

IRAs and Bankruptcy IN ILLINOIS

By [Robert S. Held](#)

Under state law in effect for a few more months, creditors are unlikely to reach an Illinois resident's IRA account regardless of whether they try in bankruptcy court or after having won a judgment against the debtor. Find out why, and learn how the new bankruptcy law will affect IRAs beginning in October.

Individual retirement accounts¹ (IRAs) are becoming a large part of family wealth – retirement accounts of all types totaled \$3 trillion in assets as of last year.² Trust companies, banks, and other advisors seek ways to profit from individuals' concern in having a large portion of their net worth in one type of account. Under current Illinois law, however, creditors find the IRA assets of Illinois residents difficult to reach.

Further, generous protection will be provided under federal law, which replaces the Illinois exemption scheme after October 17 based on the new Bankruptcy Act signed by President Bush on April 20, 2005 ("BAPCPA").³ Illinois law does provide some advantages for holders of IRAs that exceed \$1 million in assets, however (see discussion below), and any such individuals who are contemplating bankruptcy should consider the pros and cons of filing before the new bankruptcy law takes effect.⁴ This article briefly addresses the state law protection now available for IRAs in Illinois and discusses the federal bankruptcy protection that takes effect this fall.

Individual bankruptcy and IRAs

Under the federal bankruptcy code currently in effect, either Illinois or federal exemptions may be selected by a debtor unless the state of Illinois has chosen to "opt out" of the federal exemption scheme,⁵ which Illinois did in 1981.⁶ Thus, for a few more months, Illinois law provides the legal framework for the determination of which assets will be exempt from the bankruptcy estate. For bankruptcy filings after October 17, 2005, BAPCPA requires the federal rules to apply – Illinois exemptions will no longer be effective.

For bankruptcies filed *on or before* October 17, Illinois has chosen to confer exempt status to IRAs, thereby excluding them from a bankruptcy estate.⁷ Illinois law provides that a debtor's right to the assets held in pensions, annuities, or other payments under a *retirement plan* are exempt from judgment and seizure for the satisfaction of debts if the plan is intended in good faith to qualify as a retirement plan under applicable provisions of the Internal Revenue Code of 1986.⁸ "Retirement plan" is defined under the Illinois statute to include an individual retirement annuity or individual retirement account.⁹

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A trustee in bankruptcy may disagree with an IRA owner that an IRA is exempt and try to include it as an asset of the bankruptcy estate. However, the burden of proof under the Illinois application of federal bankruptcy law provides further protection. A creditor who objects to an exemption has the burden of proving that it is not properly claimed.¹⁰

In *In re Ritter*,¹¹ an individual used an IRA for her living expenses and attorney fees while under the age of 59 1/2

and testified that she would continue to use those funds in the immediate future. The trustee in bankruptcy objected to her use of IRA funds before she reached retirement age, arguing that it showed her intent not to save for retirement but to use the accounts for current needs. The trustee seemed to be focusing on the language in the Illinois statute that exempts IRAs if they are intended to qualify *in good faith as a retirement plan*. "A debtor's interest in...a retirement plan is exempt from judgment,...if the plan (i) is intended in good faith to qualify as a retirement plan under applicable provisions of the Internal Revenue Code of 1986...."¹²

The court rejected the trustee's effort. It was sufficient that the account satisfied the technical requirements of federal law in its creation, the court wrote. Indeed, it was enough that the IRA was set up properly. The only "good faith" required was that the debtor intended to qualify it as an IRA under federal tax law, and there was no evidence in the *Ritter* facts to the contrary.

A reading of the statute and the Illinois cases support only one conclusion as to the disposition of an Illinois debtor's IRA in bankruptcy court: IRA assets are exempt from the bankruptcy estate.¹³

As noted, the new bankruptcy law will make an IRA exempt for bankruptcies filed after October 17, 2005, regardless of whether a state (like Illinois) has "opted out." Thus, BAPCPA will provide a more nationally uniform and predictable treatment for IRAs in a bankruptcy estate.

One change detrimental to Illinois residents: the new federal law caps the exemption at \$1 million for IRAs and Roth IRAs.¹⁴ IRA assets above this amount will be treated as part of the bankruptcy estate. Importantly, the \$1 million cap does not apply to rollovers from qualified plans or to simplified employee pension plans. Individuals may thus want to keep their regular and rollover IRAs separate because a rollover IRA – unlimited in amount – should be exempt in bankruptcy.

Judgment creditors and IRAs

Illinois provides statutory protection for IRA owners against the claims of creditors. Specifically, the Illinois legislature has determined that an Illinois debtor's interest in an IRA should be exempt from judgment.¹⁵ Because this protection is provided under Illinois law – not federal bankruptcy law – the \$1 million bankruptcy cap under federal law is inapplicable to the Illinois protection against judgment creditors.

While the distinction made under federal bankruptcy law between "qualified plans" and IRAs previously resulted in a lack of federal protection for an IRA in some cases, Illinois state law makes no such distinction. The statute provides that the retirement plan protection provided for debtors includes, inter alia, "an individual retirement annuity or individual retirement account."¹⁶

Moreover, the exemption for retirement accounts is applied liberally¹⁷ and need not be "necessary for support" to come within the protection provided by the rules.¹⁸ Thus, even a rollover IRA that has swelled in size well beyond what would be needed for support by the owner would still be protected from a judgment creditor (outside of bankruptcy).

There are exceptions to the Illinois exclusion from judgment for IRAs. Child support payments are one example.¹⁹ Additionally, an annuity created in settlement of a personal injury claim does not come within the reach of the statute.²⁰ But exceptions are limited and usually dictated by public policy.

Efforts to expand the exceptions and allow creditors to reach IRAs under Illinois law have generally met with failure. As an example, the attorneys for a wife seeking child support modification were unable to obtain the husband's IRA assets in satisfaction of their legal fees. In the lower court, the wife obtained an order increasing child support and requiring payment of future college education costs for their children. The lower court also awarded attorney fees to the wife's attorney in connection with those proceedings.

The wife's attorney obtained a nonwage garnishment of husband's IRA. The husband asserted the Illinois exemption statute, but the lower court rejected the husband's argument, holding that Illinois' strong public policy favoring collection of child support created an exception to the exemption statute. The appellate court reversed the lower court's garnishment of the husband's IRA and said bluntly that "Illinois' public policy favors the payment of child support and maintenance obligations from exempt property to promote the support of the family, not the support of attorneys."²¹

Conclusion

The Illinois legislature's determination to "opt out" of the federal bankruptcy exemption regime – and to then exclude IRAs from the bankruptcy estate – provides significant protection for an individual who declares bankruptcy prior to October 17. Federal law exempts IRAs after that date – at least up to \$1 million. Judgment creditors seeking to attach an IRA will be unsuccessful in Illinois unless their claim falls within narrow public policy exceptions, such as a spouse seeking child support payments. ••

Bill doubling homestead exemption sent to governor

House Bill 1523 (Mathias, R-Buffalo Grove; Silverstein, D-Chicago) doubles the homestead and personal property exemptions for debtors in bankruptcy and in the enforcement of judgments. For example, the homestead exemption for a couple would increase from \$15,000 to \$30,000.

HB 1523 had passed both houses but not been signed by the governor when this article went to press. If signed as expected, its effective date will be January 1, 2006

1. 26 USC § 408.
2. Rachael Silverman, "New IRA Protects Assets In Lawsuits, Bankruptcy," *Wall St J* D2 (Oct 13, 2004).
3. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) will be effective October 17, 2005, and will provide uniform treatment of IRAs in bankruptcy. See PL 109-8. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_public_laws&docid=f:publ008.109.
4. While current federal law exempts non-IRA "qualified plans" from a bankruptcy estate, it has historically provided uneven protection for IRAs. 11 USC § 541(c)(2); *Patterson v Shumate*, 504 US 753, 753 (1992), *Reliance Ins Co v Zeigler*, 938 F2d 781, 783 (7th Cir 1991); See also *Rousey v Jacoway*, 125 S Ct 1561 (2005).
5. See 11 USC § 522(b)(1).
6. 735 ILCS 5/12-1201.
7. See 735 ILCS 5/12-1006. This Code Section applies to interests in retirement plans held by debtors subject to bankruptcy proceedings pending on or filed after August 30, 1989. 735 ILCS 5/12-1006(d).
8. 735 ILCS 5/12-1006(a)(i).
9. 735 ILCS 5/12-1006(b)(3).
10. See *In re Ritter*, 190 BR 323, 325 (ND Ill 1995).
11. *Id.*
12. 735 ILCS 5/12-1006.
13. See *In re Gordon*, 1996 WL 33401390 (CD Ill).
14. BAPCPA § 224.
15. 735 ILCS 5/12-1006.
16. 735 ILCS 5/12-1006(b)(3).
17. See *In Re Ellis*, 274 BR 782, 788 (SD Ill 2002).
18. See *In Re Schnabel*, 153 BR 809, 814 (ND Ill 1993).
19. See *In Re Marriage of Murphy and Wronke*, 338 Ill App 3d 1095, 1097, 792 NE2d 12, 14 (4th D 2003).
20. See *In Re Simon*, 170 BR 999, 1003 (SD Ill 1994).
21. *Jakubik v Jakubik*, 208 Ill App 3d 119, 126, 566 NE2d 808, 812 (2d D 1991) (emphasis supplied).

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