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Are Your Retirement Assets Protected from Creditors?

By Ed Slott, CPA

Given the extent of financial hardship inflicted by the COVID-19 pandemic, a rise in personal bankruptcies could be waiting in the wings. For those whose lives and livelihoods have been hit the hardest, it might be important to understand the creditor protections that apply to assets held in their retirement accounts.

> Retirement account owners should carefully consider the applicable state-level general creditor protections before rolling fully protected ERISA plan dollars into an IRA.

The extent to which assets are protected can vary significantly, depending on the type of account and applicable federal or state laws. Being aware of the details can help individuals in financial or legal jeopardy determine whether and/or when they should file for bankruptcy in order to preserve their retirement funds. It may also help them avoid costly rollover mistakes.

Employer Plans

Most employer-sponsored retirement plans, such as 401(k)s, provide virtually unlimited protection against both bankruptcy and non-bankruptcy general creditor claims under the Employee Retirement Income Security Act of 1974 (ERISA). An example of a general creditor claim is when a person files a lawsuit and wins a judgment in court against the account owner. Thanks to ERISA, creditors cannot attach retirement account funds to satisfy any debts or obligations, regardless of whether bankruptcy has been declared.

Solo 401(k) plans, which are often utilized by self-employed individuals and independent contractors, are not covered by ERISA. This means that solo 401(k) plans — along with other non-ERISA employer plans such as 403(b)s, 457(b) governmental plans, and SEP and SIMPLE IRAs — do not receive non-bankruptcy creditor protection under federal law, though they are fully protected from bankruptcy under the Bankruptcy Code. (Outside of bankruptcy, general creditor protection is based on state law.)

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If you have any questions about the topics in this newsletter or about your financial future, call us. We are available to help.

Gift vs. Inheritance: Consider the Tax Difference

Most people do not pay income tax on assets they inherit, but if they later sell inherited assets such as appreciated securities and real estate, they may owe tax on the capital gains. The capital gain or loss is the difference between the selling price and the asset's basis.

Thus, the basis can be an important factor when deciding whether you should gift assets now or transfer them to heirs upon your death.

What's the Basis?

Your basis in an asset is generally equal to the purchase price plus associated expenses (such as taxes and commissions on the transaction). Basis in real property may be adjusted upward for the cost of capital improvements or downward for depreciation taken for tax purposes and insurance reimbursements for casualty losses or theft.

If you are thinking about giving highly appreciated assets to your children, keep in mind that your basis will carry over with the gift. Let's say you bought shares of an investment for $50,000 (your basis) 20 years ago and they are worth $150,000 today. You would realize a capital gain of about $100,000 if you were to sell the shares.

If you give the shares to your children during your lifetime, they would keep the same $50,000 basis. When your children sell the shares, they could face substantial capital gains taxes — for the gains during your lifetime plus any additional gains that occur after they receive the gift.

However, if you leave the assets to your children in your estate, their basis will *step up* to the value at the time of your death. Your heirs would be liable only for taxes on any capital gains above the stepped-up basis, effectively erasing all capital gains that occurred during your lifetime.

Gift Tax and Other Factors

In addition to the potential for a stepped-up basis on inherited assets, you might consider the following when deciding whether to gift highly appreciated assets to your children or other family members.

Will making gifts reduce your combined gift and estate taxes? Gifted property is removed from your gross estate for federal estate tax purposes. A 40% tax rate applies to taxable estate assets exceeding the lifetime estate and gift tax exclusion ($11.7 million for individuals and $23.4 million for married couples filing jointly in 2021; indexed annually for inflation). This high threshold is scheduled to expire after 2025 and could fall earlier if the government needs to raise tax revenues in the future. Any gift over the annual exclusion amount ($15,000 for individual gifts or $30,000 for joint gifts) must be reported on a gift tax return, and it decreases the lifetime exclusion.

Does the recipient need the gift now, or can it wait? Could you gift cash or other property that would not trigger capital gains tax instead?

What tax rate might apply to capital gains on the sale of the asset? For example, if you or the recipient would pay a 0% rate on capital gains, there may be no benefit to waiting for a step-up in basis. On the other hand, if the recipient would be subject to a higher tax rate, you could gift the asset or sell it yourself and gift the cash proceeds.

Capital Gains Taxes

Capital gains and losses are classified as short term or long term, depending on how long you own the asset. A holding period of one year or less is short term; more than one year is long term. Inherited property is considered long term regardless of how long you own it. Short-term capital gains are taxed as ordinary income, whereas long-term gains are taxed at rates ranging from 0% to 20%, depending on taxable income.

2021 taxable income thresholds for long-term capital gains

Tax rate	Single filers	Married joint filers
0%	Up to $40,400	Up to $80,800
15%	$40,401 to $445,850	$80,801 to $501,600
20%	More than $445,850	More than $501,600

Because capital gains are included in net investment income, some taxpayers may also be subject to the 3.8% net investment income tax if their modified adjusted gross income exceeds $200,000 (single filers) or $250,000 (joint filers). Gains from certain assets, including coins, art, and other collectibles, may be taxed at higher rates.

Working While Receiving Social Security Benefits

Social Security has some 2,700 rules, and one of the most confusing and misunderstood is the retirement earnings test (RET).[1] Some people may think they can't work — or shouldn't work — while collecting Social Security benefits. But that's not the case. However, it's important to understand the RET and how it may affect your income.

- The RET applies only if you are working and receiving Social Security benefits *before* reaching full retirement age (see chart). Any earnings after reaching full retirement age do not affect your Social Security benefit.
- If you are under full retirement age for the entire year in which you work, $1 in benefits will be deducted for every $2 in gross wages or net self-employment income above the annual *exempt amount* ($18,960 in 2021). The RET does not apply to income from investments, pensions, or retirement accounts.
- A monthly limit applies during the year you file for benefits ($1,580 in 2021), unless you are self-employed and work more than 45 hours per month in your business (15 hours in a highly skilled business). For example, if you file for benefits starting in July, you could earn more than the annual limit from January to June and still receive full benefits if you do not earn more than the monthly limit from July through December.
- In the year you reach full retirement age, the reduction in benefits is $1 for every $3 earned above a higher annual exempt amount ($50,520 in 2021, or $4,210 per month if the monthly limit applies). Starting in the month you reach full retirement age, there is no limit on earnings or reduction in benefits.
- The Social Security Administration may withhold benefits as soon as it determines that your earnings are on track to surpass the exempt amount. The estimated amount will typically be deducted from your monthly benefit in full. For example, if your monthly benefit is $2,000 and the Social Security Administration determines that your benefits should be reduced by $6,000 for the year due to your earnings, three full monthly benefit payments may be withheld before you begin to receive benefits again.

FULL RETIREMENT AGE

Birth year	
1943–1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Note: If you were born on the first of a month, the SSA calculates your benefit and full retirement age as if you were born in the previous month. If you were born on January 1, it calculates as if you were born in December of the previous year.

- The RET applies to Social Security retirement benefits, spousal benefits, dependent benefits, and survivor benefits. Note that the RET may reduce a couple's combined monthly benefit when a spousal benefit — regardless of the spouse's age — is based on the benefit of a worker who is subject to the RET.

The RET might seem like a stiff penalty, but the deducted benefits are not really lost. Your Social Security benefit amount is recalculated after you reach full retirement age. For example, if you claimed benefits at age 62 and forfeited the equivalent of 12 months' worth of benefits by the time you reached full retirement age, your benefit would be recalculated as if you had claimed it at age 63 instead of 62. You would receive this higher benefit for the rest of your life, so you could end up receiving substantially more than the amount that was withheld. There is no adjustment for lost spousal benefits or for lost survivor benefits that are based on having a dependent child.

1) *InvestmentNews*, November 26, 2019

Signs of a Scam...and How to Resist It

Although scammers often target older people, consumers age 60 and older who encounter scams are actually less likely to lose money to fraud than younger people, perhaps because they have more financial experience. When older people do fall for a scam, however, they tend to have higher losses.[1]

Regardless of your age or financial knowledge, you can be certain that criminals are hatching schemes to separate you from your money. Here are four guidelines that may help identify a scam.[2]

Scammers pretend to be from an organization you know. They might claim to be from the IRS, the Social Security Administration, or a well-known agency or business. The IRS will never contact you by phone asking for money, and the Social Security Administration will never call to ask for your Social Security number or threaten your benefits. If you wonder whether a suspicious contact might be legitimate, contact the agency or business through a known number. Never provide personal or financial information in response to an unexpected contact.

Scammers present a problem or a prize. They might say you owe money, there's a problem with an account, a virus on your computer, an emergency in your family, or that you won money but have to pay a fee to receive it. If you aren't aware of owing money, you probably don't. If you didn't enter a contest, you can't win a prize — and you wouldn't have to pay for it if you did. If you are concerned about your account, call the financial institution directly. Computer problems? Contact the appropriate technical support. If your "grandchild" calls asking for help, ask questions only the grandchild would know and check with other family members.

Scammers pressure you to act immediately. They might say you will "miss out" on a great opportunity or be "in trouble" if you don't act now. Disengage immediately if you feel any pressure. A legitimate business will give you time to make a decision.

Scammers tell you to pay in a specific way. They may want you to send money through a wire transfer service or put funds on a gift card. Or they may send you a fake check, tell you to deposit it, and send them money. By the time you discover the check was fake, your money is gone. Never wire money or send a gift card to someone you don't know — it's like sending cash. And never pay money to receive money.

For more information, visit ***consumer.ftc.gov/features/scam-alerts***.

1–2) Federal Trade Commission, 2020

Ed Slott is a professional speaker and the creator of several public television specials, including "Retire Safe & Secure! with Ed Slott." He is the author of *The Retirement Savings Time Bomb...And How to Defuse It* and many other books about IRA planning.

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IRAs and Rollovers

Traditional and Roth IRA contributions and earnings are protected from bankruptcy up to $1,362,800 per person until April 1, 2022. This limit is for all accounts combined and is adjusted for inflation every three years. Rollovers from employer plans, including SEP and SIMPLE plans, do not count against this cap. However, the U.S. Supreme Court ruled unanimously that inherited IRAs are not protected under the Bankruptcy Code, as they do not contain retirement funds.

General creditor protection for traditional and Roth IRAs is based on individual state law, as it is with SEP and SIMPLE IRAs. For this reason, retirement account owners should carefully consider the applicable state-level general creditor protections before rolling fully protected ERISA plan dollars into an IRA. And those who change jobs should remember they may have two other options: Leave savings in the former employer's plan or transfer them to a new employer's plan, if allowed.

Unfortunately, retirement account withdrawals and pension benefits paid as income are no longer protected from bankruptcy, so creditors may wait patiently and stake a claim to retirement funds after they are withdrawn. Retirement account owners who are concerned about asset protection should be sure to seek the assistance of a qualified legal professional.