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Court: Federal Restitution Rights Override ERISA 401(k) Plan Protection

BY DAN MORGAN

In a recent opinion, the U.S. Court of Appeals for the Fourth Circuit, in *United States v. Frank*, followed the lead of several other federal courts of appeal and district courts to permit the federal government to reach an individual's 401(k) plan account to satisfy a criminal restitution order issued pursuant to the Mandatory Victims Restitution Act of 1996 (MVRA).

The facts of the case are straightforward. Jon Lawrence Frank pled guilty in federal district court to wire fraud in connection with the embezzlement of $19 million from his former employer. In addition to sentencing Mr. Frank to prison, the court ordered him to pay restitution of the embezzled amount. The government was able to recover only $7 million from Mr. Frank and sought, pursuant to the MVRA, to garnish approximately $480,000 that was being held in a 401(k) account in his name.

The MVRA Allows the Government to Garnish a Person's 401(k) Account Mr. Frank argued that the garnishment is barred by the Employee Retirement Income Security Act of 1974 (ERISA), which provides that benefits under an employee benefit plan such as a 401(k) plan ''may not be assigned or alienated.'' The only exceptions are for domestic relations orders, offsets to compensate the plan for wrongs committed against the plan, and loans from the plan that are secured by the borrower's plan benefits. ERISA Section 206(d)(1). Tax code Section 401(a)(31) has a comparable ''anti-alienation'' rule, which an employer-sponsored retirement plan must satisfy to be tax-qualified.

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The Fourth Circuit concluded that the broad wording of the MVRA, which mandates that courts ''shall order'' defendants to make restitution, ''notwithstanding any other provision of the law,'' overrides ERISA's anti-alienation shield. Interestingly, the court did not discuss either ERISA Section 403(c)(1), which states that the assets of a plan ''shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries,'' or Section 401(a)(2), which states that the assets of a qualified retirement plan must be held pursuant to a trust instrument under which it is ''impossible . . . for any part of the corpus or income to be . . . used for, or diverted to, purposes other than for the exclusive benefit of [an employer's] employees or their beneficiaries.'' Given the court's view of the reach of the MVRA, these provisions—often referred to as the ''exclusive benefit'' rule—would likely not have had an effect on the court's decision.

As part of its review, the Fourth Circuit emphasized that, when the government enforces an MVRA restitution order against someone's 401(k) account, the government stands in the shoes of the account owner and only acquires ''whatever rights to the [401(k) account] he possesses—no less, but also no more.''

This requirement means that the account owner must have a current right under the 401(k) plan to receive a distribution of their account. Because Mr. Frank was no longer employed by the company maintaining the plan, he was entitled under the terms of the plan (as would typically be the case) to get a payment of his 401(k) account. The court pointed out that it doesn't matter that

Mr. Frank might have preferred not to do so. It is the right to receive a distribution that counts.

What About the Taxes? Mr. Frank asked the Fourth Circuit to reduce the amount payable to the government by federal income withholding taxes of 20% and the tax code Section 72(t) 10% penalty tax applicable to pre-59½ qualified plan distributions (Mr. Frank is 52).

Rather than rule on Mr. Frank's request, the court remanded the case to the District Court to determine:

- whether the 401(k) plan document under which Mr. Frank's account is held requires the payment to the government be reduced by 20% income withholding taxes; and
- whether the tax law or the 401(k) plan document require the withholding of the 10% early distribution tax.

The court apparently did not know that a lump-sum withdrawal from a 401(k) plan to satisfy a restitution claim automatically triggers a statutory obligation imposed by the tax code to withhold 20% of the withdrawal as income taxes. The IRS said as much in Private Letter Ruling 200426027. *See* tax code Section 3405(c). Whether appropriate wording was missing from the plan document would not alter that outcome.

The court also expressed uncertainty as to the applicability of the tax code Section 72(t) 10% early distribution penalty tax on the payment. The court noted that an opinion by the Seventh Circuit "appears to have concluded that there would be tax penalties imposed on an early distribution pursuant to a government restitution order," citing *U.S. v. Sayyed*. The Fourth Circuit, again citing the *Sayyed* case, stated that "an early withdrawal penalty assessed against a lump-sum liquidation—whether withheld . . . under the terms of Frank's plan or separately imposed by law—also would qualify as a limit on Frank's right to access his 401(k) funds, and thus as a parallel limit on the government's right of access."

The instruction to the district court indicates that the Fourth Circuit was unaware that the early distribution penalty tax is not withheld from 401(k) plan distributions, which eliminates the possibility that the plan document would require such withholding. The court also was not aware of the IRS's view—and it's the IRS's view that matters—expressed in PLR 200426027, that "any distributions that result from the collection of . . . restitution payments are not subject to the additional [early distribution penalty] tax" and that the IRS "will not assess the IRC Section 72(t) additional tax in cases where the government action triggers an early distribution from a qualified plan," citing the IRS's acquiescence to the U.S. Tax Court decision to that effect in *Murillo v. Commissioner*.

Although it omitted any discussion of the exclusive benefit rule, the Fourth Circuit's holding that a person's 401(k) plan account is not protected from an MVRA garnishment order follows an established body of case law. Its muddled analysis of the tax obligations triggered by the garnishment, however, ignores the IRS's pronouncements regarding those obligations and is likely to produce confusion.

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