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IRAs: Are They Protected from Claims of Creditors?

Clients and their financial advisors often ask whether the "rollover" of investments held in a 401(k) plan to an IRA makes those funds subject to the claims of creditors. Some have been told that funds transferred to a new IRA are now fully subject to claims of the owner's creditors, while others believed they were as fully protected as the original 401(k) plan assets. There is understandable confusion about this issue, partly due to the differences between federal and state law on the subject, not to mention the recent changes in those laws. Simply put, the answer is that IRAs funded with assets by direct rollover from an employer-sponsored plan are indeed fully exempt from claims of creditors. While traditional and Roth IRAs are not fully exempt, they do benefit from some special creditor protections under both federal and state law, which are described briefly in this Article.

Federal Statutory Background. The Employee Retirement Income Security Act of 1974 ("ERISA") provides that an individual's interest in a qualified retirement plan, such as a profit-sharing plan, money purchase pension plan, 401(k) plan or other similar employer-sponsored plan, may not be assigned or alienated. In Patterson v. Shumate, 504 U.S. 753, 112 S. Ct. 2242, 119 L. Ed. 2d 519 (1992), the United States Supreme Court confirmed that the "anti-alienation" provisions of ERISA represent enforceable restrictions upon the rights of creditors to reach an individual's interest in a qualified retirement plan. As a result, qualified retirement plans cannot be used by creditors to satisfy judgments. However, individual retirement accounts (IRAs) do not enjoy the same unlimited protection under ERISA that is afforded to employer-sponsored qualified retirement plans.

In addition to the protections afforded to qualified plans under ERISA, Federal bankruptcy law provides an unlimited exemption from creditor process for retirement accounts which are exempt from taxation under certain sections of the Internal Revenue Code. This definition necessarily includes all ERISA plans and all non-ERISA plans which are exempt from taxation. However, for those traditional and Roth IRAs established under Internal Revenue Code sections 408 or 408A (other than SEP and SIMPLE accounts), the exemption is limited to $1,095,000 (indexed for inflation). Thus, while employer-sponsored retirement plans, as well as IRAs funded with those plan assets by way of roll-over, cannot be considered assets in an individual's estate in bankruptcy, the traditional and Roth IRA are provided with a generous exemption, but not full protection.

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State Statutory Protections. While Virginia has its own set of bankruptcy exemptions (we are an "opt out" jurisdiction), the General Assembly has seen fit to apply the Federal bankruptcy exemptions as they pertain to "retirement plans" through the recently revised Section 34-34 of the Virginia Code.

Virginia Code Section 34-34(B) exempts, from all forms of creditor process, the interest of an individual under a retirement plan to the same extent a retirement plan is exempt under Federal bankruptcy law. Moreover, the exemption applies whether the individual has an interest in the retirement plan as a participant, beneficiary, contingent annuitant, alternate payee, or otherwise. Under this statute, the term, "retirement plan," means a plan, account, or arrangement that is intended to satisfy the requirements of Internal Revenue Code Sections 401, 403(a), 403(b), 408, 408A, 409 or 457. Whether a plan, account, or arrangement is intended to satisfy the requirements of one of the foregoing provisions is determined based on all of the relevant facts and circumstances including, but not limited to, the issuance of a favorable determination letter by the Internal Revenue Service, reports or returns filed with United States or state agencies, and communications from the plan sponsor to participants.

The exemption from creditors' claims under Section 34-34 is not automatic, but must be claimed within certain time limits. Section 34-17 provides that the claim for exemption may be made at any time "before it is subjected to sale under creditor process," or if no sale is required, "before it is turned over to the creditor." In case of a bankruptcy, the exemption must be claimed no later than five days after the creditors' meeting held in the course of the bankruptcy. In addition to timing limitations, retirement plans are not protected from claims for child and/or spousal support.

Summary and Recommendations. ERISA plans (e.g., 401(k) plans) which are rolled over to IRAs continue to enjoy their unlimited ERISA protection and Federal exemption in bankruptcy. In order to maintain these unlimited creditor protections (and avoid being subject to the $1,095,000 limitation), it is strongly recommended that (1) investments rolled over from an employer-sponsored, qualified retirement plan not be commingled with an existing traditional or Roth IRA account, and (2) the newly-established roll-over account be titled accurately so as to clarify that it was funded with qualified plan assets. Failure to take these steps is likely to result in a loss of the unlimited protections of ERISA and Federal bankruptcy law.