RESOURCES

U.S. Supreme Court Decides Important Case regarding Creditor Rights to IRAs

If your friend inherits an individual retirement account from her mother and later files for bankruptcy protection, is the IRA exempt from payment of creditor claims in her bankruptcy proceeding? As is often the case, the answer is "it depends."

In the case of Clark v. Rameker (decided on June 12, 2014), the U.S. Supreme Court settled an issue that had been debated for a long time. Heidi Heffron-Clark was named as the sole beneficiary of her deceased mother's IRA having a date of death balance of $450,000. Over the next nine years, Heidi drew down annual distributions from the IRA, but it still contained $300,000 when Heidi and her husband filed for Chapter 7 bankruptcy in 2010. Heidi claimed that the IRA was an exempt asset in her bankruptcy proceeding and therefore was not available to satisfy the claims of her creditors.

At issue was the federal bankruptcy exemption allowing debtors to protect "retirement funds" held in an IRA. It is clear that, under this exemption, an IRA originally established and funded by a debtor qualifies as "retirement funds" and is exempt in the debtor's own bankruptcy proceeding. What was unclear was whether this exemption extends to the designated beneficiary of the person who establishes the IRA.

The Supreme Court held that it does not, and that the IRA established by Heidi's deceased mother was available to pay creditors in Heidi's bankruptcy. The Court reasoned that an IRA inherited by a designated beneficiary does not qualify as a "retirement" asset since (a) annual distributions to the beneficiary are required by law well before the beneficiary's retirement, (b) the beneficiary cannot make contributions to the inherited IRA in order to save for retirement, and (c) there is no tax penalty to the beneficiary for drawing down distributions before retirement and no limits on what those distributions can be spent on (the Court used sports cars and vacation homes as examples).

However, what was implied but not stated in the Supreme Court's decision was that Heidi apparently resided in a state that applied the federal bankruptcy exemptions. Under the bankruptcy code, a state either can apply the federal exemptions or "opt out" of the federal exemptions and apply the state's own exemptions to its residents.

For example, North Carolina has opted out of the federal exemptions and applied the N.C. exemptions to its residents, including one exempting IRAs from creditor claims. Section 1C-1601(a)(9) of the N.C. statutes exempts IRAs from such claims and goes on to provide that "[a]ny money …. in any such plan remains exempt after an individual's death if held by one or more subsequent beneficiaries by reason of a direct transfer or eligible rollover that is excluded from gross income under the Internal Revenue Code, including, but not limited to, a direct transfer or eligible rollover to an inherited individual retirement account as defined in section 408(d)(3) of the Internal Revenue Code."

This protection should apply not only to the original designated beneficiary but also to any subsequent beneficiary who resides in N.C. for bankruptcy purposes and succeeds to ownership of the IRA by direct transfer. For example, if a trust for a child is the original designated beneficiary and the trust remains in existence until the child is age 21, and if the IRA is transferred into the child's name by direct transfer upon termination of the trust, the IRA should be exempt if the child later files bankruptcy.

In states that apply the federal bankruptcy exemptions, an IRA owner who wants to name his or her child as beneficiary but desires to protect the IRA from the child's potential creditors instead may want to name a so-

called “spendthrift trust” as beneficiary of the IRA for the child’s benefit. Such a trust should continue to be protected from the child’s creditors in most states and avoid the result mandated by the Supreme Court’s decision in Clark.

It is important to note one other distinction. If an IRA owner designates a surviving spouse as beneficiary of his or her IRA rather than a child, a trust, or some other beneficiary, the spouse can roll over the IRA into the spouse’s own IRA and it becomes the spouse’s IRA (rather than an inherited IRA) for all purposes. In such a case the spouse’s rollover IRA should be eligible for the federal exemption (if applicable) in the event the spouse files bankruptcy, since none of the Supreme Court’s rationales for disallowing the exemption would apply. Namely, the surviving spouse could contribute to the IRA, would pay penalties on withdrawals before retirement age, and would not be subject to required distributions until the spouse reaches age 70-1/2.

The Supreme Court’s decision in Clark v. Rameker provides much need guidance in the area of creditor access to IRAs but is not necessarily the end of the analysis.

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