

## Tax/Commercial/Bankruptcy Law

# Supreme Court Rules Inherited IRAs are Not Protected in Bankruptcy

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On June 12, 2014, in a unanimous 9-0 decision in *Clark v. Rameker*, the United States Supreme Court ruled that inherited individual retirement accounts (IRAs) are not retirement funds within the meaning of the Bankruptcy Code.<sup>1</sup> This decision resolves a split among the federal appellate courts about the status of IRAs that parents leave to their children and others.

The Bankruptcy Code allows debtors to claim certain property as exempt by utilizing exemptions under state law or specifically provided in the Bankruptcy Code, shielding such assets from creditors. However, states can “opt out” of certain exemptions in the Bankruptcy Code and require debtors to use state law exemptions instead. Sections 522(b)(3)(C) and (d)(12)<sup>2</sup> of the Bankruptcy Code allow debtors to exempt retirement funds, even where the state has opted out of the federal exemptions.

Simply put, in determining that inherited IRAs do not constitute retirement funds, *Clark* squarely places funds in inherited IRAs at risk. Put another way, these assets may now be fair game for creditors under federal bankruptcy law.

*Clark* involved a dispute over whether creditors can reach a debtor’s non-spousal inherited IRA in bankruptcy. In 2010, Heidi Heffron-Clark and her husband (the “Clarks”) filed for bankruptcy relief under Chapter 7 in the United States Bankruptcy Court for the Western District of Wisconsin. The Chapter 7 Trustee and a judgment creditor objected to the Clarks’ claim to exempt an IRA inherited prepetition from Ms. Heffron-Clark’s deceased mother.<sup>3</sup>

In determining that an inherited IRA did not constitute an exempt retirement fund under the Bankruptcy Code, Bankruptcy Judge Martin reasoned that the debtors received distributions from the IRA immediately with no regard to their age, physical health or working status.<sup>4</sup> The Clarks appealed and the United States District Court for the Western District of Wisconsin reversed the Bankruptcy Court’s decision.<sup>5</sup> The Trustee and the judgment credi-

tor then appealed to the Court of Appeals for the Seventh Circuit.

Chief Judge Easterbrook, writing for a unanimous Seventh Circuit, reversed.<sup>6</sup> The Seventh Circuit agreed with the Bankruptcy Court’s original determination that inherited IRAs are not exempt retirement funds under the Bankruptcy Code. The court explained that once Ms. Heffron-Clark inherited the IRA, many of its attributes were altered. This included the fact that distributions commenced within one year of the original owner’s death and were completed within five years. The distinction, said the Seventh Circuit, was that inherited IRAs are not just savings preserved for use after their owners retire.<sup>7</sup> The ruling clashed with a contrary decision by the Fifth Circuit.<sup>8</sup> The Supreme Court ultimately granted certiorari to resolve the conflict.

Justice Sotomayor, writing for the Supreme Court, began by noting that although the Bankruptcy Code does not define “retirement funds,” they are “properly understood to mean sums of money set aside for the day an individual stops working.”<sup>9</sup> In affirming the Seventh Circuit’s decision, the court identified three principal attributes of inherited IRAs that demonstrate such funds are not preserved for retirement, and thus not exempt under Section 522 of the Bankruptcy Code.

First, an inherited IRA account holder may not invest any additional funds into the account.<sup>10</sup> In contrast, holders of traditional IRAs and Roth IRAs, are encouraged to make regular contributions over time and are penalized for early withdrawals prior to retirement.<sup>11</sup> Second, unlike traditional IRAs and Roth IRAs, the holder of an inherited IRA must withdraw the entire account balance within five years of the original owner’s death or take minimum distributions annually.<sup>12</sup> Lastly, in contrast to conventional IRAs, the holder of an inherited IRA may withdraw the entire balance for any purpose at any time without penalty.<sup>13</sup>

After examining these differences, as well as the objective of Bankruptcy Code exemptions, the Supreme Court determined that inherited IRAs represent vessels of wealth “that can be freely used for current consumption, not funds objectively set aside for one’s retirement.”<sup>14</sup>

Otherwise, Justice Sotomayor said, nothing would prevent someone seeking bankruptcy relief from using the entire balance of an inherited IRA “on a vacation home or a sports car immediately after her bankruptcy proceedings are complete.”<sup>15</sup> In fact, the court pointed out that if funds in inherited IRAs were deemed to be exempt, rather than provide debtors with a “fresh start,” the Bankruptcy Code would be furnishing debtors with a “free pass.”<sup>16</sup>

Notably, *Clark* does not speak to IRAs inherited by a spouse. However, speaking for the court, Justice Sotomayor noted that there are special tax rules for IRA spousal beneficiaries, including the ability for a surviving spouse to “roll over” the IRA funds into his or her own IRA account.<sup>17</sup>

Still, *Clark* does not preclude states from providing a property exemption to inherited IRAs under state law. Individuals with IRAs considering bankruptcy relief should consult with bankruptcy professionals in order to fully understand their options under operative state and federal law, as this ruling will have a significant impact on future retirement and bankruptcy planning.

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1. *Clark v. Rameker*, 134 S.Ct. 2242 (2014).
2. The language of Sections 522(b)(3)(C) and (d)(12) is identical.
3. *Clark*, 134 S.Ct. at 2245-46.
4. See *In re Clark*, 450 B.R. 858 (Bankr. W.D. Wis. 2011).
5. See *In re Clark*, 466 B.R. 135 (W.D. Wis. 2012).
6. *In re Clark*, 714 F. 3d 559 (7th Cir. 2013).
7. *Id.* at 562.
8. See *In re Chilton*, 674 F. 3d 486 (5th Cir. 2012).
9. *Clark*, 134 S.Ct. at 2246.
10. *Id.*, citing 26 U.S.C. § 219(d)(4).
11. *Id.* at 2247. Both traditional IRA and Roth IRA account holders are subject to a 10% penalty if withdrawals are made before reaching the age of 59 1/2. *Id.* at 2245.
12. *Id.* at 2247 (internal citations omitted).
13. *Id.*, citing 26 U.S.C. § 219(d)(4).
14. *Id.* (internal citation omitted).
15. *Id.* at 2248.
16. *Id.*
17. *Id.* at 2245.



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