NEW BANKRUPTCY LAW PROTECTS IRAs

On April 20, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPA). The new law generally makes it tougher for people to protect their assets, but there are some exceptions. For instance, IRAs, fast becoming the biggest asset people have, actually receive more protection under the new law, which takes effect on October 17, 2005

Under the new law, up to $1 million of assets held in a traditional IRA and Roth IRA, or a larger amount determined by the bankruptcy court "in the interests of justice," will be exempt from the IRA owner's bankruptcy estate.

What's more, IRA assets that came from an employer retirement plan rollover (such as a 401(k), 403(b), or profit-sharing plan) will not be subject to the claims of the IRA owner's creditors, regardless of the state in which the IRA owner resides or the value of rollover assets and their subsequent growth.

BAPA has other details to digest as well. For instance, the new law also reinforces the unlimited protection for 401(k) plans, 457 plans, 403(b) plans, governmental plans, and tax-exempt organization retirement plans, and adds to the list exemptions from the bankruptcy estate for SEP-IRAs, SIMPLE IRAs, Keogh plans and solo 401(k) plans. And given unlimited bankruptcy creditor protection, such retirement accounts are likely to become even more attractive retirement-savings vehicles in years to come.

Also, retirement funds in transit from one IRA or retirement account to another are also protected under the new bankruptcy law. The law even provides protection if funds are withdrawn from an IRA and rolled over within 60 days back into an IRA or retirement account.

But not all facets of IRAs are protected. For instance, required minimum distributions, 72(t) distributions, and hardship distributions are not protected under BAPA. Once money is withdrawn from a plan it is no longer protected.

What's more, the new law provides greater creditor protection for IRA assets, but only in bankruptcy. They do not apply to judgments awarded in other courts where state creditor protection laws will apply. And BAPA will not stop a divorcing spouse from taking a share of the pension.

So what's the significance of the new law? First, the new law creates clarity where there had been confusion. Prior to BAPA, it was difficult to determine how a person's IRA would be exempt from claims of his or her creditors if they filed for personal bankruptcy. There was such a confusing mix of federal and state laws and court cases that a person did not know whether or how much of his/her "rollover" IRA would be subject to claims of creditors. That is no longer the case. Of note: IRA owners who live in states that have poor IRA creditor protection benefit most from the new law.

One implication of the new law: Investors may want to keep IRAs that are funded with rollover contributions separate from IRAs funded with annual contributions. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 made obsolete the need to create a conduit IRA, but the new law provides an incentive to have separate IRAs – an IRA funded with rollovers and one funded with contributions. To commingle rollover and contributory IRA assets would make it difficult to identify which portion of the IRA represented assets that are "unlimited protection" rollovers (plus earnings) and which portion represented IRA contributions and earnings (subject to the $1 million limitation).

The new law also encourages investors to rollover their 401(k) to an IRA after they leave an employer. Prior to BAPA, investors often left their funds in their former employer's 401(k) plan since such plans were fully protected from bankruptcy. But now 401(k) plans and IRAs have near equal protection from creditor claims, so there's less reason to leave such funds behind.

Of note, there are some good reasons to transfer funds from a 401(k) to an IRA. For instance, transferring a 401(k) to an IRA not only broadens investment options, but also may open the door to create what some refer to as a "stretch IRA", an IRA that continues to grow tax-deferred over the life of its beneficiaries. The downside to leaving money in a 401(k) plan is that oftentimes money in such plans must be immediately distributed to beneficiaries after the plan participant dies, eliminating any chance of the plan participant creating a stretch IRA.

But there are some good reasons to leave the money in a 401(k). For instance, qualified retirement plans are protected under ERISA, which extends to judgments other than bankruptcy, regardless of your state law.

Like all new laws, BAPA will likely be challenged at some point by creditors in the courts. So it would be considered prudent to seek the advice of your financial planner and a bankruptcy attorney, and frequently review any legal challenges and clarifications issued by federal authorities including the Internal Revenue Service (IRS) or Department of Treasury.

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