

Editor's Column:

Supreme Court Clarifies: Inherited IRAs are not "Retirement Funds"



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On June 12, 2014, the United States Supreme Court decided *Clark v. Rameker*, No. 13-299, holding that funds in an individual retirement account (IRA) that a bankruptcy debtor obtained through inheritance are not "retirement funds" that the debtor may exempt from their bankruptcy estate. At long last, the advising community has definitive direction in counseling holders of retirement assets regarding their "protection" from creditor claims in a bankruptcy estate.

Prior to the ruling in *Clark*, whether or not the inherited retirement assets were protected from bankruptcy creditors often turned on which state the inheritor resided in. For example, in Minnesota, a federal bankruptcy judge there ruled in *In re Nessa*, 426 B.R. 312, 314 (8th Cir. B.A.P. 2010), that an inherited IRA is still a retirement account protected under the bankruptcy law, even though it has switched hands from the original owner to the beneficiary. Conversely, a Texas judge in another bankruptcy case, *In re Chilton*, 674 F.3d 486 (5th Cir. 2012), came to the opposite conclusion, ruling that inherited IRAs are not protected in bankruptcy because the funds in an inherited IRA "are not funds intended for retirement purposes."

In *Clark* the taxpayers (the decedent's daughter and son-in law) filed for Chapter 7 bankruptcy and sought to exclude approximately \$300,000 in an inherited IRA from the bankruptcy estate on the grounds that the money was "retirement funds" under Section 522(b)(3)(C) of the Bankruptcy Code (11 U.S.C. §522(b)(3)(C)). 11 U.S.C. §522(b)(3)(C) provided that a debtor may exempt "retirement funds to the extent those funds are in a fund or account that is exempt from taxation." The bankruptcy trustee challenged the claimed exemption, arguing that the funds were not "retirement funds" within the meaning of the bankruptcy statute.

The Supreme Court agreed with the bankruptcy trustee and held that funds in an inherited IRA are not set aside for the debtor's retirement and thus are not "retirement funds" under the exemption of the bankruptcy statute. In issuing its ruling, the Court clearly rejected the debtor's argument that, because the account was originally a retirement account when created, it also retained that character after it was inherited.

In the unanimous opinion written by Justice Sonia Sotomayor, the Court proffered three clear distinctions where Inherited IRA holders' interests differed from Traditional IRA Owners:

1. Inherited IRA holders, unlike traditional IRA owners, may not make additional contributions to the account;
2. The holder of an inherited IRA, unlike a traditional IRA owner, may withdraw the entire balance of the account at any time and for any reason without penalty.
3. Inherited IRA holders, unlike traditional IRA owners, must withdraw funds from their accounts, regardless of how many years they are away from retirement;

No longer can an inherited IRA be seen as a "retirement account," for bankruptcy purposes because in the Court's opinion, the term "retirement funds" implies that the funds are currently in an account set aside for retirement, not that they will be set aside for that purpose at some future date by an entirely different person who inherits the funds.

Simply, beneficiaries of inherited IRAs will not be able to access a “pot of money for current consumption and free from the reach of the holder’s creditors,” when those funds were not objectively set aside from the outset for the inheritor’s retirement.

Should asset protection still be an important consideration in passing on an IRA, then consider having the IRA payable to a qualified trust for the benefit of the individual beneficiary (ies) under the IRC Section 401(a)(9). Without one, the Supreme Court has ruled that seeking a “fresh start” under the bankruptcy code will not be construed to mean giving inheritors a “free pass.”

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