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INTRODUCTION

Section 522(b)(1)[1] of The Bankruptcy Reform Act of 1978 (Bankruptcy Act)[2] permits a state to force a bankrupt domiciled within its borders[3] to rely on exemptions[4] provided by state law. With the enactment of Kentucky Revised Statutes (KRS) section 427.170,[5] the Kentucky legislature imposed its own exemption

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[1] 11 U.S.C. § 522(b)(1) (1982) states:

> Notwithstanding section 541 of this title, an individual debtor may exempt from property of the estate . . . (1) property that is specified under subsection (d) of this section, unless the State law that is applicable to the debtor under paragraph (2)(A) of this subsection specifically does not so authorize . . . .

[2] The Bankruptcy Reform Act of 1978 was enacted by Pub. L. 95-598, title I, § 101, Nov. 6, 1978, 93 Stat. 2549 (Codified as 11 U.S.C. (1978)) [hereinafter cited as Bankruptcy Act with section references to U.S.C.]. See text accompanying notes 29-34 *infra* for purposes of Bankruptcy Act.

[3] The debtor may invoke the exemption statute of the "place in which the debtor's domicile has been located for the 180 days immediately preceding the date of the filing of the petition, or for a longer portion of such 180-day period than in any other place." 11 U.S.C. § 522(b)(2)(A) (1982).

[4] The estate created with the initiation of bankruptcy proceedings "includes . . . all property of the debtor, even that needed for a fresh start. After the property comes into the estate, then the debtor is permitted to exempt it under . . . 11 U.S.C. § 522, and the court will have jurisdiction to determine what property may be exempted and what remains as property of the estate." S. REP. No. 989, 95th Cong., 2d Sess. 82, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 5868.

[5] KY. REV. STAT. § 427.170 (Bobbs-Merrill Cum. Supp. 1984)[hereinafter cited as KRS] provides: "An individual debtor domiciled in this state is not authorized to exempt from property of said debtor's estate the property specified under subsection (d) of section 522 of The Bankruptcy Code of 1978. . . ."

Two-thirds of the states have enacted similar statutes. *See, e.g.*, ARIZ. REV. STAT. ANN. § 33-1133(B) (Supp. 1983-84); FLA. STAT. ANN. § 222.20 (West Supp. 1984); GA. CODE ANN. § 44-13-100(b) (1982); LA. REV. STAT. ANN. § 13:3881(B)(a) (West Supp. 1984); S.D. CODIFIED LAWS ANN. § 43-31-30 (1983); VA. CODE § 34-3.1 (1984); WYO. STAT. § 1-20-109 (Cum. Supp. 1984).

scheme[6] on Kentucky bankrupts. Consequently—with the exception of certain specific federal exemptions[7]—Federal bankruptcy courts in Kentucky are, at least initially,[8] required to test the validity of an exemption claim under state law.[9]

In *In re Worthington*[10] the United States Bankruptcy Court for the Western District of Kentucky faced the question of whether an Individual Retirement Account (IRA)[11] was exempt under the applicable state exemption statute, KRS section 427.150(1)(b).[12] In this case, the debtor had set up an IRA prior to filing a voluntary petition[13] under chapter 7 of the Bankruptcy

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[6] For exemptions allowed under Kentucky state law see KRS chapter 427.

[7] Although a state may deny its bankrupts the federal exemption scheme in 11 U.S.C. § 522(d) (1982), a state may not deny its bankrupts a variety of other federal exemptions, including:

> Foreign Service Retirement and Disability payments, 22 U.S.C. 1104; Social Security payments, 42 U.S.C. 407; Injury or Death compensation payments from war risk hazards, 42 U.S.C. 1717; Wages of fishermen, seamen and apprentices, 46 U.S.C. 601; Civil Service retirement benefits, 5 U.S.C. 729, 2265; Longshoremen's and Harbor Worker's Compensation Act death and disability benefits, 33 U.S.C. 916; Railroad Retirement Act annuities and pensions, 45 U.S.C. 228(L); Veterans benefits, 45 U.S.C. 352(E); Special pensions paid to winners of the Congressional Medal of Honor, 38 U.S.C. 3101; and Federal homestead lands on debts contracted before issuance of the patent, 43 U.S.C. 175.

H.R. REP. No. 595, 95th Cong., 1st Sess. 360, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787, 6316.

[8] A state exemption statute is enforceable only to the extent that it is consistent with the purposes of the Bankruptcy Act. *See* note 96 *infra* and accompanying text.

[9] *See In re* Volk, 26 Bankr. 457, 459 (Bankr. D. S.D. 1983) (applicable state law determined by debtor's domicile); *In re* Klein, 10 Bankr. 356, 358 (Bankr. 9th Cir. 1981), *rev'd mem.*, 711 F.2d 1067 (1983); *In re* Lockwood, 6 Bankr. 623, 624 (Bankr. S.D. Fla. 1980). *See also* Marine Midland Bank v. Surfbelt, Inc., 532 F. Supp. 728, 729 (W.D. Pa. 1982) (law of forum governs questions of exemption); *In re* Downing, 148 F. 120, 121 (W.D. Ky. 1905); Phillips v. Phillips, 285 S.E.2d 52, 54 (Ga. App. 1981).

[10] 28 Bankr. 736 (Bankr. W.D. Ky. 1983).

[11] *See* 26 U.S.C. § 408 (1982) (statutory authority for Individual Retirement Accounts). *See generally* H.R. REP. No. 807, 93d Cong., 2d Sess., *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 4639, 4670, 4791 (legislative history and purpose of IRAs).

[12] (a) An individual is entitled to exemption of the following property to the extent reasonably necessary for the support of him and his dependents . . . (b) Assets held, payments made, and amounts payable under a stock bonus, pension, profit-sharing, annuity, or similar plan or contract, providing benefits by reason of age, illness, disability, or length of service.

KRS § 427.150(1)(b) (Cum. Supp. 1984).

[13] *See* 11 U.S.C. § 301 historical and revision notes (1982).

> Section 301 specifies the manner in which a voluntary bankruptcy case is commenced. The debtor files a petition under this section under the particular operative chapter of the bankruptcy code under which he wishes to proceed. The filing of the petition constitutes an order for relief in the case under that chapter.

Id. quoting (S. REP. No. 95-989).

Code.[14] "Pursuant to that petition, on Schedule B-4[15] the debtor claimed as exempt the cash surrender value of [the] . . . Individual Retirement Account pursuant to KRS 427.150 in the amount of $5,959.68."[16] The trustee[17] objected to the exemption.[18] Since KRS section 427.150 does not expressly mention IRAs, inclusion or exclusion of such property is a matter of interpretation.[19] The court properly noted that decisions of other jurisdictions were not controlling and that the resolution of the issue was confined to state law.[20] However, the court erroneously concluded through use of a two-part test[21] that an IRA was a "similar plan or contract"[22] to a "stock bonus, pension, profit-sharing, [or] annuity,"[23] and therefore was exempt property.[24]

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[14] *See* 11 U.S.C. §§ 704-66 (1982) (Chapter 7 covers liquidation under the Bankruptcy Act).

[15] Schedule B-4 includes "property claimed as exempt" by the bankrupt and is a part of FORM No. 6, which the bankrupt is required to file. *See* 11 U.S.C. app., rule 108(a) (1982); 11 U.S.C. app., FORM No. 6 SCHEDULES (1982).

[16] *In re* Worthington, 28 Bankr. at 737.

[17] The trustee is charged with responsibility for "examin[ing] proofs of claims and object[ing] to the allowance of any claim that is improper." 11 U.S.C. § 704(4) (1982). The trustee is also obligated, "if advisable, [to] oppose the discharge of the debtor." 11 U.S.C. § 704(5) (1982).

[18] 28 Bankr. at 737.

[19] *See* Teel v. Am. Steel Foundries, 529 F. Supp. 337, 343 (E.D. Mo. 1981) ("When a federal court is faced with a lack of controlling state judicial authority, [concerning interpretation of a state statute,] it must determine the law as the state court would determine it, guided by reason and sound judicial analysis."); *In re* Kanter, 345 F. Supp. 1151, 1159 (D.C. Cal. 1972) ("The bankruptcy court has the power to construe state statutes, even exemption statutes, where there are no state decisions construing the same, or where there are conflicting cases."), *aff'd*, 505 F.2d 228 (1974). *See also* Commissioner v. Estate of Bosch, 387 U.S. 456, 465 (1967); Holler v. United States, 724 F.2d 104, 105 (10th Cir. 1983); Reid v. Life Ins. Co. of N. Am., 718 F.2d 677, 680 (4th Cir. 1983); Herndon v. Seven Bar Flying Service, Inc., 716 F.2d 1322, 1332 (10th Cir. 1983); Cole v. Cardoze, 441 F.2d 1337, 1343 (6th Cir. 1971); Loengard v. Santa Fe Indus., Inc., 573 F. Supp. 1355, 1358 (D. Colo. 1962); *In re* William Duncan & Son, 165 F. Supp. 159, 162 (N.D. Cal. 1958); *In re* Design Craft, Inc., 26 B.R. 469, 475 (Bankr. W.D. Mo. 1983); *In re* Mistura, Inc., 22 B.R. 60, 62 (Bankr. 9th Cir. 1982); *In re* Sexton, 16 B.R. 240, 242 (Bankr. D. Tenn. 1981). *But see, e.g.*, Roberts v. W.-S. Life Ins. Co., 568 F. Supp. 536, 537 (N.D. Ill. 1983) ("Federal court in construing state law should not attempt dramatic innovation in state law."); *In re* Griffin, 225 F. Supp. 482, 484 (W.D.N.C. 1963).

[20] 28 Bankr. at 738. *See* note 9 *supra* and accompanying text.

[21] 28 Bankr. at 738. For the text of this two-part test see text accompanying notes 97, 101 *infra*.

[22] *See* 28 Bankr. at 739 ("Parallel in nature [so] as to serve the same goals or purposes.").

[23] *Id.* The *Worthington* court declined to define these programs, except to say:

This Comment contends that the court's analysis of the "nature" of IRA assets was superficial and resulted in the creation of an exemption not intended[25] by KRS section 427.150(1)(b). The court's interpretation of KRS section 427.150(1)(b) and the court's two-part test fail to advance the Congressional[26] purposes[27] of the Bankruptcy Act and its exemptions.[28]

I. THE PURPOSES OF THE BANKRUPTCY REFORM ACT OF 1978 AND EXEMPTIONS

In enacting the Bankruptcy Act Congress sought to include all of the debtor's property in the estate and to aid the trustee in recovering any property that the debtor may have transferred prior to filing.[29] In *Segal v. Rochelle*,[30] the United States Supreme Court noted that bankruptcy legislation seeks to serve two competing interests.[31] The Bankruptcy Act attempts both to "secure for creditors everything of value the bankrupt may possess in

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"Each of the specifics named as well as the IRA program has the common theme of deferred tax liability on assets presently owned, and with the ostensible purpose to supplement retirement income in the future or provide benefits by reason of age, illness, disability, or death." *Id.*

[24] *See* 28 Bankr. at 739.

[25] *See* notes 79, 88 *infra*. *Cf. In re* Howerton, 21 Bankr. 621, 623 (Bankr. N.D. Tex. 1982) ("Although exemption laws are to be construed liberally in favor of the debtor, the court is not at liberty to create exemptions which do not exist.").

[26] *See In re* Balgemann wherein the court noted:

> Congress may . . . delegate its legislative authority, but in so doing it must provide guidelines to insure that Congress's objectives are met. . . . Congress has treated the subject matter of exemptions in a detailed and comprehensive manner in § 522 of the Code. The framework and principles of that section are those Congress intended that the States use when acting under the authority delegated to them.

In re Balgemann, 16 Bankr. 780, 782 (Bankr. N.D. Ill. 1982) (citing National Cable Television Ass'n v. United States, 415 U.S. 336 (1974); Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935); *In re* Rhodes, 14 Bankr. 629, 631 (Bankr. M.D. Tenn. 1981), *cert. denied*, 464 U.S. 983 (1983).

[27] *Cf. In re* Steele, 26 Bankr. 233 (Bankr. W.D. Ky. 1982). This earlier opinion, by the same judge who later decided *In re* Worthington, recognized that achievement of the spirit of the Bankruptcy Code was the ultimate end to which the "equitable and legal powers of the Bankruptcy Court" were to be used. *See id.* at 235.

[28] For a discussion of the goals and purpose of exemptions, see text accompanying notes 39-41, 98-99 *infra*.

[29] *See* S. REP. No. 989, *supra* note 4, at 5791.

[30] 382 U.S. 375 (1966).

[31] *See id.* at 379.

alienable or leviable form[32] when he files his petition,"[33] *and* "to leave the bankrupt free after the date of his petition to accumulate new wealth in the future."[34]

To accomplish such competing ends the *Segal* Court's construction of "property"[35] and the Bankruptcy Act itself must be viewed as interrelated.[36] In *Segal*, the Court noted that the term "property", as employed by the Bankruptcy Act, is to be broadly construed so as to include even property interests that are "novel or contingent."[37] The practical effect of this ruling is to place into the estate almost everything to which the debtor has any claim.[38] Section 522 of the Bankruptcy Act limits this "all inclusive approach" by permitting the bankrupt to exempt certain property from his estate[39] and hence from the reach of his creditors. The goals in granting exemptions are:

(1) protecting the individual and his family from poverty,

(2) assisting and encouraging the rehabilitation and "fresh start" of the debtor,[40] and

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[32] *See* D. COWANS, BANKRUPTCY LAW AND PRACTICE § 343 (2d ed. 1978) ("The general right of the trustee is to property which the bankrupt might have transferred or which might have been reached by legal process by his creditors . . . . [L]eviability is decided by the law of the state in which the property is located." (emphasis and footnote omitted)).

[33] 382 U.S. at 379.

[34] *Id.*

[35] See 11 U.S.C. § 541 for the definition of property and for a specification of which property is to be estate property.

[36] *See* 382 U.S. at 379-81.

[37] *See id.* at 379.

[38] *See In re* Howerton, 21 Bankr. 621, 622 (Bankr. N.D. Tex. 1982); S. REP. No. 989, *supra* note 4, at 5868.

[39] Section 522 permits a debtor to exempt property "notwithstanding section 541." *See* 11 U.S.C. § 522(b). "All property within the contemplation of Section 541 comes into the estate, and the property the debtor claims as exempt leaves the estate only after he properly files his request for exemptions." *In re* Lowe, 25 Bankr. 86, 87 (Bankr. D.S.C. 1982). *See also* notes 5-6 *supra*. *Cf.* 11 U.S.C. § 541(c)(2) (1982) (spendthrift trusts, enforceable under applicable nonbankruptcy law, are excluded from the estate); *In re* Holt, 32 Bankr. 767, 769 (Bankr. E.D. Tenn. 1983) ("The congressional intent underlying the enactment of Code ¶ 541(c)(2) was to exclude spendthrift trust property . . . of the debtor's estate to the extent the restrictions in the trust are enforceable under nonbankruptcy law.") (footnote omitted). See H.R. REP. No. 595, *supra* note 7, at 6323-25 for the legislative history and purpose of § 541.

[40] *See generally* Comment, *Protection of a Debtor's "Fresh Start" Under the New Bankruptcy Code*, 29 CATH. U. L. REV. 843 (1979-80).

(3) shifting of the burden of the social welfare of the debtor and his family from society as a whole to the creditors who dealt with the debtor and who contributed to his economic demise.[41]

Yet, as legislative history points out, "the policy of the bankruptcy law is to provide a fresh start, but not instant affluence."[42] Consequently, section 522(b)(2)(A)[43] gives state legislatures the option to create particular exemptions which will best allow the debtors of their state to make a "fresh start" without granting to them an unneeded accession to wealth.[44] KRS section 427.150(1)(b) evolved from such a framework.

II. AN IRA IS NOT A "SIMILAR PLAN OR CONTRACT" UNDER KRS SECTION 427.150(1)(b)

The Kentucky exemption provision, KRS section 427.150(1)(b), provides that "(1) An individual is entitled to exemption of the following property . . . (b) . . . stock bonus, pension, profit-sharing, annuity, or similar plan or contract . . . ."[45] The provision does not specifically mention IRAs, thus the question arises whether an IRA is a "plan or contract" similar to a "stock bonus, pension, profit-sharing, [or] annuity."[46]

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[41] *See* Beall v. Pinckney, 150 F.2d 467, 470 (5th Cir. 1945), which states:

> Bankruptcy statutes are no longer used primarily to punish an insolvent, but more often to release and rehabilitate him. In the United States public policy has looked beyond the debtor to his family, when he has one, and has regarded the reasonable protection of the family as of greater concern than the full payment of debts.

See also 9 AM. JUR. 2D *Bankruptcy* § 302 (1980) ("Exercise and Determination of Debtor's Exemptions").

[42] S. REP. No. 989, *supra* note 4, at 5792.

[43] 11 U.S.C. § 522(b)(2)(A) (1982) provides:

> Notwithstanding section 541 of this title, an individual debtor may exempt from property of the estate . . . any property that is exempt under Federal law, other than subsection (d), . . . or State or local law that is applicable on the date of the filing of the petition at the place in which the debtor's domicile has been located for the 180 days immediately preceding the date of the filing of the petition, or for a longer portion of such 180-day period than in any other place. . . .

[44] *See* S. REP. No. 989, *supra* note 4.

[45] KRS § 427.150(b)(1) (Cum. Supp. 1984).

[46] *See In re* Worthington, 28 Bankr. 736, 739 (Bankr. W.D. Ky. 1983).

The *Worthington* court stated that "deferred tax liability" and "supplemental retirement income" were "common themes" of both IRAs and those plans specifically exempted by KRS section 427.150(1)(b).[47] However, a closer examination of IRAs and the specifically exempted plans will reveal that these "common themes" are superficial and that the assets are distinguishable. As the United States Supreme Court noted in *Kokoszka v. Belford*:[48] "[T]he crucial analytical key, [is] not in an abstract articulation of the statute's purpose, but in an analysis of the nature of the asset involved in light of those principles."[49]

Certainly, all of the assets being discussed share the notion of "deferred tax liability".[50] Congress, however, did not create a pension-like system for IRAs.[51] Initially, Congress granted a tax break only to those employer established retirement plans that complied with stringent congressional requirements.[52] Congress reasoned that such a tax break would be incentive for employers to establish these "qualified plans" for their employees, thereby serving the socially desirable end of benefiting the national retirement system.[53] This legislation resulted in a disparity of retirement benefits between employees with access to qualified plans and those without access.[54] Consequently, Con-

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[47] *See id.* at 739.

[48] 417 U.S. 642 (1974).

[49] *Id.* at 646. The *Segal* court's broad interpretation of "property" has been incorporated into § 541 of the Bankruptcy Act. *See* S. REP. No. 989, *supra* note 4, at 5868.

[50] *See* I.R.C. §§ 402(a)(1), 408(d)(1) (1984) (neither qualified plans under § 401(a) nor IRAs are subject to taxation until future distribution).

[51] *See In re* Mace, 4 BANKR. CT. DEC. (CRR) 94, 95 (D. Or. 1978).

[52] *See id.*

[53] Employers who set up qualified plans which serve socially desirable ends, as determined by Congress, consequently receive favorable tax treatment:

> The committee bill . . . continues the approach in present law of encouraging the establishment of retirement plans which contain socially desirable provisions through the granting of tax inducements. In other words, . . . no one is compelled to establish a retirement plan. However, if a retirement plan is to qualify for the favorable tax treatment, it will be required to comply with specified . . . requirements which are designed to improve the retirement system.

H.R. REP. No. 807, *supra* note 11, at 4677.

[54] *See* H.R. REP. No. 807, *supra* note 11, at 4791 which states:

> *General reasons for change*
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> While in the case of many millions of employees, provision is made for their retirement out of tax-free dollars by their participation in qualified

gress created IRAs to provide equal tax treatment for employees ineligible to participate in qualified plans.[55] One court dealing with this issue noted, "[T]here has been no establishment of a pension system for IRAs but merely an amendment of the Internal Revenue Code to provide certain tax benefits for a disadvantaged group to encourage retirement savings."[56] Furthermore, IRAs and stock bonus, pension, profit-sharing, and annuity plans are regulated by different Internal Revenue Code sections.[57]

The assets examined in this case are vastly different in nature.[58] It is difficult to conclude that Congress, in establishing IRAs, sought to treat them in all respects similar to the other qualified plans.[59] Moreover, to hold that an IRA is "similar" to the other assets in providing "supplemental retirement income" is to fall victim to the theoretical niceties of its name, while ignoring the realities of its nature.[60] In granting an exempt

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> retirement plans, many other employees do not have the opportunity to participate in qualified plans. . . . Employees who are not covered under a qualified plan are disadvantaged by the fact that earnings on their retirement savings are subject to tax, and grow more slowly than the tax-sheltered earnings on contributions to a qualified plan.
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> [The proposed IRA legislation] deals with this problem by making available a special deduction for amounts set aside for retirement by employees who are not covered under a qualified plan. . . . The earnings on this amount will also be tax-free. . . . [T]he amounts set aside plus the earnings are to become taxable to the individual generally after he has reached retirement age, when he receives benefits from the account.

See also In re Mace, 4 BANKR. CT. DEC. (CRR) at 95.

[55] "[F]or the first time . . . individuals who are not covered by any qualified pension plan may take a tax deduction for contribution to an individual retirement plan." *In re* Mace, 4 BANKR. CT. DEC. (CRR) at 95. *See also* note 54 *supra*.

[56] *In re* Mace, 4 BANKR. CT. DEC. (CRR) at 95-96. *See also In re* Howerton, 21 Bankr. at 623.

[57] *See* I.R.C. § 401 (qualified pension, profit-sharing, and stock bonus plans); I.R.C. §§ 403, 404 (annuities); I.R.C. § 408 (IRAs).

[58] *See In re* Mace, 4 BANKR. CT. DEC. (CRR) at 95.

[59] *See* notes 55-58 *supra*. *See generally* 1974 U.S. CODE CONG. & AD. NEWS 5177, 5189 (statement introducing the Conference report containing the provision for IRAs does not mention exemption under the Bankruptcy Act).

[60] *Cf. In re* Howerton, 21 Bankr. at 623-24:

> This court cannot ignore the real nature of the Debtors' I.R.A.s. They are basically tax deferment plans over which the Debtors exercise a great deal of control. They may withdraw the cash . . . subject to a tax assessment at anytime and there is no guarantee the funds will be retained until retirement. If the Debtors have the unlimited capacity to reach those funds, so does the trustee.

status to a stock bonus, pension, profit-sharing or annuity plan, Congress or a state legislature can, with a high degree of certainty, say such assets will become accessible to the individual only upon his retirement.[61] Based on this "certainty" such assets represent bona fide sources of "supplemental retirement income."[62] In the case of IRAs, not only is there no guarantee the individual will leave the asset untouched until retirement,[63] there is likewise little to deter liquidation of such an asset.[64]

The most important distinction between an IRA and a stock bonus, pension, profit-sharing or annuity plan is the control that the individual retains over the asset.[65] Although the *Worthington* court sidestepped this issue,[66] the control element is crucial to an analysis of the nature of the asset based on the purposes of bankruptcy law.[67] The *Worthington* court said an IRA will func-

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[61] *See* note 62 *infra* and accompanying text.

[62] *See* 4 BANKR. CT. DEC. (CRR) at 96-97 ("In each of the . . . cases where the asset was determined to be a substitute for future wages, the bankrupt had only limited control over the fund so that there was a substantial certainty that the funds would be used at a time when a wage substitute was necessary.").

[63] *See In re* Shackelford, 27 Bankr. 372, 373 (Bankr. W.D. Va. 1983); *In re* Lowe, 25 Bankr. 86, 88 (Bankr. D.S.C. 1982); *In re* Howerton, 21 Bankr. at 623; *In re* Talbert, 15 Bankr. 536, 537 (Bankr. W.D. La. 1981); 4 BANKR. CT. DEC. (CRR) at 95.

[64] *See* 27 Bankr. at 373 (An IRA "may be revoked by the Debtor at any time, subject only to the penalty set forth in the Internal Revenue Code."); *In re* Blatter, 16 Bankr. 137, 138 n.1 (Bankr. S.D.N.Y. 1981) ("[IRA] is a self-settled trust not exempt from a judgment creditor's execution levy. . . . [I]t is of no consequence that an involuntary premature withdrawal of funds will result in tax penalties and onerous tax consequences to the debtor in addition to loss of the fund itself."). Also, see note 72 *infra* for the relevant portion of the I.R.C. section regarding penalty.

[65] *See In re* Howerton, 21 Bankr. at 623; 15 Bankr. at 537 (An IRA can be distinguished from an annuity and pension based on the amount of control the depositor has over the funds.); *In re* Mace, 4 BANKR. CT. DEC. (CRR) at 96-97. *See also In re* Clark, 18 Bankr. 824, 827-28 (Bankr. E.D. Tenn. 1982) (Keogh plan not exempt where debtor retained option to receive assets in a lump-sum payment and trust allowed distribution of the trust assets prior to the debtor attaining age 59-1/2); *In re* Watson, 13 Bankr. 391, 391 (Bankr. M.D. Fla. 1981) (Debtor's interest in qualified plan where debtor had present right to terminate plan and withdraw funds was not exempt); *In re* Baviello, 12 Bankr. 412, 412 (Bankr. E.D.N.Y. 1981) (Keogh account not exempt where debtor had complete control over the account at all times). *Accord In re* Parker, 473 F. Supp. 746, 751-52 (W.D.N.Y. 1979) (fund exempt from estate where limitations on bankrupt's control effectively precluded use of fund for any purpose other than future support of bankrupt and his dependents).

[66] *See* 28 Bankr. at 739 ("Debtor control over assets is not the determinant of whether exempt status exists.").

[67] *See, e.g.*, 4 BANKR. CT. DEC. (CCR) at 96 (recognizing the "nature of the asset" test set out in Kokoszka v. Belford, 417 U.S. at 642, the court noted the high level of control a debtor has over an IRA differentiates it from a pension and makes it not exempt). *See also* cases cited *supra* note 65.

tion as a substitute for wages during retirement.[68] Although this is ostensibly true, other courts considering the specific issue of whether IRAs are exempt property have noted that there is no certainty that such a function will be served.[69] With a stock bonus, pension, profit-sharing or annuity plan, an individual has very restricted access to the funds prior to retirement.[70] Typically, an individual would have to quit his job to receive such funds.[71] In contrast, the owner of an IRA is free at any time to withdraw the funds subject only to a ten percent tax penalty.[72] Moreover, in the case of a stock bonus, pension, profit-sharing or annuity plan, an employer-employee relationship is contemplated where each party has an equal say in the management of the fund. An IRA creates a depositor-depositary relationship in which the depositary is merely an agent of the depositor and legally obligated to act according to the depositor's directions.[73] Moreover, although a stock bonus, pension, profit-sharing or annuity plan is severely limited with regard to assignability and alienation,[74] IRAs are not so limited.[75] Absent stringent limiting

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[68] *See* 28 Bankr. at 739.

[69] *See In re* Shackelford, 27 Bankr. at 373; *In re* Lowe, 25 Bankr. at 88; *In re* Howerton, 21 Bankr. at 623; *In re* Talbert, 15 Bankr. at 537; *In re* Mace, 4 BANKR. CT. DEC. (CCR) at 96-97. *See also In re* Ferwerda, 424 F.2d 1131, 1133 (7th Cir. 1970); *In re* Graham, 24 Bankr. 305, 312 (Bankr. N.D. Iowa 1982), *aff'd*, 726 F.2d 1268 (1984); *In re* Hinshaw, 23 Bankr. 233, 235-36 (Bankr. D. Kan. 1982); *In re* Baviello, 12 Bankr. 412, 415 (Keogh account not exempt).

[70] *See* 4 BANKR. CT. DEC. (CRR) at 95.

[71] *See In re* Goff, 706 F.2d 574 (5th Cir. 1983).

> [In] the usual case of employer-created funds . . . the beneficiary employee has little or no control during the term of his employment, and may only withdraw funds upon termination of employment. He must quit his job in order to gain premature access to his retirement funds. We cannot equate a "tax penalty" with "employment termination" as equal restraints upon withdrawal of pension funds.

Id. at 589 (footnote omitted).

[72] I.R.C. § 408(f)(1) (1984) provides:

> If a distribution from an individual retirement account . . . to the individual for whose benefit such account . . . was established is made before such individual attains age 59-1/2, his tax under this chapter for the taxable year in which such distribution is received shall be increased by an amount equal to 10 percent of the amount of the distribution which is includible in his gross income for such taxable year.

[73] *See* 15 Bankr. at 538.

[74] *See* I.R.C. § 401(a)(13) (1984): "A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that benefits provided under the plan may not be assigned or alienated." See Treas. Reg. § 1.401(a)-

provisions, the potential for removal of funds from the IRA for uses other than retirement greatly increases.[76]

Another distinction between IRAs and a stock bonus, pension, profit-sharing or annuity plan is the control of the disbursal of the funds. This distinction appears in both the form and timing of disbursement, and is best seen on an asset to asset comparison. Annuities may only be distributed in installment payments,[77] while the owner of an IRA may elect to receive a lump-sum payment.[78] Funds from a pension plan may be distributed only during retirement,[79] but an IRA permits an individual to withdraw the funds while gainfully employed.[80] Profit-sharing and stock bonus plan funds, like IRAs, may be disbursed in either installments or lump-sums,[81] however, the provisions of the plan determine the timing of such disbursements.[82] In contrast, the owner of an IRA has sole control over the timing of disbursement, subject to a penalty for early withdrawal.[83] Such distinctions make it difficult to conclude that an IRA is a bona fide source of retirement income or a substitute for future wages.

Finally, some courts have denied IRAs exempt status because an IRA is an "account" and not a policy or plan.[84] These authorities conclude that the federal tax break given to a savings account established for retirement does not imply that such an account is exempt from the bankrupt's estate.[85]

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13 (1984) for the specific scope of the assignment or alienation requirement. *See also* 4 BANKR. CT. DEC. (CRR) at 95.

[75] *See* I.R.C. § 408(e)(4)(f)(2) (1982) (use of IRA as security for a loan only subjects portion designated as security to treatment as if distributed—tax plus 10% penalty tax imposed); *In re* Mace, BANKR. CT. DEC. (CRR) at 95.

[76] *See* 4 BANKR. CT. DEC. (CRR) at 97.

[77] S. GOLDBERG, PENSION PLANS AND EXECUTIVE COMPENSATION § 2.17 (1974). *See In re* Talbert, 15 Bankr. at 537.

[78] *In re* Talbert, 15 Bankr. at 537.

[79] S. GOLDBERG, *supra* note 77, at § 2.17. *See also In re* Nunnally, 506 F.2d 1024, 1026 (5th Cir. 1975) ("[P]ension payments . . . are periodic payments made during a time when the pensioner may well have none or few other sources of income.").

[80] *See* text accompanying note 72 *supra*.

[81] S. GOLDBERG, *supra* note 77, at § 2.17.

[82] *Id.* at 4.

[83] *See* text accompanying notes 71-72 *supra*.

[84] *See, e.g., In re* Talbert, 15 Bankr. at 537; *In re* Mace, 4 BANKR. CT. DEC. (CCR) at 97.

[85] *See* 15 Bankr. at 537.

Public policy favoring the prevention of fraudulent transactions also demands non-exempt status for IRAs.[86] The *Worthington* court noted that, absent intent to defraud, exemptions should be liberally construed in favor of the debtor.[87] However, the United States Supreme Court noted in *Kokoszka*—without mentioning the debtor's intent—that the "nature" of the asset is the key to determining whether an asset is exempt.[88] A liberal construction does not mean the court is free to exercise creativity.[89] If granted an exempt status, IRAs would be highly susceptible to transfers of funds by debtors seeking to evade their creditors.[90] Granting an IRA exempt status could effectively moot the issue of fraud,[91] thereby eroding the *Worthington* court's reliance on the absence of such intent.[92]

Viewed in light of the purposes and principles of the Bankruptcy Act,[93] the "nature" of an IRA is hardly a "similar plan

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[86] *See In re* Shackelford, 27 Bankr. at 373 ("[T]o exempt this property would give [Debtor] a license to convert non-exempt cash to an exempt savings account on the eve of bankruptcy."); 15 Bankr. at 538. *See also* note 90 *infra*.

[87] *See In re* Worthington, 28 Bankr. at 739 (citing Doethlaff v. Penn Mut. Life Ins. Co., 117 F.2d 582 (6th Cir. 1941)) ("There is no evidence to indicate that the establishment of the IRA was with intent to delay, hinder, or defraud creditors of the payments made thereunder, and absent such intent, express or implied, the exemption statute is entitled to a construction liberal to the debtors."), *cert. denied*, 313 U.S. 579 (1940).

[88] Kokoszka v. Belford, 417 U.S. at 646. The Court's language is quoted in text accompanying note 49 *supra*.

[89] *See In re* Howerton, 21 Bankr. at 623. *Cf. In re* Potter, 4 F.2d 807, 807 (S.D. Fla. 1924) ("While the law allowing exemptions to the debtor will be liberally construed in his favor, yet the burden of proving that the property contained in the claim comes within the exemptions of the law rests upon the bankrupt.").

[90] Before declaring bankruptcy, a debtor could transfer funds from a conventional savings account into an IRA. Since an IRA would have an exempt status, the debtor could withdraw those funds at any time, subject only to a 10% tax penalty. *See* 15 B.R. at 538; 4 BANKR. CT. DEC. (CRR) at 97.

[91] *Compare* S. REP. No. 989, *supra* note 4, at 5862 ("[T]he debtor will be permitted to convert nonexempt property before filing a bankruptcy petition. This practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.") *with In re* White, 28 Bankr. 240, 243 (Bankr. E.D. Va. 1983) ("Although courts agree that a debtor's conversion of his nonexempt property into exempt property on the eve of bankruptcy is not fraudulent per se, they conclude that extrinsic circumstances may indicate the commission of a fraud on a debtor's creditors.") *and In re* Reed, 11 Bankr. 683, 688 (Bankr. N.D. Tex. 1981) ("Where fraud on creditors is concerned, the practice of converting nonexempt property to exempt property . . . is denounced").

[92] *See* note 87 *supra*.

[93] See text accompanying notes 29-34 *supra* for a discussion of the purposes of the Bankruptcy Act.

or contract" to a "stock bonus, pension, profit-sharing, [or] annuity". A state, by exercising its prerogative to "opt out" of the federal exemption scheme in section 522(d) of the Bankruptcy Act, does not also "opt out" of the other provisions of section 522.[94] Moreover, a state can refuse to apply the exemptions of section 522(d),[95] but it cannot ignore or attempt to undermine the principles and purposes of the Bankruptcy Act itself.[96]

III. THE PROPER TEST FOR EXEMPTION UNDER KRS SECTION 427.150(1)(b)

The *Worthington* court determined that an asset must satisfy a two-part test to fall under the purview of KRS section 427.150(1)(b). Like the rest of the court's analysis of the issue, this test was overly narrow and failed to comport with the guiding principles of the Bankruptcy Act.

The first part of the court's test was: "Is the cash value of the IRA account reasonably necessary for the support of the debtor and his dependents in addition to property otherwise totally exempt?"[97] The purpose of bankruptcy law and exemptions is not to provide *immediate* support, but to provide sufficient assets to enable the debtor to make a fresh start in accumulating post-bankruptcy wealth for *future* support.[98] Ex-

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[94] *See In re* Morgan, 15 Bankr. 620, 621 (Bankr. E.D. Va. 1981), *rev'd*, 689 F.2d 471 (1982); *In re* Hill, 4 Bankr. 310, 313-14 (Bankr. N.D. Ohio 1980). *See also* note 26 *supra*.

[95] *See, e.g.*, *In re* Lee, 22 Bankr. 977, 979 (Bankr. C.D. Cal. 1982) ("Section 522 (b)(1) allows a state the opportunity to decline to authorize the federal exemption scheme and adopt its own list of allowable exemptions.").

[96] *See, e.g.*, Rhodes v. Stewart, 705 F.2d 159 (6th Cir.), *cert. denied*, 104 S.Ct. 427 (1983); *In re* Locarno, 23 B.R. 622, 631 (Bankr. D. Md. 1982) ("[S]tate bankruptcy laws are invalid . . . to the extent that they actually conflict with bankruptcy legislation enacted by Congress."); *In re* Lee, 22 Bankr. at 979 ("The intention of Congress was not to create in the states the power to make the bankruptcy laws for its residents. The intention was solely to allow the states to 'not authorize' the use of § 522(d) exemptions for all of that state's residents.") (citations omitted); *In re* Storer, 13 Bankr. 1, 3 (Bankr. S.D. Ohio 1980) ("[N]o state can pass a law to be effective in bankruptcy to deprive a debtor of [a] . . . right . . . authorized by the Bankruptcy Code.").

[97] *In re* Worthington, 28 Bankr. 736, 738 (Bankr. W.D. Ky. 1983).

[98] *In re* Hahn, 5 Bankr. 242 (Bankr. S.D. Iowa 1980). The *Hahn* court noted that:

> [t]here are five basic purposes for exemption laws:
>
> 1. To provide a debtor enough money to survive.
> 2. To protect his dignity and his cultural and religious identity.
> 3. To afford a means of financial rehabilitation.

emptions are allowed for the benefit and support of dependents, not the debtor.[99] The proper test is whether the cash value of the IRA account is reasonably necessary to allow the debtor to accumulate post-bankruptcy wealth for the future support of dependents. Given the high susceptibility of IRAs to fraudulent practices,[100] the close examination of the facts that such a test would demand would be justifiable.

The second part of the test was: "Is an IRA account a 'similar plan or contract' under the provisions of KRS 427.150(1)(b)?"[101] The Supreme Court noted in *Kokoszka* that the nature of the asset should be judged in light of the principles of the Bankruptcy Act.[102] A better test is whether an IRA account is a similar plan or contract to those mentioned in KRS section 427.150(1)(b) when the "nature" of all the assets in question are examined in light of the purposes and principles of exemptions as provided by the Bankruptcy Act. The correct answer is a resounding no.[103]

CONCLUSION

The Kentucky courts in determining whether an asset is exempt under KRS section 427.150(1)(b) should evaluate the nature of the asset in light of the principles of the Bankruptcy Act. Bankruptcy law seeks not only to satisfy claims of creditors, but also to leave the debtor ample assets with which to make a "fresh start." Bankruptcy law, however, does not seek to pro-

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4. To protect the family unit from impoverishment.
5. To spread the burden of the debtor's support from society to his creditors.

Id. at 244. *See also* notes 40-42 *supra* and accompanying text. *But cf. In re* Swartz, 18 Bankr. 454, 456 (Bankr. D. Mass. 1982) (exemptions are not intended for abuse); *In re* Kochell, 26 Bankr. 86, 87 (Bankr. W.D. Wis. 1982) ("[T]he purpose of . . . exemptions is to protect the fresh start of the debtor following bankruptcy, not to insure that no future misfortune could possibly lower the standard of living to which the debtor's dependents have become accustomed.").

[99] *See In re* Swartz, 18 Bankr. at 456 ("The purpose of an exemption under the Bankruptcy Code is not for the personal privilege of the debtor, but for the benefit of [the debtor's] family who may be destitute and the public who might otherwise be burdened with the support of an insolvent debtor's family.").

[100] *See* notes 90, 91 *supra.*

[101] *See* 28 Bankr. at 738.

[102] *See* Kokoszka v. Belford, 417 U.S. 642, 646 (1974).

[103] *See* S. REP. No. 989, *supra* note 4, at 5792.

vide instant affluence. The *Worthington* court's decision to treat IRAs as similar to traditionally exempt stock bonus, pension, profit-sharing or annuity plans established precedent that undermines such ends.

The court's decision makes it possible for a shrewd debtor to deposit funds in an IRA, file bankruptcy, and immediately have complete access to such funds free from claims by creditors.[104] Considering that any pre-bankruptcy debt has been satisfied in accordance with bankruptcy proceedings, this post-bankruptcy fund represents a windfall to the debtor which is unattainable under the traditional retirement plans provided for by KRS section 427.150(1)(b).[105]

Other courts have recognized the disparity between the true "nature" of an IRA when compared to a stock bonus, pension, profit-sharing or annuity plan. The bankruptcy courts in Kentucky should take note of such distinctions and promptly reverse the *Worthington* precedent.

Kevin Charles Dicken

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[104] *See* note 90 *supra.*

[105] *See* text accompanying notes 60-76 *supra.*