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United States Supreme Court Holds That Funds Contained In An Inherited Individual Retirement Account (“IRA”) Do Not Qualify As “Retirement Funds” And Therefore Are Not Exempt From A Debtor’s Bankruptcy Estate

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In *Clark v. Rameker*, No. 13-299, 573 U.S. (June 12, 2014), the United States Supreme Court resolved a split between the Court of Appeals for the Fifth and Seventh Circuits regarding whether funds held in an inherited IRA are “retirement funds” within the meaning of Section 522 of the Bankruptcy Code. 11 U.S.C. §522. In affirming the Seventh Circuit’s decision, the Supreme Court held that such funds are not “retirement funds” and therefore may not be exempted from an individual debtor’s bankruptcy estate. As a result, such funds are accessible to creditors in a bankruptcy proceeding.

In reaching this decision, the Supreme Court rejected scrutinizing the individual debtor’s subjective purpose for the funds in the inherited IRA and instead utilized an objective approach that analyzed the general legal characteristics of an inherited IRA. The Court found that three legal characteristics of an inherited IRA confirm that its funds are not “retirement funds”: (1) the holder of an inherited IRA may not invest additional money in the account; (2) the holder of an inherited IRA is required to withdraw money from the account, even if not retired; and, (3) the holder of an inherited IRA may withdraw the entire account balance at any time and for any purpose without penalty.

The Inherited IRA At Issue

In 2000, Ruth Heffron established a traditional IRA and named her daughter, Heidi Heffron-Clark, as the sole beneficiary. Upon Ruth’s death in 2001, Heidi inherited the IRA and elected to receive monthly distributions from it. *Slip Op.* at p. 3.

After a failed business venture, in October 2010, Petitioners Heidi and her husband jointly filed a Chapter 7 bankruptcy petition. *Id.* Petitioners claimed the funds in the inherited IRA were exempt from the bankruptcy estate. Initially, Petitioners claimed the exemption under Wisconsin state law, but later amended their schedules to also claim the exemption under 11 U.S.C. §522(b)(3)(C), which permits a debtor to exempt retirement funds from property of the estate. In response, the bankruptcy trustee and the unsecured creditors objected to the exemption, contending that the funds in the inherited IRA were not “retirement funds” within the meaning of the statute and could not be exempted from Petitioners’ estate. *Id.*

The Bankruptcy Code’s Exemption For “Retirement Funds”

The provisions of the Bankruptcy Code are intended to effectuate a balance between the interests of creditors and debtors. *Id.* at p. 6. Under the Bankruptcy Code, when an individual debtor files a bankruptcy petition, the debtor’s legal or equitable interests in the debtor’s property belong to the bankruptcy estate. However, to provide the debtor with “the basic necessities of life,” and so that the debtor “will not be left destitute and a public charge,” Congress provided for certain exemptions of property from the bankruptcy estate. *Id.* at p. 7 n.3.

One such exemption is 11 U.S.C. §522(b)(3)(C), which allows an individual debtor to exempt from property of the bankruptcy estate retirement funds to the extent those funds are in a fund or account that is exempt from taxation under

Sections 401 (pension, profit-sharing and stock bonus plans), 403 (employee annuities), 408 (IRAs), 408a (Roth IRAs), 414 (employee benefit plans), 457 (deferred compensation plans for states and local government and non-profits), or 501(a) (trusts qualified as exempt organizations) of the Internal Revenue Code.

The United States Supreme Court's Analysis

The question presented to the United States Supreme Court was “whether funds contained in an inherited [IRA] qualify as ‘retirement funds’ within the meaning of [Section 522(b)(3)(C)].” *Id.* at p. 1. At the outset, the Court noted that the Bankruptcy Code does not define the term “retirement funds” and that it must therefore be defined using its ordinary meaning. Relying upon the dictionary definitions of the respective words, the Court explained that the term “retirement funds” is best understood to mean money that is set aside for the day an individual stops working. *Id.* at p. 5.

Explaining that the funds held in traditional IRAs and Roth IRAs are considered the “quintessential retirement funds,” the Court compared their characteristics with those of an inherited IRA to determine whether they shared a similar nature. *Id.* In its analysis, the Court found that inherited IRAs differed from traditional IRAs and Roth IRAs in three fundamental respects. First, the holder of an inherited IRA may never invest additional money in the account. Second, holders of inherited IRAs are required to withdraw money from such accounts, no matter how many years they may be from retirement. Lastly, the holder of an inherited IRA may withdraw the entire balance of the account at any time – and for any purpose – without penalty. Quoting directly from the Seventh Circuit’s opinion, the Supreme Court likened funds in an inherited IRA to a “pot of money that can

be freely used for current consumption.” Thus, the Supreme Court concluded that funds held in such accounts are not objectively set aside for the purpose of retirement. *Id.* at pp. 5-6

The Court found that its reading of Section 522(b)(3)(C) was supported by the purpose underlying the Bankruptcy Code’s exemptions. Specifically, the Bankruptcy Code strives to maintain a balance between the interests of creditors and debtors. In this case, as the Court noted, “if an individual is allowed to exempt an inherited IRA from her bankruptcy estate, nothing about the inherited IRA’s legal characteristics would prevent (or even discourage) the individual from using the entire balance of the account on a vacation home or sports car immediately after her bankruptcy proceedings are complete.” *Id.* at p. 7. Thus, excluding funds in an inherited IRA from the meaning of “retirement funds” is consistent with the purpose underlying the exemptions – to provide debtors a “fresh start,” not a “free pass.”

Finally, the Court specifically found two problems with Petitioners’ primary argument that the initial owner’s death should not cause what once were “retirement funds” to lose that classification. *Id.* at p. 8. First, the Court noted that the ordinary use of the term “retirement funds” implies that the funds are currently in an account set aside for retirement, not that they were set aside for that purpose. *Id.* (emphasis added). Second, such a “backward-looking inquiry” would render the term “retirement funds” in Section 522(b)(3)(C) superfluous. As the Court explained, under Petitioners’ interpretation, the account would only need to be one of the enumerated accounts in order to be exempted, and the term “retirement funds” would have no purpose in the inquiry. As such, the Court rejected Petitioners’ reading of the provision.

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The Bottom Line

In this important decision, the United States Supreme Court has clarified a legal issue that had divided two Circuit Courts of Appeal. It is now settled that funds in inherited IRAs are not “retirement funds” and therefore cannot be exempted from a bankruptcy estate under Section 522(b)(3)(C) of the Bankruptcy Code. This decision is likely to impact those in the financial services industry and their clients, a significant percentage of whom have retirement accounts that fall within Section 522(b)(3)(C) and thus, potentially, are subject to the claims of an heir’s creditors.

Prior to this opinion, when a beneficiary came into possession of an inherited IRA, he or she was primarily concerned with the tax consequences of an immediate withdrawal of the funds versus a prorated withdrawal. Now, however, those establishing retirement accounts and their

beneficiaries, along with their financial advisors, must address the issue of how to protect these funds from the reach of creditors. For example, in the event the heir is the owner’s spouse, the surviving spouse has two options: he or she may (1) “roll over” the IRA funds into his or her own IRA or (2) keep the IRA as an inherited IRA. As a result of this opinion, if the latter selection is made, then the funds in the inherited IRA will be available to creditors. Conversely, if the surviving spouse elects to roll over the IRA funds, in the event of a bankruptcy filing, these funds would be exempt from property of the bankruptcy estate. This election is not available to anyone other than a surviving spouse. Unfortunately, for what was previously a relatively straightforward decision, owners of inherited IRAs may now need to seek advice from attorneys and other professionals who can counsel them regarding estate planning or other strategies available to them to protect these inherited assets. ■

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