

SECTION OF TAXATION

State Bar of Texas



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May 11, 2011

Submitted Electronically: Rafael.Anchia@House.State.TX.US

Representative Rafael Anchia
Texas State Representative
House District 103
Post Office Box 2910
Austin, Texas 78768-2910

Re: Comments on S.B. 1810

Dear Representative Anchia:

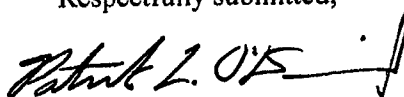
By letter of May 2, 2011, you requested that the Section of Taxation of the State Bar of Texas provide comments, guidance and provide the Committee with comments, guidance and background information in connection with the consideration of Senate Bill 1810. The Section of Taxation is pleased to provide the following comments.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We commend the Texas Legislature for its leadership in drafting and passing Senate Bill 1810, and appreciate the opportunity to participate further in proposing legislation relating to inherited individual retirement accounts.

Respectfully submitted,

A handwritten signature in cursive script, reading "Patrick L. O'Daniel". The signature is written in dark ink and includes a stylized flourish at the end.

Patrick O'Daniel
Chair, Section of Taxation
The State Bar of Texas

COMMENTS CONCERNING TEXAS FRANCHISE TAX

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the State Bar of Texas or the Section of Taxation.

These comments were prepared by individual members of the Employee Benefits Committee of the Section of Taxation of the State Bar of Texas (the "Committee"). Principal responsibility was exercised by Susan Wetzel, the Chair of the Committee, the Committee's Vice-Chair, Henry Talavera. The principal drafters of the Comments were Cecil A. Ray and Karen Suhre. The comments were reviewed by Stephanie Schroepfer as Chair of the Section's Committee on Governmental Submissions.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the state tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 11, 2011

The purpose of this comment is to provide (i) background regarding the exemption of certain retirement funds under Texas law and how that compares with the exemption of these same funds from federal law, (ii) an overview of issue associated with "inherited IRAs" and (iii) comments regarding a suggested amendment of Section 42.0021 by S.B. 1810.

It appears that the Texas legislature is proposing a property tax exemption under Texas law to protect the retirement savings of workers and their beneficiaries. We respectfully suggest that the legislature consider adopting the suggested legislation, with the modifications, attached hereto as Exhibit A, to ensure that these savings are protected for all citizens of Texas.

The protection of retirement savings is a significant issue. Many families are placing the bulk of their wealth into retirement accounts. Any part of this retirement savings not spent by the IRA owner during retirement by the IRA owner will likely be left to spouses and descendants. Consequently, it is important that these funds be protected from attachment by creditors, especially at a time when more and more families face creditor problems. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 exempts retirement funds to the extent that such funds are in a fund or account exempt from taxation under the sections referred to above. Such retirement amounts were clearly singled out as not abusive and deserving of protection.

1. Historical Background: Exemption of Retirement Funds Under Texas Law -- Section 42.0021

Texas Property Code Section 42.0021 was originally enacted in 1987 in response to concerns raised by the federal appeals court rulings in *Goff v. Taylor*, 706 F.2d 574 (5th Cir. 1983) and *In re Goff*, 812 F.2d 931 (5th Cir. 1987). *Goff* held that the assets of a "Keogh Plan," a retirement plan set up by a self-employed husband and wife, were not exempt property under Texas "spendthrift trust" law, since the assets of plan had been contributed by the individuals, not by their employer. The State Bar of Texas adopted a legislative initiative, which became section 42.0021 of the Texas Property Code, to specifically exempt retirement plans such as the Goffs' from "attachment, execution and seizure for satisfaction of debts," provided that the retirement plans meet the qualification requirements of federal tax law.

Although the exemption of individual retirement accounts (IRAs) was not addressed in the bill as introduced, the Texas Legislature itself amended the bill to include IRAs. This action was consistent with the policy of ERISA to protect retirement savings. It was also consistent with Section 2002 of ERISA which provided for an income tax deduction for retirement savings and created the IRA so that working individuals not covered by an employer-sponsored retirement plan could save for retirement.¹

Section 42.0021 has been amended several times to increase the scope of coverage to other types of retirement type savings arrangements. For example, in 2005, Section 42.0021 was amended to add two new arrangements created by federal tax law, Roth IRA accounts and health

¹ H.R.Conf. Rep. No 92-1280, 93d Cong. 2d Sess. 156 (1974). See also Joint Explanatory Statement of Conference Committee at Report of Committee at 335.

savings accounts, to the list of retirement vehicles that are exempt from attachment, execution and seizure.

2. Exemption of Retirement Funds Under Federal Law

After the enactment of §42.0021, the U.S. Supreme Court unanimously held that assets of employer-sponsored retirement plans that are governed by Title I of ERISA (29 U.S.C. §1001 et seq.) are exempt from creditors' claims in a bankruptcy proceeding, because Title I of ERISA is "applicable non-bankruptcy law" that expressly prohibits the assignment or alienation of benefits provided in a plan that is subject to Title I of ERISA. *Patterson v. Shumate*, 504 U.S. 753 (1992). However, *Shumate* did not resolve ongoing issues about creditor's rights to tax-favored retirement plans and accounts which are excluded from Title I of ERISA, such as retirement plans covering only a self-employed individual and spouse, various types of individual retirement accounts established by an employed or self-employed individual, and plans sponsored by governmental agencies and churches.²

Since Section 42.0021 was enacted and last amended, Congress has amended the Bankruptcy Code³, to provide a federal comprehensive exemption for tax-favored retirement funds in bankruptcy cases. Sections 522(b)(3)(C) and 522(d)(12) of the Bankruptcy Code exempt "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under §§401, 403, 408, 408A, 414, 457, or 501 of the Internal Revenue Code of 1986."⁴

3. Inherited IRAs

Recently disputes have arisen as to whether "inherited IRAs"⁵ are exempt property in Texas. The courts have reached mixed results in determining whether an "inherited IRA" may be exempt property under §42.0021 or similar statutes in other states. A bankruptcy case in Texas, *In re Jarboe*, 365 B.R. 717, 2007 WL 987314 (Bankr. S. D. Tex. 2007), held that an inherited IRA was not exempt property under §42.0021. Generally, an inherited IRA would not be covered by Title I of ERISA, and would not be protected under *Shumate*, so the availability

² 29 U.S.C. § 1003.

³ The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub.L. No. 109-8, applies to bankruptcies filed after October 16, 2005.

⁴ The Bankruptcy Code goes on to limit the exemption for IRAs to \$1,000,000, unless the interests of justice would support a higher amount; but amounts rolled over from an employer-sponsored plan and contributions made or contributed pursuant to a simplified employee pension plan or SIMPLE are excepted from the limit, so it is not expected to have much impact. 11 U.S.C. §522(n).

⁵ IRAs are usually non-probate assets governed by section 450 of the Texas Probate Code, and an IRA beneficiary designation directing that the account go to a person other than the decedent's estate is considered a non-testamentary instrument. Consequently, in most cases, upon the death of the IRA owner, the assets will be paid as specified in the IRA beneficiary designation and not literally as an "inheritance" pursuant to a will or intestate succession. Nonetheless, the "inherited IRA" terminology has been used in the Internal Revenue Code and has been widely used in the financial industry and by the courts.

of an exemption under Texas law is important. In response to *Jarboe* and similar decisions in other states, estate planning professionals have devised mechanisms to protect “inherited IRAs” from creditors, by designating as the beneficiary of an IRA a particular type of trust that benefits the individual who would otherwise receive the IRA directly upon death.

Neither the Texas statute nor the Bankruptcy Code expressly mentions “inherited IRAs.” The expression “inherited IRA” is, however, found in the Internal Revenue Code.⁶ *Jarboe* justified creditors’ access to “inherited IRA” funds by emphasizing differences in tax treatment of inherited IRAs versus regular IRAs: the holder of an “inherited IRA” cannot make additional contributions to the IRA account, cannot “rollover” the assets into an IRA in the beneficiary’s own name, and must generally begin receiving distributions soon after the decedent’s death.⁷ Assets held in inherited IRAs are, however, exempt from federal income tax under IRC §408(a), must, among other things, be held in a trust or custodial account by an independent financial institution, cannot be invested in life insurance contracts, must be nonforfeitable, must not be commingled with other property (except in a common trust fund or common investment fund) and lose their tax exemption if the account owner or related parties engage in certain types of self-dealing. (See IRC §4975(c) and ERISA §408(b).) Moreover, the tax characteristics of inherited IRAs are also typical of the interests of beneficiaries or survivors with interests in other types of tax-favored retirement plans, and the reasoning of *Jarboe* could, unfortunately, be extended to many other types of retirement plans.⁸

In cases interpreting the retirement funds exemptions provided in the Bankruptcy Code, the recent trend is to recognize inherited IRAs as exempt property. Most recently, the U.S. District Judge in *Chilton v. Moser*, 107 AFTR 2d 2011-XXXX, Civil Action No. 4:10-CV-180, No. 08-43414 (E. D. Tex. Sherman Division, March 16, 2011), reversed the bankruptcy court, *In re Chilton*, 426 B.R. 612 (2010) which had determined that an inherited IRA was not exempt under the federal Bankruptcy Code provisions cited above, based in part on the *Jarboe* decision. Another recent bankruptcy decision in Pennsylvania, *In re Tabor*, 2010 WL 2545524 (Bankr. M.D. Pa. 2010) found that an inherited IRA was exempt property under Bankruptcy Code §522(b)(3)(C). In Pennsylvania, as in Texas, a bankruptcy debtor may elect to claim state exemptions or federal exemptions; but with the addition of §522(b)(3)(C) to the Bankruptcy Code in 2005, the Pennsylvania bankruptcy court noted that the exemption for retirement funds

⁶ IRC §§ 402(d)(4), §402(c)(11), 408(d)(3)(C)(i) and (ii).

⁷ A surviving spouse who is the beneficiary of a retirement plan is afforded more flexibility to be able to transfer or “rollover” his or her deceased spouse’s interest in either an IRA or a qualified plan into an “inherited IRA,” or to roll it into an IRA in the surviving spouse’s own name. In the latter case, the surviving spouse, if employed, would be able to make additional contributions to the IRA and, if the spouse is younger than age 70-1/2, may be able to delay taking taxable distributions until after he or she reaches that age. Some retirement plans also give a surviving spouse the option to delay commencement of benefits until the date the employee would have attained age 70 ½, but many plans do not allow that. IRC §§ 401(a)(9), 402(c)(9).

⁸ All tax favored retirement programs are allowed (and in some cases are required) to provide benefits to survivors or beneficiaries of a deceased plan participant or account owner. While provision of death benefits is clearly recognized as a legitimate feature of a tax-favored retirement program, federal tax law provides that death benefits must be “incidental” to the primary purpose of providing retirement income to employed or self-employed individuals, thus preventing abuse of these tax-favored vehicles as vehicles for wealth accumulation and transmission. IRC § 401(a)(9)(G).

is the same in either case. While we believe *Chilton* and *Tabor* are correctly decided, and inherited IRAs should be exempt property under the Bankruptcy Code, it is not clear how the issue of inherited IRAs will be resolved after various federal appellate courts review the issue. In addition, the *Jarboe* case, interpreting Section 42.0021, casts continuing doubt on whether inherited IRAs are exempt under Texas law when a creditor attempts to attach or seize retirement funds outside of a bankruptcy proceeding.

In 2006, the Internal Revenue Code was amended to permit the “rollover” of funds in a tax-qualified retirement plan into an “inherited IRA” where the beneficiary or other person inheriting the qualified plan assets was a person other than the spouse of the deceased plan participant.⁹ This change can be expected to increase the volume of “inherited IRAs” and increase the number of disputes over whether “inherited IRAs” are exempt property. Accordingly, a clear resolution of this issue is in the best interests of all.

4. Suggested Amendment Of Section 42.0021

In our view, recent changes and developments in federal tax and bankruptcy law, and the confusion created by *Jarboe*, now warrant consideration of additional amendments and clarifications to Section 42.0021. The suggested amendment expressly protects inherited IRAs and also clarifies the exemption for other types of tax-favored retirement vehicles.

We believe that several policy considerations support an express exemption for inherited IRAs:

- Wealthy or financially sophisticated individuals can protect inherited IRAs from creditors by retaining estate planning professionals to structure a trust as beneficiary of the account; less well-to-do or less well-advised individuals may instead be caught in a trap for the unwary created by the *Jarboe* case.
- The surviving spouse of a deceased retirement plan participant or IRA owner may also be caught in a trap for the unwary by failing to elect to treat an inherited IRA as the surviving spouse’s own IRA.
- Although the issue is not definitely settled, it appears that a debtor in Texas could protect his or her inherited IRA from creditors under federal law by filing a bankruptcy, even while claiming Texas exemptions for other assets such as homestead, while the IRA might not be treated as exempt from creditor’s reach outside the bankruptcy scenario; individuals should not be required to file a bankruptcy action simply to gain greater protection of exempt property than they would otherwise have under Texas law.

We believe that public policy also supports a comprehensive exemption for tax-favored retirement programs. This policy is clearly reflected in the 2005 federal bankruptcy legislation, which was principally aimed at limiting abuses by debtors. That legislation did not view tax-favored retirement arrangements as abusive, but singled out tax-favored retirement programs for broader exemptions, reflecting the important public policy of fostering retirement savings and the safeguards and limitations imposed on such accounts by federal tax laws. Accordingly, we

⁹ The Pension Protection Act of 2006, P.L. 109-280, § 829; IRC §402(c)(11).

suggest that the State legislature consider clarifying Section 42.0021 to more clearly identify the types of tax-favored retirement arrangements that are exempt, and to make clear that *only* arrangements that are tax-exempt or tax-deferred under the federal tax laws should be exempt. The suggested language attached as Exhibit A gives a consolidated listing of tax-exempt or tax-deferred retirement vehicles by reference to specific sections of the IRC. Notably, the proposal adds a specific reference to IRC §401(a), a provision that governs a very significant number of pension and retirement savings programs in both the private and public sector, including “401(k)” plans. References to IRC §414(d) and (e) are added to clarify that government and church-sponsored retirement programs are exempt, but only if they satisfy the applicable federal tax requirements. The proposal also adds IRC §457(b), a type of retirement savings vehicle with contribution limits similar to a 401(k), that applies to employees of governmental agencies and non-profits, such as churches. Texas law permits governmental agencies to adopt §457(b) programs for their employees¹⁰ and such programs should be afforded the same protection from creditors as analogous IRC §403(b) programs for public school employees. The proposal further clarifies that so long as the retirement program meets federal tax requirements, it may be funded in a variety of ways, through a trust, custodial account, insured annuity, or other vehicle permitted by federal tax law. Lastly, the proposal clarifies that any beneficiary, survivor, co-annuitant or heir who acquires an interest in a tax-exempt retirement program by reason of the death of another holds exempt property, to avoid extension of the holding of *Jarboe* to other types of retirement programs.

We hope these comments are helpful to you and State legislature as it considers S.B. 1810.

¹⁰ Texas Government Code Chapter 609.

EXHIBIT A - PROPOSED REVISIONS TO S.B. 1810

§ 42.0021. ADDITIONAL EXEMPTION FOR CERTAIN SAVINGS PLANS.

(a) In addition to the exemption prescribed by Section 42.001, a person's right to the assets held in or to receive payments, whether vested or not, under any stock bonus, pension, annuity, deferred compensation, profit-sharing, or similar plan, including a retirement plan for self-employed individuals and a simplified employee pension plan, any individual retirement account or any individual retirement annuity, including an inherited individual retirement account or individual retirement annuity, and any health savings account, and under any annuity or similar contract purchased with assets distributed from that type of plan, ~~and under any retirement annuity or account described by Section 403(b) or 408A of the Internal Revenue Code of 1986, and under any individual retirement account or any individual retirement annuity, including a simplified employee pension plan, and under any health savings account described by Section 223 of the Internal Revenue Code of 1986,~~ is exempt from attachment, execution, and seizure for the satisfaction of debts ~~unless to the extent the plan, contract, annuity, or account is exempt from federal income tax or federal income tax on the person's interest is deferred until actual payment of benefits to the person~~ does not qualify under Section 223, 401(a), 403(a),

403(b), 408(a), 408A, ,457(b) or 501(a) the applicable provisions
of the Internal Revenue Code of 1986 ("IRC"), including a
government plan or church plan described in Section 414(d) or
414(e) of the IRC. For purposes of this subsection, the
interest of a person in such a plan, contract, annuity or
account acquired by reason of the death of another person,
whether as an owner, participant, beneficiary, survivor, co-
annuitant, heir, or legatee, is exempt to the same extent that
the interest of the decedent was exempt as of the date of death.
~~A person's right to the assets held in or to receive payments,~~
~~whether vested or not, under a government or church plan or~~
~~contract is also exempt unless the plan or contract does not~~
~~qualify under the definition of a government or church plan~~
~~under the applicable provisions of the federal Employee~~
~~Retirement Income Security Act of 1974. If this subsection is~~
~~held invalid or preempted by federal law in whole or in part or~~
~~in certain circumstances, the subsection remains in effect in~~
~~all other respects to the maximum extent permitted by law.~~

(b) Contributions to an individual retirement account,
other than contributions to a Roth IRA described in Section 408A
of the IRC,

~~Internal Revenue Code of 1986, or an annuity that exceed the~~
~~amounts deductible under the applicable provisions of the~~
~~IRC, Internal Revenue Code of 1986 and any accrued earnings on~~
~~such ontributions are not exempt under this section unless~~
~~otherwise exempt by law. Amounts qualifying as nontaxable~~

rollover contributions under Section 402(a)(5), 403(a)(4), 403(b)(8), or 408(d)(3) of the Internal Revenue Code of 1986 before January 1, 1993, are treated as exempt amounts under Subsection (a). Amounts treated as qualified rollover contributions under Section 408A, Internal Revenue Code of 1986, are treated as exempt amounts under Subsection (a). In addition, amounts qualifying as nontaxable rollover contributions under Section 402(c), 402(e)(6), 402(f), 403(a)(4), 403(a)(5), 403(b)(8), 403(b)(10), 408(d)(3), or 408A of the ~~IRC Internal Revenue Code of 1986~~ on or after January 1, 1993, are treated as exempt amounts under Subsection (a). Amounts qualifying as nontaxable rollover contributions under Section 223(f)(5) of the ~~IRC Internal Revenue Code of 1986~~ on or after January 1, 2004, are treated as exempt amounts under Subsection (a).

(c) Amounts distributed from a plan, annuity, account or contract entitled to ~~an the~~ exemption under Subsection (a) are not subject to seizure for a creditor's claim for 60 days after the date of distribution if the amounts qualify as a nontaxable rollover contribution under Subsection (b).

(d) A participant or beneficiary of a ~~stock bonus, pension,~~

~~profit sharing, retirement plan, annuity, account or contract~~
~~entitled to an exemption under Subsection (a), other than an~~
~~individual retirement account or individual retirement~~
~~annuity("an exempt plan") or government plan~~ is not
prohibited from granting a valid and enforceable security
interest
in the participant's or beneficiary's right to the assets held
in or to receive payments under the exempt plan to secure a loan
to the
participant or beneficiary from the exempt plan, and the right
to the
assets held in or to receive payments from the plan is subject
to
attachment, execution, and seizure for the satisfaction of the
security interest or lien granted by the participant or
beneficiary to secure the loan.

(e) If Subsection (a) is declared invalid or preempted by
federal law, in whole or in part or in certain circumstances, as
applied to a person who has not brought a proceeding under Title
11, United States Code, the subsection remains in effect, to the
maximum extent permitted by law, as to any person who has filed
that type of proceeding.

(f) A reference in this section to a specific provision of

the ~~Internal Revenue Code of 1986~~ IRC includes a subsequent amendment of the substance of that provision.

(g) this Section 42.0021 is intended to clarify existing law, is remedial in nature, and shall have retroactive application to all inherited individual retirement accounts or annuities, without regard to the date that such account or annuity was created.

Added by Acts 1987, 70th Leg., ch. 376, § 1, eff. Sept. 1, 1987.
Amended by Acts 1989, 71st Leg., ch. 1122, § 1, eff. Sept. 1, 1989; Acts 1995, 74th Leg., ch. 963, § 1, eff. Aug. 28, 1995; Acts 1999, 76th Leg., ch. 106, § 1, eff. Sept. 1, 1999; Acts 2005, 79th Leg., ch. 130, § 1, 2, eff. May 24, 2005.