs) as vehicles for their retirement savings. Indeed, as of May 2012, an estimated 48.9 million U.S.

households held at least one type of IRA. SIFMA members act as trustees and nonbank custodians for many of these IRAs, and as such, are required to safekeep the assets, operate pursuant to IRS determination letters that the IRAs are tax qualified, and defend the IRAs from challenge. Challenges to IRAs from creditors and others endanger the status and security of IRAs and cause SIFMA members to incur significant expense in time-consuming litigation. SIFMA fears that, if left uncorrected, the lower court's decision upholding an objection to exemption of Debtor's IRA from the bankruptcy estate—based solely on the language of the account agreements Debtor signed when opening the IRA—has the potential to cause significant uncertainty for millions of IRA account holders, for the SIFMA members that act as custodians for such IRAs, and for the retirement savings system as a whole. SIFMA and its members have a strong interest in avoiding such a result.

INTRODUCTION AND SUMMARY OF ARGUMENT

The bankruptcy court's decision, affirmed by the district court, disallowed Debtor's claim of exemption of his Merrill Lynch IRA on the ground that language in the Merrill Lynch Client Relationship Agreement purporting to grant a lien among related accounts of Debtor at Merrill Lynch constituted an extension of credit between the IRA and its owner and thus a prohibited transaction under Section 4975 of the Internal Revenue Code ("Tax Code"). The consequence of a

prohibited transaction under the Tax Code is that the entire IRA becomes immediately taxable. The courts below relied on a U.S. Department of Labor (“DOL”) advisory opinion stating that in a case where an IRA owner agreed to a cross-collateralization between his IRA and non-IRA accounts he held with the same custodian, this was a prohibited extension of credit between the owner and his IRA. However, the crucial fact in this case is that Debtor maintained no other account with Merrill Lynch. Without another account, there could be no extension of credit and the rationale of the DOL advisory opinion is inapplicable. Moreover, the district court apparently was not made aware of, and therefore did not take into account, an important IRS announcement issued in December 2011, in which the IRS took the position that **no IRA will become taxable** because of the mere existence of account language like that at issue here, *even if* there are other accounts to which the language could attach.

Lacking the benefit of the IRS announcement, the lower courts held that as a result of this purported “prohibited transaction,” Debtor’s IRA funds never acquired the tax-advantaged and creditor-exempt attributes of an IRA, and thus could be accessed by the Trustee/Appellee as part of the bankruptcy estate. SIFMA believes that this holding, which the bankruptcy court acknowledged is “incongruous,” is contrary to Congress’ intent in strengthening the exemption protections for IRAs, and conflicts with applicable IRS policy.

Like most IRAs administered by financial institutions, Debtor's Merrill Lynch IRA has received a favorable determination letter from the IRS and, accordingly, is presumed exempt from the bankruptcy estate under 11 U.S.C. § 522(b)(4)(A). In enacting this provision, Congress expressly intended to "expand the protection for tax-favored retirement plans" such as Debtor's IRA. *In re Thiem*, 443 B.R. 832, 837 (Bankr. D. Ariz. 2011) (citations omitted). Relying on the inapplicable DOL advisory opinion, the Trustee persuaded the lower courts to override this strong and vital statutory presumption based solely on an indemnity clause in the standard form account documents that, at the time, was ubiquitous in the industry. SIFMA respectfully submits that this was in error.

First, Debtor had no other accounts at Merrill Lynch that could have caused a prohibited extension of credit in violation of Section 4975 of the Tax Code. Neither the DOL advisory opinion nor any of the authorities cited by the lower courts supports finding a prohibited transaction under such circumstances.

Second, the district court apparently was not alerted to, and consequently did not consider or defer to, applicable IRS policy concerning the tax-exempt status of Debtor's IRA. In December 2011, nine months before the district court's order affirming the bankruptcy court's ruling in this case, the IRS issued Announcement 2011-81 (the "Announcement"), in which it confirmed that it will *not* deem indemnification or cross-collateralization clauses in IRA account agreements, such

as that at issue in this case, as triggering the consequences of the prohibited transaction rule.¹ In other words, the IRS is continuing to treat Debtor's IRA and other similarly situated IRAs as tax-exempt. The IRS's position is entitled to deference by this Court.

Third, the lower court rulings also have the effect of allowing the Trustee to overcome the presumption of exemption applicable to Debtor's IRS-approved IRA with a showing *less* rigorous than that necessary to defeat exemption of IRAs never approved by the IRS. Such a result is contrary to Congress' express intent to expand the Bankruptcy Code's protections for IRAs.

STANDARD OF REVIEW

This Court reviews the decision of the bankruptcy court directly, "reviewing its factual findings for clear error and its legal conclusions de novo." *In re Hood*, 319 F.3d 755, 759 (6th Cir. 2003).

RELEVANT CASE BACKGROUND

In 2008, James L. Daley Jr., the debtor in this case ("Debtor"), rolled over approximately \$61,000 from his employer sponsored retirement plan into an IRA

¹ The district court was also apparently unaware of the pending request for class relief being considered by the DOL referenced in that Announcement, which was filed by SIFMA and is in the public record. The requested exemption, which SIFMA believes will be granted, would provide retroactive relief to Debtor, even if Debtor had had other accounts subject to cross-collateralization.

at Merrill Lynch. (Amended Stipulation of Facts and Documents, RE 1-14, Page ID # 149-150.) This IRA was Debtor's first and only account at Merrill Lynch. (*Id.* at Page ID # 150.) As is common in the industry, Merrill Lynch requires customers, including Debtor, to sign a general Client Relationship Agreement that incorporates by reference additional agreements specific to the type of account or accounts the customer opens. (*Id.* at Page ID # 149-150, 153-161.) The Client Relationship Agreement also provides that the account-specific agreement (in this case, the Merrill Lynch Traditional Individual Retirement Account (IRA) Disclosure and Custodial Agreement (the "IRA Custodial Agreement")) controls in the event of inconsistencies. (*Id.* at Page ID # 158.) Accordingly, the IRA Custodial Agreement serves as "the primary document governing [Debtor's] Merrill Lynch IRA." (*Id.* at Page ID # 164.)

Merrill Lynch administered Debtor's IRA, along with numerous others, under the terms of an IRA plan that has been subject at all relevant times to an IRS determination letter approving the IRA plan as tax-exempt under Section 408 of the Tax Code. (*Id.* at Page ID # 225.) As stipulated by the parties, this IRS determination letter was in effect on the bankruptcy petition date. (*Id.* at Page ID # 150.) After Debtor filed his Chapter 7 petition on August 25, 2010, he listed the IRA account on his amended Schedule C as exempt under 11 U.S.C. § 522(b)(3)(C) and on subsequent amendments. (Debtor's Amended Schedule C,

RE 1-9, Page ID # 58; Debtor's Further Amended Schedule C, RE 1-11, Page ID # 64.)

The Chapter 7 Trustee, Appellee Ann Mostoller, filed an objection (Trustee's Objection, RE 1-2, Page ID # 41-43) to this exemption on the ground that a provision in Section 3 of the Merrill Lynch Client Relationship Agreement (Amended Stipulation of Facts and Documents, RE 1-14, Page ID # 159) granted Merrill Lynch liens against assets in any Merrill Lynch account held by Debtor to cover indebtedness arising in Debtor's IRA account (and against the IRA to cover indebtedness arising in such other accounts). There were no such other accounts at any time. (*Id.* at Page ID # 150.) Thus, this provision, which the courts found fatal, at no time caused any actual extension of credit to or from Debtor's IRA. Nonetheless, the Trustee contended that, by signing an agreement containing these provisions, Debtor engaged in a "prohibited transaction" within the meaning of 26 U.S.C. § 4975, thereby causing the IRA to lose its tax-exempt status and thus its eligibility for exemption under the Bankruptcy Code and Tennessee law. (Brief in Support of Objection, RE 1-15, Page ID # 228-235.) The objection misread a U.S. Department of Labor ("DOL") Advisory Opinion, No. 2009-03A, issued in October 2009 (the "DOL Advisory Opinion"), which only applies where there are other (non-IRA) accounts held by the owner of the IRA, which was not the case here. (*Id.* at Page ID # 232-233, 246-248.)

In response to the Trustee's objection, Debtor argued that the terms of the Merrill Lynch IRA Custodial Agreement took precedence over the terms of the Client Relationship Agreement. (Debtor's Response to Objection, RE 1-16, Page ID # 249-257.) Among other things, the IRA Custodial Agreement specified that Debtor's "right to the balance in [his] IRA cannot be forfeited at any time." (Amended Stipulation of Facts and Documents, RE 1-14, Page ID # 164.) As the parties stipulated, the IRA was the only account Debtor held with Merrill Lynch, and Debtor never took out any margin loans or other loans (*Id.* at Page ID # 150), so the IRA account was never actually subject to liens to repay any other debts, nor to any forfeiture risk. Moreover, the parties also stipulated that, "If the Merrill Lynch IRA account is found to be not in 'substantial compliance' with the IRS Code of 1986 . . . the Debtor is not materially responsible for that failure as provided by 11 U.S.C. 522(b)(4)(B)[(ii)](II)." (*Id.*)

The bankruptcy court sustained the Trustee's Objection, stating that, "[a]s incongruous as it appears, based upon the language of the Client Relationship Agreement signed by the Debtor, the mere opening of the Merrill Lynch IRA caused the Debtor to participate in a prohibited transaction under § 4975" (Memorandum Opinion, RE 1-20, Page ID # 277), "[t]hrough no fault of his own." (*Id.* at Page ID # 280.) The bankruptcy court rejected Debtor's contention that the specific provisions of the IRA Custodial Agreement should prevail over the

general provisions of the Client Relationship Agreement purporting to cross-collateralize any and all accounts. The Debtor appealed to the district court, which affirmed the decision, essentially adopting the same reasoning. (Memorandum Opinion and Order, RE 11, Page ID # 375-388.) The Debtor timely filed his appeal to this Court. (Notice of Appeal, RE 12, Page ID # 389-390.)

APPLICABLE STATUTORY FRAMEWORK

As part of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”), Section 522 of the Bankruptcy Code² was amended to clarify Congressional intent that IRAs, the principal retirement savings vehicle available to many Americans, should be presumptively exempted from the bankruptcy estate and protected from liquidation for the creditors’ benefit, provided that they qualified as tax-exempt under the Tax Code.

Among Congress’ aims in enacting BAPCPA was to resolve uncertainties that had arisen in the case law regarding the extent to which IRAs were exempt under the Bankruptcy Code³ by developing a broad presumption of exemption for

² All subsequent references to “Section 522” are to this Bankruptcy Code section, 11 U.S.C. § 522.

³ Prior to 2005, *Patterson v. Shumate*, 504 U.S. 753 (1992), had established the principle that ERISA-qualified pension plans were exempt under 11 U.S.C. § 541(c)(2) because of the anti-alienation clauses found in such plans. The Supreme Court noted in that decision that IRAs, which are exempt from ERISA’s anti-alienation requirements and thus not eligible for exemption under Section

(Continued)

IRAs. In particular, BAPCPA specifically added Sections 522(b)(3)(C), (b)(4) and (n) granting a categorical exemption of IRAs under \$1,000,000 (on an inflation-adjusted basis and excluding certain rollover contributions), so long as they qualify as tax-exempt under the Tax Code, thereby eliminating the need for case-by-case “reasonably necessary” findings.

Section 522 now permits an individual debtor to exempt from the bankruptcy estate “retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.” 11 U.S.C. § 522(b)(3)(C). For purposes of Section 522(b)(3)(C), Section 522(b)(4)(A) applies, which states: “If the retirement funds are in a retirement fund that has received a favorable determination under section 7805 of the Internal Revenue Code of 1986, and that determination is in effect as of the date of the filing of the petition in a case under

541(c)(2), might nonetheless qualify for exemption under Section 522(d)(10)(E). *Patterson*, 504 U.S. at 762-63. That Section provides a general exemption for a “stock bonus, pension, profitsharing, annuity, or similar plan . . . on account of . . . age . . . to the extent reasonably necessary for the support of the debtor and any dependent,” subject to certain requirements. However, a circuit split then developed as to whether IRAs fell within the scope of this protection. *Rousey v. Jacoway*, 544 U.S. 320, 325 (2005), resolved this split in a unanimous decision, holding that a debtor’s interest in an IRA could be exempted under Section 522(d)(10)(E), subject to a “reasonably necessary” test to be determined factually on a case-by-case basis.

this title, those funds shall be presumed to be exempt from the estate.” 11 U.S.C. § 522(b)(4)(A).

The legislative history notes that “the intent of section 224 [of BAPCPA] is to expand the protection for tax-favored retirement plans or arrangements that may not be already protected under Bankruptcy Code section 541(c)(2) pursuant to *Patterson v. Shumate*, or other state or Federal law.” H.R. REP. NO. 109-31, pt. 1, at 63-64 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 132-33 (footnote omitted). The legislative history also emphasized that IRA funds are exempt under Sections 522(b)(3)(C) and (b)(4)(B) *even if* the IRA has not received a favorable determination, and *even if* the IRA is not in substantial compliance with the IRC through no fault of the debtor:

Sec. 224. Protection of Retirement Savings . . . If the retirement monies are in a retirement fund that has not received a favorable determination, those monies are exempt if the debtor demonstrates that no prior unfavorable determination has been made by a court or the Internal Revenue Service, and the retirement fund is in substantial compliance with the applicable requirements of the Internal Revenue Code. If the retirement fund fails to be in substantial compliance with applicable requirements of the Internal Revenue Code, the debtor may claim the retirement funds as exempt if he or she is not materially responsible for such failure.

H.R. REP. NO. 109-31, pt. 1, at 63-64 (2005); *see In re Thiem*, 443 B.R. 832, 837 (Bankr. D. Ariz. 2011) (“Congress’ intent was ‘to expand the protection for tax-favored retirement plans or arrangements that may not be already protected under [§] 541(c)(2) . . . or other state or Federal Law.’” (citing H.R. REP. NO. 109-31)).

ARGUMENT

The lower courts erred by disallowing Debtor's claim of exemption of his Merrill Lynch IRA, which is presumptively exempt under Section 522(b)(4)(A). In overriding the statutory presumption of exemption based solely on the presence of form language in the account documents which is inapplicable to the case at bar, the decisions below (1) misconstrued the effect of Section 3 of the Client Relationship Agreement, (2) neither considered nor deferred to applicable IRS policy governing the tax-exempt status of Debtor's IRA, and (3) misapplied the safe harbor provisions of Section 522(b)(4).

I. DEBTOR'S IRA IS PRESUMPTIVELY EXEMPT FROM THE BANKRUPTCY ESTATE

Under Section 522(b)(4)(A), funds in an IRA that has received a favorable determination letter from the IRS still in effect on the date a bankruptcy petition is filed "shall be presumed to be exempt from the estate." Congress enacted this presumption to "expand the protection for tax-favored retirement plans." H.R. REP. NO. 109-31, pt. 1, at 63 (2005). Debtor's Merrill Lynch IRA is governed by a favorable determination letter received from the IRS on September 23, 2003, and in effect on the bankruptcy petition date.⁴ As the bankruptcy court correctly

⁴ SIFMA's members rely on favorable determination letters from IRS respecting IRAs because the IRS's imprimatur provides necessary stability and predictability, not just for the financial firms who offer IRA accounts, but for the millions of IRA account holders whose savings are held by these institutions.

acknowledged, “[u]nder § 522(b)(4)(A), the determination letter being in place creates the presumption that the funds in the Merrill Lynch IRA are exempt.” (Memorandum Opinion, RE 1-20, Page ID # 272.)

II. NO PROHIBITED TRANSACTION COULD HAVE OCCURRED BECAUSE DEBTOR HAD NO ACCOUNT OTHER THAN THE IRA WITH MERRILL LYNCH

The decisions below misconstrued the legal effect of the lien language in the Client Relationship Agreement in holding that the Debtor engaged in a prohibited “extension of credit” in violation of section 4975 of the Tax Code by “the mere opening of the Merrill Lynch IRA.” (Memorandum Opinion, RE 1-20, Page ID # 277.) Section 3 of the Client Relationship Agreement provides, in pertinent part, as follows:

All of your securities and other property in any account—margin or cash—in which you have an interest, or which at any time are in your possession or under your control, shall be subject to a lien for the discharge of any and all indebtedness or any other obligations you may have to Merrill Lynch.

You agree that Merrill Lynch holds all of your securities and other property as security for the payment of any such obligations or indebtedness to Merrill Lynch in any account in which you have an interest.

(Amended Stipulation of Facts and Documents, RE 1-14, Page ID # 159.)

The mere presence of this language in the Client Relationship Agreement at the time the IRA was opened did not cause any extension of credit between Debtor and his IRA. It did not extend credit *from* his IRA account *to* any personal (non-

IRA) account because (1) Debtor had no personal (non-IRA) account with Merrill Lynch, and (2) the Merrill Lynch Traditional Individual Retirement Account (IRA) Disclosure and Custodial Agreement (the “IRA Custodial Agreement”) that governed Debtor’s IRA⁵—and that controls over any contrary provision in the Client Relationship Agreement⁶—expressly precludes and prohibits any sale, assignment, or forfeiture of assets in the IRA. (*Id.* at Page ID # 164 § 1 [“Your IRA is a custody account established for the exclusive benefit of you and your beneficiaries for which Merrill Lynch acts as custodian. Your right to the balance in your IRA cannot be forfeited at any time.”]; *Id.* at Page ID # 189 § 73 [“You cannot sell or assign any interest in your IRA.”].) The lien language also did not extend credit *from* any personal (non-IRA) account *to* the IRA because Debtor held no personal (non-IRA) account with Merrill Lynch and had no obligation to establish any such other account with Merrill Lynch. In the absence of any

⁵ As is common among custodians of IRS-approved IRA plans, Merrill Lynch also establishes with each customer opening an IRA account an IRA Custodial Agreement that serves as “the primary document governing [the customer’s] Merrill Lynch IRA.” (*Id.* at Page ID # 164 § 2.) When the Debtor opened his IRA with Merrill Lynch, he agreed to be bound by this IRA Custodial Agreement, which provides, *inter alia*, that “[t]his custodial agreement, adopted in accordance with Merrill Lynch’s procedures for adopting an IRA, governs your Individual Retirement Account (‘IRA’)” (*Id.* at Page ID # 178 § 1.)

⁶ (*Id.* at Page ID # 158 [“The terms governing a specific account or service will control if there are any inconsistencies with the terms of this Client Relationship Agreement.”].)

personal (non-IRA) accounts, there could be no *cross-collateralization* of the kind that could trigger a prohibited extension of credit in violation of section 4975 of the Tax Code. *Cf.* Advisory Opinion, No. 2009-03A (Dep't of Labor Oct. 27, 2009) (stating view of DOL that cross-collateralization between IRA and non-IRA accounts could cause prohibited transaction).

Janpol v. Commissioner, 101 T.C. 518 (1993), does not support the lower courts' holding that the lien language by itself caused a prohibited extension of credit. (Memorandum Opinion, RE 1-20, Page ID # 277.) The petitioners in *Janpol* jointly and severally guaranteed a bank line of credit extended to a profit sharing plan. The tax court rejected petitioner's argument that the guarantee was not an extension of credit, reasoning that it was, in effect, a contract to make a loan, and that such a contract was itself a prohibited extension of credit. 101 T.C. at 528. Unlike the petitioners in *Janpol*, the Debtor here did not guarantee or otherwise contract to make a loan to his IRA, nor did he cause his IRA to guarantee or otherwise contract to make a loan to himself.

The other decision relied on by the Trustee and cited by the bankruptcy court, *In re Willis*, No. 07-11010, 2009 WL 2424548, at *7 (Bankr. S.D. Fla. Aug. 6, 2009), *aff'd*, *Willis v. Menotte*, No. 09-82303, 2010 WL 1408343 (S.D. Fla. Apr. 6, 2010), is equally unavailing. In that case, the debtor had willfully engaged in inappropriate use of his IRA funds—to purchase an assignment of a mortgage, and

to cover a shortfall in a brokerage account. 2009 WL 2424548, at *10. In contrast, the Debtor in this case did not misuse the funds in his IRA.

The DOL Advisory Opinion is likewise distinguishable. (Trustee's Objection, RE 1-15, Page ID # 246-248.) The requester in that opinion, Mr. Timothy Berry, represented to DOL that a brokerage firm had asked his client to sign a cross-collateralization provision as a requirement for establishing an IRA with the broker, when his client already had a personal (non-IRA) account there. Based on these facts, the Department opined that a cross-collateralization between the IRA and the client's existing personal account would result in a prohibited transaction.⁷ Advisory Opinion, No. 2009-03A, at 2 (Dep't of Labor Oct. 27, 2009). In contrast to the facts represented to the Department in that advisory opinion, the Debtor here maintained no other account with Merrill Lynch. The DOL Advisory Opinion thus has no application here. See ERISA Procedure 76-1

⁷ After procuring this Opinion, Mr. Berry served as plaintiffs' counsel in a series of putative class action lawsuits alleging that individuals who held IRAs with various SIFMA members, including Merrill Lynch, Charles Schwab, and Vanguard, had engaged in "prohibited transactions" by virtue of simply signing their IRA account agreements. Plaintiffs in these actions relied on the DOL Advisory Opinion and the bankruptcy court's decision in this case. Each of these lawsuits has since been dismissed at the pleadings stage, either voluntarily or by court order granting defendants' motions to dismiss. See, e.g., *Yoshioka v. Charles Schwab Corp.* (C-11-1625 EMC, Docket No. 168 (N.D. Cal. Nov. 27, 2012)) (dismissing claims for lack of standing and ripeness); *Coffey v. Merrill Lynch, Pierce Fenner & Smith Inc.* (CV-11-5860-JFW (JCX), Docket No. 46 (C.D. Cal. Nov. 16, 2011) (same, noting that "Plaintiff . . . appears to have manufactured a problem [concerning Merrill Lynch IRAs] . . . where none yet exists").

§ 10 (“[An advisory] opinion assumes that all material facts and representations set forth in the request are accurate, and applies only to the situation described therein. Only the parties described in the request for opinion may rely on the opinion, and [then] . . . only to the extent that the request fully and accurately contains all the material facts and representations necessary to issuance of the opinion and the situation conforms to the situation described in the request for opinion.”).

III. THE INTERNAL REVENUE SERVICE, WHICH ALONE HAS THE AUTHORITY TO CAUSE AN IRA TO BECOME TAXABLE, HAS DETERMINED THAT THE CROSS-COLLATERALIZATION LANGUAGE, STANDING ALONE, DOES NOT CAUSE AN IRA TO BECOME TAXABLE

In December 2011, two months after the bankruptcy court issued its ruling but before the district court ruled, the IRS confirmed in Announcement 2011-81 (the “Announcement”) that cross-collateralization language such as that present in Debtor’s Client Relationship Agreement with Merrill Lynch will not cause an IRA to lose its tax-exempt status, provided there has been no execution or other enforcement against the assets of the IRA pursuant to such language. Neither the magistrate judge’s report and recommendation nor the district court’s order made any reference to the Announcement, suggesting that it was not brought to the court’s attention by the parties.

The Announcement states in relevant part:

This announcement provides temporary relief with respect to Individual Retirement Accounts (IRAs) in circumstances in which the

IRAs' owners have signed certain indemnification agreements or granted certain security interests in accounts that may have an effect on their IRAs. ...

The DOL has advised the Internal Revenue Service (IRS) that DOL is considering further action with respect to the issues described above, including consideration of a class exemption request expected to be submitted to the DOL. Pending further action by the DOL and until issuance of further guidance from the IRS superseding this announcement, the IRS will determine the tax consequences relating to an IRA without taking into account the consequences that might otherwise result from a prohibited transaction under § 4975 resulting from entering into any indemnification agreement or any cross-collateralization agreement similar to the agreements described in DOL Advisory Opinions 2009-03A and 2011-09A, provided there has been no execution or other enforcement pursuant to the agreement against the assets of an IRA account of the individual granting the security interest or entering into the cross-collateralization agreement. No inference with respect to the application of any Code section other than § 4975 should be drawn from this announcement.

I.R.S. Announcement 2011-81, 2011-52 I.R.B. 1052.

The Announcement confirms that Section 3 of the Client Relationship Agreement, and other similar agreements, will not be deemed by the IRS to trigger the consequences of the prohibited transaction rules where “there has been no execution or other enforcement pursuant to the agreement against the assets of an IRA account of the individual granting the security interest or entering into the cross-collateralization agreement” (in this case, Debtor). *Id.* Here, there has not been any “execution or other enforcement pursuant to [Section 3 of the Client Relationship Agreement],” nor could there have been, given that Debtor has no

other account at Merrill Lynch. Accordingly, in the view of the Announcement, Debtor's IRA is and has at all relevant times remained tax exempt.

A. This Court Should Defer To IRS Policy Confirming That Debtor's IRA Remains Tax-Exempt

Sections 522(b)(3)(C) and (b)(4)(A) require courts to afford strong deference to the IRS's views on the qualification of an IRA in determining whether an IRA is exempt from the bankruptcy estate. As discussed above, subsection (b)(4)(A) presumes that an IRA is exempt from the estate if the IRS has issued a favorable determination letter with respect to the IRA, and the legislative history notes that the intent of subsection (b)(4)(A) is to expand the protection available to tax-favored retirement vehicles, such as IRAs, that have received a favorable determination from the IRS.

In the proceedings below, the Trustee urged the district court not to defer to the IRS' favorable determination letter governing the Merrill Lynch IRA because, the Trustee argued, the IRS "is unaware of the prohibited transaction." (Memorandum Opinion and Order, RE 11, Page ID # 383.) But the Announcement shows that at the time the Trustee made this argument, the IRS already had been made aware of account language like that at issue in this case and, confronted with the identical issue presented here (whether account provisions such as Section 3 cause a prohibited transaction and concomitant loss of tax exempt status), had decided *not* to revoke the favorable determination letters it had

earlier issued to Merrill Lynch and other IRA custodians responsible for the account language at issue and *not* to impose any of the tax consequences that otherwise would flow from a prohibited transaction. Because the IRS has spoken directly to this issue, its views are entitled to great deference.

The Fifth Circuit has addressed analogous circumstances arising with the application of a Texas state law bankruptcy exemption for tax favored retirement plans and IRAs. In *In re Youngblood*, 29 F.3d 225, 229 (5th Cir. 1994), the Fifth Circuit examined whether funds held in an IRA were exempt where the funds had been rolled over from a retirement plan that a creditor alleged was not qualified under the Tax Code because of an alleged violation of the qualification requirements. Noting that the retirement plan had received a favorable IRS determination letter, and that the plan had been subject to an IRS audit shortly before the funds were rolled over to the IRA (in which the IRS assessed some sanctions but did not disqualify the plan), the court determined that it was appropriate to defer to, and not “second guess the IRS in such a complex, technical area.” *Id.* at 229; *see also First Options of Chicago, Inc. v. Kaplan*, 198 B.R. 91, 93 (E.D. Pa. 1996) (following *Youngblood* and deferring to IRS determination that

a plan was qualified for purposes of applying Pennsylvania bankruptcy exemption for tax-qualified retirement plans.)⁸

Further, the fact that the IRS issued the Announcement after Debtor filed his petition for bankruptcy does not lessen the Announcement's importance to this case. The recent decision in *In re Richey*, No. AZ-10-1306, 2011 WL 4485900, at *10-11 (B.A.P. 9th Cir. Aug. 8, 2011), persuasively supports deference to post-petition action by the IRS. In *Richey*, the bankruptcy appellate panel affirmed the bankruptcy court's order permitting the debtors to obtain *post-petition* compliance statements from the IRS, which thereby allowed debtors to retain the qualified status of the plans and, thus, exemption in the bankruptcy case. *See id.* Here, Debtor is entitled to the benefit of the relief provided by IRS Announcement 2011-81: As of the petition date and all other relevant times, the IRS has rejected the position advocated by the Trustee regarding the tax consequences of Section 3 of the Client Relationship Agreement.

⁸ The Fifth Circuit's subsequent decision in *In re Plunk*, 481 F.3d 302 (5th Cir. 2007) is not to the contrary. In *Plunk*, creditors alleged that, after receiving a favorable IRS determination, the debtor affirmatively misused assets in a way that disqualified the plan. Because the IRS had not had any occasion to review the alleged misuse of plan assets, the court held that it should independently determine the tax consequences of such misconduct, rather than defer to the prior IRS determination letter. *Id.* at 306-07. *Plunk* differs from this case in two critical respects: Debtor here has not engaged in any misuse of IRA assets *and* in this case the IRS *has* considered the alleged conduct (entering into account language similar to Section 3 of the Client Relationship Agreement) and decided that it did not disqualify the IRA.

As in *Youngblood* and *Richey*, deference to the IRS's view regarding the tax-qualification of Debtor's IRA for purposes of applying Section 522(b)(4)(A) is appropriate. It also is necessary to avoid a direct conflict with IRS policy. If allowed to stand, the lower courts' decisions will throw IRA custodians and IRA holders across the country into uncertainty and confusion regarding the appropriate tax treatment of IRA accounts containing similar provisions, which is precisely what the IRS sought to avoid by issuing the Announcement.

B. In The Alternative, The Court May Wish To Defer A Ruling On This Appeal Until After DOL Has Acted On SIFMA's Pending Request For A Class Exemption

The Announcement expressly contemplates additional future guidance by the DOL, which has the ultimate administrative authority to grant a class-wide exemption from the prohibited transaction rule for all affected IRAs, including Debtor's. At SIFMA's formal request, DOL currently is considering the grant of a Prohibited Transaction Class Exemption that will categorically exempt indemnity and cross-collateralization provisions like the one at issue in this case from any consequence of the prohibited transaction rule. A retroactive effective date for the requested exemption, which SIFMA fully expects to be granted, would decisively eliminate doubt (if any remains following the Announcement) about the tax-exempt status of Debtor's IRA as a result of Section 3 of Client Relationship Agreement.

There is precedent for exactly this type of class exemption in Prohibited Transaction Exemptions 93-1, 93-33 and 97-11, whereby the DOL immunized a common industry practice (in which banks and broker-dealers would often provide small gifts or services to customers based on the amount of assets they held with the bank, including in an IRA) from the consequences of the prohibited transaction rule, which the practice arguably violated. *See* PTE 93-1, Final Exemption, 58 Fed. Reg. 3567 (Jan. 11, 1993); PTE 93-33, Final Amendment, 64 Fed. Reg. 11044 (Mar. 8, 1999); PTE 97-11, Final Amendment, 64 Fed. Reg. 11042 (Mar. 8, 1999). As is the case here, PTE 93-1 was preceded by an IRS announcement, which stated that the IRS would “not raise issues concerning the tax effects resulting from possible prohibited transactions arising from [such practices]” I.R.S. Announcement 90-1, 1990-2 I.R.B. 31.

Given the significance of the issue and the importance of the anticipated guidance from DOL, this Court may wish to defer ruling on this appeal until the DOL acts on the pending SIFMA request. *See, e.g., In re Feldman*, 171 B.R. 731, 739 (Bankr. E.D.N.Y. 1994) (staying an order addressing the exempt status of pension funds, pending a then-forthcoming ruling from the IRS regarding the qualification of a pension plan where the court determined that “[a]n IRS ruling would be enlightening” on the subject).

IV. THE DEBTOR’S IRS-APPROVED IRA SHOULD NOT BE HELD TO AN EXEMPTION STANDARD MORE ONEROUS THAN THE LENIENT STANDARD APPLIED UNDER SECTION 522(B)(4)(B) TO IRAS WITHOUT DETERMINATION LETTERS

Having held that the mere presence of the lien language in the Client Relationship Agreement caused a prohibited transaction, the lower courts concluded the Trustee had successfully overcome the statutory presumption of exemption under Section 522(b)(4)(A) for IRAs, like Debtor’s, that had a favorable IRS determination letter in effect on the petition date. The lower courts rejected Debtor’s argument that his IRA funds should nevertheless be exempt from the bankruptcy estate under the safe harbor of Section 522(b)(4)(B), which states:

If the retirement funds are in a retirement fund that has not received a favorable determination under such section 7805, those funds are exempt from the estate if the debtor demonstrates that—

(i) no prior determination to the contrary has been made by a court or the Internal Revenue Service; and

(ii) (I) the retirement fund is in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986; or

(II) the retirement fund fails to be in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986 and the debtor is not materially responsible for that failure.

Under the lenient standard of Section 522(b)(4)(B), Debtor would be entitled to exemption of his IRA, notwithstanding the purported prohibited transaction, by establishing *either* that (I) the Merrill Lynch IRA is in “*substantial*”—not perfect—compliance with the applicable requirements of the Tax Code, *or* (II) the

Debtor “is not *materially* responsible” for failure of the IRA to be in substantial compliance with the Tax Code. Had the lower courts applied this standard to Debtor’s claim of exemption, Debtor would have been able to satisfy one or both of these prongs. *First*, Debtor’s IRA with Merrill Lynch was in substantial compliance with the Tax Code—the only purported defect identified by the Trustee was a technical one, relating to form account language that (as discussed above) was never implemented and that could not have been implemented given that Debtor maintained only one account with Merrill Lynch. *Second*, as the Trustee stipulated in the proceedings below (Amended Stipulation of Facts and Documents, RE 1-14, Page ID # 150), even if the form account language caused the IRA to fail to be in substantial compliance with the Tax Code, Debtor was not materially responsible for that failure, having done nothing more than sign his name to a standard form account agreement.

The lower courts held, however, that Debtor was ineligible for this forgiving standard for establishing an exemption because the subsection of the statute setting forth this standard (Section 522(b)(4)(B)) applies by its terms only to IRAs that never received a favorable determination letter from the IRS. (Memorandum Opinion, RE 1-20, Page ID # 280; Memorandum Opinion and Order, RE 11, Page ID # 384-386.) But the statute does not expressly supply a standard for overcoming the *presumption* of exemption established by Section 522(b)(4)(A) for

IRAs subject to a favorable determination letter, and it stands to reason that Congress did not intend to make it *easier* for a trustee to defeat exemption of an *IRS-approved* IRA than an IRA without IRS approval. Such a result would be directly contrary to Congress' intention in enacting these provisions, which was to "expand the protection for tax-favored retirement plans or arrangements." H.R. REP. NO. 109-31, pt. 1, at 63 (2005); *accord In re Thiem*, 443 B.R. at 837. It also would run contrary to the canon that exemptions are to be construed liberally in favor of debtors, and "should be construed in light of the purpose for which [they were] created." *In re Lebovitz*, 360 B.R. 612, 618-19 (B.A.P. 6th Cir. 2007). Accordingly, the presumption of exemption established by Section 522(b)(4)(A) should be construed such that it cannot be overcome in circumstances where, as here, the Debtor would be entitled to exemption under Section 522(b)(4)(B).

Finally, the district court held in the alternative that even if the standard established by Section 522(b)(4)(B) applied here, Debtor would not satisfy it because, "having signed the Client Relationship Agreement, appellant [Debtor] is materially responsible for the failure of the IRA to meet the requirement that it not engage in a prohibited transaction." (Memorandum Opinion and Order, RE 11, Page ID # 386.) This interpretation and application of the "materially responsible" standard is erroneous.

First, the Trustee stipulated below that “[i]f the Merrill Lynch IRA account is found to be not in ‘substantial compliance’ with the IRS Code of 1986 . . . the Debtor is not materially responsible for that failure as provided by 11 U.S.C. § 522(b)(4)(B)[(ii)](II).” (Amended Stipulation of Facts and Documents, RE 1-14, Page ID # 150.) *Second*, this stipulation is consistent with the bankruptcy court’s determination that the purported prohibited transaction occurred “through no fault of [Debtor].” (Memorandum Opinion, RE 1-20, Page ID # 280.) *Third*, the undisputed evidence clearly and overwhelmingly supports the stipulation. Debtor did nothing other than sign a standard form account document required to open this IRA, containing language that was common to IRA account documents at that time. As he held only the IRA with Merrill Lynch, he could not have known or even suspected that the provision at issue, which purported to grant Merrill Lynch a lien in other (non-existent) accounts to cover indebtedness in his account (and vice-versa), could have any practical implication at all, let alone cause forfeiture of the tax-advantaged status of his IRA.

CONCLUSION

For the reasons stated herein, SIFMA believes that the decisions below are in error and, if left to stand, could adversely affect the IRAs of millions of Americans and cause significant and widespread disruption to the retirement system in this country.

Respectfully Submitted: January 10, 2013

/s/ Eric G. Serron
Melanie Franco Nussdorf
Eric G. Serron
STEPTOE & JOHNSON LLP
1330 Connecticut Ave., NW
Washington, DC 20036
Phone: 202-429-3000
Facsimile: 202-429-3902
eserron@steptoe.com
mnussdorf@steptoe.com

*Counsel for Securities Industry and
Financial Markets Association
(SIFMA)*

Ira D. Hammerman
Kevin Carroll
SECURITIES INDUSTRY AND
FINANCIAL MARKETS
ASSOCIATION
1101 New York Avenue, NW
Washington, DC 20005
Telephone: (202) 962-7382

RULE 32 CERTIFICATE OF COMPLIANCE

The undersigned certifies that this brief complies Fed. R. App. P. 32(a)(7)(B) because it contains 6,040 words, as counted by my word processing program, excluding the portions exempted by Fed. R. App. P. 32(a)(7)(B)(ii). This brief complies with the typeface and type style requirements of Fed. R. App. P. 32(a)(5) and (6) because it is in 14 point proportionally spaced Times New Roman font.

s/ Eric G. Serron

Eric G. Serron

CERTIFICATE OF SERVICE

The undersigned hereby certifies that the foregoing Brief of Amicus Curiae Securities Industry and Financial Markets Association in Support of Debtor-Appellant and in Support of Reversal was submitted by e-mail on January 10, 2013 to the United States Court of Appeals for the Sixth Circuit as follows:

Roy G. Ford, Case Manager
United States Court of Appeals for the Sixth Circuit
100 E. Fifth Street, Room 540
Cincinnati, Ohio 45202-3988
E-Mail: Roy_Ford@ca6.uscourts.gov

Pursuant to the Court's process for serving documents electronically, the following counsel of record for the parties to this appeal will be served by the Clerk of the Court through the ECF system:

John P. Newton, Esq.
Law Offices of Mayer & Newton
1111 Northshore Drive, Suite S-570
Knoxville, TN 37919
E-Mail: johnnewton@mayerandnewton.com
Attorneys for Debtor/Appellant James L. Daley, Jr.

Al Holifield, Esq.
Holifield & Associates, PLLC
8351 East Walker Springs Lane, Suite 303
Knoxville, TN 37923
E-Mail: aholifield@hpc-law.com
Attorneys for Trustee/Appellee Ann Mostoller

Dated: January 10, 2013

s/ Eric G. Serron
Eric G. Serron