

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 had been told the new IRA funds 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. The answer is that roll-over IRAs are indeed fully exempt, and while traditional and Roth IRAs are not, there are some special creditor protections for them under both federal and state law.

Statutory Background. The Employee Retirement and Security Act of 1974 (“ERISA”) provides that an individual’s interest in a qualified retirement plan, such as a profit-sharing 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 and cannot be considered as an asset in an individual’s estate in bankruptcy.

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 ERISA protections afforded to qualified plans, 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 \$1,171,650 (indexed for inflation).for 2011?

While Virginia has its own set of bankruptcy exemptions (we are an “opt out” jurisdiction), the Commonwealth has wisely adopted the Federal bankruptcy protections for “retirement plans” through the revised Section 34-34 of the Virginia Code.

State Statutory Protections. 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. “The exemption provided by this section shall be available whether such individual has an interest in the retirement plan

IRAs: Are They Protected from Claims of Creditors? (cont.)

as a participant, beneficiary, contingent annuitant, alternate payee, or otherwise.” The exemption from creditors’ claims is not automatic. It must be claimed 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. In addition to timing limitations, retirement plans are not protected from claims for child and/or spousal support.

Planning Pointer. When an ERISA retirement plan (i.e., 401(k) plan) account is “rolled over” into an IRA, the account maintains the unlimited creditor protections under ERISA and Federal bankruptcy laws. In order to maintain these protections, and avoid the \$1,171,650 limitation, the roll-over IRA account must not be commingled with a “traditional” IRA, and it should be titled specifically so as to identify clearly the source of the roll-over IRA.

Notice - This information is not legal advice or counsel absent an extant attorney-client relationship with the recipient; this information does not create an attorney-client relationship. Seek legal counsel before taking any action on the matters referenced above.