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The ‘R’ In Inherited IRA Does Not Stand For Retirement – The Implications of the US Supreme Court’s Clark Decision

Employment and Labor


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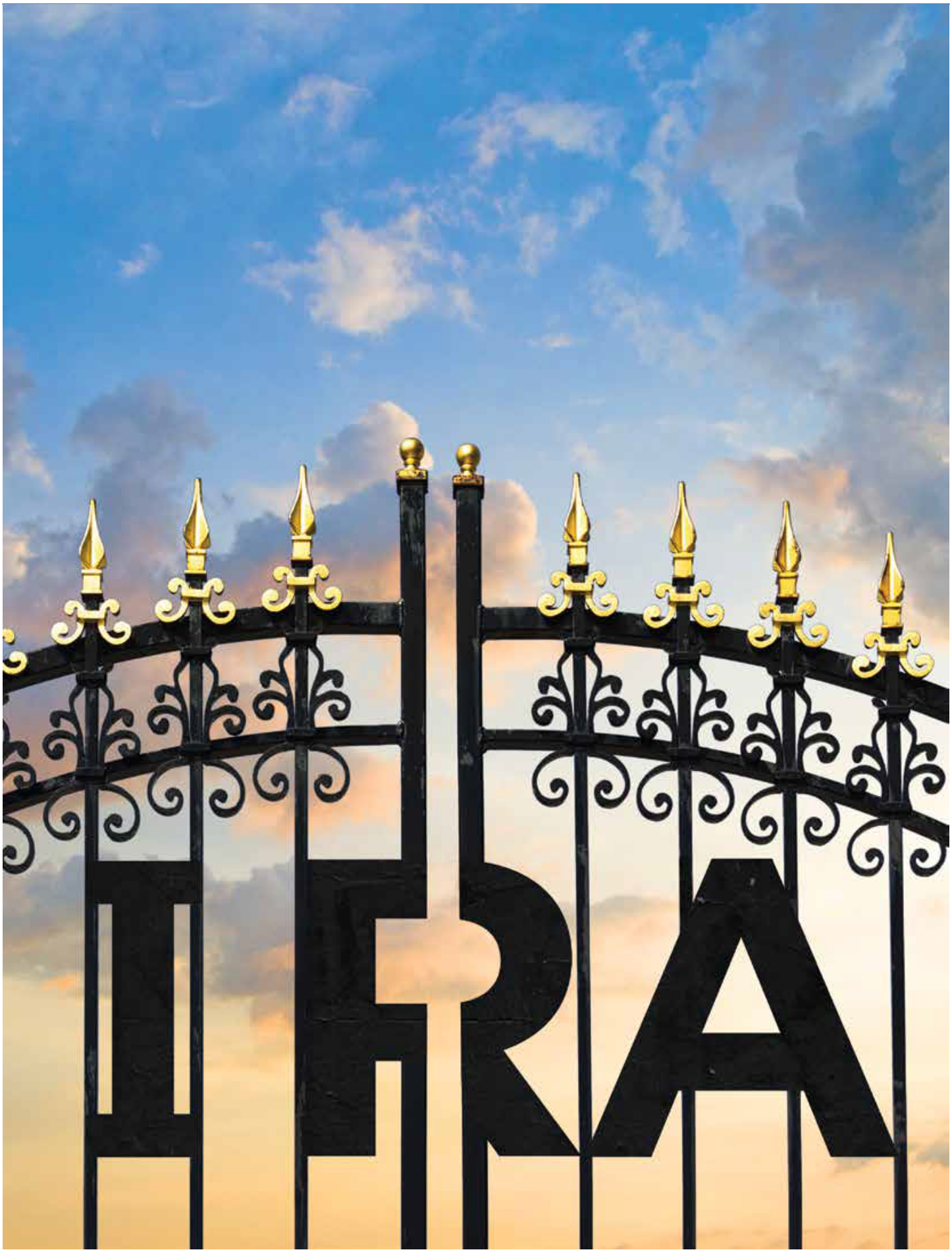
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CHEAT SHEET

- ***A look at the past: before Clark.*** Spouses, children, close friends or relatives were often named beneficiaries of inherited IRAs under the expectation that these funds would be protected from the claims of creditors once inherited.
- ***A look at the present: the Clark opinion.*** The Court's 2014 decision was the culmination of a case that began in 2000 with Ruth Heffron.
- ***How will Clark impact the bankruptcy process?*** Creditors and their counsel need to examine a debtor's bankruptcy schedules to determine what exemptions the debtor is claiming and whether the claimed exemptions protect an inherited IRA.
- ***How will this decision clearly impact future dealings with retirement plans?*** By specifically defining a retirement fund as money set aside for retirement, the US Supreme Court has effectively divided traditional and Roth IRAs and retirement plans from inherited IRAs moving forward.

Attorneys involved in the financial services industry, debt collection or estate planning for family-owned businesses should take note of the US Supreme Court's recent decision in *Clark v. Rameker*. On June 12, 2014, US Supreme Court Justice Sonia Sotomayor, on behalf of a unanimous Court, held that funds contained within *inherited* IRAs are not "retirement funds," and thus, they are not exempt under 11 U.S.C. § 522(b)(3) (C) — a decision that notably alters the landscape of inherited IRAs under the Bankruptcy Code. In order to better understand the decision and its repercussions, this article will mirror the approach Charles Dickens took in *A Christmas Carol*. It will examine the case from (1) the past before *Clark*, (2) the present — the opinion itself, and (3) the future — bankruptcy, inherited IRAs and estate planning in a post-*Clark* environment.

A look at the past: before *Clark*

Before the *Clark* decision, spouses, children, close friends or relatives were often named beneficiaries of inherited IRAs under the expectation that these funds would be protected from the claims of creditors once inherited. Individuals, and their creditors, presumed assets held in an inherited IRA were exempt under the Bankruptcy Code as "retirement funds" within the context of 11 U.S.C. § 522(b)(3)(C). Eight courts supported this position, reasoning that funds contained in inherited IRAs remained "retirement funds" and were characterized by the IRS as such, even though they were technically the decedent's funds for retirement.

An inherited IRA exists where funds from a traditional IRA or Roth IRA are inherited after the owner's death.

The Bankruptcy Court for the Western District of Wisconsin, however, broke from the majority and held that the debtor's inherited IRA was not exempt under the Bankruptcy Code. This set the stage for the path *Clark* would take to the United States Supreme Court.

A look at the present: the *Clark* opinion

The Court's 2014 decision was the culmination of a case that began in 2000 with Ruth Heffron, who named her daughter, Heidi Heffron-Clark, the sole beneficiary of her traditional IRA. Ruth Heffron's husband had recently died, and she rolled his IRA over into her account. Heffron's death soon followed in 2001, and her IRA passed on to her daughter as a now-inherited IRA. At the time of Heffron's death, the account had a value of more than $450,000.

Heidi Heffron-Clark began taking monthly distributions in 2002. Shortly after, she and her husband opened a pizza parlor in Stoughton, Wisconsin, which ultimately failed in the face of the recession. Seeking financial relief, the couple filed a Chapter 7 bankruptcy petition in the Western District of Wisconsin. In their bankruptcy petition, the Clarks listed the inherited IRA, with a value of approximately $300,000, as exempt under 11 U.S.C. § 522(b)(3)(C).

Arguing that the inherited IRA is not a "retirement fund" as contemplated by the exemption statute, the Chapter 7 trustee and other creditors objected to this exemption. The bankruptcy court agreed with the trustee, beginning the case's contentious journey through the district court, which reversed the ruling; the Seventh Circuit, which upheld the ruling; and ultimately, the Supreme Court, which agreed with the bankruptcy court's initial decision.

In reviewing the Seventh Circuit's case, the Supreme Court began by analyzing the sections of the Internal Revenue Code enumerated in Bankruptcy Code §§ 522(b)(3)(C), and specifically, 26 U.S.C. § 408 and § 408A. The Court noted that traditional and Roth IRAs created under § 408 and § 408A offer tax advantages that encourage individuals to save for retirement. By comparison, an inherited IRA under §§ 408(d)(3)(C)(ii) or 408A(a), does not offer these same tax advantages. These distinguishing tax characteristics, discussed in detail below, were critical to the Court's holding.

In addition to examining the IRC sections, the Court examined the definition of "retirement fund" in the context of the Bankruptcy Code. Because the Bankruptcy Code did not define "retirement fund," the Court looked toward the dictionary definitions of the words, noting that (1) the definition of "funds" means "sum[s] of money . . . set aside for a specific purpose," and (2) the definition of "retirement" means "[w]ithdrawal from one's occupation, business, or office." Therefore, the Court surmised that "retirement fund," as used under §522(b)(3)(C), meant: "sums of money set aside for the day an individual stops working."

The Court concluded that funds in an inherited IRA hold three legal characteristics indicating they are not "objectively set aside for the purpose of retirement." First, the holder of an inherited IRA may not invest additional sums in the account. By comparison, traditional and Roth IRAs encourage individuals to continuously invest in the account. Second, the holder of an inherited IRA is required to begin withdrawing money a short time after inheriting the funds, no matter how many years he or she may be from retirement. By requiring the holder of an inherited IRA to either withdraw all the funds within five years of the owner's death or take distributions every year, the Court noted that this "is hardly a feature one would expect of an account set aside for retirement."

Third, the holder of an inherited IRA can withdraw the entire balance of the account at any time, without penalty. While the holder of a traditional or Roth IRA faces specific restrictions and penalties if she or he withdraws the funds before reaching the age of 59 ½, a holder of an inherited IRA can withdraw all the funds at any time for any purpose, facing only income tax on withdrawal.

Checklist for lenders and other creditors

Lenders and other creditors should confirm their loan applications are updated and that they, or their counsel, are examining a debtor's bankruptcy schedules. The following is a checklist for lenders and other creditors to use in their examination:

1. Loan Application – The debtor's loan application should be updated to include a section where applicants list any "inherited IRAs." Many times, loan applications simply have a "Retirement" section, where applicants will note they have an "IRA."
2. Review of Bankruptcy Petition – When a debtor files for bankruptcy, the creditor or the creditor's counsel should examine the debtor's petition and, specifically, schedules B and C. Schedule B is where a debtor is required to list all retirement accounts. Schedule C is where the debtor lists his or her exemptions.
3. What exemptions are being used?
    1. If using federal exemptions, the Clark case is applicable. If the debtor is trying to exempt an inherited IRA, either the creditor or the Chapter 7 trustee should determine if an objection is proper.
    2. If using state exemptions, the creditor should determine if the respective state has an exemption for inherited IRAs. If the state does not, the creditor may be able to use Clark in support of an objection to the debtor's claimed exemptions.

The Court further determined that its analysis of "retirement funds" and the three unique characteristics of inherited IRAs were in line with the purpose of the Bankruptcy Code exemption provisions. Noting those provisions allow debtors to ensure they have adequate funds set aside to meet their retirement needs, the Court emphasized that allowing an exemption for inherited IRAs could encourage debtors to simply wait until after their bankruptcy is closed before they use all the funds for non-retirement purposes.

Thus, the Court found the ordinary meaning of "retirement funds," the legal characteristics of an inherited IRA, and the purpose the bankruptcy exemptions would mean that an inherited IRA is not exempt under 11 U.S.C. § 522(b)(3)(C).

A look at the future: bankruptcy, inherited IRAs, and estate planning in a post-*Clark* environment

How will *Clark* impact the bankruptcy process and estate planning moving forward? In the bankruptcy context, inherited IRAs are no longer exempt under the federal exemptions, and creditors and their counsel consequently need to examine a debtor's bankruptcy schedules to determine what exemptions the debtor is claiming and whether the claimed exemptions protect an inherited IRA.

For example, states also have specific exemptions, and while the Bankruptcy Code allows debtors to choose between state and federal exemptions, the Bankruptcy Code also allows states to opt out of the federal bankruptcy exemptions. Several of the states which have opted out have particular exemptions for inherited IRAs. Thus, creditors, trustees and debtors need to examine and discuss with their counsel whether (1) the applicable state has opted out of the federal exemptions; (2) the state has an exemption for inherited IRAs; and (3) the debtor is eligible to claim the state exemptions.

11 U.S.C. § 522(b)(2). States that have not opted out and allow debtors to choose between state and

federal exemptions are Arkansas, Connecticut, Hawaii, Massachusetts, Michigan, Minnesota, New Hampshire, New Jersey, New Mexico, Pennsylvania, Rhode Island, Texas, Vermont, Washington and Wisconsin, as well as the District of Columbia.

The following states appear to have exemptions, in one form or another, for inherited IRAs. You or your counsel should research to determine if, and to what extent, these are applicable: Alaska Stat. § 09.38.017; Ariz. Rev. Stat. § 33-1126(B); Fla. Stat. Ann. § 222.21; Idaho Code Ann. §§ 55- 1011 and 11-604A; Mo. Rev. Stat. § 513.430.1(10)(f); N.C. Stat. §1C- 1601; Ohio Rev. Code § 329.66(A) (10); and Tex. Prop. Code § 42.0021.

Creditors also need to review the debtor's bankruptcy petition to determine if an inherited IRA is an asset of the estate, and if so, whether the debtor is trying to exempt the inherited IRA. While a Chapter 7 trustee will generally handle objections to a debtor's proposed exemptions, it is good practice for creditors and their counsel to make sure they are analyzing the exemptions as well — given that an inherited IRA could provide a significant portion of any payout from a bankruptcy estate. Moreover, in states where federal exemptions are applicable, the costs of litigating this issue should decrease because of the Supreme Court's holding.

In the estate planning context, HR departments and retirement plan administrators should encourage employees to examine their beneficiary designations on retirement plans and 401(k) accounts on a regular basis. Employees now need to consider whether their likely beneficiary is currently in financial difficulties or may be at some point in the future.

As noted above, the state of residence of the beneficiary may also have an impact on whether or not an inherited IRA is exempt. Therefore, employers should, at the very least, check whether the states in which they have operations (and where a large number of their employees live) have state law protections for inherited IRAs. Employers and plan administrators also need to establish a protocol for dealing with the possibility that creditors of a deceased employee's beneficiary might attempt to seize retirement accounts and potentially dissipate the funds before the beneficiaries receive them.

Additional resources on estate planning and bankruptcy in Europe

EUROPEAN CROSS BORDER ESTATE PLANNING

This looseleaf includes information and advice on working in the EU and Europe, and the best options for US citizens resident in Europe. Each country is given a dedicated chapter, where the general law and the taxation laws are comprehensively covered. This gives you the background and estate planning tools you need to advise private clients on how to minimise their taxation, and best plan for the future of their estates.

European Cross Border Estate Planning discusses legal entities, the concepts of domicile and residence, considers reliefs and exemptions and explains the law relating to the estates of deceased individuals.

INSOLVENCY REFORMS EUROPE 2012

The global economic crisis and the increased number of debtor companies turning to the English courts in light of the UK's cram down and director-friendly procedures have exposed areas in need of improvement in many insolvency regimes across Europe. This has prompted a wave of new

European insolvency legislation.

Loan Market Association, LMA News, July 2012

Employers should also be aware that employees may choose to make an irrevocable trust the beneficiary of an employee's retirement account, rather than the intended beneficiary individually. Such a trust may be created under a will or a free standing living trust agreement of the employee. The rules are technical in this area, but lawyers well-versed in estate planning understand the ins and outs of drafting compliant trusts.

In the context of spousal beneficiaries, employers should consider that spouses of deceased employees may want to leave retirement plan balances within the deceased employee's company retirement account, if the employer allows it, rather than rolling the proceeds into an IRA in the surviving spouse's name. In light of this, employers should explore whether or not they want to implement a policy requiring spouses and other beneficiaries to remove inherited funds from the company's retirement plans within a certain amount of time. Employers should also be aware that some courts may attempt to extend the Clark precedent to IRAs containing the proceeds of retirement accounts rolled from a spouse. However, there is an important distinction that applies to a spousal rollover of inherited retirement funds: The funds will be subject to penalty if withdrawn prior to reaching the age of 59 ½ because the funds contain deferred earnings from the spouse, in addition to the inherited retirement funds. Thus, it could be argued that such contributions may remain in such an account without withdrawal until the spouse reaches the age of 70 ½.

Same-sex couples will also have special planning concerns. Unless they are married and their union fully recognized for retirement planning purposes, the only way to leave a retirement account to their partner and avoid immediate income taxation is through an inherited IRA.

Conclusion

In tracking the *Clark* ruling through the past, present and future, this decision will clearly impact future dealings of creditors, debtors and employees with retirement plans. By specifically defining a retirement fund as money set aside for retirement, the Supreme Court has effectively divided traditional and Roth IRAs and retirement plans from inherited IRAs. The selection of beneficiaries, the comprehension of state exemptions and the examination of debtor's bankruptcy schedules and petitions will all be important considerations in this arena for attorneys advising financial lenders, lenders seeking to collect troubled debt, companies administering retirement plans, and family-owned businesses whose attorneys manage estate planning. With *Clark*, the Supreme Court has permanently changed the landscape of the Bankruptcy Code, and also significantly altered the nature and characteristics of inherited IRAs.

Further Reading

Clark v. Rameker, 134 S.Ct. 2242, 2244 (2014).

In re Clark, 450 B.R. 858, 861- 62 (Bankr. W.D.Wis. 2011).

Brief of the Petitioners at 10, *Brandon C. Clark and Heidi K. Heffron-Clark v. William J. Rameker, Trustee, et al*, No. 13-299 (US Jan. 10, 2014).

Clark v. Rameker, 134 S.Ct. at 2246 (citing American Heritage Dictionary 712 (4th ed. 2000)).

Id. at 2247.

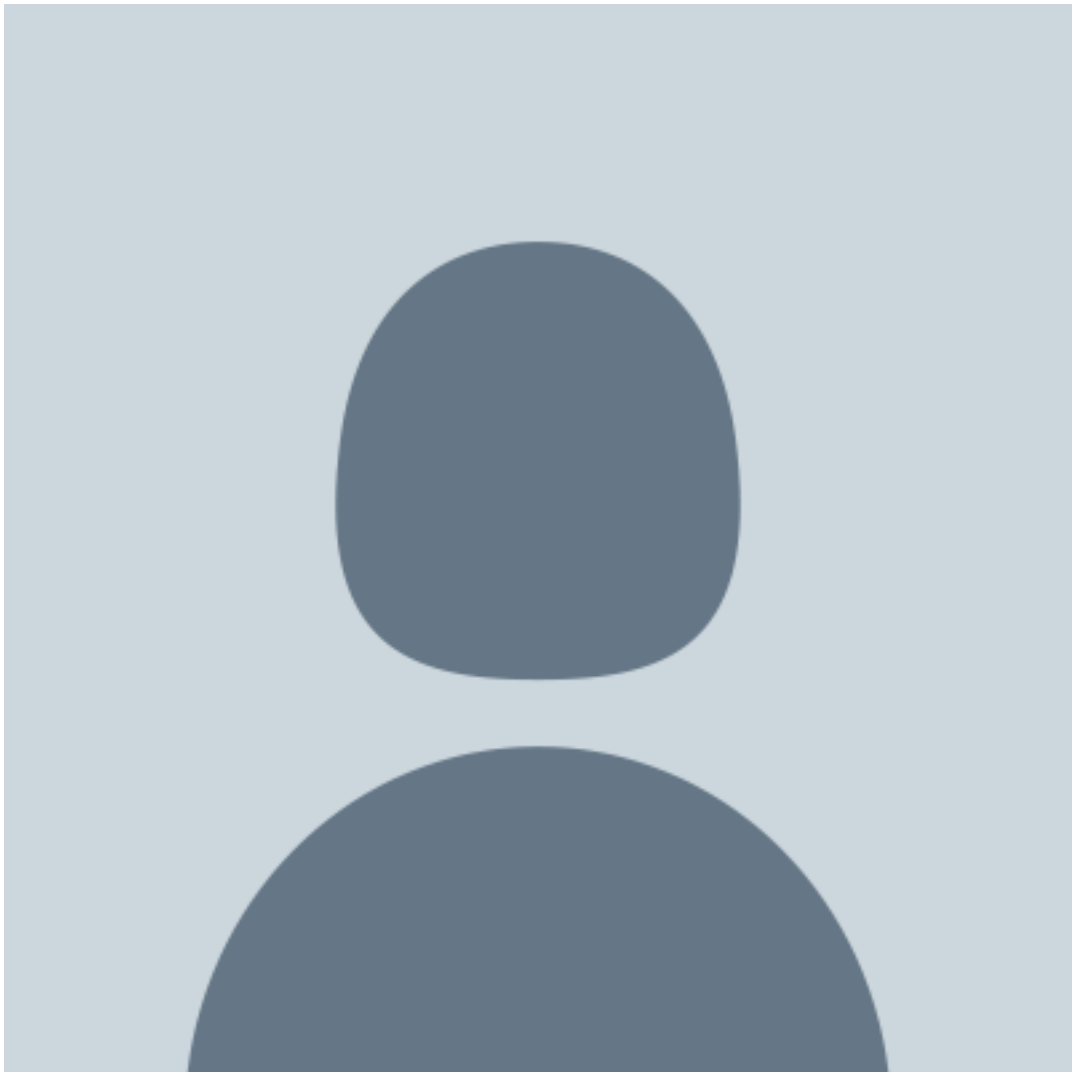
Kristen Chittenden

General Counsel and Corporate Secretary

Lykes Bros. Inc.

Kristen Chittenden is general counsel and corporate secretary at Lykes Bros. Inc. She is also chair of the ACC Small Law Department Network.

Dana B. Perry

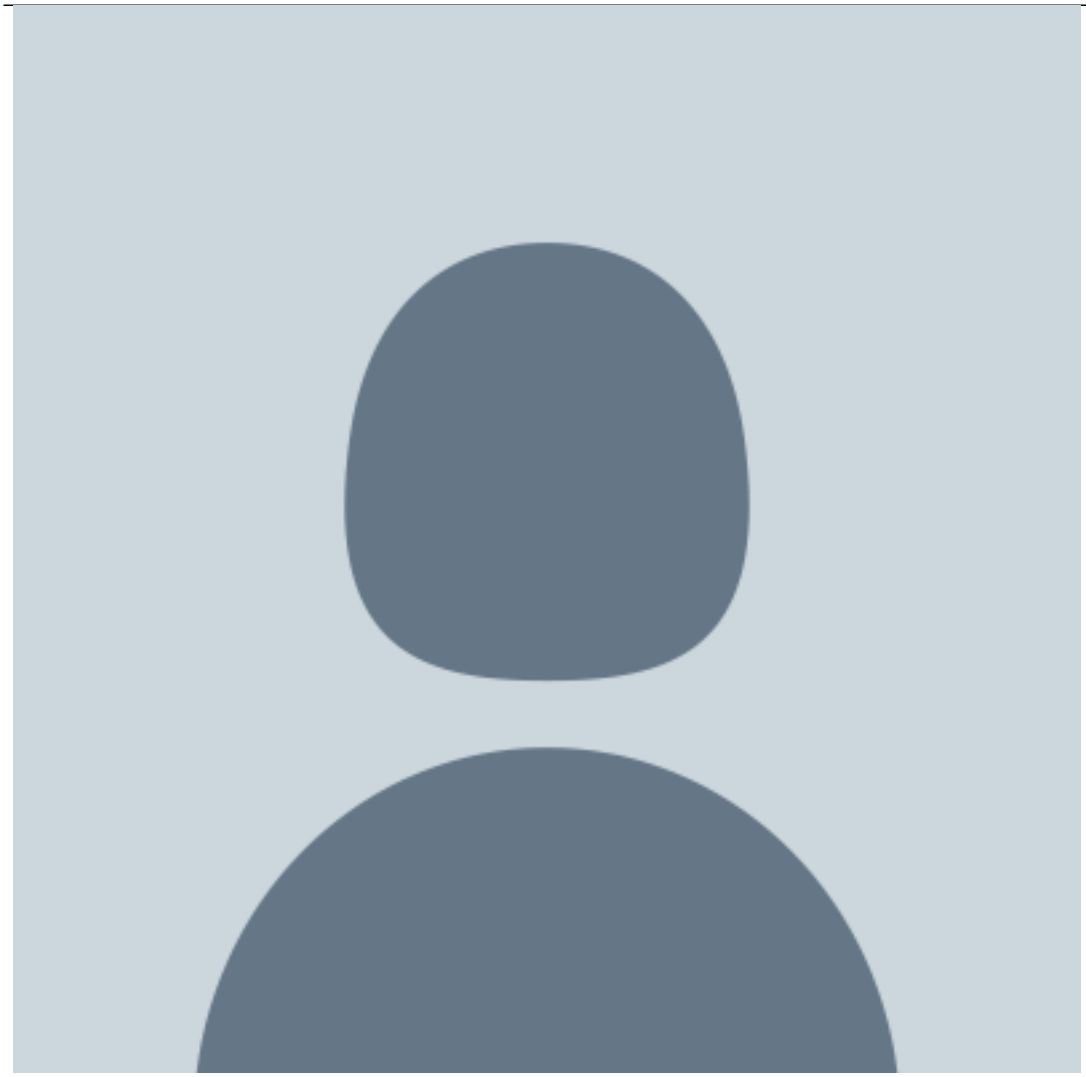


Shareholder in the Estate Planning Section

Chambliss, Bahner & Stophel P.C. in Chattanooga, Tennessee

She also serves on the board of directors for Meritas.

Jeffrey W. Maddux



Attorney in the Litigation Section

Chambliss, Bahner & Stophel P.C. in Chattanooga, Tennessee

Chambliss, Bahner & Stophel P.C. is a Meritas member firm.