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U.S. SUPREME COURT RULES INHERITED IRAS AREN'T PROTECTED IN BANKRUPTCY

Because of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Act), it's become more difficult for consumers to discharge certain debt obligations by filing for bankruptcy. While some provisions of the Act restrict the debtor's options in bankruptcy, the legislation does provide limited protection for assets in certain savings arrangements, including Traditional and Roth IRAs, Simplified Employee Pension (SEP) plans, and Savings Incentive Match Plan for Employees (SIMPLE) IRAs.

IRA Protection

Under the Act, Rollover, SEP, and SIMPLE IRAs are totally protected from creditors. The following are various protections:

- Traditional and Roth IRA assets may be exempted from a debtor's bankruptcy estate up to a limit of $1 million.
- SEP and SIMPLE IRA plan assets are not subject to the $1 million limitation (unlimited asset protection).
- Assets rolled into IRAs from employer-sponsored retirement plans, including SEP and SIMPLE IRAs, are totally exempt from creditors.

Inherited IRAs Not Protected

Unlike the IRAs noted above, an IRA that is inherited by a beneficiary after the death of the owner is not subject to the same protection. The following is an excerpt from Case No. 13-299, Clark v. Rameker, argued March 24, 2014 – decided June 12, 2014.

In October 2010, Ms. Heffron-Clark and her husband, Brandon Clark, filed a Chapter 7 bankruptcy petition. They identified an inherited IRA, by then worth roughly $300,000, as exempt from the bankruptcy estate. Heffron-Clark argued that an inherited IRA is still technically a retirement fund because that's the way it was originally set up.

The Bankruptcy Court disagreed and concluded that an inherited IRA does not share the same characteristics as a traditional IRA and disallowed the exemption.

The District Court reversed the decision, explaining that the exemption covers any account in which the funds were originally accumulated for retirement purposes.

The Supreme Court took up the case, reversed the District Court's decision, and resolved the split on the issue among federal appeals courts.

Opinion of the Court

When an individual files for bankruptcy, he or she may exempt particular categories of assets from the bankruptcy estate. One such category includes certain "retirement funds." The question presented is whether funds contained in an inherited individual retirement account (IRA) qualify as "retirement funds" within the meaning of this bankruptcy exemption. The Court determined that they do not.

When an individual debtor files a bankruptcy petition, his or her "legal or equitable interests in property" become part of the bankruptcy estate. "To help the debtor obtain a fresh start," however, the Bankruptcy Code allows debtors to exempt from the estate limited interests in certain kinds of property. The exemption at issue in this case allows debtors to protect "retirement funds to the extent those funds are in a fund or account that is exempt from taxation under Section 401, 403, 408, 408A, 414, 457, OR 501(a) of the Internal Revenue Code."

The enumerated sections of the Internal Revenue Code cover many types of accounts, three of which are relevant here. The first two are traditional and Roth IRAs in which both types of accounts offer tax advantages to encourage individuals to save for retirement. Legislation does provide limited protection under federal bankruptcy laws to these accounts.

The third type of account relevant here is an inherited IRA. An inherited IRA is a traditional or Roth IRA that has been inherited after its owner's death. It can also be established by beneficiaries of participants in employer-

sponsored plans who have directly rolled the inherited plan assets into an inherited IRA. If the heir is the owner's spouse, as is often the case, the spouse has a choice: He or she may "roll over" the IRA funds or retirement plan assets into his or her own IRA, or he or she may keep the assets in the form of an inherited IRA. When anyone other than the owner's spouse inherits, he or she may not roll over the funds into his or her own IRA; the only option is to maintain the assets as an inherited IRA and take Required Minimum Distributions (RMDs) when due. Also, unlike an IRA owner who is under the age of 59½ and who may be assessed a 10% penalty for taking premature distributions, an inherited IRA beneficiary may receive additional withdrawals from the IRA at any time, at any age, without penalty.

Relying on the "plain language of §522(b)(3)(C)," the court concluded that an inherited IRA "does not contain anyone's 'retirement funds," because unlike with a traditional IRA, the funds are not "segregated to meet the needs of, nor distributed on the occasion of, any person's retirement."

Note that this is just a brief summary of a long court battle, and to review a complete transcript of the case, see http://www.supremecourt.gov/opinions/13pdf/13-299_6k4c.pdf.

PENALTY-FREE IRA WITHDRAWALS

If an IRA owner wishes to take a distribution from an IRA before reaching age 59 ½, a 10% premature withdrawal penalty on the untaxed portion of that distribution is generally due. However, several exceptions to the general rule exist, and one such exception is found under IRC Sec. 72(t)(2)(A)(iv), or "Rule 72(t)." This rule allows IRA owners to receive predetermined distributions based on their life expectancy through a scheduled series of periodic payments (not less frequently than annually) that continue unaltered over a specified period of time.

These penalty-free withdrawals are also available to Qualified Retirement Plan (QRP) participants after they separate from service.

Distribution Methods

There are three basic methods by which payments will be considered to be substantially equal periodic payments:

1. **The Required Minimum Distribution (RMD) Method** – Using this method, payments are determined by dividing the individual's IRA or QRP balance by his or her single life expectancy factor, or a joint factor of the individual and the primary beneficiary. The factor to be used is selected from the single life expectancy table, the joint life and last survivor table, or the uniform lifetime table. Once a table is selected, that same table must be used to determine each subsequent year's distribution. The account balance that is used to determine payments must be determined in a reasonable manner based on the facts and circumstances.
2. **Fixed Amortization Method** – Under this method, the payments are determined by amortizing the IRA or QRP balance over the single life expectancy of the individual, the joint life expectancy of the individual and the designated beneficiary, or the life expectancy found in the uniform lifetime table. Any interest rate that is not more than 120% of the federal mid-term applicable federal rate, determined on the date payments begin, may be used.
3. **Fixed Annuitization Method** – The final method is to divide the IRA or QRP balance by an annuity factor. The factor is determined based on the present value of an annuity of $1 per year beginning at the individual's age attained in the first distribution year and continuing for the life of the individual. This factor is determined by using an interest rate of not more than 120% of the mid-term applicable federal rate on the date payments begin.

Payment Period

Once payments begin, they must continue for the later of a period of at least five years or until the day the IRA holder reaches age 59 ½. Note that no other additional distributions may be taken from the IRA during this period of time.

Changes to Account Balance

Under all three methods, 72(t) payments are calculated with respect to the account balance established prior to the first 72(t) payment. This means that a modification to the 72(t) program will occur if, after the starting date, there is:

- Any addition to the current account balance other than gains or losses;
- Any nontaxable transfer of a portion of the account balance to another retirement plan; or
- A rollover by the taxpayer of a 72(t) payment received resulting in such amount not being taxable.

Relief For Depreciating Accounts

Under Revenue Ruling 2002-62, if substantially equal periodic payments can no longer be supported by depreciated account balances, individuals are offered relief by:

1. Allowing a one-time switch to change the distribution method to the RMD method.
2. Allowing that a complete depletion of the IRA assets will not be treated as a "modification" of payments.

IRS Allows a One-Time Change

An individual who began distributions based on the amortization or annuitization method will be allowed in any subsequent year to switch to the RMD method for the year of the switch and for all subsequent years. This is a one-time only switch, and any subsequent change in method will be considered a modification of payments (subject to penalty).

Conclusion

There are specific IRS guidelines that govern the "substantially equal periodic payment" program, and once the program is initiated by an individual, it cannot stop (or be modified) until the conclusion of the required period. It is always recommended that individuals who are considering this program seek the aid of a competent tax advisor or attorney before making any decisions.

For detailed information, go to the irs.gov web site and type in Substantially Equal Periodic Payments in the "SEARCH" block.

QUALIFIED PLAN DISTRIBUTIONS PENALTY-FREE

It is well known that at age 59½ an employee may take a distribution from a retirement plan and not be subject to the 10% penalty tax. Not so well known are the provisions of the penalty exception at age 55.

If an ex-employee receives a distribution from a plan after separation from service and separation occurs during or after the year the employee attains age 55, the 10% penalty does not apply. So a 54-year-old taking a distribution is not subject to the penalty if she separated from service in the calendar year she turned 55. On the other hand, a 55-year-old taking a distribution cannot escape the 10% penalty if she separated from service at age 53.

The age 55 exception can be enjoyed by certain 54-year-olds but not certain 55-year-olds. No wonder it is often misunderstood.

OCTOBER 1 SIMPLE IRA DEADLINE

The SIMPLE IRA is a popular retirement plan for the small business owner who has 100 or fewer employees who earn at least $5,000 or more per year. In a SIMPLE IRA plan, all eligible employees are allowed to make pre-tax salary deferrals into an IRA account. In addition, the employer must either match dollar-for-dollar (not to exceed 3% of compensation) the deferral of participating employees, or make a non-elective 2% contribution for each eligible employee.

New Plans

October 1 is an important date for new SIMPLE plans, as there is a requirement that all new plans be established by October 1 of the year for which deferrals will be made. In addition, within a 60-day period preceding a plan year, the employer must allow eligible employees to make deferral elections (IRC Sec. 408(p)(5)(C)). **The 60-day election period for new plans must begin by October 1 to include 2014 deferrals.**

There is one exception to the October 1 establishment deadline. Newly established companies may open SIMPLE IRA plans as soon as administratively feasible to accept contributions immediately.

In conclusion, October 1 is just a few months away, and employers wishing to establish a SIMPLE IRA plan for 2014 should begin the process now. Plans established after this date are effective for 2015.

QUALIFIED DOMESTIC RELATIONS ORDERS

In general, ERISA and the Internal Revenue Code do not allow a plan participant to assign or alienate his/her interest in a retirement plan to another person. These “anti-assignment and alienation” rules are meant to assure that benefits will be available to participants in their retirement years. A limited exception to these rules is provided through qualified domestic relations orders (QDROs).

Every retirement plan is required to establish written procedures for determining whether domestic relations orders (DROs) are qualified and for administering distributions under QDROs. The plan administrator (generally the employer maintaining the plan) is required to make the determination within a reasonable period of time and to promptly notify the participant and each alternate payee when a determination is made. For a fee, plan administrators can get assistance from certain retirement plan recordkeepers in drafting a customized QDRO, determining whether a DRO is a QDRO, and communicating the order’s status to all parties and, if qualified, its approval to the alternate payee.

A DRO is a judgment, decree, or order (including the approval of a property settlement) that is made pursuant to state domestic relations law (including community property law) and that relates to the provision of child support, alimony payments, or marital property rights for the benefit of a spouse, former spouse, child, or other dependent of a participant.

A QDRO is a DRO which creates or recognizes the existence of an “alternate payee’s” (a spouse, former spouse, child, or other dependent of a participant) right to receive all or a portion of a participant’s benefits under a retirement plan. If an alternate payee is a minor or is legally incompetent, the QDRO can require payment to someone with legal responsibility, such as a guardian.

QDROs must contain the following information:

- The name and last known mailing address of the participant and each alternate payee;
- The name of each plan to which the order applies;
- The dollar amount or percentage (or the method of determining the amount or percentage) of the benefit to be paid to the alternate payee, and
- The number of payments or time period to which the order applies.

A QDRO may be included as part of a divorce decree or court-approved property settlement, or issued as a separate order. A QDRO can pertain to retirement benefits under more than one plan of the same or different employers as long as each plan and the assignment of benefit under each plan are clearly specified.

A QDRO cannot provide that benefits will be paid to an alternate payee before the participant’s “earliest retirement age” unless the plan permits payments at an earlier date.

An alternate payee will generally be considered a beneficiary under the plan for purposes of ERISA, and therefore, upon written request, be entitled to receive copies of a variety of plan documents. When benefit payments to the alternate payee begin, he/she will be treated as a “beneficiary receiving benefits under the plan” and automatically receive the summary plan description, summaries of material plan changes, and the plan’s summary annual report.

According to the DOL, more than 46 million workers are currently covered by employer-provided retirement plans. So understanding QDROs can be important in separation, divorce, and other domestic relations proceedings.

For more information on QDROs, see the Employee Benefits Security Administration’s (EBSA) booklet online at http://www.dol.gov/ebsa/publications/qdros.html.

PLAN DOCUMENTS TO BE RESTATED BY APRIL 30, 2016

All defined contribution plans must have their documents restated no later than April 30, 2016, to incorporate the provisions from the Pension Protection Act (PPA) of 2006 as well as several other

amendments that took effect between 2007 and 2011. It is an IRS requirement that each defined contribution plan document be updated and resubmitted for review and approval. (Defined benefit plan documents must be updated as well but are on a different cycle.) Plans that do not have their documents restated by the deadline can be disqualified and/or face significant financial penalties.

All qualified retirement plans are required to have a written document. Documents are either a Pre-Approved Plan document or an Individually Designed Plan (IDP) document. More than 80% of all plans use a Pre-Approved plan document. Pre-Approved plan documents are either considered prototype (PT) or volume submitter (VS) plans. Both types of pre-approved documents must be restated by April 30, 2016.

The less common Individually Designed Plan (IDP) is a document that is drafted by an attorney for a specific employer and tailored to meet the employer's specific needs. IDPs are the most flexible type of plan document and, as such, fall on a different cycle that must be restated every five years, based on the employer's Taxpayer Identification Number.

The restatement for all documents must incorporate any new laws from Congress as well as any guidance from the IRS through late 2010, including the following:

- The final Section 415 regulations
  - The Heroes Earnings Assistance and Relief Act (HEART)
  - The Worker, Retiree, and Employer Recovery Act (WRERA)
  - The Katrina Emergency Tax Relief Act of 2005 (KETRA)
  - The GULF Opportunity Zone Act of 2005 (GOZone)

The restatement will also need to incorporate any changes made in the document between the last restatement date and this restatement. Additionally, many plan sponsors find that restatements are a great time to make plan design changes that the plan trustees may have been contemplating.

After the plan document has been restated, it should be carefully reviewed. The actual operation of the plan must match that of the restated document; otherwise, it could jeopardize the qualified status of the plan. Also, a new Summary Plan Description (SPD) might need to be drafted to reflect the document changes in a language the average participant can understand. If a new SPD is created, it must to be distributed to all of the participants in the plan.

DOES YOUR PLAN NEED A CORPORATE TRUSTEE?

Every retirement plan must have its assets held in a trust, and as such, a trustee (or trustees) must be appointed. Generally, the duties of the trustee include having exclusive authority and discretion over the management and control of plan assets unless the plan document provides otherwise by, for example, delegating control over investment decisions to an "investment manager." The question is should the plan be "self-trusteed" by a key employee or group of employees or have a corporate trustee? This decision should depend on the circumstances and preferences of the company and its retirement plan.

If your plan has an Individually Designed Plan (IDP) document, a self-trustee might be the only option. IDP documents allow for more flexibility in plan design, and many corporate trustees will only serve for plans that adopt the corporate trustee's own prototype document. Similarly, a self-trusteed plan has more flexibility when choosing investments and investment managers. With a corporate trustee that is also responsible for investing plan assets in its own investment platform, it is more difficult to change trustees when desired.

A bank or trust company will charge a fee for its trustee services, usually ranging from $500 to $1,000 annually. At times, there is no direct fee assessed by the corporate trustee, so that it appears to be a free service but is likely being charged indirectly or bundled with recordkeeping services. Unless the company decides to compensate key employees to serve as trustee, which is uncommon, there would be no explicit expense to self-trustee the plan.

When a plan has 100 or more participants, regulations require that the plan be audited by an independent firm. Corporate trustees will provide certified trust statements that are necessary for such audits, whereas this responsibility would fall on key employees if the plan is self-trusteed.

Corporate trustees can eliminate potential conflicts of interest that might exist if the business owner is also the plan's trustee. Furthermore, corporate trustees provide an extra layer of protection between business owners and the plan assets by reducing potential concerns that the plan assets won't be used for the exclusive benefit of plan participants and their beneficiaries. However, this does not eliminate the fiduciary liability of the employer, as the employer still has a responsibility and liability to oversee the trustee.

Many larger employers, and a few smaller ones, prefer to hire corporate trustees instead of worrying about issues for which they have little or no expertise. It is also possible that the Third-Party Administrator (TPA) will perform some of the services required of trustees and the employer's responsibilities as a trustee would lessen. Regardless, if deciding to self-trustee or utilize a corporate trustee, employers are encouraged to have all documents pertaining to trustee services and all other plan-related issues reviewed by legal counsel well versed in retirement plan law.

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