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Did I leave my estate to my child's creditors?

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People often save with the goals of providing for their retirement, their medical needs, and then for leaving an inheritance to their family and friends. On June 12, in *Clark v. Rameker*, 2014 DJDAR 7431, the U.S. Supreme Court added to this complexity by finding that certain inherited Individual Retirement Accounts (IRAs) are not exempt in bankruptcy. The ruling will force many people to evaluate their estate plans. Otherwise, the proceeds from years of hard work may be used to satisfy their beneficiaries' creditors.

When an individual files for bankruptcy, a bankruptcy estate is created consisting of substantially all of the property and property rights of the debtor at the time the case is commenced. 11 U.S.C. Section 541(a). Additionally, the bankruptcy estate also includes any interest in eligible property that the debtor acquires or becomes entitled to acquire within 180 days of the petition date by bequest, devise or inheritance, or as the beneficiary of a life insurance policy or of a death benefit plan. 11 U.S.C. Section 541(a)(5).

While there are certain narrow exceptions, it is common that the vast majority of the assets of an individual debtor will be administered in their bankruptcy case. However, to facilitate the individual debtor's "fresh start," Section 522 of the Bankruptcy Code allows the debtor to exempt certain property.

Section 522 provides a set of exemptions commonly known as the "federal exemptions." It also permits debtors to use a different set of exemptions under the applicable laws of their state of domicile, which are often more generous. Some states have completely opted out of the federal exemption scheme requiring debtors domiciled in that state to use only the exemptions of that particular state.

In any event, a debtor is entitled to exempt retirement funds subject to certain limitations. To encourage individuals to save for retirement, Congress added certain provisions to the Bankruptcy Code with the adoption of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Specifically, an individual debtor is permitted to exempt "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." See 11 U.S.C. Section 522(b)(3)(C) and (d)(12). These sections of the Internal Revenue Code primarily deal with "pension, profit-sharing and stock bonus plans; employee annuities; individual retirement accounts; deferred compensation plans of state, local government and tax-exempt organizations; and certain trusts." 4 Collier on Bankruptcy ¶ 522.09[12] (16th ed. rev. 2013).

A plain reading of the statute suggests IRAs would be exempt. The 5th U.S. Circuit Court of Appeals so held in *In re Chilton*, 674 F. 3d 486 (2012). The 7th Circuit held to the contrary in *In re Heffron-Clark*, 714 F.3d 559 (2013). The Supreme Court granted certiorari to resolve the conflict.

In *Clark*, Ruth Heffron established a traditional IRA in 2000 and named her daughter, Heidi Heffron-Clark, as the sole beneficiary of the account. Following Heffron's death in 2001, her IRA then worth approximately $450,000 passed to her daughter and became an inherited IRA. In 2010, Heffron-Clark and her husband filed a joint chapter 7 bankruptcy petition and sought to exclude the $300,000 in funds remaining in the IRA that she inherited from her mother.

Respondents, the chapter 7 trustee and the unsecured creditors, objected claiming that the funds in the inherited IRA were not "retirement funds" within the meaning of the statute. The bankruptcy court agreed and disallowed the exemption, but the district court reversed that decision on appeal. The 7th Circuit then reversed, finding that different rules govern inherited and non-inherited IRAs.

In a unanimous opinion written by Justice Sonia Sotomayor, the Supreme Court found that the ordinary meaning of "retirement funds" is "properly understood to mean sums of money set aside for the day an individual stops working." The court then turned to the legal characteristics of the IRA to objectively determine whether it was held for the day that an individual stops working, concluding that funds held in such accounts are not objectively set aside for retirement.

First, the holder of an inherited IRA is prohibited from investing additional money in the account. The court compared this to the characteristics of traditional and Roth IRAs where the entire purpose "is to provide tax incentives for accountholders to contribute regularly and over time to their retirement savings." Second, the court found that holders of inherited IRAs are required to take minimum annual distributions every year without regard for their retirement age, or in the alternative, withdraw all of the funds in the inherited account within five years after the year of the owner's death. Third, the holder of an inherited IRA can withdraw the entire balance of the account at any time and for any purpose without penalty.

The court then reasoned that if an individual were to be "allowed to exempt an inherited IRA from her bankruptcy estate, nothing about the inherited IRA's legal characteristics would prevent (or even discourage) the individual from using the entire balance of the account on a vacation home or sports car immediately after her bankruptcy proceedings are complete." This would frustrate the balance between ensuring that assets are available to satisfy creditor claims and the policy goal of providing the debtor with a "fresh start." As a result, the court held that inherited IRAs cannot be treated as an exempt "retirement fund."

While the opinion dealt with an IRA inherited by a child from their parent, the court did state in dicta that IRAs inherited by spouses may be treated differently. In particular, the court stated that where "the heir is the owner's spouse, as is often the case, the spouse [may choose to] 'roll over' the IRA funds into his or her own IRA, or he or she may keep the IRA as an inherited IRA" subject to the applicable rules. A compelling argument can be made that where a spouse inherits an IRA from the decedent spouse and does not roll the funds into that surviving spouse's IRA or designate themselves as the account owner, the inherited IRA should not be eligible for the "retirement funds" exemption from the bankruptcy estate.

Following the court's ruling in *Clark*, an individual must carefully select a beneficiary with respect to their IRA. Any hope that such retirement funds would be out of the reach of the creditors of a spendthrift child has been rejected by *Clark*. Further, while the court's ruling is limited to inherited traditional and Roth IRAs, individuals should analyze whether any of the retirement plans enumerated in Section 522 may suffer the same fate in the hands of the beneficiary.

Special care should be taken in naming the beneficiaries of an IRA and other retirement accounts, particularly because such retirement accounts are often used in blended families to deal with difficulties in asset distribution among the spouse and biological children. Until we have a clear ruling from the court, we cannot be entirely certain whether even a spouse's interest in an inherited IRA will be exempt in a bankruptcy proceeding. Whether the intended beneficiary is a spouse, child or otherwise, after the court's ruling in *Clark*, the owner of an IRA should take care to make sure that the beneficiary of the IRA is not susceptible to claims by creditors in bankruptcy. If this is not the case, perhaps the IRA owner should consider making a distribution from a trust with spendthrift provisions to a susceptible beneficiary and leave the IRA to those beneficiaries who are not in jeopardy of a future bankruptcy. This may require amending the individual's estate planning documents, as well as the beneficiary designation on the IRA.

Another possible option to protect an estate from the beneficiaries' creditors would be to name a trust as the beneficiary of such retirement accounts. By including certain provisions within the trust, an individual can try to restrict distributions to beneficiaries with potential credit problems. However, by naming a trust as a beneficiary, the beneficiaries of the retirement account may lose certain tax advantages that would be available had they been named the direct beneficiary of the retirement account.

While there may not be a simple answer to addressing all potential bankruptcy implications when it comes to estate planning, the Supreme Court in *Clark v. Rameker* highlights the importance of giving some consideration to bankruptcy issues when planning for the distribution of an estate.


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