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Supreme Court Rules that Inherited IRAs Are Not Exempt From Creditors Under the Bankruptcy Code: Clark v. Rameker

Legal Alert

June 17, 2014
Cherry Hill, NJ

In a landmark decision that has far reaching ramifications for bankruptcy, estate, and asset protection planners, on June 12, 2014, the Supreme Court unanimously ruled that inherited individual retirement accounts ("IRA") are not protected in bankruptcy under federal law.

By way of background, in 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") was signed into law and was generally designed to make filing for bankruptcy less appealing to debtors. BAPCPA created an exemption for "retirement funds" from a debtor's bankruptcy estate whereby IRAs, as retirement funds, were suddenly entitled to bankruptcy protection. As time passed, however, bankruptcy trustees began to challenge this exception by arguing that inherited IRAs (i.e., an IRA one inherits from someone else), as opposed to an individual's own IRA, are not "retirement funds" and should not be protected under the bankruptcy code, i.e., exempt from distribution by the bankruptcy trustee.

In *Clark v. Rameker*, the Supreme Court considered whether an inherited IRA is a "retirement fund" within the meaning of the bankruptcy code that may be afforded federal bankruptcy protection. Unlike an individual's own IRA, the Court pointed to three legal characteristics of inherited IRAs which it held demonstrate that inherited IRAs are not retirement funds:

1. The holder of an inherited IRA may not contribute additional funds to the account;
2. The holder of an inherited IRA must withdraw funds from the inherited IRA, regardless of how many years he or she may be from retirement; and
3. The holder of an inherited IRA may withdraw the entire balance of the account at anytime and for any purpose without penalty.

Relying on these three factors, the Court concluded that inherited IRA's are not "retirement funds" within the definition of the bankruptcy code and are therefore not entitled to bankruptcy protection.

While the Court did not explicitly address whether an IRA rolled over to a surviving spouse would continue to be entitled to bankruptcy protection, the Court's decision may have no adverse impact on the creditor protection currently afforded to spousal rollovers, although this is not yet known for certain. Unlike an inherited IRA, in a rolled over spousal IRA, a surviving spouse may (1) contribute additional funds to the surviving spouse's rolled over IRA; (2) defer withdrawal of funds from the rolled over IRA as if the spouse were the owner, and (3) withdraw principal from the rolled over IRA without penalty only after attaining the age of 59 ½ years. Thus, a spousal rolled over IRA appears to be consistent with the definition of a retirement fund in the bankruptcy code.

In addition, the decision seems to leave open the possibility that exemptions afforded under applicable state law could protect a debtor's interest in an inherited IRAs (although there can be some negative aspects of electing state-law exemptions over federal exemptions).

In light of the Court's decision, individuals should now consider the creditor protection implications for beneficiaries of their IRAs. Rather than making a non-spousal beneficiary the outright beneficiary of his or her IRA, the individual could instead designate a spendthrift trust (either an inter vivos trust or a testamentary trust) for the benefit of an individual beneficiary. Through proper drafting of such a trust, the principal of the trust could be exempt from the beneficiary's creditors, and the minimum required distributions from the IRA could still be paid to the individual beneficiary over the beneficiary's life expectancy. Alternatively, such a trust could accumulate all of the minimum required distributions in the trust (although this can result in an acceleration of the required taxable payments from the IRA to the trust) and provide further asset protection for the individual beneficiary. Ultimately, by designating a spendthrift trust as the beneficiary of an IRA, the IRA owner may be assured that the owner's retirement funds will pass to the beneficiary and be protected from the beneficiary's current and future creditors.

To learn more about protecting an IRA from a beneficiary's creditors, we invite you to contact any member of Flaster Greenberg's Bankruptcy or Trusts and Estates Practice Groups.