

LARGE IRAS NOT FULLY PROTECTED FROM BANKRUPTCY OR LAWSUIT SEIZURE

A recent U.S. Supreme Court ruling and new federal law have extended bankruptcy and lawsuit protection over most assets in individual retirement accounts. But the protection may not be complete for owners of large IRAs, caution financial planners.

Under federal ERISA law, assets held in most employer-based retirement plans such as 401(k)s, pension plans, 403(b)s, and profit-sharing plans have generally been beyond the reach of creditors. But IRAs were not protected on the federal level. Some states protected IRAs, but many provided no protection or only limited protection.

Also unprotected, unless by a particular state, were SIMPLE IRAs, used by small employers; plans established by the self-employed with no employees other than the owner and spouse, such as a simplified employee pension (SEP) plan or individual 401(k)s; and annuities not held inside a protected employer plan.

Consequently, workers retiring or changing jobs, or those most vulnerable to possible lawsuits, such as doctors, have often been reluctant to roll assets from protected employer-based plans into IRAs—even though that might have been the best strategy from an investment and estate planning standpoint.

Then, in the time span of a little over two weeks this April, all that changed.

First, the U.S. Supreme Court unanimously ruled that assets held in IRAs, both traditional and Roth, generally are protected from creditors. The case concerned a couple who had rolled their \$55,000 in company pension and 401(k) assets into an IRA, only later to have creditors try to seize the IRA after they filed for bankruptcy protection due to hard times.

But the Supreme Court ruling left an important issue unresolved. It said that assets in IRAs were protected only to the extent of what might be considered “reasonably necessary” to support the IRA owner and his or her dependents. Anything above that value could be seized by creditors (depending on the laws of the state of residence). But it didn’t define what constitutes “reasonably necessary.”

Slightly over two weeks later, Congress passed and President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Among its many provisions, the law resolved some questions left after the Supreme Court ruling and further strengthened protection of IRAs as well as plans for the self-employed.

Especially important to participants in employer-based retirement plans is that the bankruptcy act says that all assets rolled over from these plans into an IRA, and all subsequent earnings made inside the account attributable to the rollover, are protected from creditors, regardless of the amount of the rollover. That should remove much of the reluctance among investors to move most retirement plan assets into IRAs if they decide that’s the best financial strategy.

While IRAs have unlimited protection for certain rollover amounts, such is not the case for original (nonrollover) contributions by the owner to traditional and Roth IRAs. The bankruptcy

act put a price tag on the “reasonably necessary” amount that might be protected in these IRAs—\$1 million. That is, if the aggregated value of your original contributions and their earnings to traditional and Roth IRAs exceeds \$1 million, the amount above \$1 million (excluding any protected rollover amounts) could be vulnerable to creditors. That \$1 million amount is indexed annually to inflation.

Most investors building an IRA from scratch won’t exceed the \$1 million limit, since annual contribution limits to traditional and Roth IRAs have been relatively low for the past two decades. And the bankruptcy act allows bankruptcy courts to permit the IRA owner to keep more than \$1 million if it is in the “interest of justice” (though the act did not spell out what constitutes an interest in justice).

All of this emphasizes the importance of making sure you roll any money from employer-sponsored retirement plans and pensions into separate “rollover” IRAs designed specifically for such rollovers. Try to avoid mixing rollover dollars inside a traditional or Roth IRA you’ve been funding from scratch because it makes bookkeeping complicated. Keep accurate records to document rollovers, too.

Nonqualified annuities—annuities not held within qualified retirement plans—do not fall under federal creditor protections established by the Supreme Court and Congress. Depending on state law, those assets may remain vulnerable to creditors.

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