

YOU INHERITED AN IRA. CAN CREDITORS GRAB IT?

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In what estate planners and bankruptcy lawyers are saying could be a significant case, a federal bankruptcy judge in Minnesota has allowed a bankrupt woman to keep a \$63,000 individual retirement account inherited from her father. IRAs inherited from someone other than your spouse have traditionally not been protected in bankruptcy under either federal or state laws, and thus have been available for creditors to grab. "It's a huge deal if these IRAs are now protected," said **Marc Soss, a tax lawyer in Sarasota, Fla.**

The issue is significant not only because more families are facing creditor problems, but also because more of a typical family's wealth is now in retirement accounts. As of the third quarter of 2009, 9% of all household financial assets were in IRAs, up from 4% of assets two decades ago, according to the Investment Company Institute.

Moreover, more of this IRA wealth is likely to be left to children in the future because of a provision that took effect in 2010 allowing all taxpayers to convert traditional pre-tax IRAs into Roth IRAs. In a conversion, you take money out of a traditional IRA, pay ordinary taxes on it and then move it into a Roth, where all future growth and withdrawals are tax free. While retirees are required to begin taking annual distributions from pre-tax IRAs when they turn 70.5, no such requirement applies to Roth IRAs. That means affluent retirees can leave their large Roth IRAs growing untouched, for their children, who can stretch out withdrawals over their own projected life spans. (For "10 Reasons To Convert To A Roth IRA," [click here.](#))

In the Minnesota case, *In re Nessa*, the federal bankruptcy judge relied on new language in the 2005 federal bankruptcy law that protects \$1 million in IRA assets from creditors. (The law also protects all assets rolled from an employer pension plan, such as a 401(k) or defined benefit plan, into an IRA, regardless of the amount.) The judge concluded that an inherited IRA is still a retirement account protected under that law, even though it has switched hands from the original owner to the beneficiary. Jean Hannig, the bankruptcy lawyer in Fargo, N.D., who represented debtor Nancy Nessa, hailed the decision as a resounding victory for debtors.

While the Minnesota decision was the first reported case to look at the application of the 2005 law to inherited IRAs, the judge there may not have the last word. The bankruptcy trustee has appealed the ruling to the U.S. Court of Appeals for the 8th Circuit. And earlier this month, a Texas judge in another bankruptcy case, *In re Chilton*, came to the opposite conclusion of the Minnesota judge.

The Texas judge ruled that inherited IRAs are not protected in bankruptcy because the funds in an inherited IRA "are not funds intended for retirement purposes." As evidence of that, the judge pointed out that under Internal Revenue Service rules governing inherited IRAs, debtor Janice Chilton, who is turning 52, would have to either begin taking annual distributions from the \$170,000 IRA she inherited from her mom this year, or deplete the entire IRA by 2013. (By contrast, there are elaborate IRS rules limiting when you can take money out of your own IRA without penalty before age 59.5.)

Similarly, in his appeal of the Minnesota ruling, the bankruptcy trustee is arguing that an inherited IRA should be fair game for creditors because the funds at issue are not the debtor's retirement funds. Rather, holders of inherited IRAs can withdraw the funds "regardless of their age or retirement status ... at any time without penalty," he wrote. Hannig disagrees. "Anyone who inherited money from a parent could use that money for their own future retirement," she told Forbes. "By retaining it in an inherited IRA, you're preserving that account for your future needs. Otherwise you could liquidate it and blow it." Protecting inherited IRAs from creditors is essential to the "fresh start" bankruptcy is supposed to provide debtors, she said.

Until it's clear that the favorable Minnesota ruling won't be overturned and will be followed in other courts, wealth advisers are playing it safe. Jennifer Voigt, a CPA and lawyer with Baker Tilly Virchow Krause in Green Bay, Wis., says her firm recommends using special trusts to protect inherited IRA assets from creditors and not relying on the state and federal bankruptcy exemptions until the law is clearer. (The trust is named as a "designated beneficiary" of the IRA and it contains special "spendthrift" language limiting how much power the owner has over the trust assets--and thus creditors' access to those assets.)