July 15, 2014

INHERITED IRAS ARE NOT EXCLUDED FROM BANKRUPTCY

Dear Clients and Friends:

Beneficiaries of retirement plans commonly believe that their IRA accounts will be protected from their creditors. The United States Supreme Court has ruled otherwise: an "inherited IRA" will be subject to the claims of creditors in bankruptcy proceedings. By extension, therefore, ordinary creditors should be able to reach the assets of an inherited IRA to satisfy the plan owner's debt.

In the June 12, 2014 decision in *Clark v. Rameker*, a unanimous Supreme Court held that inherited IRAs are not "retirement funds" that are excluded from a bankruptcy estate. A debtor would be required to liquidate such accounts and apply the balance to the claims of creditors.

Facts. Ruth was the owner participant in a traditional IRA, and she named her daughter Heidi as beneficiary. After Ruth's death Heidi rolled over that IRA account into an inherited account. Nine years later, Heidi and her husband filed for bankruptcy. They identified the inherited IRA as an asset, but claimed that it was excluded from claims under the retirement funds exemption.

Any beneficiary, whether a surviving spouse or other beneficiary, can defer the income tax on an IRA after the death of the owner participant. This deferral is accomplished by rolling over the IRA balance into an inherited IRA, and by electing to receive payments over a period of years. Under federal tax law minimum distributions are required annually, based upon the beneficiary's life expectancy.

The federal Bankruptcy Code exempts "retirement funds" from the claims of creditors. The Supreme Court opinion suggests that a *participant's* IRA **would be** exempt from his or her creditors under the exemptions provided in the Bankruptcy Code.

The court rationalized its decision by relying on several factors:

- No contributions are permitted to inherited IRA accounts. Such accounts are subject to minimum required distributions even before retirement.
- The owner of an inherited IRA may withdraw any or all of the account without the penalty that applies to traditional IRAs or to Roth IRAs for withdrawals prior

> to age 59½. The court was particularly concerned that the owner of an inherited IRA could withdraw funds at any time and for any purpose, and no statutory restrictions prevented or discouraged withdrawals before retirement age.

The court distinguished spousal rollover IRAs from the inherited IRAs. A surviving spouse may elect to roll over the IRA balance into his or her own account, or keep it as an inherited IRA. Even though the decision does not rule on the bankruptcy exemption for spousal rollover IRAs, the court's analysis suggests that such rollovers would be exempt. A spousal rollover is the spouse's own account. The surviving spouse may contribute additional funds to a spousal rollover account, and may defer minimum required distributions until after reaching age 70½. If a surviving spouse rolls over an IRA to his or own account, withdrawals by the spouse prior to age 59½ would be subject to the penalty for early withdrawal. A spousal rollover IRA appears to meet the purpose and intent of the federal bankruptcy exemption to preserve funds for retirement.

The court included Roth IRAs with other inherited IRAs that do not qualify for the bankruptcy exemption. Roth IRAs are subject to the minimum required distribution rules after the death of the original owner participant and there is no penalty if the inheriting beneficiary is under age 59½ at the date of distribution.

California law has a more limited exemption for a debtor's personal IRA. IRAs are exempt only to the extent necessary to support the debtor and the debtor's dependents. The Supreme Court decision means that none of an inherited IRA is exempt. Whether California courts will reach a similar result for inherited IRAs or provide broader protections remains to be determined.

The holding in *Clark v. Rameker* does not prevent an individual from structuring a gift of an IRA to protect against claims by an intended beneficiary's creditor. It only prevents an outright gift from remaining exempt from creditors. We would be pleased to discuss planning options for asset protection with you or your clients.

Very truly yours,

HARTOG & BAER
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