No Bankruptcy Exemption For Funds
Within an Inherited Individual Retirement Account

Those who work in the legal profession like to think the law is primarily logical and efficient. fter all we are a nation of laws rather than individuals. We tend to forget that laws are enacted by politicians with input from their constituents. Many times there are self-serving motives. And sometimes judges do not like the laws which they must interpret and enforce or at least they see flaws needing to be corrected. Rather than have the legislature correct such flaws, sometimes courts choose to correct such flaws by a court ruling.

In 2005, the federal bankruptcy laws were changed. One major change dealt with credit card debt. It is now much harder to eliminate credit card debt by a bankruptcy filing. A second major change dealt with increasing the amount of funds in retirement plans and IRAs that a person could exempt from his or her bankruptcy estate. In general, the limit for IRAs is now $1,000,000 and the amount for funds in an employer sponsored pension plan is unlimited.

The public policy of the bankruptcy laws is that a person should be able to provide for himself or herself during their retirement years. However, the granting of such a large exemption for IRAs and pension plans means that many times creditors are left unpaid when an individual files for bankruptcy. Some people, including many judges, would consider such a large exemption amount to be contrary to the legal framework for bankruptcy. Yes, a person should be able to have a fresh start after incurring financial difficulties, but creditors are still entitled to be paid a reasonable and fair amount and that an individual should not have a "free pass" to an unfettered new and improved financial health.

The U.S. Supreme Court recently decided the case, Clark v. Rameker. Ms. Clark had inherited an IRA from her mother with an original balance of approximately $450,000 in 2001. The amount in her inherited IRA was approximately $300,000 when she filed for bankruptcy in October of 2010. Rameker is the bankruptcy trustee and has argued that Ms. Clark is not entitled to exempt the $300,000 from her bankruptcy estate. The bankruptcy court adopted the trustee's position that Ms. Clark was not entitled to the exemption. Ms. Clark then appealed to the District Court. The District Court reversed the decision by ruling that Ms. Clark was entitled to exempt the amount in her inherited IRA. The trustee then appealed to the 7th Circuit Court of Appeals that which reversed the District Court. Since there had been split decisions in the circuit courts, the Supreme Court agreed to rule on the case to settle the issue.

The U.S. Supreme Court affirms the 7th Circuit position of no exemption for inherited IRA funds.

The legal analysis and rationale. The U.S. Supreme Court ruled, by a unanimous vote, that "The text and purpose of the Bankruptcy Code makes clear that funds held in inherited IRAs are not retirement funds within the meaning of section 522(b)(3)(C) is bankruptcy exemption." Justice Sotomayer wrote the court's opinion.

As discussed below, the U.S. Supreme Court had to
strain the law to reach the result that allowed the bankruptcy trustee to win and Ms. Clark to lose.

How does Bankruptcy Code section 522(b)(3)(C) read?
Bankruptcy code section 522(b)(3)(C) provides an exemption for "(C) 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." Code section 401 defines the laws for a qualified plan. Code section 403 defines the laws for tax sheltered annuities. Code section 408 defines the laws for traditional IRA and IRA annuities. Code section 408A defines the laws for Roth IRAs and Roth IRA annuities.

Note that there is no special tax code section for inherited IRAs. An inherited IRA is not a special type of IRA as the court tries to define it. An inherited traditional IRA is simply one that comes into existence after the IRA accountholder dies.

Also note that there is no express indication that the retirement funds must be the retirement funds of the bankruptcy debtor. This is what one expects when one has funds in a 401(k) plan or an IRA. These funds are within a legal and tax entity independent of the individual's will or estate. There is a 401(k) plan agreement or an IRA plan agreement which requires the individual to designate one or more primary beneficiaries. Such plan indicates that the beneficiary acquires his or her share upon the death of the participant or IRA accountholder.

Notwithstanding that the account is called an inherited individual RETIREMENT account, the U.S. Supreme Court on June 2, 2014, ruled that funds within an inherited IRA are not retirement funds within the meaning of Bankruptcy Code section 522(b)(3)(C).

Federal bankruptcy laws allow an individual to exempt certain property from his or her bankruptcy estate. This is property he or she is allowed to keep after the bankruptcy and that cannot be claimed by the bankruptcy trustee. The approach of the bankruptcy laws is to give a person the ability to have a fresh start after incurring financial difficulties. Of course, there should be and there are limits as to the ability of a person not to pay his or her debts.

The attorney for the bankruptcy debtor argued that Bankruptcy code section 522(b)(3)(C) was clear – funds within any traditional IRA, including an inherited traditional IRA, as established under Code section 408 were entitled to the exemption. The District Court in this case, the Fifth Circuit in a different case and the Eighth Circuit in a different case had the same understanding. The rationale of the District Court was that the exemption covers any account containing funds originally accumulated for retirement purposes. This is consistent with the legal operation of a traditional IRA. It is a special tax-preferred revocable trust. It has two express purposes. Contributions and the investments will be used for the retirement of the IRA accountholder and then after his or her death will be used to benefit the designated beneficiary over a time period which may be as long as the life expectancy of the beneficiary.

The U.S. Supreme Court reached a different conclusion. In order to be entitled to claim the exemption of Bankruptcy Code section 522(b)(3)(C) , the court ruled that an individual has to meet two requirements, not just one requirement. First the funds must be retirement funds. Second, such funds must have been 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."

The U.S. Supreme Court wrote that the two words "retirement funds" as set forth in Bankruptcy Code section 522(b)(3)(C) mean more than just funds in the enumerated tax code sections. A cardinal rule of statutory construction is, "a statute should be construed so that effect is given to all its provisions, so that no part will be in operative or superfluous. The first six words, "retirement funds to the extent that" in order not to be superfluous must have a meaning or purpose independent of the enumerated sections.

The court then found that since there was no definition of "retirement funds" within the Bankruptcy Code that it must define the term and it did so. It defined retirement funds as sums of money set aside for the day an individual stops working.

The court then reasoned that there are three principal reasons why inherited IRA funds are not retirement funds. First, the beneficiary is unable to make any additional contributions. Second,

the required distribution rules apply to an inherited IRA and distributions must be taken long before retirement age. Third, the 10% penalty tax does not apply to a beneficiary and so the beneficiary is able to take a distribution at any time and use the funds for current consumption. It is this later reason which seems to have influenced the court's decision the most. The court stated its dislike for the possibility that a person who has an inherited IRA could file for bankruptcy, claim the exemption for retirement funds and then after the bankruptcy has been granted eliminating his or her debts immediately withdraw funds from the inherited IRA for personal consumption reasons. In essence the debtor would have a free pass which is not the intent of the Bankruptcy laws. The court was unwilling to give this free pass.

Additional Litigation

There will be additional litigation by bankruptcy trustees as a result of his case. The U.S. Supreme Court has made clear it is receptive to consider cases involving whether or not - the exemption of Code section 522(b)(3)(C) is available to a bankruptcy filing.

This case settles the issue with respect to an inherited traditional IRA.

The case of In Rousey v. Jacoway, settled that a traditional IRA was a retirement account within the meaning of Bankruptcy code section 522(b) (3) (C) and was entitled to be exempted from the individual's bankruptcy estate.

When one reads this case, one certainly has the idea that an inherited Roth IRA would also be found to not be retirement funds for bankruptcy Code section 522(b)(3)(C) purposes.

What about standard Roth IRA funds? Although we expect that the rules of Rousey would apply to a Roth IRA and the exemption would apply, this issue has not been firmly settled. One can expect that a bankruptcy trustee will make the argument that Roth IRA funds are not retirement funds since the Roth IRA accountholder never has to take a distribution while alive.

What about inherited 401(k) funds still within the 401(k) plan? One can expect a bankruptcy trustee to argue that inherited 401(k) funds also are not retirement funds within the meaning of Bankruptcy Code section 522(b)(3)(C). ERISA protects such funds from creditors, including a bankruptcy trustee, as long as such funds are within the 401(k) or other pension plan. Many 401(k) plans have been written to require an inheriting beneficiary to withdraw or direct rollover his or her inherited funds within a short time period.

This bankruptcy ruling is going to result in more IRA accountholders seeking legal and tax advice regarding whether a trust should be the IRA's designated beneficiary rather than directly naming family members and other individuals.

Additional Legislation.

This case is going to make people nervous. Congressional representatives will hear from their constituents that a person who has inherited an IRA should be able to exempt a reasonable amount from his or her bankruptcy estate. If the definition of retirement funds needs to be changed, then it should be changed. What amount is reasonable will need to be discussed and settled.

In summary, the unanimous decision by the U.S. Supreme Court in Clark v. Rameker was surprising. Although an inherited IRA is certainly a retirement account for tax purposes, it is not

retirement funds within the meaning of the Bankruptcy Code. Code section 522(b)(3)(C) did not seem so unclear that it needed to be rewritten by the Court, but that is what the Court did. The Court simply could not condone a bankruptcy debtor claiming an exemption for funds within an inherited IRA and then once the bankruptcy filing was finalized (*and debts extinguished*) to be able to take immediate distributions from the inherited IRA for any personal consumption purpose. Time will tell if Congress will choose to define more specially what funds qualify as retirement funds for purposes of the exemption. We expect there will be new legislation in 2014-2015.