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Supreme Court to Decide the Plain Meaning of Retirement Funds

Clark v. Rameker *Set for March 24 Oral Argument*

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When Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), a debtor's ability to exempt an interest in a retirement account was expanded through the addition of several new subsections to § 522 of the Bankruptcy Code. Pursuant to the identical provisions of §§ 522(b)(3)(C) and 522(d)(12),[1] debtors may exempt "retirement funds" to the extent that the funds are exempt from taxation under various sections of the Internal Revenue Code (IRC).[2] Although the Bankruptcy Code does not define "retirement funds," the exemption encompasses 401k plans, pensions, profit-sharing plans and individual retirement accounts (IRAs), among other instruments.[3]

An ambiguity arises, however, in whether the exemption incorporates retirement funds inherited by debtors from non-spouses.[4] While there had been an apparent emerging consensus following the lead of the Fifth, Eighth and Ninth Circuits,[5] perceiving that the plain language of the provisions dictated that retirement funds are exempt regardless of original ownership, Chief Judge Frank Easterbrook of the Seventh Circuit unleashed a diametrically opposed broadside in April 2013 in the case of *In re Clark*.[6] The new divergence among the circuits is rooted in differing conclusions with respect to application of the same rule of statutory construction, and has sparked enough of a debate that the U.S. Supreme Court has decided to hear *In re Clark* on appeal.[7]

Same Test, Different Result

It has been observed that all cases that have examined whether inherited IRAs are exempt under the Code are factually similar in that they all include a debtor who inherited a non-spouse family member's IRA prior to filing for bankruptcy and then sought to exempt the IRA under either § 522(b)(3)(C) or 522(d)(12).[8] In each case, the courts applied the same two-part test to determine whether the inherited retirement fund in question qualified for exemption: (1) the amount that the debtor seeks to exempt must be in retirement funds; and (2) those retirement funds must be in an account that is exempt from taxation under §§ 401, 403, 408, 408(A), 414, 457 or 501(a) of the IRC.[9] Because the Bankruptcy Code does not define the term "retirement funds," courts must resort to the rules of statutory construction to decipher whether inherited IRAs can be considered retirement funds. There is unanimity among the circuit courts that any question of statutory interpretation begins with a review of the plain language of the statute. From there, the circuit courts, and in particular the Seventh Circuit, have differed in their deductions.

The Not-So-Plain Meaning

The essence of the Seventh Circuit's opinion in *In re Clark* is that retirement funds, such as IRAs, are no longer retirement funds when inherited by a non-spouse of the original owner, and therefore fail the first prong of the two-part analysis. In effect, the designation of "retirement funds" is dictated by the debtor's specific relationship to the funds. In this vein, retirement funds are unique to the retiree, specifically created to support his or her retirement. However, upon that individual's death, the retirement funds lose their intended purpose and the special mechanisms that further that purpose, such as tax deferrals, and thus cease being retirement funds. More particularly, when inherited by a non-spouse, contributions can no longer be made to the funds, the balances cannot be rolled over to other accounts, and distribution must begin either within a year of the original owner's demise in accordance with Internal Revenue Service (IRS) distribution timetables,

1 The language of § 522(d)(12), which permits the exemption of retirement funds under the federal exemption scheme, and § 522(b)(3)(C), which permits the exemption of retirement funds for debtors whose state has opted out of the federal exemption scheme, is the same. Each statute provides an exemption for "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457 or 501(a) of the Internal Revenue Code of 1986."

2 26 U.S.C. § 1001, *et seq.*

3 *See* 4 *Collier on Bankruptcy* ¶ 522.09[12] (15th ed. rev. 2009).

4 The IRC provides different treatment for non-spouse and spouse-inherited IRAs. I.R.S. Publication 590, p. 18 (2013) explains:

> If you inherit a traditional IRA from anyone other than your deceased spouse, you cannot treat the inherited IRA as your own. This means that you cannot make any contributions to the IRA. It also means you cannot roll over any amounts into or out of the inherited IRA. However, you can make a trustee-to-trustee transfer as long as the IRA into which amounts are being moved is set up and maintained in the name of the deceased IRA owner for the benefit of you as beneficiary.
>
> Like the original owner, you generally will not owe tax on the assets in the IRA until you receive distributions from it. You must begin receiving distributions from the IRA under the rules for distributions that apply to beneficiaries.

5 *See In re Chilton*, 674 F.3d 486 (5th Cir. 2012); *In re Hamlin*, 465 B.R. 863 (B.A.P. 9th Cir. 2012); and *In re Nessa*, 426 B.R. 312 (B.A.P. 8th Cir. 2010).

6 *See In re Clark*, 714 F.3d 559 (7th Cir. 2013).

7 The petition for a *writ of certiorari* was granted by the Supreme Court on Nov. 26, 2013. *See Clark v. Rameker*, 134 S. Ct. 678 (2013). The Court docket is available at www.supremecourt.gov/Search.aspx?FileName=/docketfiles/13-299.htm.

8 *See In re Hamlin*, 465 B.R. at 870.

9 *In re Chilton*, 674 F.3d at 488; *In re Hamlin*, 465 B.R at 870; *In re Nessa*, 426 B.R. at 314; *In re Clark*, 450 B.R. 858, 862 (Bankr. W.D. Wis. 2011), *rev'd sub nom.*, *Clark v. Rameker (In re Clark)*, 466 B.R. 135 (W.D. Wis. 2012), *rev'd sub nom.*, *In re Heffron-Clark*, 714 F.3d 559 (7th Cir. 2013); *In re Theim*, 443 B.R. 832, 842 (Bankr. D. Ariz. 2011); *In re Kuchta*, 434 B.R. 837, 843 (Bankr. N.D. Ohio 2012).

or be completed in full within five years.[10] Resultantly, the funds can no longer be shielded until the original owner's retirement and may become exposed to the inheritor's creditors.[11] Given the metamorphosis, the Seventh Circuit has essentially determined that §§ 522(b)(3)(C) and 522(d)(12), by their plain meaning, are inapplicable to retirement funds inherited by non-spouses because the assets are not retirement funds relative to the debtor.

Interestingly, while Judge Easterbrook cautioned against simplistically inferring that "*whatever* furthers the statute's primary objective must be law,"[12] his conclusions nonetheless seem to be guided by a grander purview of the bankruptcy exemptions and policy generally.[13] For example, if assets in a retirement fund passed to a debtor in another manner, such as through a gift following an early withdrawal by the original owner, the assets could not be exempted. Similarly, a devisee of a house cannot claim a homestead exemption on the house simply because it was the primary residence of the decedent.[14] The references to the IRC are also instructive, especially as they constitute the only source for defining "retirement funds." For instance, § 408(d)(3)(C)(ii) of the IRC denies the rollover of retirement accounts inherited by non-spouses of the original owner, thereby denoting a differentiation that could be seen as incorporated into the Bankruptcy Code by reference. Consequently, non-spouse beneficiaries will have to take distribution within the statutory time constraints and pay the requisite tax penalties rather than being able to continue to shelter the funds until their retirements, thus bolstering the view that the assets lose their special "retirement fund" qualities upon passage.[15] As observed by the Seventh Circuit, to allow beneficiaries to defer distribution of an inherited IRA until the beneficiaries' own retirement would engender the possibility that wealth could be shielded from tax liability in perpetuity through continuous deferral of distribution by each subsequent generation.[16]

"Retirement Funds" to One Are Retirement Funds to All

Perhaps in recognition of the congressional intent to increase protection for retirement accounts, as well as reliance on the general rule that exemptions should be "construed liberally in favor of the debtor,"[17] courts that have concluded that inherited IRAs are exempt have declined to read a qualifier into § 522(b)(3)(C) or (d)(12) that would limit the phrase "retirement funds" to retirement funds that were established by and belong specifically to the debtor.[18] The Fifth Circuit went a step further and looked to *Webster's* definition of "retirement" and "fund" to ascertain the plain meaning of the exemption statute.[19] It determined that the defining characteristic of retirement funds is that they are "set apart" for retirement; what happens to them after they have been set apart is not relevant.[20] Given that the exemption provisions do not dictate that the contents of a retirement account must have been contributed by the debtor, these courts refused to limit the statute "beyond its plain language"[21] and determined that inherited IRAs constitute retirement funds within the meaning of the Bankruptcy Code. Thus, unlike the Seventh Circuit's conclusion, it is sufficient that someone originally created the inherited IRA as a retirement account.

Three circuit courts bolster this conclusion by reference to § 522(b)(4)(C), which provides that a direct transfer of retirement funds that are exempt under the IRC to another account does not alter their status as retirement funds, and therefore does not alter their status as exempt funds.[22] Therefore, the protections afforded to debtors under § 522(b)(3)(C) and (d)(12) apply not only to accounts created by the debtor, but also extend to accounts that are transferred directly between trustees (*i.e.*, inherited accounts) via § 522(b)(4)(C). Failure to consider these subsections in conjunction with each other would render § 522(b)(4)(C) meaningless, and thereby ignore another canon of statutory construction that every provision of a statute should be construed so that no other provision is rendered superfluous.[23]

The Fifth, Eighth and Ninth Circuits each also determined that inherited IRAs are exempt from taxation under the IRC, and therefore meet the second prong of the two-part analysis for exemption under the Code. The courts generally ignore the fact that IRAs inherited by a non-spouse are subject to different treatment and distribution requirements than other accounts under the IRC, because the language of § 522(b)(3)(C) and (d)(12) only requires that the funds be an account that is exempt from taxation under "section 401, 403, 408, 408A, 414, 457, or 501(a) of the [IRC]."[24] Because § 408(e)(1) of the IRC provides that "*[a]ny* individual retirement account is exempt from taxation," and because the definition of an individual retirement account in the IRC encompasses inherited IRAs,[25] these courts have concluded that inherited IRAs are exempt from taxation.

Alternative Exemption Vehicles

The § 522 exemptions are not the only methods by which a debtor may keep an inherited IRA out of his or her bankruptcy estate. Some courts have upheld the validity of disclaimers, which are governed by state probate laws and permit beneficiaries to reject gifts. Disclaimers essentially operate by treating the benefi-

10 *See In re Clark*, 714 F.3d at 559 (7th Cir. 2013).

11 *See In re Jones*, 2013 WL 4084093 at *2 (Bankr. D. Neb. Aug. 13, 2013).

12 *In re Clark*, 714 F.3d at 562 (quoting *Rodriguez v. United States*, 480 U.S. 522, 525-26 (1987) (emphasis in original).

13 For a criticism of the Seventh Circuit's overreliance on policy considerations, *see Diamond v. Trawick (In re Trawick)*, 497 B.R. 572, 587 (Bankr. C.D. Cal. Aug. 29, 2013).

14 Though one may fairly argue that the homestead exemption, as stated in § 522(d)(1), is expressly limited to property that the "debtor uses as a residence," an important qualification that is absent from the provisions exempting retirement funds.

15 Of course, an individual who inherits retirement funds can take the distribution and place the proceeds, after tax penalties, into their own qualified retirement accounts and then receive the benefit of the retirement funds' exemption.

16 *In re Clark*, 714 F.3d at 560.

17 *See In re Bauer*, 2013 WL 2661835 at *2 (Bankr. D.S.C. June 12, 2013) (quoting *In re Nguyen*, 211 F.3d 105, 110 (4th Cir. 2000)).

18 *See, e.g., Nessa*, 426 B.R. at 314; *In re Hamlin*, 456 B.R. at 871 (noting that the statute "requires that the account be comprised of retirement funds; it does not specify that they must be the *debtor's* retirement funds") (emphasis in original).

19 "'[R]etirement' is defined as 'withdrawal from office, active service, or business'; 'fund' is defined as 'a sum of money or other resources the principal or interest of which is set apart for a specific objective or activity.'" *In re Chilton*, 674 F.3d at 489 (citing *Webster's Third New Int'l Dictionary* 921, 1939 (1993)).

20 *Id.*

21 *In re Nessa*, 426 B.R. at 314; *see also In re Chilton*, 674 F.3d at 489 ("As we see no reason to interpret the statutory language differently from its plain meaning, we hold that the $170,000 contained in the inherited IRA constitute[s] 'retirement funds' as that phrase is used in section 522(d)(12).").

22 11 U.S.C. § 522(b)(4)(C) states, in relevant part, that "[a] direct transfer of retirement funds from [one] fund or account that is exempt from taxation under [IRC] ... § 408 ... shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such direct transfer."

23 *See In re Nessa*, 426 B.R. at 315, n.3; *In re Chilton*, 674 F.3d at 489; *In re Hamlin*, 465 B.R. at 875 (quoting *In re Tabor*, 433 B.R. 469, 475 (Bankr. M.D. Pa. 2010) ("Whether or not Congress realized that inherited accounts were 'trustee-to-trustee' accounts, the language of § 522(b)(4)(C) is unambiguous and applies to inherited accounts whether state or federal exemptions are claimed.")).

24 *In re Nessa*, 426 B.R. at 315 ("It is irrelevant whether a traditional IRA and an inherited IRA have different rules regarding minimum required distributions.").

25 26 U.S.C. § 408(d)(3)(C)(ii).

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ciary as if it predeceased the decedent, in which case the gift will pass to the next person in line, usually the beneficiaries' spouse or child. The practical effect of a disclaimer is to prevent the beneficiary from ever acquiring an interest in the property, thereby immunizing the gift from the auspices of § 541, and by extension, § 548. Attempts to invalidate disclaimers as fraudulent often fail because a debtor cannot transfer property in which it never had an interest. For example, in Illinois, if a debtor inherits an IRA, it may execute a pre-petition disclaimer[26] but may not exempt it.[27]

26 *In re Atchison*, 925 F.2d 209, 212 (7th Cir. 1991) (declaring that Illinois law validates disclaimers against fraudulent-transfer actions under § 548(a)).
27 *In re Clark*, 714 F.3d 559.

Conclusion

Given the divide between the Seventh Circuit and the Fifth, Eighth and Ninth Circuits, which is rooted in divergent applications of the same premise of statutory construction and fueled by differing policy considerations, the only thing that may be clear is that more definitive guidance is needed to elucidate a vague area of the Bankruptcy Code. Fortunately, needed clarification may soon arrive from the Supreme Court. Until then, counsel for debtors, as well as trustees, should be cognizant of the proclivities of their circuits when dealing with cases involving inherited retirement funds. abi