Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #427

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From: Steve Leimberg's Employee Benefits and Retirement Planning Newsletter
Subject: **Are Inherited IRAs Protected Under a State Exemption Statutes?**

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Executive Summary:

The score appears to be six[1] to zero as we enter the ninth inning. Unfortunately, all seven cases are against our client's interests. In other words, when the courts have directly addressed the issue, other than for a surviving spouse, it does not appear that there has been one favorable ruling that an inherited individual retirement account ("IRA") is protected under a state exemption statute. There may even be problems if a revocable trust is named as the beneficiary of an IRA. So what should a planner recommend to solve this asset protection issue and still receive the benefits of the tax free compounding over the child's life in an IRA? Fortunately – there is a solution. The standalone IRA trust, which combines the asset protection benefits of trust law with the tax free compounding of the inherited IRA over the child's life.

Facts:

The authors would like to illustrate the pitfalls with a couple of common financial and estate planning techniques. First, dad passes away and leaves his IRA, which contains proceeds from all of dad's retirement plans to mom. Mom rolls it over to her own IRA, which contains proceeds from all of mom's retirement plans. Mom then lists son and daughter equally as the beneficiaries of her IRA. When mom passes away, daughter and son each receive an inherited IRA so that they may extend the tax free accumulation of the IRA over the son's and daughter's life under the required minimum distribution rules. Several years later, daughter files for bankruptcy. Is daughter's inherited IRA protected? All the reported cases that have identified the issue that the IRA was "inherited" say, "No."

In their wills or revocable trusts, Mom and Dad have provided for the creation of the standard A (e.g., QTIP) and B (i.e., bypass or credit shelter trust) estate planning trusts. Either, Mom or Dad dies at a time when either one of them is insolvent and the beneficiary of Mom's or Dad's IRA is the revocable trust. Can Mom's or Dad's creditors reach the inherited IRA? In the only case decided under the Uniform Trust Code ("UTC"), the answer is "Yes. [1]" Will other UTC states follow this opinion under the uniformity clause of the UTC? A case decided in one state is considered substantial authority for interpreting the same issue in another UTC state.

Why is this all of a sudden an issue?

Prior to the recently issued required minimum distribution ("RMD") rules, many clients who inherited IRAs were forced to distribute the IRA within a five year period of time. Since IRA funds were distributed to the beneficiary in a short period of time, most creditors were able to reach these distributions. However, as estate planning attorneys, financial planners and accountants, have begun to understand the new RMD rules and the incredible advantages for the tax free compounding of an IRA over the life expectancy of the next generation, they are recommending that clients use inherited IRAs (i.e., sometimes referred to as stretch IRAs).

For example, the chart below shows the results under the five-year rule and the life expectancy rule. For this example, we assume a $300,000 IRA, age 68 deceased IRA owner, age 38 beneficiary, 8% growth rate and 40% tax rate. There are three columns. The first assumes an immediate distribution, and then the funds accumulate on an after tax basis until the date of the beneficiary's anticipated death in 2042. The second column assumes that the funds are distributed under the five year rule in the fifth year, 2012, and then the funds accumulate on an after tax basis over the beneficiary's estimated life. Under the third column, compound tax free inside the IRA, except for the required minimum distributions over the beneficiary's life. For example, in the year 2007, the $300,000 compounds at 8% to $324,000. Under the immediate distribution column, after the income tax is deducted, the remaining proceeds for the IRA distribution that would be invested on a taxable basis is $192,260. Under the five year rule column, the entire amount is not distributed until the end of the fifth year 2012 and compounds tax free until that date. Therefore, under the second, the $300,000 has compounded to $324,000 at the end of 2007. Finally, regarding the last column, the beneficiary does not need to receive any distributions until 2008, and the amount inside the IRA at the end of 2007 also compounds to $324,000.

Year	Immediate Distribution	5-Year Rule	Payable Over Oldest Beneficiary Life Expectancy
2007	$ 192,960	$ 324,000	$ 324,000
2012	$ 273,175	$ 283,522	$ 454,010
2017	$ 386,736	$ 401,384	$ 633,007
2022	$ 547,506	$ 568,243	$ 877,640
2027	$ 775,109	$ 804,466	$ 1,209,103
2032	$ 1,097,329	$ 1,138,890	$ 1,653,613
2037	$ 1,553,499	$ 1,612,337	$ 2,242,293
2042	$ 2,199,302	$ 2,282,599	$ 3,009,752

In 2042, at the end of the beneficiary's life expectancy, a beneficiary could have received close to $725,000 more from a $300,000 IRA by utilizing a stretch IRA. The tax free compounding of an inherited IRA has created a situation where many beneficiaries stand to greatly benefit by taking the minimum distributions over his or her life expectancy. Therefore, the first reason as to why the asset protection of inherited IRAs has just become an issue is that many more beneficiaries are taking advantage of a stretch IRA.

The second reason appears to be related to the creditors counsel failing to see that there may a difference between an IRA and an Inherited IRA. From a Westlaw database search of all federal and state cases on the term "inherited (IRA) or Individual Retirement Account," the first case that identified a distinction between an IRA and an inherited IRA was the 1999 case, *In re Simms*[2]. This case held that the bankruptcy trustee could reach the inherited IRA.

Discussion:

All of the five bankruptcy cases following *Simms* paint the same dismal picture, a creditor may reach an inherited IRA. All six bankruptcy cases are listed below.

1. Alabama *In re Navarre,* 332 B.R. 24 (M.D. Ala. 2004)
2. California *In re Greenfield,* 289 B.R. 146 (S.D. Calif. 2003)
3. Illinois *In re Taylor,* 2006 WL 1275400 (Bkrtcy C.D. Ill. 2006) unreported
4. Oklahoma *In re Sims,* 241 B.R. 467 (N.D. Okla. 1999)
5. Texas *In re Jarboe,* 2007 WL 987314 (Bkrtcy S.D. Tex. 2007)
6. Wisconsin *In re Kirchen,* 344 B.R. 908 (E.D. Wisc. 2006)

Other than a Kansas Appellate Court case discussed below, for non-spouse beneficiaries, there appear to be no other cases that have identified the issue.

The Courts Reasons For Allowing Creditor Attachment

When holding that an IRA is not exempted from the bankruptcy estate, the Bankruptcy Courts cited one or more of the following three reasons:

1. The state exemption was for retirement benefits to be available to the retired person, not to a child who was still earning a living.[3]
2. The beneficiary has an unrestricted right to withdraw the IRA at anytime without any penalty.[4]
3. The inherited IRA is significantly different than an IRA under the Internal Revenue Code.[5]

The first and strongest theory in favor of denying an inherited IRA from the benefits of a state exemption is that the IRA, "must be for retirement needs."[6] The retirement plan exemption is based on the policy decision that the government does not want an aged person to be forced to rely on charity at a time in their life when he or she cannot make much of a living. The *Greenfield* Court stressed the debtors were "presently using the IRA funds, but they are simply not of retirement age." The *Navarre* court made an analogy by stating that when three children inherit a homestead from their widowed mother that qualified for a state homestead exemption, the children do not receive the benefit of the homestead exemption. While this analogy may not be directly on point if one of the children moves into the house as his or her homestead, the *Navarre* court went on to state, "In making a determination whether an item of property is exempt, one looks to the character of the property in the hands of the debtor and not its character in the hands of the transferor."

The second reason given by the Bankruptcy Courts appears to be quite a bit weaker – the beneficiary of an inherited IRA may withdraw the funds without penalty at anytime. It is true that a beneficiary of an inherited IRA may withdraw the funds at anytime without penalty. However, so may a person who contributed the funds to the IRA if they are over age 59 ½. In this case it is hard to see the distinction that the Bankruptcy Courts are making.

The third reason allowing a creditor to attach an inherited IRA is that it is sufficiently different from an IRA under the Internal Revenue Code. This reason also appears to be weak. The first question is why would a couple of differences in the tax code between an inherited IRA and an IRA control the outcome of a state exemption statute? In other words, the Bankruptcy Courts are advocating that because an inherited IRA does not meet all the requirements of an IRA under the Internal Revenue Code, it fails the state exemption statute.

The Bankruptcy Courts list the following distinguishing differences between an IRA and an inherited IRA:

1. A beneficiary of an inherited IRA cannot make contributions into the account[7];

2. A beneficiary of an inherited IRA cannot roll the IRA into another retirement plan[8]; and
3. The IRA was required to be distributed within five years.[9]
4. Distributions are fully taxable.[10]

Regarding the last element, distributions from an inherited IRA are fully taxable, but so are distributions from any IRA, other than a Roth IRA. Therefore, the authors also fail to see the distinction being drawn regarding the fourth reason.

It is true that many of these Bankruptcy Cases noted that the recipient of the inherited IRA was forced to take distributions within a short period of time under the five year RMD rule.[11] However, properly structured, almost any beneficiary of an IRA would be able to stretch distributions over his or her life expectancy. Therefore, some of the Bankruptcy Court's "short period of time" argument also appears to be highly questionable.

On the other hand, the Bankruptcy Courts are correct that the beneficiary of an inherited IRA can neither make contributions to the IRA nor roll over an inherited IRA to another IRA. Further, five of the Bankruptcy Courts and the Kansas Appellate Court (discussed below) concluded that tax deferral was not sufficient to qualify under the state exemption statutes.

Does the Specific State Exemption Statute Language Matter?

Of course if the state exemption statute specifically mentioned "inherited IRAs," these IRAs would be exempt. Unfortunately, the authors are not aware of any state statute that has provided such specific language.[12] Rather these statutes use the term "IRA" or a "similar plan," referring to the IRA as a retirement plan. Therefore, will courts follow the plain meaning of a statute if it includes the word "IRA" and prevent a creditor from attaching? Regrettably, this also does not appear to be the case. The following narrative is the specific statutory language of each state where a court concluded an inherited IRA was not protected:

Alabama Section 19-3-1(b)(1) states "Any benefits under a plan which includes a trust that constitutes a "qualified trust" may not be assigned or alienated, voluntarily or involuntarily, and shall be exempt from the operation of any bankruptcy or insolvency laws under 11 U.S.C. § 522(b) [i.e., the Bankruptcy Code], as from time to time amended." Later the term "qualified trust" is defined to include IRA accounts.

California: Section 703.140(b)(10)(E)(10) states that a debtor may exempt "a payment under a stock bonus, pension, profit sharing, annuity or *similar plan* or account on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor." In another case, the Ninth Circuit had rules that IRAs come within the definition of "similar plan."

Illinois Section 735 ILCS 5/12-1006 states, § 12-1006 states, "A debtor's interest in or right, whether vested or not, to the assets held in or to receive pensions, annuities, benefits, distributions, refunds of contributions, or other payments under a retirement plan is exempt from judgment, attachment, execution, distress for rent, and seizure for the satisfaction of debts if the plan (i) is intended in good faith to qualify as a retirement plan under applicable provisions of the Internal Revenue Code of 1986, as now or hereafter amended . . . ". Later the statute states the exemption includes individual retirement accounts.

Oklahoma Okla. Stat. tit. 31 § 1(A)(20) protected "any interest in a retirement plan or arrangement qualified for tax exemption purposes under present or future acts of Congress; provided, such interest shall be exempt only to the extent that contributions by or on behalf of a participant were not subject to federal income taxation to such participant at the times of such contributions, plus earnings and other additions thereon . . ." The statute goes on to state, by way of example and not limitation retirement plans include individual retirement accounts.

Texas Section 42.0021 of the Texas Probate Code states, "a person's right to the assets held in . . . any individual retirement account . . . is exempt from attachment, execution, and seizure for the satisfaction of debts unless the plan, contract, or account does not qualify under the applicable provisions of the Internal Revenue Code."

Wisconsin Wis. Stat. § 815.18(3)(j) states, "Assets held or amounts payable under any retirement . . . individual retirement account, . . . providing benefits by reason of age, illness, disability, death or length of service. . ." In this case the *Kirchen* Court may have well been determined based on the statutory language, because an inherited IRA is not received by reason of age, illness, disability, or length of service. On the other hand, the inherited IRA is the result of the death of the original owner of the IRA, and an argument can be made that the inherited IRA does in fact meet the requirements of the Wisconsin statute.

In all of the above cases, with the possible exception of *Kirchen*, the Bankruptcy Courts did not rely on a plain reading of the statute. Rather, the Bankruptcy Courts created a judicial exception that distinguished inherited IRAs from IRAs and allowed a beneficiary to reach the inherited IRA.

Not Just Inherited IRAs Are Under Attack, But so Are Decedent's Revocable Trusts

Sadly, inherited IRAs are not the only IRAs that have come under creditor attack. Upon the decedent's death, when a revocable trust was named as the IRA beneficiary, a Kansas Appellate Court has held that a creditor could reach the decedent's IRA.[13] The Kansas Appellate Court acknowledged that the state exemption statute protected the IRA during the decedent's life and that if an individual had been the beneficiary, a creditor could not attach. However, the Kansas Appellate Court reviewed the Kansas Uniform Trust Code and concluded that by naming the revocable trust as a beneficiary of the IRA upon the death of the decedent, the state exemption for the IRA also died.

The authors do not agree with the Appellate Court's holding. Fortunately, the case is unpublished and should not be used as precedent. However, this does not stop another Uniform Trust Code state from applying this case as persuasive authority to a revocable trust under the "Uniformity of Application" section of the Uniform Trust Code. UTC § 1001, states "In applying and construing this Uniform Act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among States that enact it."

How Do You Protect an Inherited IRA?

If an inherited IRA is not protected by a state exemption statute, then it would only be protected if it were part of the asset protection features of another entity.[14] An IRA standalone trust does not depend upon a state exemption statute, its protection is based on the asset protection benefits of trust law. Common trust law provides three separate types of asset protection: (1) discretionary trust asset protection; (2) spendthrift protection; and (3) trusts where a distribution can only be for a specific purpose. Since the standalone IRA trust is designed to be a conduit trust (i.e., all amounts distributed from the IRA be distributed), its protection will primarily be based on spendthrift protection. With spendthrift protection, only certain exception creditors may reach the assets of the trust such as child support and alimony.[15]

Yet, there is still another issue. Regarding the required minimum distribution that must be distributed from the trust, both the Restatement (Third) of Trusts and the Uniform Trust Code reverse common law spendthrift protection for this type of a distribution interest.[16] Therefore, in nineteen UTC states,[17] any creditor may attach the required minimum distribution amount from a standalone IRA trust.

If a beneficiary is concerned regarding creditor attachment of the RMD amount, we would recommend that the beneficiary forum shop and move their trust to a state that statutorily codifies the asset protection benefits of the Restatement (Second) of Trusts such as South Dakota[18] or Delaware.[19]

Why a Standalone IRA Trust?

The authors note that there are currently two methods to draft an IRA trust. One method is to create the IRA trust inside the bypass or credit shelter trust. The second method is to draft a standalone IRA trust. In order to avoid the confusion as demonstrated by the Kansas Appellate Court that allowed the decedent's creditors to attach the IRA, the authors recommend the standalone trust.

The special provisions necessary to make a trust a designated beneficiary often do not gel with the provisions desired in a bypass or credit shelter trust. There are numerous traps that are often unavoidable or missed when using a trust that was drafted for other purposes, such as a credit shelter trust, even when attempts are made to create a "firewall" between a particular beneficiary's sub-trust and the rest of the credit shelter trust's terms. To ensure that the client's estate planning goals are met without the loss of tax deferral, practitioners are advised to utilize a trust specifically designed to hold an retirement account.

Maximizing the Tax Deferred Growth

In order to maximize tax deferred growth within the account and to avoid the five-year liquidation rule, it is very important to have a qualified designated beneficiary. If a trust has been named beneficiary of a retirement account, it must meet all the requirements of Treasury Regulation § 1.401(a)(9)-4 A-5. An IRA trust should also follow guidelines set forth in Private Letter Rulings that have been issued by the Internal Revenue Service. While Private Letter Rulings are not binding on taxpayers other than those who requested the ruling, they are indicative of how the Service will rule in similar situations involving a trust as designated beneficiary. If a retirement account is made payable to a non-qualifying trust, a tremendous amount of tax deferred growth will be lost.

One of the most common drafting mistakes that cause trusts not to be designated beneficiaries is having non-individual or non-ascertainable remote contingent beneficiaries. By drafting the trust as a conduit trust, contingent beneficiaries do not have to be considered in determining who is the oldest potential beneficiary of the trust. Under a conduit trust, any and all amounts distributed from the retirement account must be distributed outright to the trust beneficiary.

Further Information Regarding Standalone IRAs

Many readers may well wish to implement the stand alone IRA. The authors are aware of two systems that are currently be marketed:

(1) WealthCounsel has incorporated the standalone IRA into its drafting system or it may be purchased separately at http://www.wealthcounsel.com/.

(2) Phil Kavesh has developed a complete turnkey marketing system for the standalone IRA, and further information on this system may be found at http://www.irainheritancetrust.com/index.html.

Conclusion:

A couple of the Bankruptcy courts have mentioned that the current trend is to allow for the bankruptcy trustee to reach an inherited IRA. Unfortunately, when every case that appears to have identified the issue has ruled that a creditor can reach an inherited IRA held by a child, this seems much more than a trend. One might hope that the courts will follow a plain reading of the exemption statutes. Regrettably, current case law has not supported this conclusion. Also, problems arise when an insolvent decedent names his or her revocable trust as an IRA beneficiary. Fortunately, there is a solution that many of our clients may benefit from – the standalone IRA trust. This is a trust that is specifically designed to spread out the required minimum distributions over the life of the beneficiary and still retain the benefits of spendthrift protection. Further protection of the required minimum distribution amount may be possible by forum shopping to states with favorable trust law protecting mandatory distributions.

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[1] There is a seventh case where a spouse was not allowed the benefit of an IRA granted by a qualified domestic relations order that is not discussed in this LISI. *In re Anderson*, 269 B.R. 27 (8th Cir. BAP 2001). However, this case was distinguished by *In re Farmer*, 295 B.R. 322 (W.D. Wis 2003). Also, some of the Bankruptcy cases as dictum have indicated that a spouse would be allowed to inherit an IRA and receive the benefits of the state exemption statute.

[2] *In re Sims,* 241 B.R. 467 (N.D. Okla 1999).

[3] *In re Jarboe; In re Kirchen; In re Navarre; In re Greenfield; and In re Simms.*

[4] *In re Jarboe, In re Greenfield, and In re Simms.*

[5] *In re Jarboe, In re Kirchen, In re Taylor, In re Navarre, In re Simms. Also See Commerce Bank v. Bolander,* 2007 WL 1041760 (Kan. App. 2007) unpublished.

[6] *In re Greenfield*.

[7] *In re Jarboe, In re Kirchen, In re Taylor, In re Navarre, In re Simms.*

[8] *In re Jarboe, In re Kirchen, In re Taylor, In re Navarre, In re Simms.*

[9] *In re Jarboe, In re Navarre, and In re Sims.*

[10] *In re Jarboe* citing *Taylor, In re Taylor, In re Navarre* incorporating the *Sims analysis, and In re Simms.*

[11] *In re Jarboe; and .In re Sims.*

[12] When searching all state statutes with the key words of "Inherited Individual Retirement Account or inherited IRA," the authors did not find a single state statute that specifically exempted an inherited IRA..

[13] *Commerce Bank v. Bolander,* 2007 WL 1041760 (Kan. App. 2007) unpublished.

[14] The authors are aware that technically a trust is not a judicial entity, it is a contract. However, they use the term entity loosely in this article.

[15] While the Restatements have mentioned other creditors such as necessary expenses of a beneficiary, necessary expenses of a beneficiary (including attorney fees) and governmental creditors, these exception creditors have gained little acceptance by the courts.

[16] UTC § 506 and *Restatement 50, comment a.*

[17] The Wyoming UTC recognized this problem and fixed it with its 2007 act.

[18] In 2007, South Dakota passed SB 98. For a detailed discussion of this statute see *Where Should You Situs Your Trust? A Look at South Dakota's New Third Party Discretionary – Support Statute*, Merric, Becker, and McDowell, Steve Leimberg's Asset Protection Planning Email Newsletter - Archive Message #104, May 10, 2007.

[19] Also, in 2007, Delaware passed SB 117 dealing with codifying parts of the Restatement (Second) of Trusts asset protection provisions.