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News Alert: U.S. Supreme Court Says Inherited IRAs Are Not Protected From Creditors Under Federal Bankruptcy Law

On June 12, 2014, the Supreme Court issued its decision in *Clark et ux. V. Rameker, Trustee, et al*, 573 U.S. _____ (2014), which is an extremely rare unanimous ruling. The Court held that, for purposes of federal bankruptcy law, an inherited IRA was not protected in the hands of the beneficiary in the same way that an IRA would be protected in the hands of its original owner. While some states, such as Florida, have state bankruptcy laws which still specifically protect inherited IRAs in bankruptcy cases, in many other states inherited IRAs are now clearly unprotected assets. Those who wish to protect their IRAs in the hands of their loved ones can still do so using properly-structured trusts as the designated beneficiaries of their IRA accounts. However, using trusts in this way requires careful planning and should only be attempted with the help of an experienced and sophisticated estate planning attorney.

In the *Clark* case, Heidi Heffron-Clark's mother, Ruth Heffron, established a traditional IRA account for her own benefit, designated her daughter, Heidi, as the beneficiary of the IRA, and then passed away. Heidi elected to maintain the account as an inherited IRA and take the appropriate minimum required distributions in monthly installments. Heidi and her husband later filed for Chapter 7 bankruptcy. As part of the bankruptcy petition, they identified Heidi's inherited IRA as an exempt asset, claiming that it was exempt under 11 U.S.C. Section 522(b)(3)(C) as a "retirement fund." The Bankruptcy Court ruled against Heidi and her husband, stating that an inherited IRA was not an exempt "retirement fund." The District Court disagreed with the Bankruptcy Court and ruled that the inherited IRA was exempt, and the Seventh Circuit Court of Appeals overturned the District Court and agreed with the Bankruptcy Court. The Seventh Circuit appears to have based its conclusion on the fact that inherited IRAs are not subject to the same rules to which an IRA in the hands of its original owner is subject, and the Seventh Circuit concluded that the rules applying to inherited IRAs were designed to encourage more immediate withdrawals, rather than encouraging saving for future use in retirement. Because the Seventh Circuit's conclusion conflicted with an earlier decision by the Fifth Circuit Court of Appeals, the Supreme Court decided to resolve the issue by hearing the *Clark* case.

The Supreme Court decision, written by Justice Sotomayor, begins its analysis by stating "The text and purpose of the Bankruptcy Code make clear that funds held in inherited IRAs are not "retirement funds" within the meaning of §522(b)(3)(C)'s bankruptcy exemption." *Clark*, p. 4. The Court said that it would look to the "ordinary meaning" of the term "retirement funds," and concluded that "retirement funds" meant "sums of money set aside for the day an individual stops working." The inquiry into the purpose for which sums of money were being held had to be determined objectively, based on the characteristics of the account in which the sums were held. The Court then considered the legal characteristics of inherited IRAs, and decided that three of those characteristics meant that funds held in an inherited IRA were clearly not funds being set aside for purposes of retirement. For one thing, the beneficiary of an inherited IRA can never make contributions to the account, which the Court said made the inherited IRA significantly different from traditional and Roth IRAs (the "quintessential 'retirement funds'"). *Clark*, p. 5. Without offering either the

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ability or the incentive for the beneficiary to make additional contributions to the account, an inherited IRA could not be viewed as allowing retirement savings to accumulate. *Clark*, p. 6. The Court next considered the fact that inherited IRA beneficiaries are required to take withdrawals from their inherited IRA accounts, while owners of Roth and traditional IRAs are forbidden from taking withdrawals from their accounts except under certain conditions. It stated that the required withdrawals meant that the value of the inherited IRA would be diminished over time, without regard to when the beneficiary's actual retirement was expected to occur: "hardly a feature one would expect of an account set aside for retirement." *Clark*, p. 6. Finally, the Court noted that no penalty applied to withdrawals from an inherited IRA, whereas a 10% penalty applied to most withdrawals from traditional and Roth IRA accounts if the owner is under age 59 ½. The Court contrasted the effect of the penalty, which it characterized as encouraging individuals to leave the IRA funds untouched until retirement age, with the penalty-free inherited IRA, which it viewed as "a pot of money that can be freely used for current consumption." *Clark*, p. 6.

The Court next considered the purpose for which the bankruptcy code exemptions existed. It stated that exempting traditional and Roth IRAs helped further the bankruptcy code's desire to give debtors a fresh start while still allowing them to meet their basic needs by helping ensure that their retirement needs could be met. It also mentioned that the penalty would discourage debtors under age 59 ½ from freely spending the money soon after the bankruptcy case concluded. The Court then stated that allowing inherited IRAs, which can be freely withdrawn and spent immediately after a bankruptcy case concludes, would convert the Bankruptcy Code's fresh start into a "free pass" and allow a debtor to unfairly shelter assets which could easily be given to creditors. *Clark*, p. 7. The fact that assets in the inherited IRA once were "retirement funds," in the hands of the original account owner, was not viewed as a reason to continue that status after the original account owner's death. *Clark*, p. 8.

The *Clark* case applies to federal bankruptcy law. A state which chooses to specifically exempt inherited IRAs may still do so under its own bankruptcy laws. However, there is a better way to ensure that an inherited IRA can be protected from a beneficiary's creditors. The original IRA owner can designate a properly-structured trust as the beneficiary of the IRA, instead of naming the desired individual beneficiary directly. If a properly-structured trust is named as the beneficiary of an IRA, the Trustee of the trust will still be able to use an individual beneficiary's life expectancy as the period on which minimum required distributions are calculated. However, the beneficiary will not be the legal owner of the inherited IRA, and the "spendthrift trust" provisions of the trust can apply to protect the IRA itself. Depending on how the trust is structured, the minimum required distributions may still be subject to attack by the beneficiary's creditors as they are paid out, but the inherited IRA account itself will be protected.

A trust must be carefully structured in order to allow an individual beneficiary's life expectancy to be used to determine minimum required distributions from any IRA payable to the trust. At Morgan & DiSalvo, we have many years of experience in helping clients use trusts to protect the IRA assets they may leave to their desired beneficiaries. Read our recent newsletter: IRAs and Qualified Plan Accounts: Should You Pass Them to Beneficiaries Outright or in Trust? If you have questions or would like to consider implementing this type

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