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Inherited IRAs Are Not Exempt in Bankruptcy

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The Supreme Court has unanimously ruled that inherited IRAs do not qualify for a bankruptcy exemption; that is, they are not protected from creditors in bankruptcy. Clark, No. 13-299 (June 12, 2014).

Background: The Clark case centered on the question of whether a husband and wife filing for Chapter 7 bankruptcy could exempt from their bankruptcy estate an IRA account that the wife had inherited from her mother. At the time the bankruptcy petition was filed, the value of the inherited IRA was approximately $300,000. In seeking to exempt the inherited IRA funds, the couple relied on Bankruptcy Code §522(b)(3)(C) (11) USC 522(b)(3)(C)), which permits a debtor to exempt amounts that are both (a) "retirement funds," and (2) exempt from income tax under one of several enumerated Internal Revenue Code provisions, including Code Sec. 408, which provides a tax exemption for IRAs.

The bankruptcy trustee and the unsecured creditors of the taxpayers objected to the claimed exemption on the ground that the funds in the inherited IRA were not "retirement funds" within the meaning of Bankruptcy Code. The bankruptcy court agreed and disallowed the exemption. The District Court then reversed, explaining that the Bankruptcy Code exemption covers any account containing funds that were originally accumulated for retirement purposes. Upon further appeal, the Seventh Circuit reversed the District Court's ruling concluding that the inherited IRA funds could not be exempted because "inherited IRAs represent an opportunity for current consumption, not a fund of retirement savings."

The Seventh Circuit's conclusion was directly opposite that reached by the Fifth Circuit when faced with the same question just one year earlier (In re Chilton). To resolve the conflict between these two Circuit Court rulings, the Supreme Court agreed to hear the case.

Supreme Court: Embarking on its decision, the Supreme Court noted that the Bankruptcy Code does not define the term "retirement funds." The Court therefore applied what it identified as the ordinary meaning of the term; that is "sums of money set aside for the day an individual stops working." In determining whether the inherited IRAs qualified as "retirement funds" for the purposes of the bankruptcy exemption the Court examined "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 identified the following three legal characteristics of inherited IRAs in support of its conclusion that funds in inherited IRAs "are not objectively set aside for the purpose of retirement."

1. Unlike traditional and Roth IRAs where there are tax incentives for the account holders to make regular contributions, The Internal Revenue Code (§219(d)(4)), prohibits the holder of an inherited IRAs from investing additional funds in the account.
2. Holders of inherited IRAs are required to withdraw money from such accounts and deplete the accounts over time no matter how many years away they may be from retirement or whether any funds will be left at the time or retirement.
3. While there is an early withdrawal penalty on withdrawals from a traditional or Roth IRA before the account holder reaches age 59½ (subject to one of several narrow exceptions), the holder of an inherited IRA may withdraw any or all of the funds from the account without any withdrawal penalty meaning that the funds held in an inherited IRA can be freely used for current consumption.

The Supreme Court observed that its analysis and outcome is consistent with the purposes of the Bankruptcy Code's exemption provisions – "to effectuate a careful balance between the interests of creditors and debtors." Allowing debtors to protect funds held in traditional and Roth IRAs helps to ensure that debtors will be able to meet their basic needs during retirement. Plus, the limits on traditional and Roth IRAs make sure that the debtors who hold these accounts do not enjoy a windfall due to the exemption because they must wait until age 59½ before they may withdraw the funds without incurring a

penalty. On the other hand, the legal characteristics of inherited IRAs do not prevent (or even discourage) the account holder from using the entire balance immediately after bankruptcy for any purpose whether or not the use of such funds are in connection with addressing the account holder's retirement financial needs. In light of these distinctions, the Supreme Court concluded that allowing inherited IRAs to fall within the Bankruptcy Code exemption for retirement funds would turn the Bankruptcy Code's "fresh start," into a "free pass."

Open Questions: Interestingly, the Court's decision in Clark does not necessarily mean that inherited IRAs can now never be exempted in bankruptcy. In a footnote the Supreme Court recognized that debtors have the option to elect to claim exemptions either under the federal Bankruptcy Code or state law. Some state laws exempt "retirement funds" and other state laws exempt a "retirement plan" from the debtor's estate. Thus, depending on the applicable state law a debtor may be able to elect to claim state law bankruptcy exemptions in lieu of the federal law exemption in an effort to side-step the Court's decision in Clark and exempt an inherited IRA.

In addition, an interesting, and yet unresolved, question is whether an IRA inherited by the spouse of the decedent is an inherited IRA for the purposes of the Clark holding. The Internal Revenue Code defines an inherited IRA as one which was acquired by an individual by reason of the death of another individual who is not their spouse. Whether a surviving spouse should "roll over" the IRA inherited from his/her deceased spouse into his/her own IRA and thereby side-step the question of whether these inherited funds are eligible for the federal bankruptcy exemption for "retirement funds" depends, in part, on the ages of the deceased and surviving spouse and the surviving spouse's need for funds without the imposition of any penalty and if the IRA was to fund a QTIP or Bypass Trust. As is the case with most tax (and life) issues – one size does not fit all.

