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NEWSLETTER

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FIRM NEWS:

In July, attorney DeEtte Loeffler took a Crew of Scouts on a 12-day high adventure backpacking trip at Philmont Scout Ranch in Cimarron, New Mexico. The Venturers backpacked 60 miles in bear country at 6,000-12,000 feet while engaging in activities such as firing black powder rifles, spar pole climbing, blacksmithing, skeet shooting, horseback riding, burro racing and touring an old gold mine. It was the adventure of a lifetime. DeEtte is an Associate Advisor for Crew 500, a co-ed Venturing Crew out of Point Loma. Venturing is a program of the Boy Scouts of America, open to teens between the ages of 13 and 20.

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INHERITED IRAS: UNCERTAINTY REIGNS AS TO PROTECTION IN BANKRUPTCY

Bradford N. Dewan, Esq.

The size of Individual Retirement Accounts ("IRAs") can be quite significant, perhaps tens of thousands but maybe hundreds of thousands, or even several millions of dollars. This results from an individual rolling over the funds from a qualified retirement plan into an IRA upon retiring or upon changing employers. Congress had a very specific purpose when it created IRAs. Just as with qualified retirement plans formed under Section 401 of the Internal Revenue Code, IRAs created under Section 408 are designed to provide the IRA owner with financial resources during retirement.

In order to protect this financial resource for use in retirement, Congress decided that funds in an IRA or qualified retirement plan need not be used to pay pre-retirement debts. This policy is implemented through two sections of the U.S. Bankruptcy Code, namely 11 U.S.C. Sections 522(b)(3)(C) and (d)(12), which exempt "retirement funds" from creditors' claims in bankruptcy. These two sections are identical. Each exempts from creditors' claims any "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under sections 401, 403, 408, 408A, 414, 457 or 501(a) of the Internal Revenue Code." It is clear that an IRA by which a person provides for his or her own retirement meets this requirement. Importantly, if a married holder of an IRA dies, the decedent's spouse inherits the account and can keep it separate or roll it over into his or her own IRA. Either way, it is pretty clear that the funds remain as "retirement funds" in the same sense as for the original owner of the IRA: the surviving spouse cannot withdraw any of the money before age 59 ½ without paying a tax penalty and must start taking withdrawals no later than the year in which the survivor reaches age 70 ½.

But this scenario changes when the IRA owner names a "non-spouse" as the primary beneficiary of the IRA. This is typically the children of the IRA owner and generally occurs when the spouse has predeceased the IRA owner or there has been a divorce. This type of IRA is referred to as an "Inherited IRA." See IRC section 408(d)(3)(C).

The Seventh Circuit of the US Court of Appeals, in the case of *Rameker v. Clark*, recently determined that an Inherited IRA does not qualify as a "retirement fund" and therefore is not an exempt asset in bankruptcy. See No. 12-1241 & 12-1255, United States Court of Appeals (7th Cir. 2013).

<u>FACTS</u>

At her death in 2001, Ruth Heffron owned an IRA worth approximately $300,000. Ruth's daughter, Heidi Heffron-Clark, was the designated beneficiary on the IRA account. Upon Ruth's death, the account passed to Heidi. While not mentioned in the opinion, it probably can be assumed that the transfer of funds from Ruth's IRA account to the Inherited IRA for Heidi was done correctly so that the title of the Inherited IRA was likely "Ruth Heffron (deceased) FBO Heidi Heffron-Clark IRA". Without this "correct" titling of the Inherited IRA account, the full amount of Ruth's IRA would have been taxed to Heidi as a complete taxable distribution from Ruth's IRA.

In 2010 Heidi and her husband filed for bankruptcy and claimed the Inherited IRA as an exempt asset under both Wisconsin and federal law. The Bankruptcy Judge disagreed, and held that the Inherited IRA did not represent "retirement funds" in the hands of Heidi and thus was not exempt under Sections 522(b)(3)(C) and (d)(12) referenced above. This decision was based on the view that money counts as "retirement funds" (a term that the Bankruptcy Code does not define) only when such funds are held for the owner's retirement, while an Inherited IRA must be distributed earlier.

The federal district judge reversed and adopted the view first articulated in *In Re Nessa* (426 B.R. 312 (BAP 8th Cir. 2010)) that any money representing "retirement funds" in the decedent's hands must be treated the same way in the successor's hands. [Note: The Fifth Circuit in *In Re Chilton* (674 F.3d 486 (5th Cir. 2012)) agreed with that approach, in observing that sections 522(b)(3)(C) and (d)(12) refer to "retirement funds" without providing that such funds must be the debtor's "retirement funds". Thus *Chilton* concludes that it is enough if such funds were ever someone's retirement funds in order for this requirement to be satisfied.]

<u>ANALYSIS</u>

___The Seventh Circuit Court of Appeals based its decision on the several different rules that apply to an Inherited IRA but not to regular IRAs. First, while the funds in the Inherited IRA are sheltered from taxation until the money is withdrawn, the beneficiary of an Inherited IRA may not make any new contributions to the Inherited IRA account. Second, the funds in an Inherited IRA cannot be rolled over into any IRA account of the beneficiary of the Inherited IRA (or any other account). <u>See</u> IRC Section 408(d)(3)(C). Finally, and maybe most importantly, the owner of the Inherited IRA must begin taking distributions from the Inherited IRA in the year immediately following the year of the IRA owner's death. <u>See</u> IRC Section 402(c)(11)(A), incorporating <u>IRC</u> Section 401(a)(9)(B). Consequently, from the Court's perspective, an Inherited IRA is a "time-limited tax-deferral vehicle" rather than a "place to hold wealth for use after the new owner's retirement." Thus, although the Inherited IRA remains a tax-deferral vehicle until the mandatory distributions are completed, these distributions will likely precede the retirement of the owner of the Inherited IRA.

The Court noted that *Chilton* gave weight to the phrase "inherited individual retirement account" since this phrase included the word "retirement." But the Court's view was that the "IRA" part of "Inherited IRA" (as the Internal Revenue Code uses the phrase) designates the fund's *source*, but not the assets current status. The Court stated: "(A)n inherited IRA does not have the economic attributes of a retirement vehicle, because the money cannot be held in the account until the current owner's retirement."

In its conclusion, the Court stated: "The district judge (which had reversed the bankruptcy decision) thought the question close (i.e. whether the exemption applied or not) and believed that close questions should be decided in debtors' favor. We do not think the question close; inherited IRAs represent an opportunity for current consumption, not a fund of retirement savings."

Planning Strategy

With this uncertainty as to whether the funds of an Inherited IRA will be protected in bankruptcy, the owners of IRA accounts with significant value may well give serious consideration to forming a trust to name as the beneficiary of the IRA rather than the owner's son or daughter personally. These trusts, sometimes referred to as IRA Beneficiary Trusts or IRA Standalone Trusts, can protect the assets of the Inherited IRA from the creditors of the child until actual distributions of funds occur. Indeed, if the trust is structured as an "accumulation" trust (which gives the trustee the discretion whether or not to pass the distributions from the Inherited IRA to the child/beneficiary) even greater protection is provided since the trustee may decide not to make a distribution if a creditor is simply waiting to receive it.

Finally, it should be noted that in 2003 the U.S. Bankruptcy Court for the Southern District of California, in *In re Greenfield* (289 B.R. 146 (2003)), determined that the exemptions under California Law in bankruptcy were not available to the beneficiary of an Inherited IRA. However, it is not clear how the Ninth Circuit Court of Appeals would resolve this issue once presented with it.

PREPARING FOR COLLEGE, FINANCIALLY AND LEGALLY

DeEtte L. Loeffler, JD, LL.M Taxation

If you have a child heading off (or back) to college, summer is a great opportunity to get them financially and legally prepared to go. Having certain legal documents in place now will make the separation easier for both you and your child.

We recommend you establish a bank account with your child which you can access and monitor. Many college age adults do not pay adequate attention to accounts and can overdraw them, incurring unnecessary fees.

Your child will need a credit card too, to simplify payment of expenses. Credit cards can be established either jointly (not recommended) or in the student's name only. Obtaining a card in the child's name alone can help him or her to establish a credit history. Some companies allow you to put a prepaid amount on the card, thus limiting spending. We recommend you be added as an additional person who can view and pay the card as necessary to avoid later problems with your child's credit.

It is also recommended that your child sign a general power of attorney for financial purposes, allowing you to deal with any unforeseen financial issues while he or she is away at school.

Finally, we recommend your child sign both an Advance Health Care Directive (i.e., a health care power of attorney) and a HIPAA waiver to allow the college or university medical staff to contact you and discuss with you any medical emergencies your child may experience while away at school. In the event your child is injured or too ill to make medical decisions for hims/herself, such documents will allow you to act on your child's behalf.

Young adults walk a fine line of newly acquired independence and continuing dependence on their parents to assist in a crisis. Obtaining the financial and legal documents set forth above will allow your child to continue to develop his or her independence while allowing you to quickly help in the event of a crisis.

STATE TAX NEWS

California eliminated its business enterprise zones in favor of three new programs to encourage business growth and investment. Starting in 2014, the California Competes Credit will provide $750 million toward 3 programs to include: (1) a sales tax exemption for manufacturing equipment, as well as for research and development equipment for biotech companies; (2) a hiring credit for "challenged areas" (which will include those areas covered by the former enterprise zones until 2021), and (3) a new agency to oversee tax incentives for corporations and small businesses.

On July 1, the state excise tax on gasoline rose another 3.5 cents a gallon, bringing the overall taxes (federal, state and local) on a gallon of gas to

72 cents, the highest in the nation. The tax increase occurred under a 2010 law which requires the state to collect the same amount of this tax on gasoline annually. With consumption down, the Board of Equalization was required to raise the excise tax.

FEDERAL LEGISLATIVE UPDATE

Key leaders in the Senate and House of Representatives continue to push for federal income tax reform. On June 27, 2013, Senate Finance Committee Chairman Max Baucus, D-Mont., and House Ways and Means Chairman Dave Camp, R-Mich., proposed simplifying the tax code by eliminating all tax expenditures, deductions and credits (a "blank slate" approach). Tax expenditures do not appear in the annual federal budget but significantly reduce federal revenue each year. Under the proposal, expenditures, credits and deductions would only be allowed back into the tax code if they can be shown to (1) help grow the economy, (2) make the tax code fairer, or (3) effectively promote other important policy objectives.

This proposal would initially eliminate such popular tax benefits as (i) employer sponsored health insurance, (ii) deductions for pension contributions, (iii) home mortgage interest deductions, (iv) charitable deductions, (v) the child tax credit and (vi) the earned income tax credit. The goal of the blank slate approach is not to eliminate all tax credits and expenditures, but to require the legislature to reconsider the benefit of each one before it is readmitted. Unfortunately, no Senators appear willing to take the political risk of being the first to submit a proposal. In addition, on July 25, 2013 Senate Majority Leader Harry Reid indicated that he would not consider the blank slate proposal or any other tax reform plan unless it includes significant revenue increases.

The deadline for proposed additions to the Code was July 26, 2013. After several Senators publically declined to participate, on July 19, 2013 Senators Baucus and Camp offered to protect any submissions from disclosure for 50 years. However, no proposals were submitted. Senator Reid's declaration may have effectively terminated the blank slate plan for the time being.

If you would like to receive further information regarding the topics in this or past newsletter, or if you would like to let us know any issues or topics you would like to see addressed in future newsletters, please contact us at (619) 239-7777 or newsletter@mmpph.com.

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