IRAs Demystified

A Sampling of Prohibited Transactions, Required Minimum Distributions, and Creditor Issues for the Non-tax Lawyer

By Jeremy Graber

I. Introduction

One of your long-time business clients comes to your office to discuss her planned business acquisition. As you are gathering information from her, she tells you the purchaser will be an entity to be formed, which will be funded by her IRAs. You raise your eyebrows. "No worries," she says, "my financial advisor put this structure together." You go back to drafting the letter of intent but not without hesitation and a note to follow-up later with her, and possibly her "advisor."

Later that day, a long-time friend and estate-planning client comes by your office to update his estate plan. Your client wants to leave money to a charity, and you have prepared a simple amendment to his trust document. Knowing the client has IRAs and life insurance, you ask him if he has updated his beneficiary designations. As you begin discussing the various options as well as offering to contact the financial institutions to ensure it is handled properly, your thrifty client tells you that he has everything taken care of. "I simply named my trust as beneficiary on all my accounts to protect my kids from their creditors, and to make sure that ex of mine doesn't get a penny." You try to interject, but he is already discussing Bill Self's next recruiting class.

At the end of 2014, assets owned in IRAs reached $7.4 trillion, representing 30 percent of all retirement assets in the country.[1] As IRAs grow and baby boomers age, issues concerning IRAs are becoming more prevalent. IRA owners want to tap the liquidity in their IRA to fund business start-ups or expand existing businesses. As IRA owners die, their spouses, heirs, beneficiaries, trustees, or executors may be faced with uncertain tax consequences and potentially complicated distribution rules to preserve the IRA's tax benefits. This article will attempt to address these issues at a high level to help non-tax lawyers identify potential tax and practical issues in dealing with IRAs. Specifically, this article will examine the prohibited transaction rules broadly forbidding self-dealing. Next, this article will examine the required minimum distribution rules with a focus on issues following the death of the IRA owner. Lastly, this article will touch on IRA creditor protection, its exceptions, and the tax implications of the division/transfer of IRAs in a divorce proceeding.

II. Prohibited Transactions

A. What is a prohibited transaction (in code-speak)?

Any direct or indirect:

(A) sale or exchange, or leasing, of any property between a plan and a disqualified person;

(B) lending of money or other extension of credit between a plan and a disqualified person;

(C) furnishing of goods, services, or facilities between a plan and a disqualified person;

(D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;

(E) act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interests or for his own account; or

(F) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.[2]

This broad definition covers almost all types of transactions between a "disqualified person" and the IRA.[3] The Code defines a "disqualified person" as a person who is:

(A) a fiduciary;

(B) a person providing services to the plan;

(C) an employer any of whose employees are covered by the plan;

(D) an employee organization any of whose members are covered by the plan;

(E) an owner, direct or indirect, of 50 percent or more of—

(i) the combined voting

power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation,

(ii) the capital interest or the profits interest of a partnership, or

(iii) the beneficial interest of a trust or unincorpo rated enterprise, which is an employer or an em ployee organization described in subparagraph (C) or (D);

(F) a member of the family (as defined in paragraph (6))[4] of any individual described in subparagraph (A), (B), (C), or (E);

(G) a corporation, partnership, or trust or estate of which (or in which) 50 percent or more of—

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,

(ii) the capital interest or profits interest of such partnership, or

(iii) the beneficial interest of such trust or estate, is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);

(H) an officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder, or a highly compensated employee (earning 10 percent or more of the yearly wages of an employer) of a person described in subparagraph (C), (D), (E), or (G); or

(I) a 10 percent or more (in capital or profits) partner or joint venturer of a person described in subparagraph (C), (D), (E), or (G).

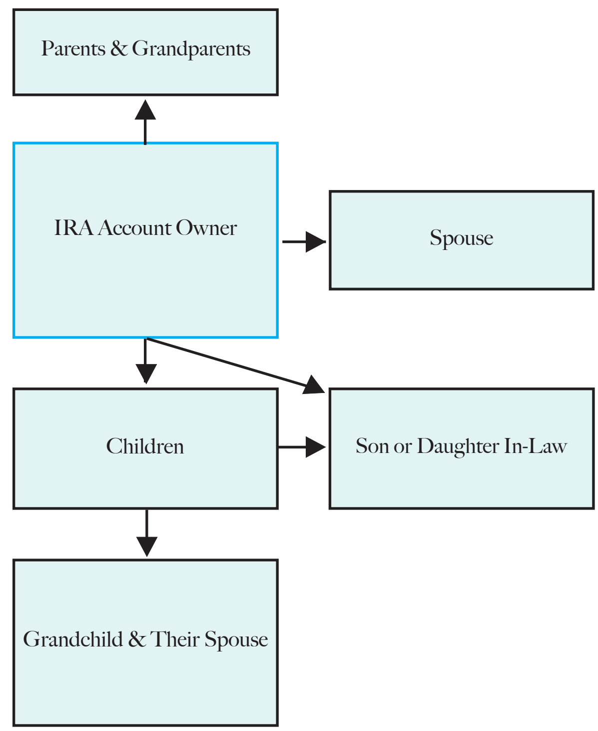
A "fiduciary" is generally a person who exercises any discretionary authority or control over plan assets or who renders investment advice for a fee.[5] When determining entity interests, the attribution rules of Code Section 267 apply.[6]

In short, a disqualified person includes the IRA owner, the owner's spouse, ancestors, lineal descendants and spouses of the lineal descendants. Corporations, partnerships, trusts and estates are disqualified persons if at least 50 percent of the entity or its interest is owned directly or indirectly by disqualified persons.

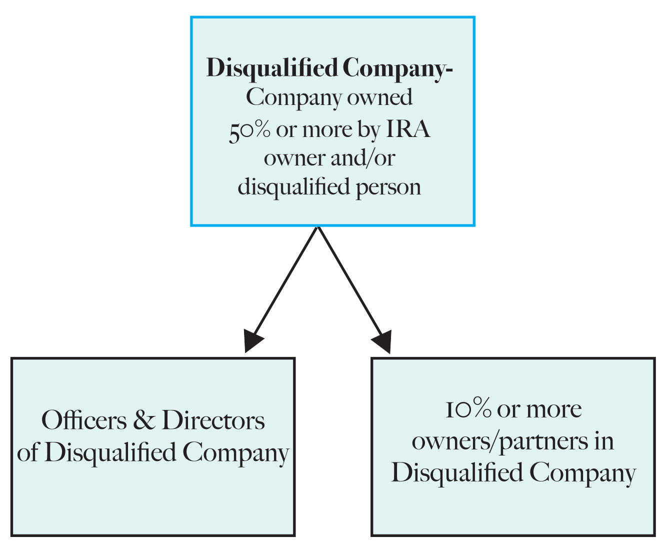
B. What is a prohibited transaction (in plain English)?

Under Code Section 4975(e)(2), there are nine subcategories of disqualified persons. The following charts summarize the basic definition of disqualified persons as to individuals and entities.[7] When an IRA transacts with any one of these disqualified persons, directly or indirectly[8], the IRA has likely engaged in a prohibited transaction under Code Section 4975. Whether a transaction was undertaken in good faith or beneficial to the IRA is inapplicable to the prohibited transactions analysis.

Family



Companies & Directors/Officers/Partners



C. A prohibited transaction causes termination of the IRA and deemed distribution of its assets as of Jan. 1 of the year of the prohibited transaction

If a prohibited transaction occurs, the resulting effect is straightforward. The account (1) ceases to be an IRA, and (2) is treated as having distributed all of its assets on January 1 of the year of the prohibited transaction.[9] Importantly, the entire IRA is deemed distributed as of January 1, not just the amount of the prohibited transaction.

Because distributions from IRAs are generally 100 percent taxable,[10] the IRA owner realizes ordinary income of the entire IRA's value in the year of the prohibited transaction. In addition to ordinary income, the IRA owner may be subject to the 20 percent accuracy-related penalty under Code Section 6662, and the 10 percent early distribution penalty under Code Section 72(t). As illustrated in the Ellis case below, the effect of a seemingly small prohibited transaction can be quite extraordinary to the unsuspecting IRA owner.

D. Case studies and hypotheticals

i. Ellis v. Comm'r—Payment for services

In *Ellis*,[11] the taxpayer received distributions totaling $321,366 from his former employer's 401(k) and deposited the proceeds into his newly-formed self-directed IRA. Ellis also formed an LLC called CST to engage in the used-car sales business. Ellis was its designated general manager. After forming CST and funding his new IRA, Ellis caused his IRA to acquire 98 percent of CST's membership units with the bulk of his IRA assets. During its first year of operation, CST paid Ellis $9,754 as compensation for his role as CST's general manager.

It was undisputed that Ellis was a disqualified person under 4975(e)(2)(A) because he was a fiduciary of his IRA under 4975(e)(3).[12] The parties also agreed that CST was a disqualified person because Ellis was a beneficial owner of the IRA's membership interests in the company.[13] The sole issue was whether Ellis's $9,754 compensation—from the LLC—was a prohibited transaction.[14]

The 8th Circuit affirmed the Tax Court's holding that Ellis engaged in a prohibited transaction. Ellis caused his IRA to invest the majority of its value in CST as its majority owner with the understanding that he, Ellis, would receive compensation as its general manager. "By directing CST to pay him wages from funds that the company received almost exclusively from his IRA, Mr. Ellis engaged in the indirect transfer of the income and assets of the IRA for his own benefit and indirectly dealt with such income and assets for his own interest or his own account."[15] The court found irrelevant that Ellis's salary was drawn from CST's corporate account—not from the IRA account—relying on the broad "direct or indirect" prohibition on self-dealing of 4975(c).

Because of Ellis's $9,754 compensation, the IRA lost its exempt status and its entire fair market value, in excess of $300,000, was treated as being distributed, and therefore, includible in Ellis's taxable income.[16] Because Ellis did not report the deemed distribution in the year it occurred and was under 59½-years-old, Ellis was also liable for the 20 percent accuracy-related penalty[17] and the 10 percent early-distribution penalty.[18]

As the Tax Court noted, transactions described in 4975 are prohibited even if "they are made in good faith or are beneficial to the plan."[19] The Tax Court succinctly summarized the gist of Ellis's acts and Code Section 4975's prohibitions:

> In essence, Mr. Ellis formulated a plan in which he would use his retirement savings as startup capital for a used car business. Mr. Ellis would operate this business and use it as his primary source of income by paying himself compensation for his role in its day-to-day operation. Mr. Ellis effected this plan by establishing the used car business as an investment of his IRA, attempting to preserve the integrity of the IRA as a qualified retirement plan. However, this is precisely the kind of self-dealing that section 4975 was enacted to prevent.[20]

ii.Peek v. Comm'r—Extension of Credit

In Peek,[21] the two taxpayers, Peek and Fleck, used their self-directed IRAs to capitalize a newly-formed entity, FP Company, as 50 percent owners. In 2001, FP Company purchased another business, AFS, for $1,100,000. The purchase price was paid out of various sources, including the cash from the IRAs and a $200,000 promissory note to the seller from FP Company (not the IRAs). The promissory note was secured by the personal guaranties of Peek and Fleck. In 2006, Peek and Fleck's IRAs sold their interests in FP Company to a third party for $1,668,192. Until the 2006 sale, Peek and Fleck were the sole owners, officers, and directors of FP Company.

On examination, the IRS contended the IRAs ceased to qualify as IRAs as of the first day of 2001 because the loan guaranties were prohibited transactions under 4975(c)(1)(B). Peek and Fleck argued that the prohibition did not apply because their personal guaranties did not guarantee a loan by the IRA, but rather a loan by FP Company, an entity owned by the IRAs.

The Tax Court agreed with the IRS finding the taxpayer's argument would "rob [4975(c)] of its intended breadth." The Court found 4975(c)(1)(B) was intended to prevent taxpayers "from making loans or loan guaranties directly to their IRAs or indirectly to their IRAs by way of an entity owned by the IRA."[23]

Because the IRAs engaged in a prohibited transaction in 2001, the IRAs ceased to be exempt from income tax and were deemed to have distributed the accounts (the FP Company stock) in 2001. Thus, the taxpayers were liable for tax on the 2006 sale of FP Company. Like the taxpayer in Ellis, Peek and Fleck were also liable for the 20 percent accuracy-related penalty under Code Section 6662.[24]

iii. *In re Kellerman*—Prohibited Transaction leads to loss of exempt status25

In this case, the bankruptcy trustee challenged the debtors' claimed exemption[26] of Mr. Kellerman's IRA arguing the IRA lost its IRA status due to a prohibited transaction. While the facts are somewhat complex, they can be summarized as follows. Barry Kellerman was a real estate developer, and he and his wife each owned 50 percent of a company named Panther Mountain. Panther Mountain and the IRA purported to form a partnership as 50 percent owners to purchase real property.

According to the partnership agreement, the IRA would initially contribute cash and property to the partnership (totaling approximately $163,000), and Panther Mountain would contribute cash at an unspecified construction completion date. On the same day that the partnership was created, the IRA purchased real property that was adjacent to other property owned by Panther Mountain for approximately $123,000.[27] Later, the IRA paid approximately $40,000 to develop the adjacent property. The purchase and development of the adjacent real property benefited the development of the Panther Mountain property.

Later, the Kellermans and Panther Mountain filed for bankruptcy. On Panther Mountain's schedules, it listed the IRA as an unsecured creditor for $163,000 described as "50 percent Interest in new entity."

The Kellermans conceded and the court found that Barry Kellerman was a disqualified person[28] as well as his wife, as a member of the family.[29] Panther Mountain and the partnership were also disqualified persons because Barry Kellerman owned a 50 percent membership interest in Panther Mountain (which owned 50 percent of the partnership).[30]

The Court determined the IRA engaged in prohibited transactions under 4975(c)(1)(B) (lending of money), (D) (use of assets by or for the benefit of a disqualified person), and (E) (acts by a fiduciary where he deals with assets in his own interest or for his own account).[31] While the court went through each transaction at issue, it summarized its main holding as, "[t]he real purposes for these transactions was to directly benefit Panther Mountain and the Kellermans…[They] utilized the IRA to indirectly secure additional financing for their existing" development.[32] Accordingly, the IRA ceased to qualify as an IRA under Code Section 408, losing its exempt status under the Bankruptcy Code.

E. Lessons learned and practice pointers

As these cases illustrate, the reach of the prohibited transaction rules is broad and not always easily defined. IRA-owned business interests (including farming interests) in which the owner or the owner's family is actively involved in the business, are rife with prohibited transaction issues. Lending of money and using an IRA's cash for alternative financing are also hot spots for prohibited transactions.[33]

While the prohibited transaction analysis is fact-specific, the lawyer should focus on some high-level concepts when faced with a possible prohibited transaction issue. First, clearly identify the disqualified persons in relation to the IRA. Only transactions with disqualified persons can be prohibited transactions. Second, accurately define the transaction that may be potentially prohibited. Who are the people and entities directly involved and who are the entity owners, family members, and related parties to those directly involved? A simple business transaction may be a complex prohibited transaction issue depending on ownership structures of the entities involved as well as family members. Lastly, courts have broadly applied the prohibited transaction rules relying on the "direct or indirect" statutory language. This leaves significant gray area that requires judgment and cannot be resolved by a checklist. Keep in mind that Code Section 4975 is intended, in part, to prevent taxpayers from engaging in transactions that could place the IRA's assets at risk of loss before retirement.[34] Accordingly, the IRS may closely scrutinize a transaction that is tangentially connected between the IRA and its owner, owner's family, or owner's business ventures for possible prohibited transaction issues. As described above, a seemingly minor infraction can lead to serious tax consequences.

III. Required Minimum Distributions[35]

Books have been written solely on the issue of required minimum distributions (RMDs), so one-half of a journal article can hardly begin to address all the nuances. Instead, this article will focus primarily on issues arising on the death of the IRA owner. This will include the basic RMD rules and potential planning opportunities to minimize issues that may arise.

A. Basic RMD rules during the owner's life

IRAs are subject to the required minimum distribution rules under Code Section 401(a)(9) and its accompanying regulations.[36] In general, payments from the IRA must commence not later than the required beginning date (sometimes referred to as the "RBD"), and the entire benefit must be paid over a period not longer than the life expectancy of the payee or the joint life expectancy of the payee and the payee's designated beneficiary.[37] The required beginning date is April 1 of the calendar year following the year in which the payee reaches age 70½.[38] The life expectancy tables are set forth in Treas. Reg. § 1.401(a)(9)-9 with reference to the payee's age (and payee's spouse's age, if relevant) in that year.[39]

B. RMD rules following the IRA owner's death

i. IRA owner dies after the owner's required beginning date

In the year of the owner's death, the last RMD is determined as if the owner lived through the entire year. The last RMD must be paid to the beneficiary to the extent it has not already been paid to the owner prior to death.[40]

In the years after the owner's death, the distribution period depends on whether the owner has a designated beneficiary, which is discussed more fully below. If the owner has a designated beneficiary, the distribution period is the longer of: (a) the remaining life expectancy of the designated beneficiary; or (b) the remaining life expectancy of the owner.[41] If the owner does not have a designated beneficiary, the distribution period is the remaining life expectancy of the owner.[42] Accordingly, the calculation of RMDs for an owner already in pay status at death (i.e. already reached her RBD) requires a determination of whether the IRA owner has a designated beneficiary and if so, what the remaining life expectancy of that beneficiary is relative to the owner's remaining life expectancy.

ii. IRA owner dies before the owner's required beginning date

The determination of the payment commencement date and distribution period is more complex if the IRA owner dies before reaching the required beginning date. Determining when RMDs are required to begin and the payment period will depend on whether the owner has a designated beneficiary and if so, whether the designated beneficiary is the IRA owner's spouse.

a. No designated beneficiary: 5-Year Rule

Under the 5-year rule, the IRA must be distributed not later than the end of the calendar year containing the fifth anniversary of the IRA owner's death.[43] The 5-year rule applies if the IRA owner dies before her required beginning date and does not have a designated beneficiary.[44] However, the IRA may require application of the 5-year rule or permit election between the 5-year rule and the life-expectancy rule described below, even if there is a designated beneficiary.[45]

b. Non-spouse designated beneficiary: Life Expectancy Rule

If the IRA owner has a designated beneficiary other than the owner's spouse, RMDs are required to begin by the end of the calendar year after the year of the IRA owner's death.[46] The payment period is determined using the beneficiary's age in the calendar year after the year of the IRA owner's death. Thereafter, the payment period is determined by subtracting one from the number of years in the payment period for the prior year. In the case of multiple designated beneficiaries, each beneficiary may use separate distribution periods based on each beneficiary's age under the separate accounts rule.[48]

c. Spouse designated beneficiary

If the IRA owner's designated beneficiary is the owner's spouse, the surviving spouse can (1) treat the IRA as the surviving spouse's own IRA, or (2) follow the life expectancy rule. If the owner's surviving spouse is the sole beneficiary of the IRA, the spouse may elect to treat the IRA as her own (instead of as a beneficiary).[49] If the election is made, RMDs are determined as if the spouse is the IRA owner for all purposes and not as a beneficiary. This may permit significant deferral of the commencement date and payment period, particularly if the surviving spouse is significantly younger. But it also subjects the surviving spouse to the 10 percent early withdrawal penalty under Code Section 72(t) if the surviving spouse is younger than 59½. Needs of the surviving spouse should be balanced with tax deferral before deciding to elect the IRA as the surviving spouse's own IRA.

Instead of treating the IRA as her own, the surviving spouse may elect to follow the life expectancy rule as a beneficiary. If elected, RMDs are required to begin by the later of (i) the end of the calendar year after the year of the IRA owner's death; or (ii) the end of the calendar year in which the IRA owner would have reached age 70½ had the IRA owner lived.[50] The payment period is determined under the Uniform Lifetime Table each year, using the surviving spouse's age as of his or her birthday in that year. In the year the surviving spouse dies, the payment period is fixed based on the surviving spouse's age in that year. Thereafter, the payment period is determined by subtracting one from the number of years in the payment period for the prior year.[51]

iii. Who is a Designated Beneficiary?

Generally, only individuals may be "designated beneficiaries" for RMD purposes.[52] A beneficiary may be designated under the IRA by the IRA's default terms or by an affirmative election by the IRA owner (e.g. a beneficiary designation form).[53] The designated beneficiary does not need to be specifically named so long as the beneficiary is identifiable or part of a class with identifiable members. An individual is not a designated beneficiary merely because the individual would acquire the IRA owner's interest by operation of law (e.g. via will, intestacy, etc.). The individual must be designated under the IRA's terms.

A trust can be a designated beneficiary for RMD purposes so long as four requirements are satisfied[54]:

1. Valid trust under state law.

2. Irrevocable: By its terms or becomes irrevocable at death of the IRA owner.

3. Identifiable Beneficiaries: By reference to the trust instrument and must be individuals.

4. Documentation: Certain trust information must be timely provided to the IRA provider (either trust instrument or list of all beneficiaries with offer to provide trust instrument).

If these four requirements are satisfied, the trust qualifies as a "designated beneficiary" and the account is not required to be distributed in accordance with the 5-year rule discussed above. In most instances, the RMD is calculated with reference to the age of the oldest trust beneficiary.[55]

C. Common problems and possible solutions

To be a designated beneficiary for RMD purposes, an individual must be a beneficiary as of the date of the employee's or IRA owner's death.[56] However, the designated beneficiary is not determined for RMD purposes until September 30 of the year following the year of the IRA owner's death. Thus, there is an opportunity to "fix" some beneficiary designation problems after death.[57]

i. Accelerating payments

As described above, the "designated beneficiary" must be an individual for RMD purposes. However, this determination is based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the year following the IRA owner's death.[58] Sometimes a beneficiary of an IRA may be a charity or other non-individual. If even one beneficiary is a non-individual, the entire IRA is treated as not having a designated beneficiary for RMD purposes. Depending on the circumstances, paying out the non-individual's interest (e.g. a charity) before September 30 of the year after the IRA owner's death will permit the remaining individual beneficiaries to take payments over their life expectancies.[59]

ii. Utilizing disclaimers

Occasionally, the beneficiaries designated under the IRA do not permit the most tax-efficient distribution of the IRA under the RMD rules. For example, a surviving spouse and non-spouse beneficiaries (e.g. their children) might be named on the beneficiary designation form. Significant tax deferral may be achieved if the surviving spouse was the sole beneficiary of the IRA. In some instances, this can be accomplished through use of a qualified disclaimer.[60] If the non-spouse beneficiaries timely disclaim their interest in the IRA, they would be treated as having predeceased the IRA owner.[61] Thus, in this example, the sole IRA beneficiary as of Sept. 30 would be the surviving spouse.

iii.Estate as beneficiary

Often, the owner's estate is the default beneficiary of an IRA in the absence of a beneficiary designation or if no designated beneficiaries are living at the owner's death. In this event, the estate would be the beneficiary for RMD purposes. But an IRA owner's estate is not a designated beneficiary even if the estate beneficiaries are solely individuals.[62] Thus, the IRA interest could not be stretched over the individual beneficiary's lives.

The solutions to this issue are minimal (beyond fixing the beneficiary designation during the IRA owner's life). Regulations clearly state that an owner's estate is not a designated beneficiary and the IRS has followed this clear wording in Private Letter Rulings. Further, orders from the probate court to change the result are not binding on the IRS, and the IRS refuses to follow these state court orders to the extent they are inconsistent with federal tax law.[63]

iv. Keeping beneficiary forms up to date

IRA beneficiary designation forms vary widely from institution to institution. Some forms give sufficient space and flexibility to name multiple beneficiaries, while others may simply have enough space for a limited number of individuals and their percentage interest. Often, little long-term thought is placed in filling out these forms and the institutions' default rules often receive inadequate attention. The default and ordering rules can have significant effects and disrupt the IRA owner's intent. A simple example highlights some of these issues.

Alvin and Betty have two children, Chris and Diane. Chris has two children (A&B's grandchildren). Alvin has an IRA and names Betty as the 100 percent primary beneficiary and Chris and Diane as the contingent beneficiaries, 50 percent each. Assume Alvin's wife, Betty, and his son, Chris, predecease Alvin. Who inherits Alvin's IRA? 100 percent to Diane or 50 percent to Diane and 25 percent to each of Chris's children? The answer is likely found in the IRA's ordering rules, which vary by institution or under state law.[64] The ordering rules may state the surviving contingent beneficiary, Diane, would receive 100 percent in these circumstances, and Chris's kids would receive nothing. This may not have been Alvin's intent. "To my living descendants, per stirpes" or to the trustee of Alvin's revocable trust may have been alternatives if Alvin intended for his grandchildren to inherit a deceased child's share.

Assume the same initial facts but Alvin and Betty divorce. Alvin marries Estelle and dies 20 years later without changing his beneficiary designation, which still lists Betty at 100 percent, who survives. Who inherits Alvin's IRA? Likely Betty, notwithstanding the divorce. What if Alvin agreed to keep Betty as the IRA beneficiary as part of the divorce agreement but changed it to Estelle anyway? Estelle likely inherits, but Betty may have a breach of contract claim against Alvin's estate for violating the divorce decree and perhaps against Estelle for unjust enrichment.[65]

While these examples seem obvious, the beneficiary designation is often overlooked or even changed without the lawyer's knowledge or input. In some instances, IRAs are the largest assets of a person's estate. Thus, the beneficiary designation arguably takes on as much importance as the person's will or trust in carrying out the client's post-mortem intent. Further, the strict IRA rules for maximizing tax effects post-death require careful attention to the beneficiary designation during life. While there are some fixes that can be achieved after death, properly designating the IRA beneficiary during life is the optimum solution.

IV. Creditor and Divorce Issues

Assets in an IRA are generally exempt from the IRA owners' creditors under state and federal law.[66] However, at death, the IRA assets may lose their exempt status when they become a beneficiary's inherited IRA.[67] Further, assets in an IRA are not exempt for determining Medicaid eligibility of the IRA owner in Kansas.[68] This section will not attempt to discuss all the exceptions to the general rule but will focus on inherited IRAs in light of the U.S. Supreme Court's *Clark v. Rameker*[69] decision and the tax implications in a divorce as it relates to IRAs.

A. Inherited IRAs are not exempt under federal bankruptcy law, but the law is unsettled for opt-out states, such as Kansas

11 U.S.C. § 522(b)(3)(C) and (d)(12) exempt from the bankruptcy estate "retirement funds to the extent 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. In a unanimous opinion, the Supreme Court in *Clark* held that inherited IRA assets are not "retirement funds" under the Bankruptcy Code, and accordingly, are not exempt from the bankruptcy estate.[70]

In reaching its conclusion, the Court focused on the statute's use of "retirement funds," which is not otherwise defined in the Bankruptcy Code. After crafting a definition, the Court determined that three characteristics of inherited IRAs did not meet its "retirement funds" definition: (1) holders of an inherited IRA may not add funds to the inherited IRA, (2) holders of an inherited IRA must take minimum withdrawals no matter their age, and (3) holders may withdraw the balance at any time without penalty. In further support, the Court looked at the purposes of the Bankruptcy Code, finding that protecting inherited IRAs would be akin to a "free pass" and not to ensure that debtors will be able to meet their basic needs in retirement.[71]

Kansas has opted out of the federal bankruptcy exemptions.[72] Kansas's exemption relevant to IRAs is governed by K.S.A. 60-2308(b), which states:

> (b) Except as provided in subsection (c), any money or other assets payable to a participant or beneficiary from, or any interest of any participant or beneficiary in, a retirement plan which is qualified under Sections 401(a), 403(a), 403(b), 408, 408A or 409 of the federal internal revenue code of 1986, and amendments thereto, shall be exempt from any and all claims of creditors of the beneficiary or participant. Any such plan shall be conclusively presumed to be a spendthrift trust under these statutes and the common law of the state.

Arguably, a decision different from *Clark* could be reached based on the Kansas exemption statute. However, on June 17, 2015, Judge Somers handed down an opinion finding inherited IRAs of Kansas debtors are not exempt under the Kansas exemption statute.[73] In so ruling, Judge Somers relied on the reasoning of *Clark* and found "no material difference between the federal and Kansas exemptions."[74] In an opinion issued Oct. 30, 2015, Judge Lungstrum affirmed Judge Somers's decision on essentially the same grounds, finding an inherited IRA is not exempt under the Kansas exemption statute.[75] If creditor protection is a concern, naming a spendthrift trust as the IRA beneficiary—which meets the elements described above to qualify as a "designated beneficiary"—may be the optimal solution.

B. IRA assets *transferred* incident to a divorce are not treated as a distribution and are not immediately taxable. But IRA assets distributed incident to divorce are taxable and potentially subject to the 10 percent early withdrawal penalty

Under Kansas law, IRAs are subject to division in a divorce proceeding.[76] In making the property division, the court must consider a number of factors, including the tax consequences of the property division.[77] The division of an IRA incident to a divorce and transfer of an interest in the IRA to the spouse or former spouse is not a taxable event for the IRA owner.[78] Following the transfer, the transferred portion is treated as the former spouse's IRA, and the tax consequences of distributions from that portion are borne by such former spouse.[79]

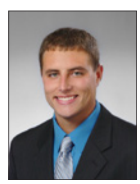
While the concept seems straightforward, there are a couple of possible traps. First, the transfer must be pursuant to a divorce decree or separation instrument as described in Code Section 71(b)(2)(A).[80] Even if the parties have agreed to a division of property, the parties cannot transfer the IRA until after the court has entered its divorce decree. Otherwise, the transfer would be treated as a taxable distribution to the IRA owner, who was intending to transfer the IRA (and all associated tax burdens) to the owner's soon-to-be former spouse.[81]

Second, the distribution of IRA assets (as opposed to a transfer) is taxable to the IRA owner. And distributions to an IRA owner under age 59 ½ incident to a divorce are still subject to the 10 percent penalty tax for early withdrawals.[82] The QDRO exception to the 10 percent early withdrawal penalty for distributions from a qualified pension plan does not apply to IRAs.[83] Thus, if an outright distribution is preferred for a spouse under age 59 ½ and there is a choice between assets held in an IRA and a qualified plan, the outright distribution from the qualified plan would be preferred to avoid the 10 percent penalty tax.

V. Conclusion

Like many creatures of the tax code, IRAs are subject to specific requirements and restrictions that are not inherently intuitive. Transactions and other dealings with IRAs are strictly limited. Distributions during life and at death are subject to specific rules to maintain the IRAs tax deferral. It is critical to identify the specific nature of the transaction or issue at hand and then apply the correct rule to ensure the IRA's benefits are not lost during the owner's lifetime or after death.■

About the Author



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Endnotes

1. Investment Company Institute, 2015 Investment Company Fact Book, available at www.icifactbook.org.
2. I.R.C. § 4975(c)(1).
3. An IRA is a "plan" under this definition. *Id.* § 4975(e)(1)(B).
4. Includes spouse, ancestor, lineal descendant, and any spouse of a lineal descendant. *Id.* § 4975(e)(6).
5. I.R.C. § 4975(e)(3). This typically includes the IRA owner. On April 14, 2015, the Department of Labor issued proposed regulations defining a fiduciary under ERISA and Code Section 4975 and withdrew the proposed regulations published in 2010. While those regulations have a direct impact on IRA owners and those advising IRA owners, the nature and extent of those proposed regulations are beyond the scope of this article. *Id.* § 4975(e)(4) and (5).
6. *Id.*§ 4975(e)(4) and (5).
7. It goes without saying that when confronted with a prohibited transaction situation, the lawyer must carefully review all the definitions, particularly the attribution rules and the undefined "direct or indirect" definitions under Code Section 4975(e)(2)(E) and (G).
8. The Supreme Court has recognized and enforced Congress's broad use of "direct or indirect" under Code Section 4975(c)(1). Comm'r v. Keystone Consol. Indus., Inc., 508 U.S. 152, 159-60 (1993).
9. I.R.C. § 408(e)(2).
10. Under Code Section 408A, Roth IRAs consist of after-tax proceeds, and distributions are generally tax-free. 408A(d)(1). However, if a prohibited transaction occurs, any gain resulting from the deemed distribution will be taxable to the IRA owner. See generally I.R.C. § 408A(a).
11. *Ellis v. Comm'r,* 2015 U.S. App. LEXIS 9380, (8th Cir. June 5, 2015), affirming *Ellis v. Comm'r,* 106 T.C.M. (CCH) 468, T.C. Memo. 2013-245 (2013). 2015 U.S. App. LEXIS 9380 at *6–7.
12. 2015 U.S. App. LEXIS 9380 at *6–7.
13. I.R.C. § 4975(e)(2)(G)(i) (owning 50% or of the combined voting power or value of shares of all classes of stock) and 4975(e)(4) (ownership includes indirect ownership).
14. On the facts, the Tax Court found the IRA's purchase of an interest in CST was not a prohibited transaction. It declined to address the IRS's argument that the purchase was part of a pre-conceived arrangement for Ellis to receive wages. The 8th Circuit refused to consider this argument as well.
15. 2015 U.S. App. LEXIS 9380 at *7 (citing I.R.C. § 4975 (c)(1)(D), (E); 29 C.F.R. 2509.75-2(c)).
16. *Id.* 9380 at *6; I.R.C. § 408(e)(2).
17. I.R.C. § 6662 imposes a 20% accuracy-related for, inter alia, substantial understatements of income tax. 6662(b)(2). There is a substantial understatement of income tax if the understatement exceeds the greater of 10 percent of the required tax or $5,000. Id. § 6662(d).
18. Id. § 72(t).
19. 2015 U.S. App. LEXIS 9380 at *6 (citations omitted).

20. 106 T.C.M. at 473.

21. 140 T.C. 216 (2013).

22. I.R.C. § 4975(c)(1)(B) prohibits any direct or indirect lending of money or other extension of credit between a plan and a disqualified person.

23. 149 T.C. at 225 (emphasis in original). This result should not have been a surprise to the taxpayers. In 1990, the Department of Labor issued DOL Advisory Opinion 90-23A. On facts nearly identical to those in *Peek,* the DOL concluded that a disqualified person's guarantee of a loan to an IRA violated Code Section 4975(c)(1)(B), relying on ERISA's legislative history directly on point.

24. 149 T.C. at 227–230. The Tax Court held the 2006 deficiency was subject to the substantial understatement penalty under Code Section 6662(b)(2). However, for the 2007 tax year, the deficiency did not meet the threshold. Instead, for 2007, the court imposed the 20 percent penalty under Code Section 6662(c) for the taxpayers' negligence. The court noted the taxpayers' reliance on an active promoter of the structure was not reasonable, and the opinion letter from the accountant expressly mentioned the detrimental effects of a prohibited transaction.

25. 531 B.R. 219 (E.D. Ark. 2015), affirmed by the district court, *In re Kellerman*, No. 4:15-cv-00347, 2015 U.S. Dist. LEXIS 122046 (E.D. Ark. Sep. 14, 2015).

26. 11 U.S.C. 522. The bankruptcy exemption issues are discussed more fully below.

27. It appears the property was conveyed one-half to the IRA and one-half to Panther Mountain and was never titled in the name of the new partnership.

28. I.R.C. § 4975(e)(2)(A).

29. *Id.* § 4975(e)(2)(F).

30. *Id.* § 4975(e)(2)(G).

31. 531 B.R. at 227.

32. *Id.* at 227–28.

33. In certain circumstances, however, qualified plans (e.g. ESOPs and profit sharing plans) can clearly be used to provide seed capital to new business ventures. These are referred to as Rollovers as Business Startups or ROBS. ROBS arrangements typically involve rolling over an IRA or a prior qualified plan account into a newly established plan, sponsored by the start-up business. This new plan then invests the funds in stock of the new corporation. This arrangement is fundamentally different from the IRA for several reasons, primarily because the qualified plan is subject to ERISA. ERISA has its own prohibited transaction provision, § 408(e) (29 U.S.C. § 1108(e)), which expressly permits investments in qualifying employer securities. Code Section 4975(e)(13) recognizes this exemption for tax qualification purposes. The concerns the court cited in *Peek* are less prevalent in the qualified plan context because of the exclusive benefit rule of Code Section 401(a), the fiduciary requirements of ERISA, and associated regulatory filings and recordkeeping required to maintain plan compliance that are not found with IRAs. For further discussion of ROBS, see Memorandum of Michael Julianelle to the Director for Employee Plans Examinations, RE: Guidelines regarding rollovers as business start-ups, dated October 1, 2008, available at https://www.irs.gov/pub/irs-tege/robs_guidelines.pdf.

34. *Ellis v. Comm'r*, 106 T.C.M. (CCH) at 472.

35. These are the minimum requirements required by the Code and Regulations. The specific IRA terms (generally set forth in the IRA agreement with the financial institution) may vary within the bounds of these minimum requirements, so it is important to review the actual IRA terms.

36. I.R.C. §§ 408(a)(6), 408(b)(3); Treas. Reg. § 1.408-8.

37. Treas. Reg. § 1.401(a)(9)-2, Q&A-1(a).

38. *Id.* § 1.401(a)(9)-2, Q&A-2.

39. See also, IRS Publication 590-B, Distributions from Individual Retirement Arrangements (IRAs).

40. Treas. Reg. § 1.401(a)(9)-5, Q&A-4(a).

41. *Id.* § 1.401(a)(9)-5, Q&A-5(a).

42. *Id.*

43. *Id.* § 1.401(a)(9)-3, Q&A-2. Note that the 5-year rule does not require equal or periodic distributions during the 5-year term. Distributing the entire balance on December 31 of the 5th year after the owner's death would satisfy this rule.

44. *Id.* § 1.401(a)(9)-3, Q&A-4.

45. *Id.*

46. *Id.* § 1.401(a)(9)-3, Q&A-3(a). As stated above, in the year of the owner's death, the RMD must be determined as if the owner lives throughout the entire year.

47. *Id.* § 1.401(a)(9)-5, Q&A-5(c)(1).

48. *Id.* § 1.401(a)(9)-8, Q&A-2(a)(2). The separate accounts must be set up by December 31 of the year after the owner's death. Note that the separate accounts rule does not apply to trusts. See footnote 58, infra.

49. *See id.* § 1.408-8, Q&A-5(a).

50. *Id.* § 1.401(a)(9)-3, Q&A-3(b).

51. *Id.* § 1.401(a)(9)-5, Q&A-5(c)(2).

52. *Id.* § 1.401(a)(9)-4, Q&A-3.

53. *Id.* § 1.401(a)(9)-4, Q&A-1.

54. *Id.* § 1.401(a)(9)-4, Q&A-5.

55. *See Id.* § 1.401(a)(9)-5, Q&A-7. The separate account rules (described above) do not apply to trusts with multiple beneficiaries. Treas. Reg. § 1.401(a)(9)-4, Q&A-5(c). Thus, individual trust beneficiaries are not entitled to separate distribution periods with respect to their separate trust shares.

56. *Id.* § 1.401(a)(9)-4, Q&A-4

57. Another potential issue relating to inherited IRAs is the inability to maintain its tax-favored status utilizing rollovers that otherwise apply to IRAs (the 60-day requirement many people are aware of). Instead, inherited IRAs may be *transferred* to other institutions via trustee-to-trustee transfer only. 408(d)(3)(C). Attempting to use a rollover will cause the entire inherited IRA to be fully distributed, and therefore, fully taxable.

58. Treas. Reg. § 1.401(a)(9)-4, Q&A-4.

59. This "fix" also applies to trusts, such as a trust that leaves a specific bequest to charity and the remainder to individuals or has creditors that need paid from a portion of the IRA proceeds. Paying the charitable beneficiary prior to September 30 of the year following the IRA owner's death can permit the trust to now qualify as having a "designated beneficiary" for RMD purposes.

60. I.R.C. § 2518(a). The general disclaimer rules require a written refusal to accept the benefits within 9 months after the decedent's death, and the disclaimant must not have received any benefit from the disclaimed interest.

61. *See Id.*; K.S.A. 59-2293. Disclaimers could also be used to "fix" non-individual beneficiaries existing on the date of death.

62. Treas. Reg. § 1.401(a)(9)-4, Q&A-3. This effect would also apply to a pour-over will that bequeaths all assets to a trust that would otherwise qualify as a "designated beneficiary."

63. *See* PLR 200846028 (Aug. 20, 2008). IRS determined the IRA did not have a "designated beneficiary" notwithstanding state court's ruling that persons named by trust (as sole beneficiary of pour-over will) were directly named under the decedent's IRA.

64. Which leads to the inevitable question of which state law applies—the state of the institution, state of the owner, or state of the beneficiary (or beneficiaries)?

65. *See Grothe v. Grothe*, 2014 Kan. App. Unpub. LEXIS 892 (Kan. Ct. App. 2014).

66. K.S.A. 60-2308, 11 U.S.C. § 522.

67. An inherited IRA is an IRA that the owner acquired by reason of the death of another individual. I.R.C. § 408(d)(3)(C)(ii).

68. However, the community (or well) spouse's IRA is not included in the resource allowance when determining Medicaid eligibility. Kansas Economic and Employment Services Manual (KEESM) §5430(18)(c)(iii). Whether IRAs are exempt for Medicaid eligibility purposes is left up to the states. *Houghton v. Reinertson*, 382 F.3d 1162, 1173 (10th Cir. 2004).

69. 134 S. Ct. 2242, 189 L.Ed.2d 157 (2014).

70. *Id.* at 2247.

71. *Id.*at 2248.

72. K.S.A. 60-2312. 11 U.S.C. § 522(b).

73. *In re Mosby*, 14-22981 (Bankr. D. Kan. 2015).

74. Slip op. at 6.

75. Mosby v. Clark (*In re* Mosby), 15-5193-JWL (D. Kan. Oct. 30, 2015).

76. K.S.A. 23-2802.

77. *Id.* 23-2802(c)(9).

78. I.R.C. § 408(d)(6), Treas. Reg. § 1.408-4(g). The use of the term

"transfer" is important to avoid taxation. In this context, transfer means a transfer to the former spouse's IRA, and not a transfer to the former spouse outright. The latter, a "distribution," would be a taxable event as discussed below.

79. In practice, transferring the IRA to the former spouse may depend on the financial institutions' (custodian of the IRA) proclivities. Some practitioners use a Domestic Relations Order, modeled after a Qualified Domestic Relations Order (or QDRO), to avoid sending the often lengthy divorce decree and property settlement agreement to the financial institutions. A one or two-page court order for the IRA may be more welcoming to the employee tasked with handling such issues at the relevant financial institution, which may lead to an easier transfer.

80. I.R.C. § 408(d)(6).

81. *See* PLR 9344027 (written separation agreement between the parties to divide IRAs that is not incident to a divorce decree or presented to a court to enter a similar order does not constitute a decree or separation agreement under I.R.C. § 71(b)(2)(A), and therefore, the I.R.C. § 408(d) exception does not apply.)

82. I.R.C. § 72(t).

83. *Id.* § 72(t)(2)(C); *See also* Natalie Choate, Life and Death Planning for Retirement Benefits, 565, (7th ed. 2011).