There have been a number of news articles lately that have reported on rulings affecting Individual Retirement Accounts. We thought this would be a good opportunity to provide a brief summary of those reports to make our readers aware of how these rulings may affect them.

Multiple Rollovers of IRA’s.

As a result of a recent Tax Court case (Alvan L. Bobrow v. Comm’r., Jan. 28, 2014) an IRA owner who takes a distribution from an IRA and rolls it over into an IRA cannot do so again within one year, either from the same IRA or a different IRA. However, the IRS will allow IRA owners to rollover accounts from separate IRAs until the end of 2014.

Alvan Bobrow, a tax lawyer, withdrew $65,064 from his traditional IRA on April 12, 2008. On June 6, 2008, he withdrew another $65,064 from his rollover IRA. On June 10, 2008, he put $65,064 back into his traditional IRA. On August 4, 2008, Alvan put $65,064 back into his rollover IRA. The IRS attempted to cross Alvan’s repayments treating the August 4, 2008 deposit as a repayment of the April 4, 2008 distribution, so that it would have been beyond the 60-day deadline. Alvan argued that he rolled over each IRA distribution within 60 days.

IRS Code Section 408(d)(3)(B) permits tax-free treatment for an IRA that is rolled over to a new/replacement IRA “if at any time during the 1-year period ending on the day of such receipt such individual received any other amount described in that subparagraph from an [IRA] which was not includable in his gross income because of the application of this paragraph.”

Alvan argued that Section 408(d)(3)(B) only applies to multiple rollovers from the same IRA. The Tax Court’s decision interpreted Section 408(d)(3)(B) on an aggregate basis.

Interestingly, proposed (but not final) IRS Regulations and IRS Publication 590 applied the same interpretation as Alvan. As a result of this Tax Court Case, the IRS acknowledged in Announcement 2014-15 that the proposed regulations and Publication 590 apply the
limitation on an IRA-by-IRA basis; however, since the Tax Court interpreted Section 408(d)(3)(B) on an aggregate basis, the Court’s interpretation prevails and any rollover that involves an IRA distribution occurring after January 1, 2015 will be subject to the Tax Court’s interpretation.

Bottom line – when moving funds between multiple IRAs, your best course of action is to make a direct, trustee-to-trustee transfer as authorized in IRS Revenue Ruling 78-406. Transferring funds directly between Trustees of multiple or replacement IRAs would not result in a “distribution” within the meaning of IRC Sec. 408(d)(3)(A) and would not be considered “rollover contributions.”

The U.S. Supreme Court ruled that Inherited IRAs are not exempt from Bankruptcy.

The Supreme Court has unanimously ruled that Inherited IRAs are subject to the claims of creditors of a person who declares bankruptcy. Clark v. Rameker, Trustee (June 12, 2014).

Background: The account owner (mother) of an Individual Retirement Account died after naming her daughter as the sole beneficiary of the account upon the mother’s death. The account became an Inherited IRA held by the designated beneficiary (daughter) following the mother’s death. The daughter and the daughter’s husband subsequently filed for Chapter 7 bankruptcy.

Bankruptcy Code §522(b)(3)(C) permits a debtor to exempt amounts that are both (1) “retirement funds,” and (2) exempt from income tax under one of several IRS Code sections. Accordingly, the daughter and the daughters’ husband claimed an exemption for the Inherited IRA, claiming that it was not subject to their creditors in bankruptcy.

The Bankruptcy Trustee (who is responsible for disposing of the couple’s estate pursuant to the Bankruptcy Code) and the couple’s unsecured creditors objected to the claimed exemption. They argued that the funds in the Inherited IRA did not fall within the definition of “retirement funds” under the Bankruptcy Code.

This case focused on whether a person filing for Chapter 7 bankruptcy should be able to exempt from his or her bankruptcy estate an IRA account that the person had inherited.
The Court questioned whether the daughter’s Inherited IRA was a “retirement fund” once the daughter inherited the account. The bankruptcy code does not define “retirement fund.” The Supreme Court determined that funds in an Inherited IRA cease to be “retirement funds” once the account owner dies. The Court applied what it identified as the “ordinary meaning” of the term; i.e., “sums of money set aside for the day an individual stops working.” In determining whether the Inherited IRA qualifies as “retirement funds” the Court identified the following in support of its conclusion that funds in an Inherited IRA “are not objectively set aside for the purpose of retirement.”

- Unlike traditional IRAs or Roth IRAs, there are no tax incentives for the owner of an Inherited IRA to make regular contributions.

- The owner of an Inherited IRA is required to withdraw funds from the account regardless of whether the account owner is retired or not.

- While there is a withdrawal penalty when amounts are withdrawn from a traditional or Roth IRA before the account owner turns 59½ years, the account owner of an Inherited IRA may withdraw any or all of the funds from the account without any withdrawal penalty. While the account owner of an Inherited IRA may face a significant income tax liability in doing so, the funds held in an Inherited IRA can otherwise be consumed freely.

The Supreme Court stated that its ruling is consistent with the legislative intent of the exemptions provided under the Bankruptcy Code, namely “to effectuate a careful balance between the interests of creditors and debtors.” On the one hand, allowing a debtor to protect a Traditional or Roth IRA helps to ensure that the debtor will be able to meet his or her basic needs during retirement and not become a burden on the government. On the other hand, the owner of an Inherited IRA is not precluded from consuming the entire balance of the account immediately after exiting bankruptcy.

Given these distinctions, the Supreme Court found that allowing Inherited IRAs to fall within the Bankruptcy Code exemption for “retirement funds” would turn the ability for a bankrupt person to make a “fresh start” and instead provide the bankrupt person with a “free pass.”

Lemons into Lemonade…. 

While the Supreme Court’s ruling produced a negative result for the bankrupt couple, the decision could do more good than harm. It is now more important than ever for estate planning attorneys and financial advisors to assist their clients in structuring the beneficiary designations for traditional IRAs and Roth IRAs to name properly structured IRA “Accumulation Trusts.” Accumulation Trusts can be structured to receive Inherited IRAs without the assets in the account being subject to the claims of creditors. Accumulation Trusts were discussed in detail in a prior edition of the Understanding Investments Journal. If you would like to request a reprint, please e-mail the author at mbartram@chartertrust.com, and we would be pleased to send a copy to you or discuss any questions you may have.

Nota Bene

N.B. Debtors who are domiciled in states like Florida, Arizona, Alaska, and Texas that provide express statutory creditor protection for Inherited IRAs will not be impacted by the Supreme Court decision if they qualify to file bankruptcy in their state of domicile.