BANKRUPTCY PROTECTION FOR IRAs (YES) vs. INHERITED IRAs (NO)

In 2005, President Bush signed into law the **Bankruptcy Act of 2005**. The Act extended significant bankruptcy protection to IRAs by exemption and exclusions of certain amounts from a bankruptcy estate.

Contributory IRAs and Rollovers / Direct Transfers from Employer Qualified Plans

The exemption for contributory IRAs is generally limited to an aggregate amount of $1,000,000 (indexed). However, for amounts "rolled over" or "directly transferred" from other employer provided qualified retirement plans (QRP) that already had an unlimited bankruptcy exemption (i.e. Profit Sharing plans, Defined Benefit plans, 401(k) plans, 403(b) plans, SEP plans), there is a 100% exclusion from the bankruptcy estate. Taxpayers with large IRA balance may be advised to keep their contributory non-rollover accounts segregated from their "rollover" IRA accounts that had previously been transferred from an employer plan.

In addition, in 2005 the U. S. Supreme Court extended bankruptcy protection to "rollover" IRAs in the case of **Rousey v. Jacoway, 125 S. Ct. 1561**. In this case, the Supreme Court unanimously held that the "rollover" IRAs in question were totally exempt from the reach of the bankruptcy creditors of the IRA participant. The Court's previous decision in **Patterson v. Schumate, 112 S. Ct. 2242** held that certain employer provided QRPs (see above) were totally exempted from the bankruptcy estate. The Court viewed their decision in the 2005 Rousey case as simply an extension of its previous decision in the Patterson case and consistent with treating an IRA as a qualified retirement plan.

The asset protection exemptions provided by the federal Bankruptcy Act and the supporting Supreme Court decisions certainly gives a green light to accumulating large IRA balances with the assurance of protection from bankruptcy creditors. These exemptions and exclusions apply to IRAs funded with mutual funds, bank accounts, and annuity products.

Inherited IRAs by a Non-Spouse Beneficiary After the Death of an IRA Owner

Much has been written about the so-called "inherited" IRA concept. This is the situation where an IRA owner dies and names a beneficiary to receive the remaining IRA account funds. The beneficiary inheriting the account can stretch the payout and taxation of those IRA funds over a 10-year period of time.

The U.S. Supreme Court subsequently ruled on an "inherited" IRA where the beneficiary inheriting the deceased's IRA account had filed for bankruptcy. In **Clark v. Rameker, 134 S. Ct. 2242**, the Court ruled unanimously that inherited IRAs were NOT retirement funds within the meaning of the Bankruptcy Code. Accordingly, the inherited IRA funds were NOT excluded from the claims of creditors.

The Court held that the funds in an "inherited" IRA are not set aside for the debtor beneficiary's retirement and are not "retirement funds" under the Bankruptcy Code exemption. The Court listed three legal characteristics of inherited IRAs to support their conclusion:

- Unlike traditional IRAs, holders of inherited IRAs may never invest additional money in the account
- Holders of inherited IRAs, no matter how many years they are from retirement, are required to withdraw account values following the guidelines of the 10-year distribution rule.
- Holders of inherited IRAs may withdraw the entire balance of the account at any time and for any reason without a penalty, which is not true for traditional IRAs

Planning to Protect Inherited IRAs from Bankruptcy of Non-Spousal Beneficiaries

One method that would seem to protect inherited IRAs from the creditors of non-spousal family members is to name a trust as the beneficiary of the IRA account. The trust can serve as a conduit "pass-through" to make K-1 RMDs to trust beneficiaries. However, the trust should be structured with language that gives the trustee total discretion NOT to distribute inherited RMDs through the trust to the trust beneficiaries under certain conditions.

This would mean that the inherited RMDs held in the trust would be taxed to the trust at the trust's higher income tax bracket. Nevertheless, the funds remaining in the trust would be protected from the reach of the personal bankruptcy creditors of the trust beneficiary. When the personal bankruptcy has been finalized and fully discharged, then the trustee can resume pass-through RMD distributions to that trust beneficiary who is now clear of bankruptcy.

Planning for large balance IRAs must be handled carefully. With the growth of the equity markets over the last twenty years, it is common for IRA owners to have large six-figure and even seven-figure IRA accounts. Naming a trust as the beneficiary of a large balance IRA could be a prudent decision to protect the IRA owner's adult children from personal bankruptcy problems down the road as well as stretching the taxable distributions from the account over a 10-year period.

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