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Protecting Inherited IRAs from Bankruptcy Claims After Supreme Court Decision in *Clark v. Rameker*

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On June 12, 2014, the U.S. Supreme Court unanimously held in *Clark v. Rameker* (134 S. Ct. 2242) that inherited IRAs are not exempt from the claims of creditors of a beneficiary who has filed for bankruptcy. The Supreme Court held that they are not protected "retirement funds" under the Bankruptcy Code. An inherited IRA is a traditional or Roth IRA that is payable to a designated beneficiary after the owner's death.

The court reasoned that in the absence of a statutory definition, the ordinary meaning of "retirement funds" should be understood to mean sums of money set aside for the day an individual ceases to work. The court pointed out that an inherited IRA is distinguishable from retirement funds for three reasons. First, the holder of an inherited IRA can never make contributions to the account. Second, the holder of an inherited IRA is required to begin withdrawing funds from the account no later than the end of the year following the year of the death of the owner, no matter how many years the holder may be from retirement. Third, said the court, the holder of an inherited IRA may withdraw the entire balance in the account at any time without penalty, unlike a traditional or Roth IRA, where withdrawals prior to age 59½ are subject to a 10% penalty. Thus, if a person inherits an IRA from his or her grandfather in 2014 when that person is 23 years of age, that person must begin taking distributions from the account in 2016 when he or she is age 25.

Is the Outcome Different if the Surviving Spouse is the Beneficiary or if State Bankruptcy Law Protects Inherited IRAs?

Although the Supreme Court's reasoning in *Clark* is sound, there are some questions that are left unanswered. The court noted that where the surviving spouse is the beneficiary of an IRA, he or she has the option of either treating the IRA as that spouse's own IRA or as an inherited IRA. If the surviving spouse elects to treat the IRA as that spouse's own IRA, and if doing so is not considered a fraudulent transfer, then it would appear that the funds in that IRA would, under the court's reasoning, be treated as retirement funds that are exempt from a debtor's bankruptcy estate. The beneficiary in *Clark* was the owner's daughter, not her spouse, and so we do not know if the result would have been different if the spouse had inherited the IRA. Even if the surviving spouse elects to treat the IRA as that spouse's own IRA and obtains bankruptcy protection, it may come at a cost. For example, if the surviving spouse is age 45 he or she could not withdraw funds from a spousal IRA until age 59½ without penalty. If that spouse needed funds immediately, then he or she would have the choice of 1) taking funds out of the IRA and paying a 10% penalty or 2) electing to treat the IRA as an inherited IRA and losing the bankruptcy exemption for the funds.

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Debtors may elect to claim bankruptcy exemptions either under federal law or state law. Seven states have specifically exempted inherited IRAs from the debtor's bankruptcy

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estate: Alaska, Arizona, Florida, Missouri, North Carolina, Ohio and Texas. The court noted that the debtors in *Clark* had elected state law exemptions. The debtors in *Clark* filed for bankruptcy in Wisconsin, and so the issue of state law exemption for inherited IRAs did not arise. However, it would appear that if the debtors had resided in one of the foregoing seven states and satisfied the 2-year residency requirement of the Bankruptcy Code, the Supreme Court would have reached a different holding.

Nonetheless, there are actions that an IRA owner can take to protect the funds in his or her IRA in the event a designated beneficiary inherits such funds and subsequently files for bankruptcy.

Consider Naming a Trust as the Designated Beneficiary

If a trust is the designated beneficiary of an IRA, there would still be required minimum distributions that would have to be withdrawn from the IRA by the trust, but the trust could be drafted so that it could accumulate those distributions, rather than pay them out to the beneficiary, where they would be subject to claims of the beneficiary's creditors. Trusts have many other uses besides creditor protection, such as exclusion from the marital assets of the beneficiary in the event of his or her divorce, or as a special needs trust if the beneficiary receives public medical assistance such as Medicaid.

Just as there are drawbacks if a spouse-beneficiary treats an IRA as his or her own IRA instead of as an inherited IRA, the use of a trust that can accumulate has its negative aspects, too, such as the higher federal income tax rates to which trusts are subject. A complete discussion is beyond the scope of this article, but the use of a trust as the designated beneficiary of an IRA should be considered in appropriate situations.

Helpful Tip: *In designing beneficiary designations, it is important to consider the financial health of the intended beneficiary and the likelihood of future claims against him or her. More care may be needed if the beneficiary is in a high-risk occupation, such as a neurosurgeon, than if he or she is a college professor.*

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