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SUPREME COURT CONFIRMS THAT ASSETS HELD IN AN INHERITED INDIVIDUAL RETIREMENT ACCOUNT ARE NOT EXEMPT FROM A DEBTOR'S BANKRUPTCY ESTATE

Executive Summary:

On June 12, 2014, the Supreme Court ruled that inherited IRAs, unlike traditional IRAs, do not receive protection in bankruptcy. Depending on the size of the IRA and the age of the intended beneficiary(ies) and estate planning considerations, IRA holders may wish to consider creating a trust for each intended beneficiary, and designating those trusts as the beneficiaries of the IRA to maintain the asset protection.

Supreme Court Decision in Clark v. Rameker

A person, when she files for bankruptcy, makes all her "legal or equitable interest in property" available to satisfy the debts arising before the bankruptcy petition. Nevertheless, the U.S. Bankruptcy Code exempts certain assets from the bankruptcy estate and, thus, from payment to creditors, including "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation…." 18 U.S.C. §522(b)(3)(C). In a ruling dated June 12, 2014, the United States Supreme Court, in *Clark v. Rameker*, No. 13-299, 573 U.S __, (June 12, 2014), limited what assets could be considered exempt "retirement" funds.

In *Clark*, Ruth Heffron had established a traditional individual retirement account ("IRA") and named her daughter, Heidi Heffron-Clark, as the sole beneficiary of the account. When Mrs. Heffron died in 2001, her IRA passed to her daughter and became an "inherited IRA." Some nine years later, Ms. Heffron-Clark and her husband filed for Chapter 7 bankruptcy and identified the inherited IRA as exempt from the bankruptcy estate pursuant to 12 U.S.C. §522(b)(3)(C). The Bankruptcy Trustee and unsecured creditors objected to the claimed exemption, arguing that the inherited IRA did not constitute "retirement" funds as the term is used in the Bankruptcy Code. The Bankruptcy Court concurred and disallowed the exemption, but the District Court overturned the Bankruptcy Court, finding that the inherited IRA funds had initially been set aside by the late Mrs. Heffron for "retirement" purposes. The Seventh Circuit Court then reversed the District Court, and held that the inherited IRA could not be deemed a "retirement" account, since the rules concerning inherited IRAs differed so greatly from those governing retirement accounts, generally.

In affirming the Seventh Circuit, the Supreme Court found that funds held in inherited IRAs are not "retirement funds" within the meaning of the Bankruptcy Code and, therefore, not subject to the bankruptcy exemption. In order to qualify for exemption, the Court stated, the retirement funds must <u>both</u> be qualified under relevant provisions of the U.S. Tax Code *and* be held by the debtor for "retirement" purposes – *i.e.*, "money set aside for the day an individual stops working." Three characteristics of inherited IRAs disqualified the funds from protection: (1) the holder of an inherited IRA may never invest additional monies in the account; (2) the holder of an inherited IRA must withdraw money from the account on an accelerated basis, no matter how many years he is from retirement; and (3) the holder of an inherited IRA may withdraw the entire balance of the account at any time and for any purpose without penalty. Because of that, the Court concluded, an inherited IRA could not objectively be considered "retirement funds" exempt from the bankruptcy estate.

Application to Account Holders

The Supreme Court's decision in *Clark* should be part of the mix of factors that an IRA account holder assesses in designating a beneficiary. While beneficiary selection always includes an analysis of tax consequences, the Supreme Court's ruling in *Clark* effectively removed asset protection characteristics from most inherited IRAs that some account holders may have presumed was present. Of course, IRA rules permitting a surviving spouse to roll-over an account into his/her own IRA affects this determination. Also, eight states (Alaska, Arizona, Florida, Missouri, North Carolina, Ohio, South Carolina and Texas) currently provide their citizens greater protection for inherited IRAs than the Bankruptcy Code. Nevertheless, an account holder particularly concerned with insulating a beneficiary's assets from creditors might consider creating a trust as the IRA beneficiary, and disbursing the IRA assets and income through the trust. The value of protecting assets from creditors, however, needs to be weighed against the additional costs and possible tax consequences of passing the IRA assets through a trust.

For a more detailed explanation or specific application of this technique, please contact my partners Joseph Zarlengo (312) 924-4247 or Ted Koester (312) 924-4257, who handle these issues on a regular basis.