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Should You Dip Your Toes into the Waters of Shark-Fin CLATs?

Summary

Shark-fin CLATs have emerged as a charitable planning technique that promises income, estate and gift tax benefits to the donor. One version of the shark-fin CLAT uses life insurance as a way to enhance those benefits. But, there are many unanswered questions that make life insurance inside of a shark-fin CLAT a risky proposition.

Related Information

Lifetime Charitable Giving in depth

In a stroke of luck, Henry just won the state lottery and is looking at a big pay day. Because of this, he's also looking at a big tax bill and would like to find ways to reduce his income tax liability this year. Henry has read about a charitable planning technique that would allow him to (1) take a large up-front charitable income tax deduction, (2) give money to his favorite charity and (3) pass assets to his children. Even better, he has heard that life insurance can be used to maximize the amount of assets passing to his family.

The technique Henry heard about is called a shark-fin charitable lead annuity trust (CLAT)[1]. Let's explore shark-fin CLATs to see if they deliver on the promised benefits. But first, let's start with a general discussion of CLATs.

What is a CLAT?

A CLAT is an irrevocable trust into which the grantor makes a gift, and which then provides an annual annuity stream (the charitable lead interest) to a charity for a period of time.[2] At the end of the period of time, the remaining assets in the CLAT pass to non-charitable remainder beneficiaries. The remainder beneficiaries can be anyone, including the grantor himself. Typically, children are named as the remainder beneficiaries.

1. Gift Tax Consequences. There are two components of a gift to a CLAT: the charitable lead interest and the remainder interest. Let's say that Henry contributes $1 million to a CLAT that will pay an annuity stream to a charity for his life. At his death, the remaining assets will pass to his children. Valuing the charitable lead interest is a function of Henry's age, the amount of the annual annuity, the § 7520 rate, and the value of the assets going into the CLAT. For example, suppose the terms of the CLAT are as follows:

Henry's age:	65
Value of assets:	$1 million
Annual annuity:	$60,000 (6%)

[1] The term "shark-fin CLAT" refers to the fact that, if one were to draw a chart showing the size of the annual payments made by the CLAT, it would be minimal for many years and spike in the final year, resembling the dorsal fin of a shark. This type of CLAT is also known as a variable CLAT or VCLAT.

[2] The period of time can be for a specified term of years or for the life or lives of certain individuals (the donor, donor's spouse, and/or an individual who is either a lineal ancestor or the spouse of a lineal ancestor of the remainder beneficiaries). Treas. Reg. § 1.170A-6(c)(2)(i)(A).

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§ 7520 rate (July 2011): 2.4%
CLAT term: Henry's life

Using these numbers, the value of the charitable lead interest is about $759,000. The value of the remainder interest, then, is the difference – about $241,000. The charitable lead interest qualifies for the charitable gift tax deduction.[3] Henry must use $241,000 of his $5 million gift tax exemption on the gift of the remainder interest. The remainder interest does not qualify for the gift tax annual exclusion because it is not a present interest gift.

2. Income Tax Consequences. Henry is entitled to an income tax charitable deduction in the year of a contribution only if the CLAT is designed as a grantor trust for income tax purposes.[4] The tradeoff is that Henry is then taxed on all net income as it is earned by the trust under the grantor trust rules.

   If the CLAT is not designed as a grantor trust, then Henry is not entitled to an up-front income tax charitable deduction. In addition, Henry is not taxed on the net income earned by the CLAT. Rather, the CLAT pays income tax on the net income each year, and it also receives an income tax charitable deduction each year for amounts actually paid to charity.[5]

What is a Shark-Fin CLAT?

In the version of the shark-fin CLAT that Henry read about, the CLAT is a grantor trust and pays an annuity to a charity for his lifetime. But instead of having a level annuity amount, a shark-fin CLAT provides for a very small – say $1,000 – annuity payment to the charity each year while Henry is alive. In the year Henry dies, the trust makes a large balloon payment to the charity. Any assets remaining after the balloon payment pass to the remainder beneficiaries.

What issues arise with a shark-fin CLAT generally?

The I.R.S. has not specifically ruled on the validity of shark-fin CLATs nor has any guidance been issued on the increases in annuity amounts.[6] This has caused some debate over whether Henry will get the results he desires. Let's take a look at the issues.

1. Guaranteed Annuity. In order to qualify for the charitable income and gift tax deductions, the annuity payment to the charity must be a "guaranteed annuity."[7] Some commentators have expressed concern that a shark-fin CLAT does not meet the definition of a guaranteed annuity. However, this concern appears to be unwarranted.

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[3] § 2522(c)(2)(B).
[4] § 170(f)(2)(B). In this case, the income tax charitable deduction is about $759,000. The income tax charitable deduction is limited to 30% of Henry's adjusted gross income (AGI) (or in the case of appreciated assets, 20% of AGI) because it is a transfer *for the use of* the charity rather than *to* the charity. Any excess charitable deduction can be carried forward for five years.
[5] § 642(c).
[6] Contrast this to an increasing annuity payment of a grantor retained annuity trust (GRAT); a GRAT payment can increase by no more than 20% of the GRAT payment from the previous year. Treas. Reg. § 25.2702-3(b)(ii).
[7] §§ 170(f)(2)(B) and 2522(c)(2)(B).

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The requirements for a guaranteed annuity are that the amount is (i) determinable and (ii) paid periodically (but not less than annually).

a. An amount is determinable if it can be ascertained as of the date of the transfer.[8] In 2007, the IRS issued sample trust forms for charitable lead trusts.[9] The annotations to the sample trust forms allow for an annuity amount that is initially stated as a fixed amount but increases during the annuity period as long as the value of the annuity amount is ascertainable at the time the trust is funded.[10] While the payments of a shark-fin CLAT are admittedly more complex than a fixed annual annuity payment, the calculation can be done. So, it seems to fit this element.

b. The second prong is fulfilled easily; payments will be small for many years, but they will be made at least annually.

2. Recapture of Income Tax Deduction. There is another issue that cannot be as easily dismissed. In order to get the large up-front income tax charitable deduction that Henry desires, the CLAT must be a grantor trust. The tradeoff for Henry obtaining this deduction is that he is personally income taxed on the CLAT's income during the period of the charitable lead interest (due to the CLAT being a grantor trust). What's more, when the CLAT ceases to be a grantor trust – particularly if before its intended time – then some of that big up-front deduction might be recaptured and included in Henry's income.[11]

   How to determine the recapture amount is the mystery. The Internal Revenue Code provides a formula, as do Treasury Regulations. Both formulas start with the amount initially allowed as a charitable deduction to Henry, and then subtract something. The resulting difference is the recaptured amount.

   The problem is that the "something" that is subtracted under the Code formula is not the same "something" that is subtracted under the Treasury Regulation formula. Also, it's not clear that the formulas even agree as to when or if the recapture calculation is supposed to occur; the Regulation states that it should occur only if grantor trust status ceases before the charitable lead interest ends, but the Code contains no such limitation. So the results do not match one another and provide a different taxable recapture amount to Henry.[12]

   Here is how they work:

   a. Code formula: charitable deduction amount, minus discounted value (to date of gift) of *income that had been taxable to Henry* before grantor trust status ended. A shark-fin CLAT typically is designed to end at Henry's death; thus, grantor trust status will end at that point. The income that was taxable to Henry up until his death should be minimal,

[8] Treas. Reg. §§ 1.170A-6(c)(2)(i) and 25.2522(c)-3(c)(2)(vi).
[9] Rev. Proc. 2007-45, 2007-29 I.R.B. 89.
[10] Rev. Proc. 2007-45 also provides that CLATs are not subject to any minimum payout requirement.
[11] § 170(f)(2)(B); Treas. Reg. § 1.170A-6(c)(4).
[12] And, to make matters more confusing, the sample forms that the Service provides in Rev. Proc. 2007-45 recite the Code recapture rule.

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perhaps even zero, because (as is explained below) the CLAT likely held assets that do not generate taxable income, such as municipal bonds and life insurance. Under this formula, the charitable deduction amount minus zero would result in a significant recapture amount.

b. Regulation formula: charitable deduction amount, minus discounted value (to date of gift) of *payments that had been made to charity* before grantor trust status ended, but *only if* grantor trust status ends before the termination of the charitable lead interest. Again, a shark-fin CLAT is typically designed to end at Henry's death. So grantor trust status would not cease before the charitable lead interest does. Under the regulation, then, there would be no recapture whatsoever. (And, again, even if there were recapture, the calculation used under the Regulation differs from the calculation used under the Code).

Unfortunately, there is no guidance reconciling the disparities between the Code and the Regulation, so recapture remains a risk if the CLAT is designed as a grantor trust.

The role of life insurance with a shark-fin CLAT

Where does life insurance fit into the picture? With this shark-fin CLAT technique, Henry contributes cash to the CLAT. The trustee uses a substantial portion of the cash to purchase a life insurance policy. As already alluded to, the balance of the cash is used to purchase tax-exempt securities, such as municipal bonds. The municipal bonds generate the income to make the nominal annuity payments to the charity during Henry's life. On Henry's death, the life insurance proceeds are available to make the balloon payment to the charity, with the remainder passing to Henry's children.

There are some advantages to this strategy. Neither the municipal bonds nor the life insurance generate annual income that Henry would need to report on his individual income tax return.[13] In addition, funding a CLAT with life insurance minimizes the risk that the CLAT will not have adequate funds to pay the charity and remainder beneficiaries. In fact, it is hoped that the life insurance death benefit will provide a larger distribution to the remainder beneficiaries than what would have occurred by using other assets, such as marketable securities.

Sounds great, right? Well, not so fast.

What issues arise with shark-fin CLATs using life insurance in particular?

1. Payment of Premiums by CLAT. Henry might not get his charitable income and gift tax deductions if the CLAT pays premiums on a life insurance policy. Section 170(f)(10) denies a charitable deduction (including an income, estate, or gift tax deduction) if:

   a. A charity directly or indirectly pays any premium on a personal benefit contract, or

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[13] Municipal bond interest is not taxable for federal income tax purposes. This example assumes that the municipal bond interest is not taxable for state income tax purposes either because the bond interest is not taxable (double tax-free bond) or because Henry's state does not have an income tax. But if neither is true, Henry will report some income on his state income tax return.

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b. There is an understanding or expectation that any person will pay any premium on any personal benefit contract.[14]

These provisions give rise to two main issues.

First, there is no direct guidance as to whether § 170(f)(10) applies to CLATs. Section 170(f)(10) applies to charitable organizations described in §170(c). Is a CLAT a charitable organization? Section 170(f)(10)(C) does not tell us; however, it does specifically provide that the reference to an "organization" includes a charitable remainder trust (CRT) – was there a fear that "organization" would not include a CRT unless specifically provided? And can one infer that if this section were meant to apply to CLATs, the statute would have said so explicitly, as it did for CRTs?

Even if the CLAT is not viewed as a charitable organization, there is still the danger that it will be viewed as a "person" paying the premium on a personal benefit contract. In that case, § 170(f)(10) would apply to CLATs.

On the other hand, there is an argument that it shouldn't apply in this situation. Section 170(f)(10) was enacted in response to charitable reverse split dollar schemes that created benefits for the individuals, but passed little benefit onto the charity. A shark-fin CLAT, however, *does* provide benefits to the charity, and does so before anything goes to the family. Thus, a CLAT does not present the same opportunity for abuse that § 170(f)(10) was intended to prevent.

Second, if § 170(f)(10) applies to CLATs, our next question is whether the life insurance contract in the CLAT is a "personal benefit contract." The definition of a personal benefit contract includes a life insurance policy if any direct or indirect beneficiary under the contract is the transferor or any member of the transferor's family.[15] Some commentators say the CLAT's life insurance policy is not a personal benefit contract because the beneficiary of the contract is the CLAT, not a member of the donor's family.

While it's true that the CLAT is the direct beneficiary, there's a chance that the transferor or his family would be viewed as "indirect" beneficiaries. Indeed, the premise of the shark-fin CLAT strategy is that some of the life insurance proceeds will ultimately pass to the donor's family.

Moreover, § 170(f)(10) provides that, *with regard to CRTs*, the person receiving income payments is *not* treated as an indirect beneficiary of the life insurance.[16] This is good ... for CRTs. If the same treatment were meant to apply to CLATs, would not § 170(f)(10) have said so (assuming the statute applies to CLATs in the first place)? So, the argument that the life insurance policy in the CLAT is not a personal benefit contract is not terribly strong.

[14] § 170(f)(10)(A).
[15] §§ 170(f)(10)(B) and (H). Family includes the grandparents of both the donor and the donor's spouse, the lineal descendants of those grandparents and the spouse of any of those lineal descendants.
[16] § 170(f)(10)(E).

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Also, while it can be intellectually interesting to argue these positions, one must keep in mind a very practical aspect. If § 170(f)(10) applies and if the life insurance is a personal benefit contract, the penalty is quite hefty – *a 100% excise tax* imposed on a charity (or the person paying the premium) equal to the premiums paid on a personal benefit contract.[17]

Without further guidance from the I.R.S., it seems risky to assume that § 170(f)(10) does not apply.

2. <u>Transfer of a Paid-Up Policy.</u> Interestingly, § 170(f)(10) comes into play only if premiums are paid after the policy is inside the CLAT. So, if Henry likes the idea of using life insurance, he could transfer a paid-up policy to the CLAT.

Observations: CLATs are popular right now because the historically low § 7520 rate makes them more efficient. Shark-fin CLATs present opportunities because the low initial annuity payments give the assets inside the CLAT ample time to grow before the balloon payment is made to the charity, and the remainder can be distributed to, for example, the transferor's family. But there are many unanswered questions with this technique, particularly if the CLAT will own life insurance.

Conclusion: Henry would be wise to talk with his tax advisor before diving in. While using life insurance inside of a shark-fin CLAT offers the promise of big rewards, the risks may outweigh the potential benefits.

[17] § 170(f)(10)(F).

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Partial Exchange Rules for Annuities are Changed Yet Again (It's Relevant for Exchanges to LTC Insurance Too): Revenue Procedure 2011-38, 2011-30 I.R.B. (June 28, 2011)

Summary

New Rev. Proc 2011-38 states that partial exchanges of annuities will be honored as long as no withdrawal is made from either resulting contract in the next 180 days (6 months), shortening the time period from the previous 12 months.

Related information

Good News for Partial Exchanges and Partial Annuitizations; Don't Believe Anything You Hear – I.R.S. Changes its Tune on Partial Exchanges of Annuity Contracts Under Revenue Procedure 2008-24, 2008-13 I.R.B. 1 (March 13, 2008); I.R.S. Revises Guidance on Partial Exchanges of Annuity Contracts – Some Good, Some Bad, and Some Unknown: Revenue Procedure 2008-24, 2008-13 I.R.B. 1 (March 13, 2008).

Background

The federal government has long feared that annuity owners might try to circumvent the "gain first" withdrawal rules of § 72(e) by doing a partial exchange, and then pulling money out of one of the resulting contracts.

For example –

- If the owner of a deferred annuity with $100,000 cash value and $60,000 basis (gain of $40,000) were to withdraw $30,000, he normally would be income taxed on the entire $30,000.
- But if he were to first partially 1035 exchange only $30,000 of the contract, the new annuity would have a pro-rata basis of $18,000 (gain of $12,000). Then he could surrender this smaller contract, again receive $30,000, but be taxed on only $12,000.

Largely to prevent such maneuvers, the government has created rules that essentially challenge the tax-free nature of the partial exchange if a withdrawal is taken from either resulting contract too quickly after the exchange. As we've pointed out in previous articles, these rules have changed from time to time, and some of the guidance has not always been entirely clear.[1] Now these rules have been changed yet again, in Revenue Procedure 2011-38.

[1] Our previous articles on this topic include: Good News for Partial Exchanges and Partial Annuitizations, *Advanced Planning Bulletin*, October 2010; Don't Believe Anything You Hear – I.R.S. Changes its Tune on Partial Exchanges of Annuity Contracts Under Revenue Procedure 2008-24, 2008-13 I.R.B. 1 (March 13, 2008), *Advanced Planning Bulletin*, July 2008; and I.R.S. Revises Guidance on Partial Exchanges of Annuity Contracts – Some Good, Some Bad, and Some Unknown: Revenue Procedure 2008-24, 2008-13 I.R.B. 1 (March 13, 2008), *Advanced Planning Bulletin*, April 2008.

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But first, the last version of the rules

Due to previous guidance, if the partial exchange of an annuity to another annuity occurs *before October 24, 2011*, it remains tax-free as long as no withdrawal is taken from either resulting contract in the *next 12 months* and no exception to the 12-month waiting period applies.

Importantly, there is an exception to the 12-month waiting period for partial exchanges that occur after the contract holder attains age 59½. Although the government initially interpreted this exception narrowly to apply only to contract holders attaining age 59½ during the period between the exchange and the withdrawal, it has now rejected that interpretation and has stated that it will apply the exception broadly to all partial exchanges taken after age 59½.[2] In those cases where a withdrawal is taken within the 12-month period and before age 59½, the transfer will be automatically recharacterized as a gain-first withdrawal.[3]

New rules

The newly issued Revenue Procedure 2011-38 changes existing guidance in two key ways. First, it establishes several safe harbors in which tax-free exchange treatment is clearly allowed for certain partial exchanges. Second, it eliminates the automatic disqualification of a partial exchange that does not satisfy a safe harbor and instead looks to general tax principles to determine the substance of the transaction. These new rules apply to any partial exchange of an annuity to another annuity that occurs *on or after October 24, 2011*.

Revenue Procedure 2011-38 eliminates the exceptions provided in prior guidance, including the age 59½ exception, but replaces them with several safe harbors. These provide that a partial exchange will be treated as a tax-free exchange if:

1. no withdrawal is taken from either the original contract or the new contract during the 180 days following the exchange;

2. part or all of either contract is annuitized for a period of 10 years or more or during one or more lives;[4] or

3. part or all of either contract is involved in an exchange that qualifies (or is intended to qualify) as a tax-free exchange.

The revenue procedure also provides that even if a partial exchange does not satisfy one of these safe harbors, it is not automatically disqualified as a tax-free exchange. In that case, the I.R.S.

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[2] See Rev. Proc. 2008-24, 2008-13 I.R.B.; and also Priv. Ltr. Rul. 2010-38-012 (September 24, 2010).

[3] There are other exceptions to this 12-month rule, such as becoming disabled or the occurrence of some other "unexpected event" but it is likely that they must occur after the partial exchange and before the later withdrawal occurs.

[4] The exception for partial annuitizations that continue for 10 or more years or life is intended to mirror the recent enactment of § 72(a)(2) by the Small Business Jobs Act of 2010, which explicitly grants exclusion ratio tax treatment to partial annuitizations after December 31, 2010 (before the amendment, only annuitizations of the *entire* contract were allowed to enjoy exclusion ratio taxation). P.L. 111-240, Sec. 2113(a).

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will characterize the transaction "in a manner consistent with its substance, based on general tax principles and all the facts and circumstances." The revenue procedure gives two examples of a potential recharacterization – the *subsequent withdrawal* could be treated as a gain-first withdrawal under either contract or as "boot" received in the exchange. Neither example actually recharacterizes the partial exchange as a taxable withdrawal nor changes the expected tax result of the withdrawal significantly (the only difference is that the withdrawal would be taxable based on the post-exchange gain in the source contract while "boot" would be taxable to the extent of the higher pre-exchange gain in the original contract). The most likely reading of the I.R.S.'s somewhat cryptic language is that the partial exchange could be disqualified if the I.R.S. determines that the exchange and subsequent withdrawal were part of a tax avoidance scheme – which has been the concern underlying all of the I.R.S. guidance from the beginning. This determination would presumably have to be made by the I.R.S. on an audit of an individual contract holder's tax return.

What does this mean for partial exchanges to LTC insurance?

Since the beginning of 2010, § 1035 has permitted tax-free exchanges to long-term care (LTC) insurance policies from either life insurance or annuities. There is no guidance about *partial* exchanges from these contracts to *LTC insurance*, but the more reasonable view is that, because partial exchanges are allowed if going to an annuity, they should be allowed if going to an LTC contract too.[5]

What's more, partial exchanges for the purpose of paying LTC insurance premiums should be even less likely to invoke a tax avoidance concern than partial exchanges to another annuity. If anything, the recent addition of LTC insurance to § 1035 shows that Congress generally wants to *encourage* such exchanges. It is unlikely that Congress intends for contract holders to be effectively foreclosed from taking withdrawals or surrenders from their life insurance or annuity contracts during the entire time that they are taking annual (or more frequent) partial exchanges from those contracts to pay LTC premiums. Finally, unlike a new annuity, the LTC contract will not contain cash value that can be withdrawn, so it does not lend itself to any basis/gain manipulations. All contract holders will have to rely on their own tax advisors, of course, but given all this, it appears unlikely that a partial § 1035 exchange to LTC is the type of exchange that the I.R.S. would challenge under the new revenue procedure.

Conclusion

Revenue Procedure 2011-38 is generally good news. Sure, those over age 59½ no longer have the complete exemption they used to have, but the new rules clear up some ambiguities and will most likely impact partial exchanges only if they are part of a tax avoidance scheme.

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[5] To read more about partial exchanges to LTC insurance, see Update on Long-Term Care and 2010 - Combo Products and Using Cash Values from Life and Annuity Contracts to Pay LTC Premiums or Expenses, *Advanced Planning Bulletin*, December 2009.

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IRAs and Loans Contain Pitfalls and Potholes: DOL Advisory Opinion 2011-04A

Summary

Financial advisors can help their clients steer clear of traps such as a loan in an IRA, and avoid transactions that cause undesirable tax consequences or put the IRA's qualification at risk.

Related Information

Alternative IRA Investment: A Golden Goose or a House of Cards?

Most clients know that they can't borrow money from their Individual Retirement Account (IRA). But when financing is hard to come by, they may decide to get creative with IRA funds and try to find a way around the loan rules. Financial advisors can help their clients steer clear of traps, and avoid transactions that cause unintended tax consequences, or even put the IRA's qualification at risk.

The Internal Revenue Code prohibits a number of transactions in an IRA, cleverly titled "prohibited transactions."[1] Among them is any direct or indirect loan[2] between a "plan" (which includes an IRA[3]) and a "disqualified person," which includes a "fiduciary" who exercises discretionary authority or control with respect to the management of the fund.[4] This means the IRA owner.

Long story short, IRA owners and their spouses[5] are disqualified persons, and can't engage in loans to or from their IRAs.

Aside from the prohibited transaction rules, if the IRA owner uses the IRA as security for a loan, he will be treated for income tax purposes as if he took a distribution from the IRA in the amount of the loan.[6] In other words, the amount of the loan will be treated as a distribution, subject to income tax and potentially the 10% penalty.[7]

In a recent Advisory Opinion[8] from the Department of Labor, a couple attempts a novel solution to this problem. They propose using IRA funds to purchase a note from a bank. Importantly, the note was a loan that the couple themselves had taken from the bank for an apartment building they had purchased years earlier. The note was secured by the real estate.

The Department of Labor therefore concludes that the proposed transaction would create a prohibited creditor-debtor relationship between the IRA and its owners from the moment of the IRA's acquisition of the note. That is, it's a prohibited transaction.

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1 See §4975(c)(1).
2 See §4975(c)(1)(B).
3 See §4975(e)(1)(B).
4 See §§4975(e)(2)(A), (e)(3)
5 See §4975(e)(6).
6 See § 408(e)(4).
7 See §§ 408(d)(1), 72(t).
8 See DOL Advisory Opinion 2011-04A (February 3, 2011).

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Why is that a problem, you say? Why is this not the same thing as purchasing a bond? The difference is that a bond is, in a sense, a loan to a business or the government. But the facts of this opinion involve a loan from an IRA *to the IRA owner.*

The penalty for a prohibited transaction is much worse than the penalty for pledging the account as collateral. If the account is pledged, only the amount of the IRA that secures the loan is treated as a distribution. *But if a prohibited transaction takes place, it disqualifies the IRA and causes the entire account to be treated as distributed – with all the corresponding income tax – on January 1 of the year in which the transaction occurs!*[9]

The take-away of this ruling is this: friends don't let friends engage in prohibited transactions with their IRA. Better sources for funding include traditional commercial loans, or perhaps a qualified plan loan, if available.

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[9] See § 408(e)(2).

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Definitely Maybe: Inherited IRA Protection in Bankruptcy Still Undecided

Summary

Retirement funds are exempt from bankruptcy proceedings. Because IRAs hold retirement funds, they are exempt. It is not clear, however, that inherited IRAs are exempt because some courts don't think these accounts hold retirement funds.

Related Information

Are Inherited IRAs Protected from the Beneficiary's Creditors?

Background

We wrote about the bankruptcy protection for inherited IRAs[1] last year, concluding that some courts protect it, and some don't.[2] If the results of two recent cases are any indication, nothing has changed in the last year. The battle line is drawn clearly enough. The definition of "retirement funds" is at issue, and different interpretations are yielding different results. But we're getting ahead of ourselves.

The Test

The courts do, at least, agree on the test to apply to determine whether or not an inherited IRA is exempt in bankruptcy.[3] Specifically, an exemption from bankruptcy is available for:

> *retirement funds* to the extent that those funds are in a fund or account that is *exempt from taxation* under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.[4]

Stated another way, amounts are bankruptcy exempt if they are (i) retirement funds and (ii) tax exempt. Two recent cases illustrate the division in thinking on the definition of retirement funds.

Two New Cases – *In re Mathusa* and *In re Clark*

In *In re Mathusa,*[5] the debtor inherits an IRA upon the death of her mother. The debtor claims an exemption for retirement funds under Bankruptcy Code § 522(b)(3). The bankruptcy trustee

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[1] An inherited IRA is one that is received as a result of someone's death and not rolled over into the recipient's own IRA, as is permissible for a surviving spouse.

[2] See Are Inherited IRAs Protected from the Beneficiary's Creditors?, *Advanced Planning Bulletin*, May 2010. In that article we discussed the *In re Chilton* and *In re Nessa* decisions, which reached different results. As a follow up to that article, note that *Chilton* was reversed on appeal. *Chilton v. Moser*, 107 A.F.T.R.2d 1391 (E.D. Tex. March 16, 2011). So *Nessa* and *Chilton* are now consistent with one another.

[3] This article addresses only an exemption from the bankruptcy estate and not an exemption in any other type of legal proceeding.

[4] Bankruptcy Code § 522(b)(3)(C)(emphasis added). This section applies to those states that have opted out of the federal exemption scheme. However, for those states that opt in, § 522(b)(2) applies, which in turn exempts retirement plans under § 522(d)(12). Section 522(d)(12) reads exactly like § 522(b)(3)(C), so the rulings discussed in this ruling apply equally to all states, whether they have opted in or opted out.

[5] No. 6:10-bk-13336-KSJ (March 28, 2011).

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objects. The court sides with the debtor, stating an exemption for the inherited IRA is warranted because:

1. The inherited IRA holds retirement funds and
2. Section 408 exempts IRAs from taxation.

According to the court, IRAs contain retirement funds, as in Individual *Retirement* Account. When an IRA owner dies, the inherited IRA contains those same funds for the benefit of someone else, in this case the debtor. The fact that they are not funds held for the *debtor's* retirement is irrelevant. Once they are retirement funds, they will remain retirement funds.

This case follows the reasoning of *Nessa* in reaching the same conclusion. With *Chilton* reversed and also following *Nessa*, do we finally have agreement in the courts that inherited IRAs are retirement funds and therefore protected in bankruptcy? Not so fast.

Along comes *In re Clark*.[6] This case has *exactly* the same facts as *Mathusa* – debtor inherits an IRA from her mother, claims an exemption for retirement funds under Bankruptcy Code § 522(b)(3), and the bankruptcy trustee objects. Here, however, the court came to the opposite conclusion, stating that the exemption was unavailable because:

1. The inherited IRA does not hold retirement funds and
2. Inherited IRAs aren't tax exempt.

The *Clark* court said that while retirement funds might have been in the account at some point, the retiree died. Therefore, these are no longer "retirement funds" because they aren't held for anyone's retirement anymore. Rather, they are "inheritance funds." That seems reasonable enough. The court's view that inherited IRAs aren't tax exempt, on the other hand, is a stretch.

Conclusion

So where are we? We're right where we were last year – the courts don't agree whether inherited IRAs hold retirement funds. Until the courts agree, the bankruptcy exemption for inherited IRAs is a definite maybe.

[6] 2011 WL 1814209 (Bkrtcy. W.D. Wis. May 7, 2011).

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