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Trusts & Estates Practice Group

How to Protect Retirement Accounts from Creditors (It May Be Time To Update Your Beneficiary Designation Forms)

Qualified Plans v. IRAs

Qualified plans such as 401(k)s and 403(b)s are exempt from most creditor claims under a federal law, the Employee Retirement Income Security Act (ERISA). The two creditors that can attack a qualified plan are the federal government (for unpaid taxes and restitution claims) and spouses for qualified domestic relations orders (QDROs) in connection with a claim for child support, alimony payments, or resolution of marital property rights.

IRAs are not protected from creditors under federal law but may be protected under state law. Most states have laws that protect certain retirement accounts from creditors. In Missouri, traditional IRAs, Roth IRAs, SEP IRAs, and SIMPLE IRAs are protected from creditors (but subject to the same exceptions explained above for qualified plans).

Account Owner v. Beneficiary

Most people want the assets they leave their beneficiaries to be protected from the beneficiaries' creditors. Qualified plans are protected from the account owner's creditors and are also protected from the beneficiary's creditors after the account owner dies. However, *after the account owner dies, for a number of reasons most qualified plans are rolled over to an IRA - therefore the recommendations below apply to both qualified plans and IRAs.*

There are only a handful of states (Alaska, Arizona, Florida, Missouri, North Carolina, Ohio, and Texas) where it is clear that an inherited IRA is protected from the beneficiary's creditors after the original account owner dies. Missouri amended its law in 2013 to clarify that inherited IRAs are protected, but this law generally only applies if you are sued in Missouri and are a resident of Missouri at the time you are sued.

State Law Creditors v. Bankruptcy

If you are sued directly by a creditor, then you look to the law of the state you live in to determine whether an IRA is protected from creditors. If you file for bankruptcy, you look to federal bankruptcy law to determine whether an IRA is protected (qualified plans are also protected from bankruptcy under ERISA).

Each state gets to choose between using the federal bankruptcy statutes

or the state's own exemptions. Missouri has "opted out" of the federal exemptions and uses its own exemption statutes. If Missouri law applies to a bankruptcy, then IRAs and inherited IRAs are protected. Missouri law generally applies to a bankruptcy if you have lived in Missouri for the 730 days immediately preceding the filing of bankruptcy.

In 2005, Congress passed a new provision of the Bankruptcy Code that applies even if a state has opted out of the federal exemptions. Under this bankruptcy provision, IRAs are protected (up to a maximum amount of $1,245,475 in 2014 and 2015) if it is a "retirement fund." Cases around the country were split on whether an IRA inherited by the beneficiary was still considered a "retirement fund" to the beneficiary. In June 2014, the U.S. Supreme Court in *Clark v. Rameker* decided that inherited IRAs were not retirement funds and therefore not protected in bankruptcy.

Spousal Rollover

To defer income taxes on withdrawals from IRAs, most individuals name the spouse as the primary beneficiary. Although not 100% clear, it appears an IRA rolled over by a spouse will have creditor protection in bankruptcy but the IRA will not be protected from the spouse's creditors if it is not rolled over (i.e. if the spouse takes the IRA as an inherited IRA).

Planning Implications

It is now clear inherited IRAs are not protected in bankruptcy unless you reside in a state that has opted out of the bankruptcy exemptions and your state of residency has a specific law that protects inherited IRAs. The problem is that you do not know where your family members (or other beneficiaries of your IRA) will be living if they are sued, so you can never be sure if the inherited IRA will be protected from their creditors under state law. To be certain your retirement accounts (IRAs and qualified plans) will be protected from your beneficiary's creditors, name a spendthrift trust as the beneficiary (a "spendthrift trust" is a trust that specifies that the beneficiary's interest in the trust cannot be involuntarily seized by a creditor) . It is clear under every state's law that spendthrift trusts are protected from most creditors of the trust beneficiaries (each state has different exceptions). If you currently name *individuals* as the beneficiaries of your retirement account, consider updating your estate plan to leave the retirement account to a spendthrift trust. To do this you will need to amend your revocable trust/will and complete a new beneficiary form. The trust must have very specific language to qualify for maximum income tax deferral.

After the account owner has died it is too late to use a trust. If you die naming an individual as beneficiary, the individual cannot transfer the IRA to a trust.

Avoid Naming Your Revocable Trust as Beneficiary

There are several problems with naming your revocable trust as beneficiary of your retirement plan. First, a revocable trust does not provide creditor protection (although a spendthrift trust created under the revocable trust can provide creditor protection). Second, to defer the income taxes on the retirement account assets for as long as possible you must name a very specific type of trust as beneficiary, a "see-through" trust. There are only two types of see-through trusts, conduit trusts and accumulation trusts, which have very specific requirements. A revocable trust will not qualify as a conduit trust or accumulation trust. Your revocable trust can create a see-through trust at your death, but *the beneficiary designation form should specifically name the see-through trust, not your revocable trust, as the beneficiary.*

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