Taxation and Wealth Planning Department

ALERT

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U.S. Supreme Court Rules Inherited IRAs Are Not Retirement Funds

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On June 12, 2014, the United States Supreme Court ruled that funds held in an "inherited IRA" are not *retirement funds* within the meaning of Section 522(b)(3)(C) of the Bankruptcy Code. As such, these funds are not exempt from the IRA holder's bankruptcy estate and are subject to the claims of creditors in bankruptcy.

The facts of the case (*Clark et ux v. Rameker, Trustee, et al*) are relatively simple. Ruth Heffron established a traditional IRA and named her daughter, Heidi Heffron-Clark, as the sole beneficiary. Upon Ruth's death, the IRA became an inherited IRA. Some years later, Heidi and her husband filed a Chapter 7 bankruptcy petition and claimed that the inherited IRA was excluded from the bankruptcy estate as a retirement fund. The Bankruptcy Court sided with the bankruptcy trustee holding that an inherited IRA is not a retirement fund and, as such, is not exempt from the bankruptcy estate. In reversing that decision, the District Court ruled that the exemption covers any account containing funds originally accumulated for retirement. On appeal, however, the Seventh Circuit agreed with the Bankruptcy Court and reversed the District Court's ruling, thereby creating a split among the circuits, which now has been resolved by the Supreme Court.

In a unanimous decision written by Justice Sonia Sotomayor, the Supreme Court, noting that the Bankruptcy Code does not define "retirement funds," looked to the ordinary meaning of the term and, after consulting the American Heritage Dictionary, concluded that retirement funds are "sums of money set aside for the day an individual stops working." The Court then identified three characteristics of inherited IRAs, which compel the finding that funds held in such accounts are not set aside for retirement:

1. The holder of an inherited IRA may never invest additional money in the account.
2. Holders of inherited IRAs are required to withdraw money from such accounts, regardless of their ages and regardless of how many years they are from retirement.
3. The holder of an inherited IRA may withdraw the entire balance of the account at any time, and for any purpose, without penalty, while a withdrawal from a traditional or Roth IRA prior to age 59-1/2 triggers a 10 percent penalty, unless an exception applies.

Overall, the Court found that funds held in an inherited IRA constitute "a pot of money that can be freely used for current consumption" rather than funds "objectively set aside for one's retirement." Accordingly, the Court concluded, a balancing of the interests of creditors and debtors must favor the creditors insofar as inherited IRAs are concerned.

By way of background, prior to the Pension Protection Act of 2006, the Internal Revenue Code permitted no one other than the participant and the

participant's surviving spouse to roll money from one retirement plan to another. The Pension Protection Act added Section 402(c)(11) to the Internal Revenue Code to permit rollover to an individual retirement account by a nonspouse beneficiary.

The Internal Revenue Code does not define "inherited IRA." Rather, Section 408(d)(3), which deals with rollover contributions, says that an IRA "shall be treated as inherited if -- (I) the individual for whose benefit the account or annuity is maintained acquired such account by reason of the death of another individual and (II) such individual was not the surviving spouse of such other individual."

The availability of nonspouse beneficiary rollover means the distributions from that inherited IRA can be extended over the beneficiary's life expectancy, if the original IRA owner dies before he or she was required to begin distributions, or over the balance of the IRA owner's distribution period, if distributions already commenced. However, it means that those assets will be vulnerable to bankruptcy creditors.

It is important to note that the laws of each state also provide individual protections from creditors that apply in bankruptcy situations when the debtor elects to utilize the state law exemptions, in lieu of the exclusions available under federal bankruptcy law. State law also controls in situations of nonbankruptcy judgment creditors. Some states provide special exemption for retirement funds and accounts, and it remains to be seen whether any of these state exemptions will be redefined in light of the Supreme Court decision.

While rollover IRAs can be used effectively to reduce income tax liability by spreading distribution over several years, other strategies may be preferable, particularly when the beneficiary is vulnerable to creditors. Certain trusts can qualify as designated beneficiaries for retirement plans and IRAs, and these trusts can incorporate spendthrift provisions, which provide full asset protection. Moreover, the trust vehicle can ensure ongoing management and control over ultimate disposition, while allowing flexibility in distributing assets among individual beneficiaries.

The Supreme Court decision is an emphatic reminder that care must be taken to maintain appropriate beneficiary designations for all retirement plan accounts, that special attention must be paid to retirement funds when planning one's estate and that estate plans must be reassessed periodically as financial and familial circumstances change.

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