IRAs and bankruptcy

In personal bankruptcy proceedings, the general rule is that IRAs and other qualified retirement assets are protected; they not subject to the claims of the individual's creditors. However, a recent Florida court case showed that every rule has its exceptions.

Ernest Willis filed for bankruptcy in 2007. Among his assets were a $1.2 million Merrill Lynch IRA and two smaller IRAs of less than $150,000 each. The IRAs had favorable determination letters from the IRS, which created a presumption that they would be exempt from the claims of Willis' creditors. However, the bankruptcy court ruled that the creditors had an opportunity to rebut that presumption, which they did.

In December 1993 Willis took a $700,000 distribution from the Merrill Lynch IRA to take care of a delinquent mortgage on property that he owned with his wife. The money was returned to the IRA in February 1994, 64 days later. Had the money been restored to the IRA within 60 days, there would have been no problem. However, because Willis crossed the 60-day line, the bankruptcy court ruled that the loan was a prohibited transaction, one that cost the IRA its tax-qualified status. The entire $700,000 should have become a taxable distribution, and the redeposit of the money should have been penalized as an excess contribution. However, the IRS never noticed the problem. Nevertheless, the bankruptcy court now holds that because the IRA ceased being a qualified retirement plan in 1993, it was no longer a protected asset in bankrupcy.

What's more, in 1997 Willis made a series of eight transfers between his regular brokerage account and the Merrill Lynch IRA. Transfers from the IRA were all returned to it within 60 days, but the tax law allows for only one 60-day rollover per year. The Court held that this "check-swapping" scheme also amounted to prohibited borrowing from the IRA, so that if the IRA hadn't become invalid in 1993, it certainly did become so in 1997.

The other two IRAs were traceable to funds received from the Merrill Lynch IRA after 1997, so they were similarly unprotected.

The statute of limitations has run for the 1993 and 1997 tax years, so the IRS isn't likely to get the tax money that arguably came due then. But the shield created by the lapse of time with respect to the tax claims offers no protection in the bankruptcy context. Thus, it's important to handle tax-qualified assets with utmost care, to be certain that they will be available during retirement.

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