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When is an IRA not an IRA?

When it is inherited, high court says

by Christopher J. Burns and Kiley Henry

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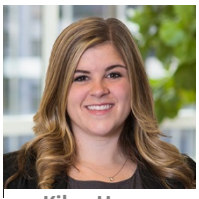

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Just because an account has "Individual Retirement Account (IRA)" in its title does not mean that it will be protected from creditors in bankruptcy, according to a unanimous United States Supreme Court in *Clark v. Rameker*.

Prior to *Clark*, funds of individuals who inherited IRAs were thought by some to be protected from bankruptcy creditors. After *Clark*, this is known not to be the case.

To give some sense of perspective of this decision, consider that according to the Investment Company Institute, as of March of 2014, over $6.6 trillion were held in IRAs.

The relevant facts in *Clark* are fairly straightforward. A child inherited a $450,000 IRA from her mother. Nine years later she and her husband filed for Chapter 7 bankruptcy protection. As a part of the bankruptcy proceeding, she and her husband claimed that the remaining $300,000 in the inherited IRA account was protected from bankruptcy proceedings under 11 U.S.C. § 522.

The couples' creditors disagreed, arguing that the funds from the inherited IRA were an inheritance that should be subject to their claims. The Bankruptcy Court agreed with the creditors, holding that funds in the inherited IRA were not "retirement funds" within the meaning of the applicable statute.

The District Court reversed, explaining that the exemption covers any account containing funds "originally accumulated for retirement purposes."

The 7th Circuit Court of Appeals reversed the District Court stating that there are different rules that govern inherited IRAs and non-inherited IRAs and concluded that "inherited IRAs represent an opportunity for current consumption, not a fund of retirement savings."

The United States Supreme Court affirmed the 7th Circuit Court of Appeals and unanimously held that an inherited IRA account did not qualify as a retirement fund for the purposes of the exemption provided under the Bankruptcy Code. The court explained:

"An inherited IRA is a traditional or Roth IRA that has been inherited after its owner's death. . . . If the heir is the owner's spouse, as is often the case, the spouse has a choice: He or she may "roll over" the IRA funds into his or her own IRA, or he or she may keep the IRA as an inherited IRA. . . . When anyone other than the owner's spouse inherits the IRA, he or she may not roll over the funds; the only option is to hold the IRA as an inherited account."

Bankruptcy planning at a glance

- Your own IRA is (generally) protected from creditors.
- A spouse's IRA that you elect to "roll over" is protected from creditors.
- An inherited IRA is not protected from creditors in a subsequent bankruptcy proceeding by the account holder.

The court went on further to state:

"Inherited IRAs do not operate like ordinary IRAs. Unlike with a traditional or Roth IRA, an individual may withdraw funds from an inherited IRA at any time, without paying a tax penalty. . . . Indeed, the owner of an inherited IRA not only may but must withdraw its funds: The owner must either withdraw the entire balance in the account within five years of the original owner's death or take minimum distributions on an annual basis. . . . And unlike with a traditional or Roth IRA, the owner of an inherited IRA may never make contributions to the account. . . ."

After examining the foundational differences between IRAs and inherited

IRAs, the court held that an inherited IRA did not qualify as a "retirement account" for exemption purposes under existing bankruptcy law. In coming to this conclusion, the court, after comparing traditional and Roth IRAs with inherited IRAs, stated:

"Allowing debtors to protect funds held in traditional and Roth IRAs comports with this purpose by helping to ensure that debtors will be able to meet their basic needs during their retirement years. At the same time, the legal limitations on traditional and Roth IRAs ensure that debtors who hold such accounts… do not enjoy a cash windfall by virtue of exemption. …

"The same cannot be said of an inherited IRA. For if an individual is allowed to exempt an inherited IRA from her bankruptcy estate, nothing about the inherited IRA's legal characteristics would prevent … the individual from using the entire balance of the account on a vacation home or sports car immediately after her bankruptcy proceedings are complete. Allowing that kind of exemption would convert the Bankruptcy Code's purposes of preserving debtors' ability to meet their basic needs and ensuring that they have a "fresh start" … into a "free pass." …"

The Supreme Court's decision provides some clarity and guidance on how beneficiaries of IRAs may be designated to minimize future creditor issues for recipients of those funds.

Consequently, before designating an individual as beneficiary of an IRA, estate planning attorneys and other advisors should consider the alternative beneficiary designations that might be available. For those who are reasonably certain that their beneficiaries will never have issues with creditors, the best choice may be to leave their account outright. Doing so will put the account at risk in a subsequently declared bankruptcy by the beneficiary, but, may be administratively simpler.

For many others, the best choice for a beneficiary designation might be to have the retirement account distributed to separate trusts for each of a client's children or other beneficiaries. The answer may also be a mix of trusts for some beneficiaries and outright for others.

Lastly, if a part of the answer is to hold a decedent's IRA in separate trusts for the decedent's children, the drafting attorney should make sure to familiarize herself or himself with all of the rules for Minimum Required Distributions and other complicated rules for administering such trusts. A good resource to consult when examining these rules is author Natalie B. Choate's "Life and Death Planning for Retirement Benefits."

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