State and Federal Exemption of Inherited IRAs and IRA to Roth Conversions, Recharacterizations and Reconversions

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I. Recent Change to Florida Statute § 222.21

1. History of Florida Statute § 222.21

   a. Florida Statute § 222.21 was enacted in 1987 with the intent to exempt all interests of a beneficiary of all retirement accounts. Prior to the new legislation the applicable provisions stated as follows:

      i. "(2)(a) Except as provided in paragraph (d), any money or other assets payable to an owner, a participant, or a **beneficiary** from, or any interest of any owner, participant, or **beneficiary** in, a fund or account is exempt from all claims of creditors of the owner, **beneficiary**, or participant if the fund or account is:" (emphasis added).

      ii. "(c) Any money or other assets that are exempt from claims of creditors under paragraph (a) do **not** cease to qualify for exemption by reason of a direct transfer or eligible rollover that is excluded from gross income under s. 402(c) of the Internal Revenue Code of 1986. " (emphasis added).

   b. Florida Statute § 222.21 was enacted to ensure that the creditor protection features of a qualified plan created under the Internal Revenue Code (the "Code") also applied to single owner/participant plans, which included a spendthrift provision to implement the anti-alienation rules of § 401(a)(13) of the Code.

      i. The legislature was concerned that bankruptcy courts were permitting creditors to attach single owner/participant plans on the theory that the plan was a self-settled trust that does not defeat claims of the settlor's creditors.

      ii. Even though the single owner/participant plans were required to have a spendthrift clause in the governing instrument.

      iii. Florida Statute § 222.21 was enacted to make crystal clear that ALL plans would be exempt, even if there were a single owner/participant.

   c. The term "beneficiary" as used in Florida Statute § 222.21 was intended to mean any beneficiary, including the person who created the IRA and a beneficiary of an inherited IRA after the IRA owner's death.

      i. According to a drafter of the legislation, the statute was enacted to protect ALL types of tax qualified retirement plans, including IRA's.

ii. The drafter also pointed out that the legislature used the term "beneficiary" with no qualifiers.

d. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 made it clear that the federal government intends to exempt these types of accounts and assets as long as they maintain "tax qualified" status.

i. An inherited IRA that is administered properly by a qualified custodian will meet the requirement of "tax qualified."

ii. Subparagraph (c) of Florida Statute § 222.21 was added to clarify that those "tax qualified" funds could be rolled over or transferred between accounts without losing the protection intended by the statute.

iii. A member of the Florida Session Law Staff stated that the change was made "because technically the owner of an IRA is neither a beneficiary nor a participant in the account." Thus, it is clear that the term "beneficiary" as used in Florida Statute § 222.21 was intended to mean something different than "owner" and "participant."

2. Florida Courts Misapplying Florida Statute § 222.21

a. *Robertson v. Deeb*, 16 So. 2d 936 (Fla. 2d D.C.A. 2009):

i. The Second District Court of Appeals concluded that the interest of a beneficiary or owner of an inherited IRA was not an exempt asset protected from creditors under the terms of Florida Statute § 222.21.

ii. Mr. Robertson was named the beneficiary of his father's IRA. Upon his father's death, the IRA custodian informed Mr. Robertson of his 2 choices: 1) roll the IRA into an inherited IRA and take minimum distributions over his remaining life, or 2) keep the current IRA and take distributions over 5 years. Mr. Robertson chose the first option. The IRA funds were properly transferred into an inherited IRA by way of an account to account transfer and properly titled.

1. The issue before the trial court was whether Mr. Robertson's interest in the inherited IRA was exempt from garnishment from his creditors.

2. The trial court held that the inherited IRA was not exempt because the "account became Robertson's property and no longer qualified for the same exemptions from taxation." The

court further held that the inherited IRA was "not like an IRA in terms of taxing and penalty tax for early withdrawal and things of that nature."

iii. On appeal, Mr. Robertson argued that under Florida Statute § 222.21(2)(a) he was a "beneficiary" of a "fund or account" and thus his beneficial interest in the inherited IRA was exempt from creditors' claims.

1. The Second District Court of Appeals concluded that the statute did not "exempt the money or assets at issue" unless such amounts were maintained in the original "fund or account." The court reasoned that the inherited IRA was a different fund or account that was "created when the original fund or account passes to a beneficiary upon the death of the participant."

2. The Second District Court of Appeals also stated that the availability of the creditor exemption for an IRA was a function of the fund's tax-exempt status. Thus, once the IRA was transferred to an inherited IRA upon the death of the original owner, the tax-exempt status of the original account changed and the exemption subsequently vanished.

iv. There is no distinction in the statute between the original and subsequent funds or accounts. Florida Statute § 222.21(2)(a) by its terms makes the interest of ANY beneficiary exempt, without any qualifications.

1. The term "beneficiary" would be superfluous if an IRA is not exempt because it passes to a beneficiary upon the death of the participant.

2. As stated in the White Paper, the intent of the Florida Legislature in drafting Florida Statute § 222.21(2)(a) was to protect the interest of ALL beneficiaries of IRAs and the courts of Florida do not have the power to ignore the statutes.

v. There is no distinction between the tax status of the original IRA and the inherited IRA.

1. The Second District Court of Appeals reasoning was that while inherited IRAs are exempt from taxes until distributions are

made to the beneficiary, the beneficiaries of inherited IRAs are required to take yearly distributions. Thus this requirement of yearly distributions destroys the tax status of inherited IRAs. The flaw in this reasoning is that the original IRA owner is also exempt from taxes until distributions are made to the owner, but owners of IRAs are also required to take yearly distributions upon reaching the age of 70 and ½.

2. Both IRAs and inherited IRAs are exempt from tax under the same section of the Code, so using the Second District Court of Appeals reasoning, no beneficiary could ever have a protected interest in an IRA or inherited IRA.

b. *In re Ard*, WL3400368 (Brkrtcy. M.D. Fla) (August 18, 2010)

i. The Bankruptcy Court for the Middle District of Florida concluded that a Chapter 7 debtor's interest in her father's inherited IRA was not exempt from creditors' claims.

1. The court determined that the outcome of these types of cases turns on the particular language of the individual state's law applicable to the exemption of IRAs.

2. In applying Florida Statutes § 222.21(2)(a), the court followed the reasoning in *Robertson*, concluding that the funds in the original IRA did not retain the same tax exempt status after being transferred to the debtor's inherited IRA.

ii. Relying heavily on *Robertson*, the Bankruptcy court determined that an individual IRA is different than an inherited IRA under § 408(d)(3) of Code. Thus the inherited IRA is a different account or fund than the original IRA and is not protected under Florida Statute § 222.21(2) from creditors' claims.

3. The Solution to the Problem created by *Robertson* and *In re Ard*

a. The Amended Florida Statute § 222.21(2) was signed by the Governor on May 31, 2011 and was effective upon becoming law.

b. The Amendment to Florida Statute § 222.21(2) is intended to override the incorrect results reached by the courts in *Robertson* and *In re Ard*. Florida Statute § 222.21(2)(c) now provides that an IRA that is exempt from creditors under Florida Statute § 222.21(2)(a) would continue to be exempt if the original IRA were transferred into an Inherited IRA. Under the new statute, when an owner of an IRA passes away, his or her named beneficiary would continue to enjoy the protection from creditors that the original owner enjoyed under Florida Statute § 222.21(2)(a). This protection would most likely extend to protection in bankruptcy proceedings, as well.

c. The Amendment to Florida Statute § 222.21(2) is intended to ensure that the intent of the Florida Legislature to exempt the interest of a beneficiary in an inherited IRA from the beneficiary's creditors is given full effect.

II. Federal Protection of Inherited IRAs

1. Bankruptcy Code § 522(b)(2) allows each state to preclude the use of federal exemptions set forth in Bankruptcy Code § 522(d) and to apply the exemptions as provided under such state laws. However, a debtor may still choose to apply the federal exemptions set forth in Bankruptcy Code § 522(b).

2. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 made it clear that the federal government intends to exempt these types of retirement accounts and assets as long as they maintain "tax qualified" status. Regardless of whether the state opts-out of the Bankruptcy Code § 522(d) exemptions, the retirement fund exemptions of Bankruptcy Code § 522(b)(3) are still available to the debtor in that state.

3. Thus, Bankruptcy Code § 522(b)(3)(C) and § 522(b)(4)(C) may apply to Florida bankruptcy proceedings, even though Florida opted out of the Federal Bankruptcy statute exemption of § 522(d). Thus, the debtor may claim an exemption under Bankruptcy Code § 522(b)(3)(C) in Florida.

4. **Both Bankruptcy Code § 522(b)(3)(C) and § 522(d)(12) protect "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under § 402, 403, 408, 408A, 414, 457 or 501(a) of the Internal Revenue Code of 1986."**

5. For a debtor's retirement funds to be exempt under Bankruptcy Code § 522(d)(12) and § 522(b)(3)(C), the funds must meet 2 requirements:

    a. The amount must consist of retirement funds; and

b. The retirement funds must be in an account that is exempt from taxation under § 402, 403, 408, 408A, 414, 457 or 501(a) of the Code.

6. Applying the plain meaning of the statute, the amount must only consist of “retirement funds” and not explicitly the debtor’s retirement funds. Thus, an inherited IRA should qualify as a retirement fund for purposes of Bankruptcy Code § 522(b)(3)(C).

7. The funds in an inherited IRA are exempt from tax under § 408 of the Code. The proceeds are only taxable when distributed to the beneficiary of the inherited IRA. Thus, the inherited IRA meets the second requirement of Bankruptcy Code § 522(b)(3)(C).

8. Under Bankruptcy Code § 522(b)(4)(C), the direct transfer of retirement funds from an account that is exempt from taxation under § 408 of the Code does not cease to qualify for the exemption by reason of the transfer to another account exempt from taxation under § 408 of the Code. The IRA is exempt from taxation under § 408 of the Code in the hands of the deceased and the inherited IRA is exempt from taxation under § 408 of the Code in the hands of the beneficiary. Thus, the transfer from an IRA to an inherited IRA should not force the funds to lose exemption from creditors’ claims.

III. <u>IRA to Roth Conversions, Recharacterizations and Reconversions</u>

1. Remembering the Individual Retirement Account (“IRA”) basics

    a. Governed by § 408 of the Code

    b. Maximum contribution is $5000

    c. Catch-up contribution if age 50 or more is $1000

    d. Deduction for contribution to IRA is allowed under § 219 of Code, subject to income and participation under employer retirement plans.

    e. Deductions are eliminated when joint return adjusted gross income is $110,000 or single is $66,000

    f. Amounts earned in IRA are not taxed until distributions

    g. Any non-deductible after tax contributions received by taxpayer is tax free. However, if taxpayer receives both deductible and non-deductible then each distribution is prorated

    h. At required beginning date (“RBD”) minimum required distributions (“MRD”) must be made and consequently taxed to the participant or beneficiary

2. Remembering the Roth IRA basics

    a. Governed by § 408A of the Code

    b. Maximum contribution is $5,000

    c. Catch-up contribution if age 50 or more is $1,000

    d. Deduction for contribution to Roth IRA is not allowed

    e. Contributions eliminated after adjusted gross joint return income of $179,000 or single return income of $122,000

    f. No minimum required distributions during lifetime of owner

    g. Amounts earned and distributions (a "Qualified Distribution") from Roth IRAs are NEVER taxed, assuming that the following distribution time periods are met. Note that the 10% penalty can apply if distributions are made prior to the following time periods:

        i. A Qualified Distribution can not be made before 5 years after date of contributions

        ii. A Qualified Distribution must be made either

            1. to the participant after age 59 ½;

            2. to a beneficiary as a result of death;

            3. to a participant as a result of disability; or

            4. to a participant who is a qualified first time homebuyer

3. Under current law (2011) a taxpayer can convert his or her IRA to a Roth IRA

    a. Pay income tax and no premature distribution penalty

    b. Adjusted gross income can exceed $100,000

    c. Clients may want to convert in 2011 because of certainty of income tax rates. They may be able to reduce income in 2011 by

        i. "harvesting" losses

        ii. utilizing certain plans to obtain capital gains treatment instead of income treatment

        iii. utilizing certain oil and gas investments

    d. BIG DEAL – The Tax Increase Prevention and Reconciliation Act enacted of 2005, Public Law No. 109-222, 120 Stat. 345 (2006) ("TIPRA") eliminates the income limitation

i. No age limit

ii. Applies if you are single or married

iii. Convert at any time

iv. Convert when stock market values are substantially reduced

v. Conversion by a trustee to trustee transfer, direct rollover or withdrawal followed by a rollover (60 days period)

vi. No 10% penalty <u>if</u> taxes are not paid out of conversion funds

e. Income tax only applies to the deductible portion of the contribution but you can not convert only non-deductible contributions

f. Remember that RMDs are <u>not</u> required to be paid in the owner's lifetime so the income tax savings on the RMDs will affect the decision to convert

g. How Do You Do It?

i. Contact IRA holder to do a trustee to trustee transfer to an existing or new ROTH account in 2011.

ii. The IRA holder will issue a 1099-R by January 31, 2012. The financial institution will generally put in box 1 Gross Distributions, then in 2(a) the taxable amount will be zero and the 2(b) box of taxable amount not determined will be the distribution. Federal income tax withheld will also be on 1099-R.

iii. Contact CPA directly to be sure that the distribution amount is correct. If not then contact financial institution within February to correct, otherwise have to correct through IRS. Each client must work with tax advisor to determine what is taxable.

iv. Confirm with CPA if paying tax in 2012.

v. If you recharacterize (see below) you MUST check the 1099-R that was issued to determine if correct and you will receive a Form 5498 to reflect the "rollover" from the Roth back to the traditional IRA. The boxes on the 1099-R and the 5498 must match to avoid paying taxes on the distribution. Further the IRA owners must report recharacterizations on their federal income tax return by attaching a statement and the taxpayer may have to file a Form 8606.

4. What if You Change Your Mind After You Convert? Recharacterize!

a. If stock values decline after conversion then income tax may be incurred in the year you converted on "phantom" appreciation

b. You can recharacterize until the due date of the tax return for the tax year in question <u>including</u> extensions

c. Will Internal Revenue Service (the "Service") Grant Extensions of Time to Recharacterize?

    i. Relief granted under Treas. Reg. § 301.9100-3 to 89 year old widow whose income, after corrected 1099 was issued, was over the threshold for conversion. The Service determined that she discovered error before Service; didn't make election because of events beyond her control, after exercise of reasonable diligence was unaware of need for election and she relied upon qualified tax professionals. PLR 200905039

    ii. Relief granted under Treas. Reg. § 301.9100-3 for taxpayer who discovered that he was not able to convert because his adjusted gross income was too high. The Service determined that the taxpayer acted reasonably and in good faith because his request was filed before the failure was discovered by the Service and the taxpayer, after exercising reasonable diligence, was unaware of the necessity of the election. PLR 200905034

    iii. Relief granted under Treas. Reg. § 301.9100-1 and 301.9100-3 when enrolled agent advised taxpayers to convert when the gross income was above maximum amount. PLR 200839039

    iv. Relief granted under Treas. Reg. § 301.9100-1 and 301.9100-3 for taxpayer who obtained information from the Service which was incomplete. PLR 200628032

5. Not Only a Woman's Prerogative – You Can Change Your Mind Again**!**

    a. Timing to Reconvert– the <u>later</u> of the:

        i. tax year following the tax year in which the amount was converted to a Roth IRA or

        ii. the end of the 30 day period beginning on the day on which IRA owner transfers the amount from the Roth IRA back to traditional IRA

6. Why Convert from an IRA to Roth?

    a. Use favorable tax attributes such as carry forward losses and charitable deductions to offset income

    b. No income tax to beneficiaries when distributions are taken from the Roth

    c. Possible lowest income tax right now – only convert when the tax rate is the lowest

d. Lower stock values now

e. No need for any required minimum distribution so can benefit future generations

f. You have outside funds to pay income taxes

g. Convert when married rather than single (i.e. in year of death of spouse) because tax rates will be lower

h. Reduce size of estate by paying income taxes on the conversion

i. Credit shelter funding more tax efficient with a Roth IRA

7. Why Not Convert?

   a. You know you will be in lower tax bracket in future

   b. Family members who are beneficiaries will be in lower tax bracket

   c. If beneficiary is a charity why pay <u>any</u> income taxes?

   d. Do you <u>know</u> what the tax rates will be in 2011 or 2012?

   e. Are these assets still exempt under Florida law and federal bankruptcy law? § 222.21 of the Florida Statutes specifically refer to § 408 and 408A of the Code and § 222.21(2)(c) specifically states that "money or other assets that are exempt from claims of creditors under paragraph (a) do not cease to quality for exemption by reason of a direct transfer or eligible rollover that is excluded from gross income under § 401(c) of the Code."

   f. You may not have the money to pay the income taxes. If you use the IRA dollars to pay the taxes then the 10% penalty applies.

   g. Individuals who will need the distributions in the future. Why pay tax early?

8. Factors to Consider

   a. Client's spending habits

   b. Income tax rates now and in future

   c. Inflation rate

   d. Interest rate earned inside IRA or Roth

   e. Time value of money

   f. Deferral of distributions

   g. No distributions

   h. Time period

i. Growth of “side fund” with which to pay the taxes

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