

## U.S. Supreme Court Rules U.S. Bankruptcy Code Affords Protection for IRAs from Creditors

In an April 4, 2005 decision, the U.S. Supreme Court held that a debtor may exempt a qualified IRA (Individual Retirement Account) from property of the bankruptcy estate under section 522(d)(10)(E) of the U.S. Bankruptcy Code, shielding the funds held in the IRA from his or her creditors to the extent reasonably necessary for the support of the debtor and any of the debtor's dependents. *Rousey v. Jacoway*, No. 03-1407, 2005 U.S. LEXIS 2933 (April 4, 2005). That section of the Code allows debtors to protect their "right to receive" payments such as pensions and annuities that are made "on account of age."

### Supreme Court Decision

Writing for a unanimous court, Justice Clarence Thomas noted that a split existed among the federal Courts of Appeals on the question of whether funds held by a debtor in a qualified IRA may be exempted from the debtor's bankruptcy estate pursuant to section 522(d)(10)(E). The Court examined two factors in considering the exemption:

- 1) whether distributions under qualified IRAs represent payments "on account of illness, disability, death, age, or length of service"; and
- 2) whether IRAs are stock bonuses, pensions, profit sharing, annuity or similar plans or contracts.

The Court concluded that both the purpose and the language of section 522(d)(10)(E) support a debtor's ability to exempt funds held in a qualified IRA and prevent their being used to pay off debts. The Court reasoned that an IRA satisfies the requirements of section 522(d)(10)(E) because:

- 1) it is a right to payment made on account of age, since the penalty for early withdrawal "is removed when the accountholder turns age 59 ½"; and
- 2) it is similar to stock bonuses, pensions, profit sharing, or annuity plans since, like those plans, an IRA "provide[s] income that substitutes for wages earned as salary or hourly compensation."

### IRAs and Bankruptcy

Under section 408 of the Internal Revenue Code, Congress established qualified IRAs to enable individuals to deposit funds into certain restricted accounts that earn interest which accrues tax-deferred until withdrawn. Because IRAs are intended to provide individuals with a vehicle for retirement planning, funds held in IRAs may not be withdrawn (with certain limited exceptions) before the accountholder reaches the age of 59 ½. Congress built in a disincentive to early withdrawal by subjecting IRAs to a 10 percent penalty in the event that funds are withdrawn before the accountholder reaches the required age.

However, when an individual files a petition for relief under the Bankruptcy Code, all of that individual's property (with certain specified exclusions and exemptions) becomes property of the debtor's bankruptcy estate, which is administered under the supervision of the bankruptcy court for the benefit of the debtor's creditors. Where a debtor's property includes one or more IRAs, a court must determine whether such IRAs may be exempted from property of

the bankruptcy estate. The U.S. Courts of Appeals came down on both sides of the issue, creating a split among the circuits on whether IRAs could be shielded from the bankruptcy estate.

With the *Rousey* decision, the Supreme Court has settled the uncertainty surrounding the treatment of IRAs in a bankruptcy situation, making it clear that under section 522(d)(10)(E) of the Bankruptcy Code a debtor can keep his or her IRAs beyond the reach of creditors to the extent reasonably necessary for the support of the debtor and any of the debtor's dependents. The conclusion the Court reached is consistent with proposed changes to section 522 in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, passed by the U.S. Senate on March 10<sup>th</sup>, which expressly exempts qualified retirement accounts such as those at issue.

**Section 522 applies only where a state has not opted out of the federal exemptions (35 states have opted out of these exemptions). Some state exemptions for IRAs may, in fact, be more generous than the federal exemptions.**

### For Further Information

If you have any questions about the information in this Alert, please contact one of the members of the Duane Morris Business Reorganization and Financial Restructuring Group or the lawyer in the firm with whom you are regularly in contact.

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