Does Bankruptcy Protection Extend to Inherited IRAs?

_Estate Planning Journal_, Volume 40 Number 11, November 2013
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If an inherited IRA will not get favorable retirement fund treatment in bankruptcy, trust arrangements should be explored to achieve asset protection.

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One of President Obama's 2014 Greenbook proposals would require the full distribution of all inherited IRAs within five years of the participant's death, with narrow exceptions for accounts payable to minors (until majority), beneficiaries not more than ten years younger than the participant, and transfers to special needs beneficiaries. This proposal, which has been kicking around the Senate for a few years, was attached to the Senate version of this year's student loan bill (S. 953) but failed on June 6 to get the 60 votes required for consideration. Under another 2014 Greenbook proposal, retirement plans eligible for tax deferral would be capped at roughly $3.4 million per taxpayer.

While using a trust with discretionary distribution and spendthrift provisions does not protect against the tax ramifications of accelerated withdrawals, such a structure can offer protection from creditors and unwarranted distributions. Discretionary trusts with spendthrift provisions are also an answer to avoiding the outcome that befell the plaintiffs in a recent Seventh Circuit decision. In _In re Clark_, the court ruled that the inherited account in that case was not "retirement funds" under the Bankruptcy Code's definition of exempt assets.

This article examines the _Clark_ decision and the resulting conflict among the federal circuit courts. The U.S. Supreme Court will likely grant certiorari given the split in the circuit courts and the prevalence of inherited IRAs caught up in bankruptcy proceedings. Implementing trust planning with clients could avoid or at least mitigate the harsh effects of accelerated payout periods and reduced asset protection for retirement funds. These planning opportunities will also be reviewed and analyzed under the American Taxpayer Relief Act of 2012 (ATRA) and the new tax on accumulated trust investment income under the Affordable Care Act.

Judge Frank H. Easterbrook wrote the _Clark_ decision using his literal approach to jurisprudence and his penchant for economic analysis of legal issues. A former Deputy Solicitor General, Judge Easterbrook was appointed to the Seventh Circuit by Ronald Reagan and has served as the chief judge of the Seventh Circuit since 2006. Given his interest in market forces and the relationship between federal laws and state law property rights, Judge Easterbrook likely welcomed the opportunity to write an opinion addressing the issues presented by the intersection of bankruptcy law and retirement planning.

Analysis of the Case

In _Clark_, the Seventh Circuit was asked to determine whether inherited IRAs qualify as an "exempt" asset under Bankruptcy Code sections 522(b)(3)(C) and (d)(12), which were enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Under BAPCPA, states must choose whether to "opt in" or "opt out" of the federal exemption scheme. If a state opts in, section 522(b)(2) applies and the exemptions provided under federal law govern. If a state opts out, section 522(b)(3) applies and the exemptions available under state law govern. In bankruptcy, debtors are permitted to exempt certain assets from creditors' claims, often in specified amounts. Section 522 exempts from creditors' claims any "retirement funds to the extent that those funds are in a fund or
account that is exempt from taxation under Sections 401, 403, 408, 408A, 414, 457 or 501(a) of the Internal Revenue Code of 1986."

In a bankruptcy proceeding, the objecting party has the burden of establishing that the debtor's exemptions are invalid, and exemptions are generally construed liberally in favor of the debtor whenever ambiguity exists.² The Seventh Circuit panel addressed the question of whether the IRA that the debtor inherited from her mother was "a retirement fund" covered by one or more of the sections enumerated by Congress.

Judge Easterbrook began the court's opinion by pointing out the differences between inherited IRAs and IRAs held, withdrawn from, and transferred by the plan participant. For instance, the opinion notes that no new contributions can be made to an inherited IRA, and the balance cannot be rolled over or merged with any other account. In paragraph two of the decision, the court drew a distinction between inherited IRAs and the options available to a surviving spouse who can elect to roll over the inherited account into his or her own IRA or elect to maintain the IRA as a separate account.

According to the Seventh Circuit, because the designated beneficiary of an inherited IRA must begin making withdrawals within a year or so of the participant's death, there is a limited opportunity for further tax deferral. The limited options for deferral in turn render an inherited IRA insufficiently "tax exempt" under IRC Sections 408 and 401, according to the Seventh Circuit. But IRAs inherited by spouses would continue to be "retirement funds" under Bankruptcy Code section 522, the court said, citing the inability of the surviving spouse to begin withdrawals prior to attaining age 59 1/2 without incurring a penalty and the mandatory withdrawal start date, which are the same rules that are in effect for the plan participant. Evidently, these are the significant attributes, according to the court.

Likely in an effort to cast the decision as simple and straightforward, the opinion avoids discussing the intricacies of the notoriously complicated IRA rules. In so doing, the court misses some of the subtleties that make this issue so contentious and worthy of consideration by the Supreme Court. After comparing the Seventh Circuit decision with decisions by the Fifth Circuit and the Bankruptcy Appellate Panel of the Eighth Circuit (BAP), the relevant question appears to become whether an inherited IRA is more like a regular IRA or more like a bank account.

**designated beneficiary.** The Clark decision fails to address the rules that govern inherited IRAs—specifically, all the rules found in the extensive regulations to Section 401(a)(9) as well as Section 408. These rules permit a plan participant to name a designated beneficiary or multiple beneficiaries to receive the account upon the participant's death. Where the designated beneficiary is an individual or a "see-through" or "look-through" trust, distributions can be taken by the designated beneficiary (or the trust) over the life expectancy of the beneficiary, or the oldest beneficiary in the case of a trust.

In this way, Section 401(a)(9) rewards plan participants who name a designated beneficiary with the considerable financial benefit of long-term deferral. In fact, with a respectable investment return and a relatively young beneficiary, the account could grow for decades despite the annual withdrawals of the minimum required distributions. Under the Single Life Table used to calculate the annual minimum required distribution for a trust or individual beneficiary, the divisor for a 40-year-old is 43.6. If the account had a balance of $1 million in the year following the year of the plan participant's death and the designated beneficiary of the account was 40, he or she would need to withdraw $22,936, or 1/43.6 of the plan, which equates to about 2%. Each year thereafter the divisor is reduced by 1. If the account is growing at 4% or 5% per year, the account is increasing faster than the required distributions are depleting it. In this way, the account acts exactly as it would in the hands of the plan participant taking his or her initial required distributions. At some point, though, the account reaches its "tipping point" and the required distributions would exceed the investment returns, as is depicted in Exhibit 1.
Exhibit 1. Account Value During Distribution Period

Assumptions: The beneficiary begins receiving distributions at age 40, and the account balance earns a 4% investment return.

Assumptions: The beneficiary begins receiving distributions at age 50, and the account balance earns a 5% investment return.
Roth IRAs offer even greater opportunities for tax deferral. With a Roth IRA, appreciation of plan assets is tax exempt, and there are no required minimum distributions when the owner of a Roth IRA reaches age 70 1/2. The designated beneficiary does have to withdraw minimum required distributions just like with an inherited non-Roth IRA. It is interesting to consider whether the court's analysis would have been different if the Clark case had involved a Roth IRA, which is designed to be a legacy asset.

**Successor beneficiaries.** Judge Easterbrook's opinion also does not account for the role of successor beneficiaries. Under the Regulations, if the original beneficiary dies before having withdrawn all the benefits from the plan, the named successor beneficiary steps into the shoes of the original beneficiary as owner of the account. Once the payout period has begun, it is written in stone. If the plan is passed along to an heir, the heir succeeds to the payout period established for the original beneficiary. This provision is squarely within Section 408. The Clark court does concede that payouts can be stretched, but qualifies this fact and states that an IRA is "not a place to hold wealth for use after the new owner's retirement."

But this is surely not always the case. The court omits any substantive discussion of these favorable provisions of Sections 401 and 408 and the regulations interpreting those Code sections.

**Restriction on contributions.** Judge Easterbrook's opinion notes that Heidi Clark, the beneficiary, could not make contributions to the account. However, there are also age limits for contributing to a regular IRA (not a Roth IRA), and as long as Heidi had "compensation" under Section 401, she could have taken her required distributions and used them to fund her own IRA.

**Tax deferral.** These involved and convoluted rules make an inherited IRA a complex asset. The Clark court's assessment that inherited IRAs are not retirement funds seems overly superficial. To be sure, they are different assets than when held by the original participant. It is equally true, though, that these assets have many attributes that render them closer to a retirement account than a bank account given the substantial opportunity for significant tax deferral. Even under a five-year payout regimen, the account holder can invest the entire account for a substantial period without incurring tax on the investment profits. And, in any event, the inherited IRA accounts continue to be governed by Sections 401(a)(9) and 408(a) and the accompanying regulations.

**Lower court decisions**

In Clark, the bankruptcy judge ruled that an inherited IRA does not represent "retirement funds" in the hands of the debtor. The district court judge reversed, siding with the decisions in In re Chilton, In re Nessa, and several other bankruptcy court decisions, such as In re Mathusa.

**Questionable interpretation**

Judge Easterbrook's opinion cites a sentence from the bankruptcy judge's opinion in Clark, which is incorrect. In concluding that an asset counts as "retirement funds" only when the account is "held for owner's retirement while an inherited IRA must be distributed earlier," the judge overstated the rule of Section 408. There are many situations where the payouts would not work out that way, especially where the participant is past his or her required beginning date and has named a much younger beneficiary, such as a grandchild. The bankruptcy judge also stated that the IRS' treatment of inherited IRAs is not relevant. But the IRS' extensive regulations governing inherited IRAs were in place in 2002, years before BAPCPA. It is reasonable to conclude that Congress understood the rules governing inherited IRAs and articulated the exemption rules accordingly.

Moreover, the judge's ruling misses the general premise of Section 401(a)(9), which is known among estate planners as the "at least as rapidly rule." The Single Life Table is the IRS' attempt at ensuring that the retirement benefits are paid out to a designated beneficiary as least as rapidly as the payments would have been made to the participant. But, in practice, the rule is very taxpayer friendly and can provide for significant tax deferral.

This is important for understanding the fundamental issue raised by all of these cases. Is the IRA a
materially different asset once it has passed to the designated beneficiary? Does death change everything? Judge Easterbrook answers both questions affirmatively in his decision for the court. His view is that at death, the funds are no longer retirement funds, except if inherited by a spouse. Otherwise, the IRA becomes just another asset. And-unlike a residence—which can be claimed by an heir as one’s residence and morph into an exempt asset, no such recasting is possible with an inherited IRA. There is no way for the beneficiary to make it his or her own IRA.

Judge Easterbrook states that the inherited IRA "does not have economic attributes of a retirement vehicle because money cannot be held in the account until the current owner's retirement." This is true and is the opinion's best point. If that is the sole definition of "retirement funds," namely a fund that its owner can rely on for support upon reaching a set retirement age, then the court's analysis is correct. The assets could be used for retirement, but withdrawals cannot be postponed to a certain age as with a regular IRA.

Under English common law, death was deemed to be a significant event in property law. The owner's rights to his or her assets concluded, and a new owner took over the asset. This concept spawned both modern trust law and the UK and U.S. transfer tax systems. The transfer of an asset became the taxable event. Under Section 2039, the transfer of an IRA is a taxable event. Sublimating through Judge Easterbrook's opinion is this concept that death marks a fundamental change in the nature of an IRA, even if it passes to a designated beneficiary under favorable payout terms. Conversely, the Fifth Circuit and the Eighth Circuit Bankruptcy Appellate Panel (BAP) concluded that the death of the original account owner had not substantively changed the asset.

Circuit court split

Taxation and death, however, are not determinative for the Bankruptcy Code definition of exempt assets. Rather, the question hinges on whether inherited IRAs count as "retirement funds" under section 522. The Fifth Circuit Court of Appeals and the Eighth Circuit Bankruptcy Appellate Panel answered and analyzed the question differently than Judge Easterbrook and his panel. In the words of Judge Schermer, writing for the BAP in *Nessa* and describing the transfer of the IRA account from father to son: the account funds remained "in form and substance 'retirement funds.'"

The *Nessa* and *Chilton* courts wrote strikingly similar opinions and, in looking at the language of section 522, agreed that it had two components:

1. The amount the debtor seeks to exempt must be retirement funds.
2. Those retirement funds must be in an account that is exempt from taxation under Section 401, 403, 408, 408A, 414, 457, or 501(a).

These courts next explained that because Congress did not define the term "retirement funds" in the Bankruptcy Code, they would look at the term’s "plain meaning." Since Congress could have limited, but chose not to limit, the term "retirement funds" to retirement funds in accounts funded by the debtor, they concluded that retirement funds could include the funds that others had originally set aside for their retirement. "The defining characteristic of retirement funds is the purpose they are set apart for, not what happens after they are 'set apart,'" announced the Fifth Circuit in *Chilton*. This is a strong point. Once the funds are put in the retirement "bucket," they are retirement funds. The taxation follows this logic. The asset is taxed under the same general scheme. Income taxes generally are paid gradually over the retiree’s or the beneficiary’s lifetime and depend on the other income attributes of the taxpayer. IRAs do not have a one-time realization/recognition event (as with a sale or exchange) unless the designated beneficiary opts for an immediate lump-sum payout.

The courts then went on to consider the second part of section 522 and determined that inherited IRAs are governed by Section 408 and do have tax-exempt features because they are taxed only when distributions are made. In this part of the courts’ analyses, these appellate judges impliedly recognize the
considerable opportunities for tax deferral and build-up under Sections 401 and 408. They also noted that Section 408(e) provides that "[a]ny individual retirement account is exempt from taxation."

In addition, the courts looked to section 522(b)(4)(C), which provides that retirement funds directly transferred from one fund or account that is exempt from taxation under Section 408 "shall not cease to qualify for exemption by reason of such direct transfer." The Chilton and Nessa courts interpreted this section to mean that the direct transfer of retirement funds to another account does not alter the status as exempt retirement funds. A direct trustee-to-trustee transfer is the mechanism for creating an inherited IRA, as both courts detailed and deemed significant.

The judges’ approach to the issue can be summed up in two ways. If the retirement funds account can be traced to a regular IRA, the account is a "retirement fund" under section 522. There is no rationale in either the Bankruptcy Code or the Internal Revenue Code for selecting a point in time to differentiate between a regular IRA and an inherited IRA. According to these courts, death of the original account owner is not a defining event. By contrast, the Seventh Circuit does seek to impose a temporal restriction onto section 522, and that court found death of the original account owner and transfer to a non-spousal beneficiary to be a disqualifying event under BAPCPA.

The interpretation by the Fifth Circuit and the BAP gets a boost from the manner in which plan holders administer many IRAs. Many institutions holding IRAs re-title the IRA upon the account owner's death simply by adding a "for the benefit of" and then the name of the designated beneficiary. In this way, it is clear that the institution has taken the position that the IRA is perpetuated as the original owner's IRA, even though the distributions are going to a different beneficiary.

**Planning for inherited IRAs**

None of the courts discuss the planning opportunities that would obviate the section 522 issue. This is an area where form has substance. Section 408 provides that a trust can be a designated beneficiary, and the Service has issued several Regulations and letter rulings approving of trusts as designated beneficiaries. There are generally four criteria for qualifying a trust as a beneficiary:

1. The trust must be valid under the local state law.
2. The trust must be irrevocable at death.
3. The administrator must receive a copy of the trust document.
4. The designated beneficiary must be identifiable. 7

If there is no designated beneficiary, the account must be withdrawn within five years. A five-year payout occurs, for example, where the participant names his or her estate as the beneficiary, although tax deferral is still available because there is no requirement to take a portion of the funds each year. The rule requires only that the entire account be distributed no later than December 31 of the year that contains the fifth anniversary of the participant's death. 8

**Types of trusts holding retirement assets**

Trusts that qualify as designated beneficiaries are nicknamed "see-through" or "look-through" trusts as the Service will look through the trust to the individual trust beneficiaries. Because all trust beneficiaries must be individuals, a trust that obligates the trustee to give 10% of the residue to charity and divide the remaining 90% among the decedent's living children flunks the designated beneficiary test. But, if the trust names just "my living children," the payout would be based on the oldest child's life expectancy. One advantage of using a trust is the ability to blanket the trust property with a spendthrift provision.

Estate planning attorneys use two types of trusts to hold retirement accounts:

1. A "conduit trust."
2. An "accumulation trust." 9
Conduit trust. Because this type of trust is specifically blessed in Section 401(a)(9)(B)(ii), it is a safe harbor. A conduit trust contains provisions to funnel retirement plan distributions directly out to a designated beneficiary. These trusts are also commonly used where a retirement account is payable to a marital trust and the attorney wants the trust to qualify for the marital deduction. In such a case, there is typically a provision that requires the trustee to distribute to the surviving spouse the greater of all the income of the retirement assets or the minimum required distribution.

While trusts with conduit provisions have spendthrift clauses, they will not insulate the required distributions from creditor claims once the minimum required distributions have been received by the trustee and then paid out. In this regard, it may be advisable to include a provision that states that no distribution can be made to a beneficiary who has filed a Chapter 11 proceeding. As such a provision could take the conduit trust outside of the safe harbor as set forth in Section 401(a)(9)(B)(ii), the ramifications of such a clause should be clearly explained to the client.

Some of the benefits of the conduit trust would be lost if President Obama's budget proposal voiding stretch payouts is adopted and passed by Congress. It is an interesting public policy issue that in many ways mirrors the issue in Clark, Chilton, and Nessa. Are retirement funds solely for the retiree's support and maintenance, so that any balances passed along should not be accorded any legal or tax preferences? Or is it reasonable to allow wage earners to make a retirement fund a legacy asset?

Accumulation trust. The second type of trust used to hold retirement accounts is an "accumulation trust." As the name suggests, this is a trust where the trustee has the discretion to retain the minimum required distributions received by the trust. The trustee has no obligation to pass out the distribution to the beneficiary. Rather, distributions are governed by the standards set forth in the trust, often a "health, education, maintenance, and support" standard. If one is scoring trusts based on the ability to shield principal and income from creditors of trust beneficiaries (including ex-spouses), an accumulation trust offers the most protection if drafted with a broad spendthrift provision and unfettered discretion for the trustee.

Accumulation trusts are not sanctioned by the Internal Revenue Code or the Service. Remember that a trust can qualify as a designated beneficiary only if the beneficiary is identifiable. If the trustee can accumulate the plan distributions for subsequent (unborn) beneficiaries, the current beneficiaries, as well as the trust remaindermen, count for purposes of the minimum required distribution rules. Powers of appointment further complicate this analysis.

The Service has shed some light on which beneficiaries count for purposes of testing an accumulation trust in several letter rulings (which, of course, are not authoritative). Essentially, at the time of the participant's death, the tax advisor must look at all successive beneficiaries who could potentially receive distributions from the retirement funds until he or she finds the beneficiaries (often grandchildren or great-grandchildren) who will have a right to an outright distribution of their share of the trust. If the trust is perpetual with successive generations having only an expectancy of receiving account funds, the trust is unlikely to work as a see-through trust.

The Service has said that "mere potential successors" can be disregarded, which means that if a child has a right to an outright distribution of his or her trust share, the beneficiaries who would take that share if the child predeceased his or her parent can be disregarded. Yet, this analysis only goes so far and does not shed much light on whether a dynasty trust holding a large Roth IRA could qualify for the stretch payment option of Reg. 1.401(a)(9)-4. Of course, even if the trust fails to qualify for a stretch payout, the trust provisions, including the spendthrift provision, still control-and protect-the distributions and the rest of the trust corpus and income.

Spendthrift restriction. A spendthrift provision is a restraint on voluntary or involuntary alienation of a beneficiary's interest in a trust. It is an inapt label; its connotation is of protecting beneficiaries who would blithely waste inherited funds, and it fails to capture the larger purpose of the device: to limit involuntary transfers caused by creditor threats and claims. The concept stems from a settlor's right to govern the terms under which distributions are made from a trust he or she created. A typical spendthrift
provision provides that no beneficiary has the right to assign or alienate his or her interest in the trust and that no creditor has a right to lien or levy against any interest that may be distributable to such beneficiary.

Spendthrift provisions have been upheld by most courts for more than 100 years. Last month, for instance, a Florida court considered whether a beneficiary of a multi-million dollar spendthrift trust could be forced to use trust proceeds to pay off a guarantee the beneficiary had given in connection with a loan he had received. The lender argued that the Florida statute recognizing spendthrift clauses was unconstitutional in that it precluded the lender from having a remedy for its injury. The court said that the trustee had correctly refused to make a distribution on behalf of the beneficiary in Zlatkiss v. All American Team Concepts.

Some states have limited the extent of the protection provided by a spendthrift trust where a beneficiary is involved in a bankruptcy. In Virginia, for example, spendthrift protection is limited to the first $1 million of assets, and in Oklahoma, trust distributions in excess of $50,000 are subject to creditor claims. Most states also have "exception" creditors that have access to certain otherwise exempt assets. One example is support payments to dependent children. The variation in state laws is considerable and should be reviewed with clients. In light of these concerns, it is increasingly popular for trusts to include a provision that converts any required trust distributions into a discretionary distribution if a beneficiary has creditor issues.

The merits of establishing a trust to accumulate retirement plan distributions have to be evaluated under ATRA. The grantor of the trust, as well as the trustee, will have to look at using an accumulation trust in light of the compressed income tax rates under ATRA. Making distributions to beneficiaries who are in lower tax brackets could produce a better tax outcome. A liberal distribution policy, nonetheless, must comport with the language and objectives of the trust agreement. Some trusts provide distributions only for college expenses and medical emergencies and cannot be used for more general distributions to beneficiaries. This year, the highest tax rate hits trust income in excess of $11,950. It is interesting to note that retirement funds are exempt from inclusion in the calculation of net investment income (NII) under new Section 1411, the Code section implementing the new Medicare surtax. However, the calculation of adjusted gross income includes IRA distributions. For most taxpayers, using NII will produce the least amount of surtax.

Conclusion

Clearly, the competing advantages and disadvantages of these trust structures have to be evaluated with clients. Where a client is concerned about a bankruptcy or claims by a former spouse of a beneficiary such that the client’s priority is obtaining the fullest creditor protection available, the optimal planning trust will be an accumulation trust, despite the possibility of a poor tax result. Where the priority is obtaining the greatest tax deferral, the grantor should be advised to take the sure thing—the conduit trust—and hope that President Obama and Senators Tom Harkin (D-Iowa) and Jack Reed (D-R.I.) do not prevail in their negotiations with House and Senate Republicans on this issue. The other possibility where the IRA is substantial is to split the retirement account into separate shares and in essence pair each beneficiary with the preferred objective.

If the five-year-payout proposal becomes law, planning options will have to be reevaluated. Many trustees will no doubt wait out the five years and then take a lump-sum distribution. At least for that period, there will be tax deferral and the opportunity for investment returns based on the full account value. Regardless of what the Supreme Court ultimately decides on this issue, the assets can be protected by the well-settled asset protection offered by a trust with a broad spendthrift provision.
2. In re Stevenson, 374 Bkrtcy. Rptr. 891 (Bkrtcy. DC Fla., 2007).
4. 105 AFTR 2d 2010-1825, 426 BR 312 (BAP CA-8, 2010).
5. 446 Bkrtcy. Rptr. 601 (DC Fla., 2011).
7. Reg. 1.401(a)(9)-4, Q&A-5. See also Ltr. Ruls. 200610026 and 200438044.
9. This terminology is used by Natalie B. Choate in her book, Life and Death Planning for Retirement Benefits (Ataxplan Publications). The terminology has been adopted by many estate planners.
10. Ltr. Ruls. 200610026 and 200438044
11. Reg. 1.401(a)(9)-5, Q&A-7(c); Ltr. Rul. 2006-10026.
12. D12-3324 (Fla. 5th Dist., 5/31/2013).

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