

MEMO# 28226

June 24, 2014

Supreme Court Holds That Inherited IRAs are Not Excluded from Debtor's Bankruptcy Estate

[28226]

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TO: PENSION MEMBERS No. 27-14

BANK, TRUST AND RETIREMENT ADVISORY COMMITTEE No. 29-14

OPERATIONS MEMBERS No. 6-14

TRANSFER AGENT ADVISORY COMMITTEE No. 41-14 RE: SUPREME COURT HOLDS THAT INHERITED IRAs ARE NOT EXCLUDED FROM DEBTOR'S BANKRUPTCY ESTATE

On June 12, 2014, the U.S. Supreme Court unanimously held in *Clark v. Rameker* [\[1\]](#) that an inherited IRA is subject to the claims of creditors in bankruptcy because it does not qualify for the "retirement funds" exemption in the bankruptcy code. [\[2\]](#)

Background

In 2000, Ruth Heffron established a traditional IRA and named her daughter, Heidi Heffron-Clark, as the sole beneficiary of her account. Upon her death in 2001, her IRA (which was then worth just over \$450,000) passed to her daughter and became an inherited IRA. Ms. Heffron-Clark elected to take monthly distributions from the account. In October 2010 Ms. Heffron-Clark and her husband filed a Chapter 7 bankruptcy petition. The petition identified the inherited IRA, then worth approximately \$300,000, as exempt from the bankruptcy estate.

The bankruptcy trustee and the estate's unsecured creditors objected to the claimed exemption on the grounds that the funds in the inherited IRA were not "retirement funds" within the meaning of the bankruptcy code. The bankruptcy court agreed and disallowed the exemption, holding that an inherited IRA does not contain anyone's "retirement funds" because, unlike a traditional IRA, the funds are not "segregated to meet the needs of, nor distributed on the occasion of, any person's retirement." [\[3\]](#) The debtors appealed, and the District Court reversed, holding that the exemption covers any account containing funds originally accumulated for retirement purposes. [\[4\]](#) Upon further appeal, the Seventh Circuit reversed the District Court's decision, holding that inherited IRAs "represent an opportunity for current consumption, not a fund of retirement savings." [\[5\]](#) The Supreme

Court granted certiorari to resolve a conflict between the Seventh Circuit's ruling and the Fifth Circuit's decision in *In re Chilton*, where the Fifth Circuit held that funds held in an inherited IRA qualify for the "retirement funds" exemption in the bankruptcy code. [\[6\]](#)

The Court's Holding

The Court affirmed the 7th Circuit's decision that an inherited IRA is not a "retirement fund" exempt from a bankruptcy estate. In reaching this conclusion, the Court, after consulting the American Heritage Dictionary, construed the phrase "retirement funds" as "sums of money set aside for the day an individual stops working." As such, the Court determined it appropriate to look at the legal characteristics of the account in which the funds are held, asking whether, as an objective matter, the account is one set aside for the day when an individual stops working. The Court concluded that the following three legal characteristics of an inherited IRA illustrate that funds held in such accounts are not objectively set aside for the purpose of retirement:

1. The holder of an inherited IRA may never invest additional money in the account. The Court compared an inherited IRA to a traditional or Roth IRA, stating that the entire purpose of traditional and Roth IRAs is to provide tax incentives for accountholders to contribute regularly and over time to their retirement savings.
2. Holders of inherited IRAs are required to withdraw money from such accounts, no matter how many years they may be from retirement. The Court noted that the tax rules governing inherited IRAs routinely lead to their diminution over time, regardless of their holder's proximity to retirement, and one would not expect this feature to be associated with an account set aside for 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. The Court contrasted this with the penalty associated with a withdrawal from a traditional or Roth IRA prior to the account holder reaching age 59½.

The Court stated that its conclusion was consistent with the purposes of the bankruptcy code and its balancing of the interests of creditors and debtors.

We note that *Clark v. Rameker* involved a daughter's inheritance of her mother's IRA. The rules differ when a spouse inherits an IRA, as a spouse has a right to treat the inherited IRA as his or her own IRA. In such circumstances, the IRA is subject to the same rules as a traditional or Roth IRA. It is unclear whether the Court's reasoning in *Clark v. Rameker* would apply to an IRA inherited by a spouse and treated as his or her own IRA.

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endnotes

[\[1\]](#) Sup. Ct. Slip Op. No 13-299, affirming *In re Clark*, 714 F.3d 559 (7th Cir. 2013). A copy of the Court's opinion is available here:

www.supremecourt.gov/opinions/13pdf/13-299_mjn0.pdf.

[2] The bankruptcy code provides an exemption for particular categories of assets from an individual's bankruptcy estate. One such category includes "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." See 11 U.S.C. Section 522(b)(3)(C).

[3] In re Clark, 450 B.R. 858, 863 (WD Wisc. 2011).

[4] In re Clark, 466 B.R. 135,139 (WD Wisc. 2012).

[5] In re Clark, 674 F.3d. 559, 563 (7th Cir. 2013).

[6] 674 F.3d. 486 (5th Cir. 2012).

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