

Inherited IRAs in bankruptcy

A substantial portion of the trillions of dollars that will be transferred through the estates of baby boomers in the coming decades is expected to be in IRAs, qualified retirement plans and other tax-preferred accounts. IRA rollovers have grown significantly as workers have moved their 401(k) money at retirement in order to extend its tax-deferred status. Planning for the inheritance of this money is assuming greater and greater importance. In particular, can this money be shielded from the claims of beneficiaries' creditors?

The U.S. Supreme Court has held that, in general, the anti-alienation rules of federal pension law put the money that is saved in qualified retirement plans beyond the reach of creditors in bankruptcy. However, that law does not apply to IRAs. State spendthrift statutes do, however, come into play, with mixed results.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 revisited the rules, adding an exemption for "retirement funds." Under Bankruptcy Code §522(n), the exemption for a Roth IRA or a traditional IRA may be limited to \$1 million in some circumstances. However, the term "retirement funds" was not defined in the Act. What about an inherited IRA? Does it constitute "retirement funds" when the beneficiary did not contribute the money to the account?

New case

Marilynn and James Mathusa inherited an IRA when Marilynn's mother died. A trustee-to-trustee transfer moved the money to an inherited IRA in their names. When the couple declared bankruptcy, they sought to protect the IRA money from the claims of their creditors.

Some courts have held that for the "retirement funds" exception of the bankruptcy code to apply, the funds must be the person's own savings, and an inheritance falls outside the scope of the intended protection. Other courts have focused on the literal language, holding that because an inherited IRA retains its tax-deferred status for income tax purposes, the statutory requirements have been met. The decision in the *Mathusa* case, decided in Florida on March 28, 2011, went the latter way, exempting the IRA from creditor claims.

When the inheritance is an IRA, the heir accepts the burden of future income taxes along with the legacy. But this case shows that the IRA may have built-in asset protection features that offset the tax negatives. State bankruptcy laws vary, and in many states this issue hasn't even been addressed as yet. Before making any irreversible financial decisions with important tax consequences, be sure to seek professional counsel.

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