Asset Protection and Self-Direction:
Fully Self-Directed IRA'S/401(k)'s Lay Beyond the Reach of Creditors

"*The plans of the diligent lead to profit as surely as haste leads to poverty.*"
(Proverbs 21:5)

This timeless adage applies with particular force during our income-producing years and may ultimately determine the standard of living we realize at retirement age. Prudence admonishes us to save as much as we can of today's earnings for tomorrow's benefit, while, at the same time, investing those dollars wisely. Accordingly, to the extent we earnestly develop a retirement **plan** and persistently execute the plan, our future welfare should be marked with abundance. On the other hand, if we fail to plan, or do so haphazardly, our lifestyles may prove quite lean during the sunset years.

Let's explore this "reap what you sow" principle in a hypothetical illustration. Earnest Licht participated in the company profit sharing plan and regularly made annual 401(k) contributions during his tenure at Galactic Enterprises, Inc. The employer-sponsored plan, however, limited his investment choices to stocks, bonds and mutual funds. Nonetheless, when he left the company, Earnest had accrued over $100,000.00 in his retirement account.

A friend told Earnest about self-directed retirement plans and the ability he would enjoy to freely choose "alternative" retirement account investments. So, he rolled-over his former company plan assets to a "*Fully* Self-Directed IRA" with **RealTrust IRA Alternatives, LLC** as his new Custodian/Administrator. This strategy expanded Earnest's investment choices to include **real estate, limited liability companies, partnerships, private placements, discounted notes, private lending, precious metals** and a whole host of alternative opportunities.

Darrell Licht, Earnest's father, had not bothered with a retirement plan. He married-up, as they say; his new wife had over $100,000.00 in savings. Both Earnest and Darrell intended to co-venture on some local real estate investments.

Father and son made an offer to buy a $200,000.00 rental house repossessed by a bank, Earnest using his IRA monies and Darrell using his wife's personal funds. They each put $100,000.00 down at closing. RealTrust took title to an undivided 50% interest in the REO, as Custodian/Administrator for the benefit of Earnest's IRA. Darrell and his wife took title to the remaining 50% interest, personally.

The REO generated $10,000.00 per year in positive cash flow; $5,000.00 each. Earnest's IRA enjoyed tax-favored status, so realized no current tax liability. Darrell was able to take the normal investment real estate deductions to reduce or eliminate his tax liability on the annual income.

The real estate market was heating up in their area. The investor team anticipated doubling their money within the next three to five years. Should they each realize a $100,000.00 profit, however, the investors would experience completely divergent outcomes. The IRA's gains would compound on a tax-deferred basis until Earnest started taking distributions at retirement age. Darrell, unless he initiated an IRC §1031 Exchange, would recognize the full gain in the year of the sale and lose between 15% and 25% to federal income taxes. (If they sold the REO in less than one year from the date of acquisition, Darrell would be taxed at the short-term capital gain rate of up to 35%.)

Unfortunately, calamity struck before the proverbial ship came in. Unbeknownst to Earnest and Darrell, the electrical system in the REO was faulty. One morning, a toaster full of Pop-Tarts blew-out the electrical panel and caused a ferocious fire. A caustic chain reaction engulfed the house in flames and severely burned three of the tenants, one an aspiring pianist protégé. The ensuing personal injury lawsuits resulted in judgments totaling almost **$5,000,000.00**! (Fortunately, the REO was insured, so insurance proceeds were available to restore the improvements at their replacement cost and cover personal liability up to the insurance limits.)

Here's where Earnest's diligence really paid off. Asset protection for Retirement Plans derives from a variety of sources. ERISA protects assets held in Employer-sponsored Plans from legal process, pursuant to the "anti-alienation" provisions of the statute. In addition, the Bankruptcy Code excludes the Qualified Plan assets from a Bankrupt's estate. ERISA does **not** protect assets held in an **IRA** from creditor claims, however. But, many States have statutes that exempt retirement plan assets, including those held in IRA's, from legal process. In our home state of Washington, for example, a statute exempts any "employee benefit plan" (defined to include IRA's, Roth IRA's, Qualified Plans, etc.) from "execution, attachment, garnishment, or seizure by or under any legal process whatever." (RCW 6.15.020.)

Even in Bankruptcy, thanks to recent court cases and changes in the Bankruptcy Code, assets held in Retirement Plans, including IRA's, are effectively shielded from creditor claims. The recent decision of the U.S. Supreme Court in Rousey v. Jacoway (April, 2005) ruled that the IRA's held by Debtors in Bankruptcy, under the facts of that case, were exempt from the reach of their creditors. That decision may have limited application, however. The better news, for IRA Holders, is that the Bankruptcy Code itself has been amended (effective October 17, 2005) to exempt all IRA's (up to $1,000,000.00, plus CPI) from the reach of creditors when an IRA Holder becomes a Debtor in Bankruptcy.

Because Earnest's 50% interest in the REO was held **inside** the IRA, both Earnest and his IRA are insulated from legal process initiated to collect on the judgments. How? By virtue of the State Statute and US Bankruptcy Code protections, a virtually impenetrable barrier repels a judgment creditor from trying to reach inside the IRA and grab assets to satisfy the judgment. (The IRA's interest in the duplex may be at risk, however, because a Court is hard-pressed to see a victim go without a complete remedy and the duplex had been placed in the stream of commerce.) The Retirement Plan Trust (e.g.- IRA) owned the REO, so Earnest was not personally implicated in the REO-related enterprise; both the benefits and liabilities were exclusively within the confines of the IRA.

In other words, the claimants have to sue the IRA Custodian, not Earnest, to obtain a judgment in the first place. So, only his IRA assets, not his personal assets, were potentially exposed to the claims. However, following the entry of a judgment against the IRA, a legal roadblock bars the creditor from executing against assets (other than possibly the particular REO) because other assets of the IRA are exempt from legal process. Earnest's retirement plan assets lay beyond the reach of creditors.

Darrell did not fare as well as Earnest. His REO investment was made with personal funds; Darrell and his wife held title personally. The judgment creditors had a field day going after Darrell and wife's 50% interest in the REO, then proceeded to execute against their remaining personal assets. Darrell filed Bankruptcy, but still ended up with only his '88 Buick Riviera and the gold-plated cufflinks Grandma had given him.

The diligent Retirement Planner is wise to hold real estate and other assets inside his/her IRA or 401(k) Plan. Not only does this strategy lead to profit, but it serves to preserve the assets so amassed over a lifetime of investing. Abundant living is the reward during retirement years.

The hasty will fail to plan or do so on a "Hail, Mary and hope for the best" approach. We see that Darrell lived up to his namesake by losing everything for lack of diligence. Be an Earnest, not a Darrell Licht.

*Mark Hodges has almost 30 years of experience as a Real Estate, §1031 Exchange and Self-Directed IRA Lawyer. He presently serves as Managing Director of **RealTrust IRA Alternatives, LLC**, a provider of Custodial and Administration Services for "Fully Self-Directed IRA's and 401(k)'s." Contact Mr. Hodges directly @ (800) 503-1031 or markh@realtrustgroup.com.*