CREDITOR'S RIGHTS IN IRAS

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I. SCOPE AND PURPOSE. Given the economic situation, there has been an increased number of bankruptcies and more aggressive trustees. One of the assets which has come under scrutiny is the inherited IRA, an IRA acquired as a result of the death of the account owner by a non-spouse beneficiary. While most states have laws which clearly provide an exemption for an IRA held by the owner or the owner's spouse, the statutes are less clear with regard to inherited IRAs, probably because such assets were not given consideration when the statutes were enacted. Indeed, the 2005 amendments to the Bankruptcy Code providing additional exemptions for IRAs, did not clearly deal with such assets. This outline analyzes the bankruptcy statutes and state laws which apply to IRAs, all of the reported cases dealing with inherited IRAs, and the planning techniques (and associated issues) available to protect the beneficiary's interest in an inherited IRA.

II. BAPCPA. The Bankruptcy Abuse Prevention and Creditor Protection Act ("BAPCPA") contains provisions relating to retirement benefits, creating several new exemptions which can be used in lieu of or in addition to state law exemptions, even if such exemptions are elected, as well as providing new federal exemptions.[1] It provides a huge liberalization in the protection of qualified plans, IRAs and some non-qualified plans by providing ***exemptions*** from the bankruptcy estate. As a reminder, it should be noted that **this protection is available only in the context of a bankruptcy proceeding, and does not affect the rights of creditors in other contexts.**

A. **Governing Law Prior to BAPCPA.**

1. ***Patterson v. Shumate***.[2] After many years of wrangling over the status of qualified plans in bankruptcy, the Supreme Court finally settled the issue as to plans which were subject to the anti-alienation clause of ERISA.[3] The Supreme Court decided that ERISA was "applicable non-bankruptcy law,"[4] and thus retirement plans were *excluded* from the bankruptcy estate. Some lower courts have tried to limit the applicability of this case by considering whether the plan in question met the qualifications of ERISA and the Internal Revenue Code. This case does not apply to situations in which the business owner and the business owner's spouse were the only participants in the plan.

2. ***Rousey v. Jacoway***.[5] On April 4, 2005, the Supreme Court issued its opinion in *Rousey v. Jacoway,* opinion by Mr. Justice Thomas. In that case, the Court

[1] The Bankruptcy Code permits states to "opt out" of federal exemptions and require their residents to use only exemptions provided by state law.

[2] 504 U.S. 753 (1992).

[3] 29 U.S.C. §1056(d)(1) [ERISA §206(d)(1)]

[4] Bankruptcy Code §541(c)(2). "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title."

[5] 544 U.S. 320 (2005)

resolved a conflict among the circuit courts as to whether the exemption from the bankruptcy estate in 11 U.S.C. §522(d)(10)(E) [the "(d)(10)(E) exemption"] applied to IRAs. The (d)(10)(E) exemption provides an exemption for:

> a payment under a stock bonus, pension, profit-sharing, annuity, **or similar plan or contract 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....
> (emphasis added)

There are several things which should be noted about this exemption. First, it is available only if the debtor does not claim state law exemptions, which are much more liberal in many cases and are the only ones available in opt out states. Second, the exemption is limited to the amount necessary for the support of the debtor. Third, although it remains in the Bankruptcy Code, its efficacy is questionable in that it is effectively overridden for all practical purposes by the new exemption in §522(d)(12) added by BAPCPA.

The Court decided that an IRA[6] was similar to the types of plans enumerated in §522(d)(10)(E) in that in each case the plan "provide[s] income that substitutes for wages earned as salary or compensation." Further, the Court determined that the 10% early withdrawal penalty was not insubstantial (noting that they need not decide whether a lesser penalty would be) and thus distributions were made on account of age, unlike those from a simple savings account which could be accessed penalty free without regard to age. [7]

B. **<u>BAPCPA Benefits Expanded Under State Exemption Election</u>.** Under BAPCPA, §522(b)(1) allows debtors to elect between federal exemptions under §522(b)(2) and state law exemptions under §522(b)(3). There are three exemptions in §522(b)(3), and they are listed in the **conjunctive**. If the state exemptions are elected, §522(b)(3)(A) exempts property that is exempt under state or local law of the debtor's domicile and federal law other than under §522(d); §522(b)(3)(B) retains the existing exemption for joint tenancy and tenancy by the entirety property; **and** §522(b)(3)(C) exempts "retirement funds" to the extent those funds are in a fund or account that is exempt from taxation under sections 401 [a qualified pension, profit sharing or employee stock bonus plan established by an employer for the exclusive benefit of the employees], 403 [qualified annuity plans established by an employer for an employee], 408 [IRA], 408A [Roth IRA], 414 [retirement plans for controlled groups], 457 [eligible deferred compensation plans maintained by an eligible employer for an eligible employee], or 501(a) [retirement plans by qualified charities] of the Internal Revenue Code."

1. **<u>Additional Exemption</u>.** An earlier version of this paper stated, "It would seem that because §522(b)(3) is written in the conjunctive, that a debtor claiming state law exemptions would have available to the debtor the greater of the (3)(C) exemption or the exemption of qualified plans and IRAs under state law. There does not appear to be any sort of preemption of state law, which could easily have been done. Thus, if a debtor elects state exemptions, and the state law provides little or no shelter for retirement

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[6]The IRA in this case was a rollover, but I do not think that is relevant.

[7]In *Patterson v. Shumate, supra*, the Court had stated in dictum: "Although a debtor's interest [in an IRA] could not be excluded under §541(c)(2)..., that interest could nevertheless be exempted under §522(d)(10)(E)." *Id, 762-763.*

benefits or is to restrictive, the federal exemption would be available to the debtor to claim exemptions." The cases cited below have confirmed this analysis.

a. **Based on Tax Qualification.** While the exclusion provided under *Patterson v. Shumate* was based on the application of the anti-alienation provision in ERISA, Title I, the (3)(C) exemption is based only on tax qualification under the enumerated sections of the Internal Revenue Code. BAPCPA also provides a method for determining whether the plans meet the qualifications of those sections.[8]

(1) Subsection (A) creates a **presumption** that plans which have received a favorable determination under IRC §7805, which determination is still in effect at the date of filing the bankruptcy petition, are exempt for purposes of §§522(b)(3)(C) and 522(d)(12).

(2) Subsection (B) provides that, even if there is no favorable determination under §7805, those funds **are** exempt if the debtor demonstrates that (x) no prior determination to the contrary has been made by a court or the IRS, and (y) the retirement fund is in substantial compliance with the IRC, **or** (z) if not in substantial compliance, the debtor is not materially responsible for that failure. Note, curiously enough, that in the case of a plan which has not received a favorable determination, such plan **will** still be exempt if it meets the other requirements of (B), while a plan that has a received a favorable determination is only entitled to a presumption.

(3) Subsection (C) provides that direct trustee to trustee transfers will not cause a loss of the (b)(3)(C) or (d)(12) exemption as a result of such transfer. See the discussion below for the arguably strained interpretation of this section in the eyes of some courts.

(4) Subsection (D) states that a qualified rollover will not cause a loss of the exemption as a result of the rollover.

C. **New Federal Exemption.**[9] A new exemption is created if the federal exemptions are elected. This exemption is identical to the §522(b)(3)(C) exemption and applies to:

> (12) Retirement funds to the extent that those funds are exempt from taxation under sections 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.

With the addition of this paragraph, it is difficult to understand the need for the §522(d)(10)(E) exemption, which was the subject of *Rousey v. Jacoway, supra*. Even with the $1,000,000

[8] Bankruptcy Code §522(b)(4). Note that the Bankruptcy Code can be found at 11 USC.

[9] Bankruptcy Code §522(d)(12).

limitation on the exemption for non-rollover IRAs and Roth IRAs (discussed below), the relief under (d)(12) would seem to be so much more liberal than the "need of the debtor" requirement in the (d)(10)(E) exemption that the latter section is unnecessary.

D. **Limitation on Exemptions.**[10] The blanket exemptions which (3)(C) and (d)(12) would appear to grant, are subject to a limitation which reads:

> (n) For assets in individual retirement accounts described in section 408 or 408A...other than a simplified employee pension under 408(k)...or a simple retirement plan under 408(p)..., the aggregate value of such assets **exempted under this section**, without regard to amounts attributable to rollover contributions under section 402(c), 402(e)(6), 403(a)(4), 403(a)(5) and 403(b)(8)...and earnings thereon, shall not exceed $1,000,000 in a case filed by a debtor who is an individual, except that such amount may be increased if the interests of justice so require. (Emphasis added).

1. **Plans Affected by Limitation**. The $1,000,000 limitation is apparently designed to apply to other than employer plans and rollovers from employer plans to IRAs; *i.e.,* to individually established IRAs and Roth IRAs. A rollover consists of a distribution to the participant followed by a contribution within 60 days to another tax exempt plan. Without the rollover provisions, the initial distribution would be taxable to the participant irrespective of what the participant did with the money. The exemption for a rollover is defined by reference to specific Internal Revenue Code sections, which sections do not include rollovers from one IRA to another under IRC §408(d)(3). The apparent result of this is that an IRA rolled over to another IRA will be subject to the $1,000,0000 limitation, while a rollover from an employer plan to an IRA would not. This should not be the case if the funds in the original IRA were rolled over from an employer plan and thus were exempt from the limitation in the original IRA. Note that limitation applies only to rollovers, and the issue of an IRA to IRA rollover can be avoided by the use of a trustee to trustee transfer, which, unlike a rollover, is not treated as a distribution.[11] However, this technique cannot be used to increase the exemption of an IRA originally subject to the limitation.[12]

2. **Applicability to State Law Exemptions.** If state law exemptions are elected and provide unlimited exemptions for IRAs, a question arises whether the highlighted language in §522(n), *supra,* applies only to the (3)(C) exemption or whether it also applies to limit the state law exemptions under (3)(A). Certainly there is an argument that the (3)(C) exemptions are the assets "exempted under this section" and that the state law exemptions are not limited since the exemptions, as pointed out earlier, are in the conjunctive. On the other hand, the phrase may be interpreted as applying to all of §522. However, given the effect of the limitation, this question would appear more academic than real, unless the IRA contains an "explosive" asset.

3. **Applicability to Federal Exemptions.** The limitation clearly applies to the

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[10] Bankruptcy Code §522(n).

[11] Rev. Rul. 78-406, 1978-2 C.B.

[12] Note the language in Bankruptcy Code §522(b)(4)(C) which prevents loss of the exemption "as a result of" the rollover.

(d)(12) exemption (and presumably, [but who cares?] to the (d)(10(E) exemption also.)

4. **Application of Limitation**. In the real world, this limitation would appear to have little effect, except in the event that a rollover IRA is commingled with a non-rollover IRA.

a. **Adjusted for Inflation**. The amount of the limitation is adjusted for inflation under Bankruptcy Code §104. Given the limitations on contributions to IRAs and Roth IRAs, it is almost mathematically impossible to accumulate more than $1,000,000 in an individually established IRA, particularly given the increase in the limitation due to inflation.[13] A person who began making maximum contributions 30 years ago would have contributed approximately $70,000 to the IRA. It would have taken greater than a 15% compound annual return to reach $1 million.

b. **IRAs Are Commingled**. If the IRA is a commingled IRA, is tracing available to segregate the rollover portion (and its earnings) from the non-rollover portion so that the limitation does not somehow get exceeded by the rollover portion? There is no answer to this in the Act, but certainly it would be worth a try.

5. **Discretionary Increase in Amount of Limitation.** It is most mystifying under what circumstances the "interests of justice" would require an increase in that amount. Perhaps this could refer to a situation in which a rollover IRA also has contributions, therefore taking it out of the safe harbor. If it could be shown that the contributory portions (including earnings on that portion) were less than $1,000,000, then arguably there would be a reason to raise the limitation. Obviously, to the extent possible, rollover IRAs and contributory IRAs should be kept separate.

III. INHERITED IRAS. Many, but not all states, have statutes exempting IRAs from claims of creditors.[14] While it is clear that such protection extends to the IRA owner and the IRA owner's spouse dealing with that issue), it is not clear whether such statutes extend to inherited IRAs. This is important in state law proceedings, as well as bankruptcy cases. As, noted above, state law exemptions are available in bankruptcy and only if they fail (or if the federal exemptions are elected in non opt out states) is there need to resort to BAPCPA. One of the primary concerns is that the state statutes are not uniform, although many can be grouped based upon the approach taken.

A. **Distinguishing Characteristics of Inherited IRAs.** As pointed out in IRS Publication 590 at page 20, the inherited IRA differs from the regular IRA in several important aspects: (1) The beneficiary of an inherited IRA must maintain the account in the name of the deceased owner for the benefit of the beneficiary. (2) The beneficiary must begin withdrawals no later than December 31 of the year following the year of the owner's death (or withdraw the entire amount within 5 years). (3) There is no penalty for withdrawals regardless of the age of the beneficiary. (4) The account may not be rolled over, although there can be a trustee to trustee transfer so long as the account continues in the name of the deceased owner. (5) There can be no contributions or addition to the account. However, the primary characteristic of an IRA is still

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[13]As in every case, there are exceptions that prove the rule. Occasionally, an IRA will invest in an asset which skyrockets in value, and, in that case, the conventional IRA could exceed the $1,000,000 limit.

[14]Some states provide total protection for IRAs, while other states limit the protection. For a table of state laws see: http://www.assetprotectionbook.com/s1_asset_protection_state_resources.htm. *Caveat:* The table has not been updated since 2007.

maintained – **the funds remain in tax deferred status until distributed.**

B. **State Exemption Statutes.**[15] Prior to BAPCA, most states adopted "Shield Statutes" which exempt IRAs from claims of creditors. Many also have limitations on how much can be exempted.

1. **Categories of Statutes**. Some state statutes require that retirement plans be either exempt from taxation or that they have tax-deferred funds in order to be exempt in bankruptcy.[16] The largest group of statutes require a retirement plan to be "qualified"[17] (or use some type of similar language)[18] under the IRC before it will be exempt under state law. Typically, these statutes exempt plans "on account of ...age...unless" they do not "qualify"

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[15] The text in this section (almost in its entirety) and ALL of the footnotes are taken from "Protection of IRAs", a paper authored by James L. Boring, Richard R. Gans, Meghan Gearhart, Nancy Roush Schmidt, and Susan Slater-Jensen, and presented to the Asset Protection Committee and the Employee Benefits in Estate Planning Committee at the Summer Meeting, 2010, of the American College of Trust and Estate Counsel. The author is grateful for their willingness to share their scholarship. This paper is now published in 36 ACTEC Law Journal 571 (Winter, 2010)

[16] *See* FLA. STAT. § 221.21 (2007) (exempting plans "exempt from taxation" under the IRC); Indiana (exempting plans "not subject to...taxation"); KY. REV. STAT. ANN. § 427.150(2)(f) (2007) (exempting IRAs "described" in the IRC "which qualify] for the deferral of...tax"); LA. REV. STAT. ANN. § 13:3881(D) (2007) (exempting plans, including IRAs, described as "tax-deferred" arrangements); N.H. REV. STAT. ANN. § 511:2(XIX) (2007) (exempting "retirement plan[s]...qualified for tax exemption"); OKLA. STAT. tit. 31, § 1(A)(20) (2007) (exempting "retirement plan[s] or arrangement[s] qualified for tax exemption or deferment" under the IRC); VT. STAT. ANN. tit. 12, § 2740(16) (2007) (exempting "IRAs...and all other plans qualified under" the IRC but only for contributions, dividends, or other earnings exempt from taxation); Wyo. STAT. ANN. § 1-20-110 (2007) (exempting plans if they are "protected from...or subject to deferral" from taxation).

[17] *See* ALA. CODE § 19-3B-508 (2006) (exempting "qualified trusts," which are defined to include IRAs); ALASKA STAT. § 09.38.017 (2007) (exempting an "interest" in or money "payable" from an IRA "qualified" under the IRC); ARK. CODE ANN. § 16-66-220 (2007) (exempting IRAs unless they do not "qualify" under the IRC); CA. Civ. PROC. CODE § 703.130 (2007) (exempting IRAs "qualified" under the IRC); CONN, GEN. STAT. § 52-321a (2007) (exempting any IRA "qualified" under the IRC); DEL. CODE ANN. tit. 10, § 4915 (2007) (exempting any retirement plan "qualified" under the IRC); IDAHO CODE ANN. § 11-604A (2007) (exempting plans "qualified" under the IRC); KAN. STAT. ANN. § 60-2308(b) (2007) (exempting plans "qualified" under the IRC); MD. CODE ANN., CTS. & JUD. PROC. § 11-504(h) (2007) (exempting retirement plans "qualified" under the 1RC); Miss. CODE ANN. § 85-3-1(e) (2007) (exempting plans "established to provide retirement benefits...and qualified under" the IRC); N.Y. C.P.L.R. 5205(c) (2007) (exempting IRAs "qualified" under the IRC); N.D. CENT. CODE § 28-22-03.1(3) (2007) (exempting all plans "qualified" under the IRC); TENN. CODE ANN. § 26-2-105 (2007) (exempting "retirement plan[s]...qualified under" the IRC).

[18] *See* COLO. REV. STAT. § 13-54-102(1)(s) (2007) (exempting any IRA, as "defined" under the 1RC); GA. CODE ANN. § 44-13-100(a)(2)(2.1) (2007) (exempting any IRA "within the meaning" of the IRC); HAW. REV. STAT. § 651-124 (2007) (exempting any plan "described" in the 1RC); N.C. GEN. STAT. § 1C-1601(a)(9) (2007) (exempting plans "as defined in" the IRC and "any plan treated in the same manner as an individual retirement plan under the IRC, including [IRAs]...as described in" the IRC); OR. REV. STAT. § 18.358 (2005) (exempting IRAs, "including one that is pursuant to a simplified employee pension, as described in" the IRC); 42 PA. STAT. ANN. § 8124(b) (2007) (exempting "any retirement...fund provided for under" the IRC); R.I. GEN. LAWS § 9-264(11) (2007) (exempting IRAs "as defined in" the IRC); S.D. CODIFIED LAWS § 43-45-17 (2007) (exempting plans "described" in the IRC); TEX. PROP. CODE ANN. § 42.0021 (Vernon 2006) (exempting plans "described" in the IRC); Utah (exempting "retirement plan[s] or arrangement[s] that [are] described in" the IRC); WASH. REV. CODE § 6.15.020 (2007) (exempting plans "described in" the IRC).

under the IRC.[19] Then the question boils down to what exactly is meant by the word "qualified?" Some statutes exempt: "any...retirement plan under" the IRC;[20] plans "intended in good faith to qualify" under the IRC;[21] IRAs "established" under the IRC;[22] IRAs which "conform[s] with the applicable limitations and requirements" of the IRC;[23] plans "created or qualified and maintained pursuant" to the IRC;[24] "retirement accounts described in [or] established" under the IRC;[25] and those that simply exempt IRAs[26] or "pension[s] or retirement fund[s]."[27] Virginia's statute exempts plans "intended to satisfy the requirements of the IRC", which will be "determined based on all of the relevant facts and circumstances."[28] Illinois's statute exempts plans "intended in good faith to qualify as a retirement plan" under the IRC.[29]

2. **The Easy Solution**. If the state exemption statutes had specifically mentioned "inherited IRAs," these IRAs would be exempt and there would be no room for debate or interpretation, judicial or otherwise, both in state law and bankruptcy proceedings. Instead, the statutes use the terms "IRA" or "similar plan," which provides courts with the opportunity to create their own interpretation as to what the plain meaning of the statute is. At the time of this writing, Florida,[30] Texas[31], and Arizona[32] passed a statute specifically

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[19] *See* ME. REV. STAT. ANN. tit. 14, § 4422(13)(E), (F) (2005) (exempting plans "on account of...age...unless" the plan "does not qualify under" the IRC); MICH. COMP. LAWS § 600.5451(1)(/) (2007) (exempting IRAs "as defined" in the IRC); Minnesota (exempting IRAs or "plans...on account of...age"); Mo. REV. STAT. § 513.430(1)(10)(e), (f) (2007) (exempting plans "on account of...age...unless" they do not "qualify" under the IRC); MONT. CODE ANN. § 25-13-608(1)(e) (2007) (exempting plans "on account of...age...unless" they do not "qualify" under the IRC); NEB. REV. STAT. § 25-1563.01 (2006) (exempting plans "on account of...age...unless" they do not "qualify" under the IRC); OHIO REV. CODE ANN. § 2329.66(A)(10) (2007) (exempting plans "on account of...age...unless" they do not "qualify" under the IRC); W. VA. CODE § 38-10-4(j)(5) (2007) (exempting plans "on account of...age...unless" they do not "qualify" under the IRC); Wis. STAT. § 815.18(3)(j) (exempting plans "providing benefits by reason of age" unless they do not "comply] with the provisions of the [IRC]...).

[20] ARIZ. REV. STAT. ANN. § 33-1 I 26(B) (2007).

[21] 735 ILL. COMP. STAT. 5/12-1006 (2007).

[22] IOWA CODE § 627.6(1)(e), (0 (2007).

[23] NEV. REV. STAT. § 21.090(1)(q) (2005).

[24] N.J. STAT. ANN. § 25:2-1 (2007).

[25] S.C. CODE ANN. § 15-41-30(12) (2006).

[26] MASS. GEN. LAWS ch. 235, § 34A (2007).

[27] N.M. STAT. § 42-10-1 (2007).

[28] VA. CODE ANN. § 34-34 (2007).

[29] 735 ILL. COMP. STAT. 5/12-1006 (2007).

[30] FL. STAT. ANN §222.21

[31] TX. PROP. CODE §42.0021

[32] AZ. REV. STAT. ANN. § 33-1126

exempting inherited IRAs. A similar statute is expected to be introduced in the Kansas legislature's next session in 2012, and several other states are considering such legislation.[33] It's precise language is, of course, unavailable at this time.

C. **Bankruptcy Court Construction of State Statutes.** Several bankruptcy cases have cast doubt upon the efficacy of such state law protection for a beneficiary's interest in inherited IRAs.[34] In reading the cases, it is well to remember that counsel and the court generally lack expertise with respect to retirement benefits.[35] In fact, (with the exception of an Idaho case discussed below), the debtor lost every case until *In re Nessa*, *infra*, which seems to represent a turning point in the line of decisions on this matter.

1. ***In Re Sims.***[36] The first case to deal with the issue of inherited IRAs arose in an opt out state which exempts "any interest in a retirement plan or arrangement qualified for tax exemption purposes." The court determined that an inherited IRA does not meet that test, noting:

> Once the account has been "inherited," the beneficiary may make no contributions to the account, nor may he or she "roll over" the inherited individual retirement account into another retirement plan. He or she is required to take distributions from the account over a relatively limited period of time, in most cases five years. [Note that the debtor was obviously a designated beneficiary and thus could withdraw over his life expectancy.] Upon receipt, those distributions are fully taxable. [This is hardly a distinction.] (Internal citations and footnotes omitted)

The Court then embarks on an examination of construction principles for determining legislative intent, finding that, "The rule of 'liberal construction' merely means that statutes shall be interpreted and applied sensibly rather than literally, with due regard for legislative purpose." It then concludes in its most trenchant observation, "In the present case, Dr. Sims argues that a statute designed to protect funds set aside in the ordinary course of the debtor's financial affairs for retirement purposes may properly be used to shield a cash inheritance, available to Dr. Sims at his will without penalty."[37]

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[33]The Colorado bar considered such a statute, but was afraid that the law would be "clarified" in a disadvantageous way.

[34]*See In re Greenfield,* 289 B.R. 146 (Bkrtcy. S.D. Cal. 2003); *In re Taylor*, 2006 W.L. 1275400 (Bkrtcy. C.D. Ill. 2006); *In re Sims*, 241 B.R. 467 (Bkrtcy. N.D. Okla. 1999); *In re Kirchen*, 344 B.R. 918 (Bkrtcy. E.D. Wisc. 2006). *See also In re Mullican,* 2008 WL 5191196 (Bkrtcy. E.D. Texas 2008).

[35]One need only review the tortured and tortuous history of bankruptcy court decisions leading up to *Patterson v. Shumate.*

[36]241 B.R. 467 (Bkrtcy. N.D. Okla. 1999)

[37]*See also, In re Greenfield,* 289 B.R. 146 (Bkrtcy S.D. Cal. 2003) (relying on *In re Sims*, but holding "In order to qualify for an exemption the IRA must be used for 'retirement needs.' The Debtors are presently using the IRA funds, but they are simply not of retirement age."); *In re Navarre*, 332 B.R. 24 (Bkrtcy M. D. Ala. 2004) (an IRA is different from an inherited IRA); and *In re Taylor*, 2006 W.L. 1275400 (Bkrtcy. C.D. Ill. 2006) (again distinguishing the tax aspects of an inherited IRA)

2. ***In re Navarre***.[38] The Alabama court, following the reasoning of *In re Sims*, found that an inherited IRA was not exempt under the predecessor to the Alabama statute cited above. What makes this case interesting is that the debtor did not elect to have the IRA paid out over his life expectancy, but rather withdrew the funds. While Alabama Code §19-3-1(b)(1) referred to "benefits" from a "qualified trust" (which includes IRAs), the court's analysis would seem to be unnecessary because the funds were no longer in a tax deferred status.

3. ***In re Kirchen***.[39] The Wisconsin statute provided an exemption for a retirement account "payable by reason of age", which "complies with the provisions of the Internal Revenue Code". The court, relying on *Rousey v. Jacoway, supra,* found that an inherited IRA's benefits were not payable on account of age because there was no penalty for early withdrawal and benefits were required to begin immediately. Further, the court found that inherited IRAs did not comply with the Internal Revenue Code, following the reasoning of *Sims* and its progeny.

4. ***In re Jarboe.***[40] Texas Property Code §42.0021 exempts a debtor's interest in an IRA with the following language: "[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." The *Jarboe* court, again following the unanimous (at that time) reasoning of prior bankruptcy courts, focused on the differences between an inherited IRA and a participant or spousal IRA.

While the distinctions as to the inability of the beneficiary (1) to contribute to the IRA, (2) to rollover the IRA to another plan, and (3) to wait until 70-1/2 before being required to take distributions are certainly valid distinctions, there is a serious question as to whether they should be interpreted to prevent the inherited IRA from qualifying as such "under the applicable provisions of the Internal Revenue Code." In fact, the Code still treats the inherited IRA as tax deferred and subject to the RMD rules (albeit that the required beginning date is December 31 of the year following the year of the participant's death).[41]

5. ***In re McClelland***.[42] Idaho is a community property state so that both spouses filed. Mrs. McClelland was the sole named beneficiary of her aunt's IRA. After transferring IRA custodians, Mrs. McClelland annuitized the IRA. (*See* discussion of amusing facts below.) She claimed the IRA as exempt, and the Trustee in bankruptcy objected. The Court

[38] 332 B.R. 24 (Bkrtcy. M. D. Ala. 2004

[39] 344 B.R. 918 (Bkrtcy. E.D. Wisc. 2006)

[40] 365 B.R. 717 (Bkrtcy. S.D. Tex. 2007)

[41] One of the more amazing facets of *Jarboe* is that although the debtor argued that §829 of the Pension Protection Act (dealing with non-spousal rollovers) indicated that the IRA was exempt, he failed to argue the exemption for IRAs in bankruptcy §522(b)(3)(C) created by the Bankruptcy Abuse Prevention and Creditor Protection Act of 2005 (effective a year before the bankruptcy filing). However, the language of that section exempts "retirement funds to the extent those funds are in a fund or account that is exempt from taxation under sections...408...of the Internal Revenue Code." The argument that inherited IRAs are not "retirement funds" would be consistent with the reasoning in *Jarboe* and similar cases.

[42] 2008 WL 89901 (Bkrtcy. Idaho 2008)

construed Idaho Code §11-604A, which reads in relevant part as follows:

> (1) It is the policy of the state of Idaho to ensure the well-being of its citizens by protecting *retirement income* to which they are or may become entitled....
>
> (2) The right of *a person* to a pension, annuity, or retirement allowance or disability allowance, or death benefits, or any optional benefit, or any other right accrued or accruing to any citizen of the state of Idaho under any employee benefit plan, and any fund created by the benefit plan or arrangement, shall be exempt from execution, attachment, garnishment, seizure, or any other levy by or under any legal process whatever....
>
> (4) For the purposes of this section, the term "employee benefit plan" means: ...
>
> > (b) Any plan or arrangement, whether funded by a trust, an annuity contract, an insurance contract, or an individual account, that is described in sections 401(a), 403(a), 403(b), *408*, 408A or 457 of the Internal Revenue Code of 1986, as amended, or section 409 of the Internal Revenue Code as in effect before January 1, 1984....
>
> (5) An employee benefit plan shall be deemed to be a spendthrift trust, regardless of the source of funds, the relationship between the beneficiary and the trustee or custodian of the plan, or the ability of the debtor to withdraw, borrow, or otherwise become entitled to benefits from the plan before retirement. (Emphasis added.)

a. **The Generous Idaho Legislature**. The court decided that "the Legislature painted with a broad brush" in creating this exemption. Looking at the policy to protect "retirement income" for any citizen of Idaho, the court (anticipating, perhaps, the holding in *In re Nessa, infra*) refused to engraft a requirement that the person exempt be the participant or owner. Then, looking to the broad definition of "employee benefit plan", the court determined that Mrs. McClelland's aunt's "account was an 'employee benefit plan' for purposes of Idaho Code §11-604A."

The court acknowledged the adverse decisions in other jurisdictions, while simultaneously relying on the fact that the Idaho statute includes §408 plans. In many of the other decisions, the courts had gone to great lengths to explain why an inherited IRA was not a §408 plan, primarily because the beneficiary could not contribute to it.

b. **The Facts – Saved by Bad Advice.** After her aunt's death, Mrs. McClelland contacted Westmark Credit Union (the custodian) and requested a complete distribution of the IRA to set up "a separate savings account." The assistant manager informed Mrs. McClelland that she would have to pay income tax on the entire IRA and would be subject to a penalty for early withdrawal! Westmark refused to give her the funds when she insisted upon it, despite the described adverse tax effects. So, Mrs. McClelland established an account in another institution styled "Debra J. McClelland ABO Carol Morrow." In that account she purchased the annuity.

To compound matters, the court noted that the advice concerning the early withdrawal penalty was erroneous, and then continued:

> The rules pertaining to distribution upon the death of an IRA owner are set out in C.F.R. 1.408-2. Under these regulations, the entire balance of the IRA "must, within 5 years after [Carol Morrow's] death ... be distributed or applied to the purchase of an immediate annuity for [the] beneficiary ... which will be payable for the life of such beneficiary ... and which annuity contract will be immediately distributed to such beneficiary." 26 C.F.R. 1.408-2(b)(7)(i). If a beneficiary elects to purchase an annuity in accordance with these rules, the entire balance will not be included in gross income of the beneficiary upon distribution, but rather will be taxed as distributions are received by the beneficiary in accordance with section 1.408-4(e). *Id*

6. ***In Re Chilton***[43]. In this Texas case, the debtor elected federal exemptions and sought to bring himself within Bankruptcy Code §522(d)(12). Given the very liberal exemptions under Texas law, one can only assume that this was done in attempt to avoid the direct application of *In re Jarboe, supra,* despite the availability of Bankruptcy Code §522(b)(3)(C) (which was not urged in *Jarboe).* The Court first found that an inherited IRA did not meet the definition of "retirement funds" because it was not held for the retirement of the beneficiary, using what other courts had used for tax qualified tests – no contributions, immediate withdrawal required, no penalty for withdrawals. Assuming that the funds did qualify at retirement funds, which she had already held they did not, the judge then went on to engage in a very complex statutory analysis . (Something for which bankruptcy court judges are ill-equipped for statutes other than the Bankruptcy Code.) The court first states that, "An inherited IRA, which is a vehicle for receiving distribution from a tax exempt account, does not fit within the definitional scope of § 408(e)(1)." IRC §408(e) (1) states: "Any individual retirement account is exempt from taxation under this subtitle...." However, the Court says that the exemption for inherited IRAs arises under §402(c)(11), not IRC §408, as the Bankruptcy Code requires. In fact, §402(c)(11) simply authorizes a non-taxable trustee to trustee transfer [which would otherwise have been prevented by §408(d)(3)(C)], so long as the IRA remains an inherited IRA; *i.e.,* one maintained in the name of the decedent fbo the beneficiary.

7. ***Chilton v. Moser.***[44] The Federal District Court reversed *In re Chilton*, relying on the reasoning in *In re Nessa, infra,* and its progeny. The court reasoned that "retirement funds, as used in BC §522(d)(12) [and BC §522(b)(3)] was not limited to the retirement funds of the original participant or owner, but included inherited IRAs. The court held that there are only two requirements that must be met: (1) The funds must be retirement funds, and (2) the funds must be in a tax exempt account. The inherited IRA met both these tests. *The Trustee has appealed this case to the Fifth Circuit.*

8. ***In re Nessa***.[45] In the first (and so far only) appellate decision dealing with the

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[43] 426 B.R. 612 (Bkrtcy. E.D. Texas, Sherman Division (2010)

[44] WL 938310 (E.D., Texas, Sherman Division 2011)

[45] 426 B.R. 312 (B.A.P. 8th Cir. 2010)

issue, the Bankruptcy Appeals Panel for the 8th Circuit[46] affirmed the Bankruptcy Court and held that the debtor's inherited IRA was exempt under the federal exemptions of Bankruptcy Code §522(d)(12) as "retirement funds" which are "exempt from taxation under [IRC] section...408...." The court refused to interpret the meaning of "retirement funds" to be restricted to the retirement funds of the deceased participant and basically held that funds that had their origin in an IRA continued to be "retirement funds" in the hands of the non-spousal beneficiary. The court also found that the second prong of the test under Bankruptcy Code §522(d)(12) was met because the funds therein were exempt from taxation under the general language of IRC §408(e). (Note the different interpretation given to that section by this court versus the *Chilton* bankruptcy court.) The *Nessa* court the went on to find that the necessary exemption under Bankruptcy Code §522(d)(12) was provided by Bankruptcy Code §522(b)(4)(C), which states,

> [a] direct transfer of retirement funds from 1 fund or account that is exempt from taxation under section ... 408 ... of the Internal Revenue Code of 1986, ..., shall not cease to qualify for exemption under ... subsection (d)(12) *by reason of such direct transfer*. (Emphasis added)

The court chides *Chilton* for failing to take that section into account and that such failure renders the section meaningless. Perhaps the Court was reasoning that the retirement funds in the hands of the deceased account owner were exempt, and that such exemption is not destroyed as a result of the trustee to trustee transfer at the death of the account owner. If so, the court does not set out such reasoning. Bankruptcy Code §522(b)(4)(C) would, in fact, seem to be inapplicable, unless the court felt it necessary to decide that the trustee to trustee transfer did not cause the asset, determined to be exempt under the two prong test, to lose such exemption simply because of such transfer.

9. ***In re Klipsch*.**[47] This case really added nothing new. Indiana is an opt out state, so the court was construing the Indiana exemption statute, which relied upon Internal Revenue Code provisions in defining what is an IRA. Citing *Chilton* (which dealt primarily with Bankruptcy Code §522(d)(12) because the debtor had claimed the federal exemptions) and *Sims*, the court summarily determined that an inherited IRA was not an IRA for purposes of the exemption statute. In reaching that determination the court relied in large part on the distinctions drawn in IRS Publication 590, which draws several distinctions between regular IRAs and inherited IRAs. There would have been no benefit in urging the Bankruptcy Code §522(b)(3)(C) exemption because it is identical to Bankruptcy Code §522(d)(12), which was the basis upon which the *Chilton* court rejected the claimed exemption.

10. ***In re Tabor*.**[48] This is a most interesting case, which ultimately follows the reasoning in *Nessa*. The debtor claimed that her inherited IRA was exempt under Pa. C.S. 8124(b)(1)(ix) which exempts IRAs if they are "provided for" by certain sections of the Internal Revenue Code, which includes §408. Debtor urged that the Pennsylvania statute was broader than the federal exemption under Bankruptcy Code §522(b)(3)(C). However,

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[46] Note that this is a panel composed of three bankruptcy judges and is not a panel of judges sitting on the 8th Circuit.

[47] 2010 WL 2293957 (Bkrtcy. S.D. Ind., Evansville Div. 2010)

[48] 2010 WL 2545524 (Bkrtcy M.D. Penn. 2010)

debtor alternately urged the federal statute. The court went through the distinctions drawn by *Jarboe, Sims,* and *Navarre,* and noting that none of those cases dealt with the Bankruptcy Code exemption, either because they predated BAPCPA or because it was not argued by counsel. The *Tabor* court noted that in applying state statutory exemptions, it owed deference to the interpretation given by the Pennsylvania courts. Because there had been no Pennsylvania cases applying that exemption, the court decided the case under the Bankruptcy Code.

The court, noting that the exemptions provided under Bankruptcy Code §§522(b)(3)(C) and 522(d)(12) were identical, then applied the two prong test of *Nessa* – "(1) the amount the debtor seeks to exempt must be retirement funds; and (2) the retirement funds must be in an account that is exempt from taxation under one of the provisions of the [IRS Code] specified in § 522(d)(12)." *Id*. at 314. As in *Nessa,* the retirement funds did not have to be those of the debtor, and the fact that such funds were only taxable upon withdrawal met the second prong of the test. *Tabor* did not enunciate the reason for the application of Bankruptcy Code §522(b)(4)(C)for funds made the subject of a trustee to trustee transfer any more clearly than *Nessa*.

This case was affirmed by the District Court in an unpublished opinion.[49] It is presently on appeal to the Third Circuit.[50]

11. ***In re Ard.***[51] This Florida Bankruptcy Court case followed *Robertson v. Deeb,* while also citing most of the earlier bankruptcy cases. Applying the Florida exemption statute, without considering the Bankruptcy Code exemption, the court concluded that the inherited IRA did not "retain the same tax exempt status" as in the hands of the owner and that, "The tax consequences had nothing to do with [the debtor's] age or retirement status."

12. ***In re Weilhammer***.[52] Stating that *In Re Greenfield*, fn. 34 *supra,* preceded BAPCPA, this California Bankruptcy Court, followed *Nessa* and *Tabor* in holding that BC §522(b)(3)(C) provided an exemption for inherited IRAs by refusing to read into the statute a requirement that the "retirement funds" be the retirement funds of the debtor, following an "inception of title" approach – once retirement funds, always retirement funds. The *Wellhammer* court carefully analyzes and distinguishes *Chilton*, and ultimately concludes that *Chilton's* failure to apply BC §522(b)(4)(C) regarding trustee to trustee transfers is a fatal flaw in that court's reasoning.

13. ***In re Kuchta***.[53] Counsel in this case took three swings and after two strikes, connected on the third one. First, counsel argued that the inherited IRA was really a trust and could be excluded under BC §541(c)(2), as having restrictions on transferability under applicable non-bankruptcy law. The court had little trouble holding that the IRA was not a trust with spendthrift features because the beneficiary could take out as much or as little as

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[49] 1:10-cv-1580, Doc. #6 (M.D. Pa. Dec. 2, 2010).

[50] Doc. No. 10-4660.

[51] 435 B.R. 719 (M.D. Florida, Tampa Division 2010)

[52] 2010 WL 3431465 (S.D. California 2010)

[53] 434 B.R. 837 (N.D. Ohio, Eastern Division 2010)

she liked at any time. Second, the debtor claimed that the IRA was exempt under Ohio law, which provided a partial exemption for payments made on account of age. The court, again, had little trouble finding that there were no age restrictions for inherited IRAs. However, on the third swing, the debtor hit a home run. The court followed *Nessa* and *Tabor* and applied the exemption under BC §522(b)(3)©.

14. ***In re Thiem***.[54] This case follows the growing trend of courts that have found that BC §522(b)(3)(C) exempts inherited IRAs from claims of creditors in bankruptcy. This case also relied on ARS §§ 33—1126(B), which provides, in pertinent part:

> B. Any money or other assets payable to a participant in *or beneficiary of,* or any interest of any participant or beneficiary in, a retirement plan under §§ 401(a), 403(a), 403(b), 408, 408A or 409 or a deferred compensation plan under §§ 457 of the United States internal revenue code [sic] of 1986, as amended ... shall be exempt from any and all claims of creditors of the beneficiary or participant. (emphasis added).

This statute certainly is easier to apply to inherited IRAs than most due to its reference to beneficiaries.

The facts of this case present another interesting issue. The debtor and her sister were equal beneficiaries of the mother's IRA. Rather than split the IRA in two, the debtor paid her sister for the sister's one-half of the IRA from the debtor's personal funds. This was several years before the bankruptcy filing. The trustee argued that the use of the separate cash was an unauthorized "contribution" which tainted the entire IRA, or, alternatively, that one-half of the IRA was not exempt because it was not inherited from the mother but rather purchased from the sister. In holding that the entire IRA retained its exemption, the court "reasoned:"

> This court does not agree that Mrs. Thiem's payment to her sister was essentially a "contribution" of her personal funds to the IRA. The same funds, which were the mother's retirement funds, remained in the inherited IRA at all times. The arrangement between the two sisters was a distinct and separate transaction between two beneficiaries which did not affect the total amount or nature of the inherited IRA.

It would seem very clear that the portion acquired in this "separate and distinct transaction" should not qualify for the exemption. Suppose the parties had been unrelated. Could the debtor have purchased the inherited IRA from a beneficiary if the debtor were not herself a beneficiary, which she clearly was not as to her sister's one-half? From the IRS side of things, the author believes that the Service would clearly hold that there had been a prohibited "contribution", despite the fact that the dictionary definition used by the court would not literally apply.

15. ***In re Mathusa***.[55] This latest case joins the ever longer line of cases which simply follow the reasoning in *Nessa* and find the inherited IRA exempt under BC §522(b)(3)©.

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[54] 443 B.R. 832, (Bkrtcy, Arizona 2011)

[55] 2011 WL 1134680 (Bkrtcy M.D. Florida, Orlando Division 2011)

16. ***In re Johnson.***[56] The facts in this case are basically the same as its predecessors – inherited IRA from which the debtor has been taking MRDs. And the holding in this case follows the reasoning of *In re Nessa* and its progeny. The one thing that is remarkable about this opinion is that it applies BC §522(b)(4)(C) correctly. Prior cases, as noted, have used that section to support their result that the inherited IRA is exempt. *Johnson* uses that section for the proposition that, having determined that the inherited IRA is exempt under BC §522(b)(3) [or BC §522(d)(12), as the case may be], §533(b)(4)(C) prevents the trustee to trustee transfer from causing a loss of that exempt status. The Court states:

> Upon the owner's death, the Debtor transferred such funds to his Inherited IRAs through a direct trustee-to-trustee transfer. According to §522(b)(4)(C), such transfer did not negate the Debtor's ability to claim such funds as exempt under §522(d)(12).

17. ***In re Clark.***[57] This case, dealing with BC §522(b)(3)(C), is another with facts virtually identical to its predecessor, but it may signal the beginning of a new trend in the case law. Until now, almost every case after *In re Nessa* that has analyzed the exemptions added under BAPCPA has held that the term "retirement funds" included funds set aside by someone for retirement but later passed on as a result of death, even though the new beneficiary clearly was not using them for retirement purposes. Because of that, it is worth quoting the court's reasoning (to which the author subscribes in part) at length.

The Court begins its analysis by recognizing the trend in the law, but states that there is no controlling Ninth Circuit authority, and (as if it had some relevance to the legal analysis) involved much smaller amounts than in *Clark*. The Court then continues by adopting the two prong test set out in *Nessa* and its progeny – (1) the amount the debtor seeks to exempt must be retirement funds, and (2) those retirement funds must be exempt from tax under one of the designated sections of the Internal Revenue Code. Because there is no definition of "retirement funds" in the Bankruptcy Code, the Court must look to the "ordinary meaning" or "plain meaning" of the term. This is, of course, the same test that *Nessa* applied. However, one judge's "plain meaning" is not necessarily that of another. The Court says:

> The trustee argues that the Inherited IRA does not constitute retirement funds of the debtor (or any living person) and requests that this court look to the substance of the Inherited IRA and not to its name. The substance of the account, the trustee contends, will reflect funds that no longer hold any attributes of a traditional "retirement" account....
>
> Based on my reading of the plain language of §522(b)(3)(C), the trustee has the more persuasive argument in this case. The first prong of the analysis requires that—"(1) the amount the debtor seeks to exempt must be retirement funds." *Nessa*, 426 B.R. at 314. Finding no ambiguity in the language of the statute, I must defer to the "common or ordinary meaning" of the phrase "retirement fund." *Rousey*, 544 U.S. at 330. "Retirement" is defined as the "withdrawal from one's position or occupation or from active working life." Webster's Ninth New Collegiate Dictionary 1007 (9th ed.1986). Thus to qualify as exempt under §522(b)(3)(C), the

[56] 2011 WL 1674928 (Bkrtcy W. D. Washington at Tacoma 2011)

[57] 2011 WL 1814209 (Bkrtcy W.D. Wisconsin 2011); *rev'd Clark v. Rameker*, 2012 WL 233990 (W. D. Wis. 2012)

funds must be held in anticipation of "withdrawal from one's position or occupation." *Id.*

The debtors' Inherited IRA does not contain *anyone's* "retirement funds." Ruth Heffron established the retirement account, and elected her daughter as a beneficiary of the account. While living, the funds in Ms. Heffron's account were indeed funds for *her* retirement——that is held in anticipation of one day withdrawing from her occupation. After Ms. Heffon passed away, however, the funds passed to her beneficiary. The funds could no longer be classified as *anyone's* retirement funds – Ms. Heffron had died and was incapable of retiring further or using the funds during her retirement, and her daughter was able (in fact obliged) to take distributions from the account while both of the debtors continued to work. Currently, the funds are held in anticipation of no person's retirement and likewise cannot, under the plain meaning of the statute, constitute "retirement funds." They are not segregated to meet the needs of, nor distributed on the occasion of, any person's retirement. (emphasis in original)

In arriving at this conclusion, most courts dwell on the fact that inherited IRAs contain funds set aside for *someone's* "retirement" and in most cases are still characterized by the Internal Revenue Service ("IRS") as individual retirement accounts. This reasoning is unpersuasive however, and seems to avoid the plain meaning of the statute. The fact that the funds were once held for a decedent's retirement is irrelevant. As noted above, while the funds may have been set aside originally for retirement purposes, once the decedent dies the funds are no longer held by the beneficiary for that purpose. The IRS may refer to an "inherited IRA" as an "IRA," but that label is without significance. *See* I.R.S. Publication 590, p. 18 (2010) (discussing tax treatment of an "inherited IRA"). It is the purpose of the fund, and not its name, that determines the plain meaning of the phrase. For this reason, I cannot agree with the other courts' interpretation of "retirement funds" in §§ 522(b)(3)(C). (emphasis in original)

Were we to peek behind the curtain of "plain meaning" it would seem beyond any quibble that Congress intended to permit debtors to retain amounts saved for their retirement and not sums inherited from their parents. Because this obvious point supports the common sense reading of the words that Congress chose for the statute, the resort of other courts to rely on income tax labels is hard to explain.

Had the Court stopped there, it would have been a clear and concise (and, in the author's opinion, perfectly reasonable) explication of the proper construction of the statute. After all, once the funds are determined not to be retirement funds, the exemption claim fails, irrespective of whether the funds are exempt from taxation. But the Court, as in *In re Chilton*, could not resist going further and analyzing the second prong of the test. And here the Court runs aground – illustrating once again the danger of bankruptcy lawyers arguing the law in this area to bankruptcy judges. Citing the CCH Explanation of the Pension Protection Act of 2006 without referencing the Act itself, Judge Martin treats the allowance

of trustee to trustee transfers from an "eligible retirement plan of a deceased employee"[58] to an IRA as providing relief from lump sums distributions of the deceased owner's IRA. The relief provided related primarily to the situation in which an employer plan terminated and required lump sum distributions. He then goes on to apply the pre-BAPCPA line of reasoning to distinguish an inherited IRA from a traditional IRA. The facts in this case are basically the same as its predecessors – inherited IRA from which the debtor has been taking MRDs.

The Court then goes on to say that it can find no "primary legal source for the proposition that the debtor's inherited IRA is tax exempt."

> While the statute does indeed exempt from tax "any individual retirement account," I find no sources that suggest an "inherited IRA" is considered "any individual retirement account" under IRC §408. To fall within IRC §408, the fund must meet certain criteria related to distribution requirements and asset regulation. *See* 26 U.S.C. §408(a) (requiring that "contributions" into the account be made "in cash" and not exceed the limits set forth under §219(b)(1)(A); "[t]he interest of an individual in the balance in this account [be] nonforfeitable;" "[t]he assets of the trust not be commingled with other property ...;" *etc*.). The debtors' Inherited IRA does not seem to meet any of those criteria listed in IRC §408(a).

After going off on this tangent, the Court finally deals with BC §522(b)(4)(C), following somewhat the approach of *Johnson*:

> Finally, §522(b)(4)(C) does not help the debtor in this case. That poorly drafted statute seems to apply only if by reason of a "direct transfer of retirement funds from 1 fund or account that is exempt from taxation" a retirement account loses its exemption status under §522(b)(3)(C). 11 U.S.C. §522(b)(4)(C) [*sic*]. Here, the debtors' Inherited IRA does not qualify for exemption status because the account does not contain "retirement funds." Each of the required distributions from the fund is taxable and the holding of the funds by itself is not a taxable event. Section 522(b)(4)(C) simply does not apply.

And, finally, the Court follows *In re Kirchen* in holding that the Wisconsin statute, referencing distributions "by reason of age" does not provide an exemption either.

18. ***Clark v. Rameker.***[59] Overruling the Bankruptcy Judge, the Federal District Court concurred with *In re Nessa* and its progeny in finding that the omission in the statute of the express requirement that the "retirement funds" be the "debtor's retirement funds" was significant. The Court further applied the rule that exemptions were to be liberally construed, and, as with other courts, buttressed its argument by reading §522(b)(4)(C) to somehow create an exemption for an inherited IRA simply because it was created by a trustee to trustee transfer.

19. ***In re Cutignola***.[60] This case involves a turnover motion by the bankruptcy trustee

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[58]Pension Protection Act of 2006, §829, adding IRC §402(c)(11)

[59]2012 WL 233990 (W. D. Wis. 2012)

[60]2011 WL 1886182 (Bkrtcy. S.D. New York 2011)

as a result of a post petition acquisition. Husband and wife filed for bankruptcy, and wife died during the pendency of the bankruptcy proceeding within the 6 month period after filing, which would cause any property inherited by the debtor to be included in the bankruptcy estate. Among wife's assets was an inherited IRA. Husband, who was the sole beneficiary of her estate, asserted that the asset was an exempt asset and that it retained its exempt status even after wife's death. The parties had claimed the inherited IRA as exempt and the trustee had not challenged such claim and there is no dispute that the funds are held in an account exempt from taxation. The Court initially determined that property acquired post petition could still be claimed as exempt. Having done that, it was an easy trip to hop on the reasoning of *Nessa*, especially since the trustee had not originally objected to the wife's claim of exemption. The fact that the IRA was inherited by the husband was not relevant because the exemption issue revolved around an IRA inherited by the wife, of which the husband clearly could not do a spousal rollover.

20. ***In re Kalso***.[61] This case follows the majority of cases since *Nessa*, holding that an inherited IRA is exempt from claims of cereditors. It adds nothing new.

21. ***In re Hamlin***.[62] This case is on appeal to the Bankruptcy Appellate Panel for the Ninth Circuit. It also follows the majority rule.

22. ***In re Stephenson***.[63] In another Federal District Court opinion reversing a Bankruptcy Court, indistinguishable on its facts, the Court found the inherited IRA exempt under §522(d)(12) and additionally relied on §522(b)(4)(C). Along the way, noting the distinctions between an inherited IRA and a traditional IRA, the court notes, "For example, non-spouse beneficiaries of inherited IRAs must withdraw all funds within five years following the year of the owner's death," (*sic*) citing Publication 590 at 35. The court also dealt with the azrgument that Congress could not have meant to exempt inherited IRAs because BAPCPA was passed before the Pension Protection ACT of 2006 which allowed rollovers from qualified plans to inherited IRAs.. However, the court stated, that no matter what Congress intended, the statutory language provides an exemption.

D. State Court Construction. There has been only one state court case which has dealt with inherited IRAs. While the Bankruptcy Court cases finding in favor of the trustee are not overly surprising, the author would have thought that state court cases would produce a different result, especially in a state with liberal exemptions such as Florida.

1. ***Robertson v. Deeb***[64]. In this case, the Florida court found that inherited IRAs were not protected from claims of creditors. Kevin Deeb attempted to garnish an inherited IRA to satisfy a judgment against the beneficiary of such IRA. Section 222.21(2)(a), Florida Statutes (2008) (now superseded) provided:

> Any money or other assets payable to an owner, a participant, or a beneficiary from, or any interest of any owner, participant, or

[61] 2011 WL 3678326 (Bkrtcy. ED Michigan 2011)

[62] No citation available. (Bkrtcy. Arizona 2011)

[63] 2011 WL 6152960 (E,D, Michigan, Southern Division 2011)

[64] 16 So. 3d 936 (Dist. Ct. Of Appeals, Florida, Second District 2009)

> beneficiary in, a fund or account is exempt from all claims of creditors of the owner, beneficiary, or participant if the fund or account is...exempt from taxation...[under IRC §408].

Affirming the trial court, the Florida court reasoned that the statute protected a specific "fund or account", and that the inherited IRA was a new "fund or account". Relying upon the bankruptcy cases, the Florida court then went on to reason that the new fund or account of the inherited IRA did not meet the "exempt from taxation" standard because Robertson could not contribute to the account, could withdraw all funds without penalty, and was required to start taking distributions within one year of death. The court's narrow construction of fund or account can certainly be justified or criticized. Under their analysis, spousal rollovers would still be protected because the spouse is treated as the owner and thus should meet the "exempt from taxation standard. The court simply ignored the use of the word "beneficiary" in the statute.

IV. SOME SUGGESTED SOLUTIONS. In light of the uncertainty of the exempt status of inherited IRAs, if asset protection planning for subsequent beneficiaries is an important consideration, then there are some steps that can be taken to attempt to provide protection.

A. **<u>Pay Benefits to a Spendthrift Trust.</u>** As a general rule, only individuals can be a designated beneficiary ("DB") of a retirement plan. However, protection may be provided by paying such benefits to a spendthrift trust, the beneficiary of which meets the requirements of a DB. The trust should be excluded from the bankruptcy estate under Bankruptcy Code §541(c)(2), and reliance on an exemption for inherited IRAs is unnecessary. The trust should not be a conduit trust (one which requires that all distributions from IRA must be distributed to beneficiary of trust) or creditors will be allowed to reach the amounts that are required to be distributed to the beneficiary upon such distribution or if not distributed within a reasonable time; *i.e.,* the creditor may enforce whatever rights the beneficiary has. The use of a trust as a beneficiary raises all of the usual issues concerning whether the trust beneficiary is a DB, and what measuring life is used in determining the identity of the DB.[65]

B. **<u>Use a Trusteed IRA</u>**. Some providers will allow the trustee to be held as a trust in its trust department rather than as a custodial IRA. IRS Form 5305 provides the vehicle for creating such an IRA, although many providers have their own prototype. *Caveat: Some will not allow the IRA owner to customize, in which case, you should seek another provider.* This is also a difficult sell to clients who have difficulty understanding why they should pay the attorney to draft a trust or review the provider's from for a trusteed IRA instead of using the free custodial account offered. But, the trust agreements have multiple choices and are more complex than custodial IRA joinder agreements, and MUST BE REVIEWED by an attorney. Because the IRA itself is a trust, it is not necessary to qualify the trust under Treas. Regs. §1.401(a)(9)-4, A.5. And the beneficiaries of the trusteed IRA are the persons named in the trusteed IRA. The use of a trusteed IRA, however, does not avoid the rules surrounding the determination of whether there is a designated beneficiary and who is the measuring life. To attain creditor protection, the trusteed IRA must be a spendthrift trust under state law.

C. **<u>Use an IRA Annuity</u>**. Some state laws exempt annuities from claims of creditors.

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[65] For a more complete discussion, *see* Golden, "It Should Not Be This Hard: A Look at Trusts as Beneficiaries of Retirement Benefits," 36 ACTEC Law Journal No. 2 (Fall 2010). A discussion of the various problems with spendthrift trusts if the beneficiary is trustee or the impact of the UTC or Restatement (Third) of Trusts is beyond the scope of this outline.

While there are no cases dealing directly with Individual Retirement Annuities, it is at least arguable (and perhaps even probable) that the rationale which protects commercial annuities could be extended. However, the relative inflexibility should be balanced against the potential creditor protection benefits.

V. SOME POLICY THOUGHTS ON INHERITED IRAS. Prior to the cases noted in this outline, most practitioners believed that state exemption statutes extended to inherited IRAs, and it may well be that the state courts (at least outside of Florida) would reach such a result. Many believed, also, that the BAPCPA amendments certainly created such protection. And, as the law develops, these more optimistic practitioners may prove to be correct. However, at this point in time, even though a trend in favor of exemption appears to be developing, the answers remain unclear. Perhaps the cases on appeal to the 3rd and 5th Circuit Courts of Appeals will clarify matters, but it may take a decision by the United States Supreme Court. And, even then, the answer will be clear only in a bankruptcy context. State statutes will still need to be interpreted. Therefore, in counseling clients, lawyers must explore how important creditor protection of the inherited IRA is to the client, explain what techniques are available to achieve that protection, and the complexities such planning adds. Of course, if the owner wants to restrict the access of the beneficiary to the IRA proceeds, the creditor protection aspect may follow easily from that desire.

The policy argument in protecting IRAs is that creditors should not be allowed to reach retirement benefits of an owner or the owner's spouse. However, these funds are clearly not set aside for the retirement of the beneficiary, and are, because of the ability to cash out (which many, if not most, do), no different than a bank account. Thus, there would appear to be no policy reason to extend creditor protection to such an asset. However, the bankruptcy courts have applied a liberal reading of §522 to interpret "retirement funds" on an inception of title basis – once retirement funds, always retirement funds. But, if some reasonable finality exists that inherited IRAs are exempt in bankruptcy proceedings, it would seem that many states may wish to clarify that such assets are exempt under state law so as not to essentially force their citizens into the bankruptcy courts to protect the inherited IRA.