

INHERITED INDIVIDUAL RETIREMENT ACCOUNTS

NOT PROTECTED IN BANKRUPTCY

In *Clark v. Rameker*, decided on June 12, 2014, the U.S. Supreme Court settled a split in the circuit courts and unanimously held that funds in an inherited individual retirement account (“IRA”) are not protected in bankruptcy. The opinion, written by Justice Sotomayor, found that Heidi Heffron-Clark, who inherited an IRA from her mother in 2001 and filed for bankruptcy 9 years later, could not shield the account from her creditors.

Justice Sotomayor, first described an inherited IRA:

“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 (subject to the rules discussed below). . . . 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.

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. . . .”

Justice Sotomayor remarked that the phrase “retirement funds” is not defined in the Bankruptcy Code, and thus accorded its ordinary meaning and understanding as “sums of money set aside for the day an individual stops working.” To reach this determination, an objective test is used – it doesn’t matter what the debtor really intended to do with the money, but instead turns on whether the account is one set aside for retirement.

Applying this analysis, an inherited IRA is not money that is set aside for retirement. Justice Sotomayor concentrated on 3 points:

1. The holder of an inherited IRA is prohibited from contributing additional monies to the account;
2. The holder of an inherited IRA is required to take mandatory withdrawals from the account whether the holder has retired or not; and
3. The holder of an inherited can withdraw the money at any time without penalty, and accordingly is not encouraged to save the money for retirement.

The whole structure is different from the one that pertains to IRA owners, which is designed to ensure that they will have money available during retirement, and therefore warrants protection of those assets during bankruptcy, Justice Sotomayor noted. The result, the Court held, is consistent with general creditor-debtor law, whereby specific exemption serve specific purposes, and here the purpose of exempting a traditional, non-inherited IRA is to provide for the retirement needs of debtors even to the detriment of their creditors. In contrast, an inherited IRA has no such purpose.

The Court's decision is not a surprise. Justice Sotomayor's reasoning is correct and can hardly be argued with, and indeed gained a unanimous opinion from a Court.

The decision has important implications for spouses. A spouse who inherits has an option not available to others. The spouse can rill the assets into his or her own IRA and postpone distributions from a traditional IRA until he or she reaches age 70-1/2. However, like other IRA owners the spouse may have to pay a 10% early withdrawal penalty if he or she takes money from his or her own IRA prior to age 59-1/2.

Nevertheless, unless the spouse does a rollover, the account is considered an inherited IRA. The spouse would not have to take any money out until his or her deceased spouse would have turned age 70-1/2. But under the Court's decision those assets would not be protected in bankruptcy. Thus, spouses now have one more reason, in addition to income tax benefits, to do a rollover.

Another option that can be used to benefit a spouse or anyone else is to name a trust as the IRA beneficiary. This is a very complicated alternative and should not be done without assistance from advisors who are experts in this field.