Collection of Funds in Individual Retirement Accounts: Are They Really Exempt?

By Sherry L. Johnson / May 24, 2017

This article explores the assumption that IRAs are fully exempt from attachment by judgment creditors. Recently, Clark Hill argued that a judgment debtor's use of IRA funds for purposes that were not intended by Illinois exempt status or the Internal Revenue Code (IRC) caused the IRA to not only lose its exempt status under Illinois law but also ceased to exist under the IRC, and that the entire funds in the IRA were available to the judgment creditor for payment of the debt. The judge, in response to our arguments, stated that "this is the first time in over 29 years that I ever encountered this particular issue." Why? Most assume that IRAs are fully exempt and that IRA funds are not available to pay debts owed to a judgment creditor. The judge, after an evidentiary hearing and submission of briefs, found that the IRA funds ceased being an IRA under the IRC and that the funds in the IRA were available to the judgment creditor.

Most, if not all, states have an exemption statute that presumably protects IRAs from attachment by judgment creditors. However, the Internal Revenue Code (IRC), *26 USC §§ 408(e)(1) and (2)(A), and 4975(c)*, may preempt state exempt statutes if it is determined under the Code that an IRA ceases to be an IRA. Sections 408(e)(1), (2)(A) and (B) of the IRC provide:

> (e) Tax treatment of accounts and annuities.
>
> > (1) Exemption from tax. Any individual retirement account is exempt from taxation under this subtitle (26 USCS §§1 et seq) unless such account has ceased to be an individual retirement account by reason of paragraph (2)....
> >
> > (2) Loss of exemption of account where employee engages in prohibited transaction.
> >
> > > (A) In general. If, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual...engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year...

26 USC §408(e)(1), 2(A) and (B). Consequently, the IRC imposes certain restrictions on the use of IRA funds. Section 4975(c) of the IRC lists "Prohibited Transactions" as follows:

> (1) General rule
>
> For purposes of this section, the term "prohibited transaction" means any direct or indirect-
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> (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.

26 U.S.C. §4975(c)(1).

The IRS generally describes a prohibited transaction for an IRA as any improper use of an IRA account by the IRA owner, his or her beneficiary or any disqualified person. In *IRS Retirement Topics - Prohibited Transactions*, the IRS notes that if an IRA owner or his or her beneficiary engages in a prohibited transaction in connection with an IRA at any time during the year, the account stops being an IRA as of the first day of that year. The IRS defines what constitutes a "disqualified person" under 26 U.S.C. §4975(e)(2), which includes, but is not limited to, a fiduciary of the plan and an individual providing services to the plan.

Some courts also have addressed this issue. In Illinois, the court in *O'Malley v. Commissioner* of IRS, 972 F.2d 150 (1992) held that prohibited transactions include a direct and indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan, and that a prohibited transaction is intended to prevent people with a close relationship to the plan (a disqualified person) from using the relationship to the detriment of plan beneficiaries. In Michigan, the court in *AEBIG v. Cox*, 2006 Mich. App. LEXIS 1695, *5 opined that if an individual or his beneficiary engages in any transaction prohibited under §4975 of the IRC with respect to an IRA, the IRA ceases to be an IRA from the first day of such taxable year. A Texas court in *Nu-Way Energy Corp. v. Delp*, 205 S. W. 3d 667, 681 (2006) held that an IRA ceases to be an IRA under §408(e)(2)(A) of the IRC if the account

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holder engages in any transaction prohibited under §4975, and that the entire funds in the IRA will become non-exempt. Also, a Florida court held in In Re Hughes, 293 B.R. 528 (FL 2003) that a debtor, who lent money from his IRA account to his corporation, subsequently filed for bankruptcy protection, and claimed the IRA exempt, engaged in a prohibited transaction under §4975 of the IRC causing debtor's IRA to lose its IRA status under §408(e)(2)(A) of the IRC. None of these cases have been overturned and remain good law.

In light of the above, under certain circumstances, an IRA could lose its exempt status exposing the IRA funds to judgment creditors for payment of an outstanding debt.

If you have any questions about the issues discussed in this article, please contact Sherry Lowe Johnson at (312) 985-5599 | sljohnson@clarkhill.com or another member of Clark Hill's Litigation Practice Group.