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Do inherited IRAs protect assets well?

Whether a client has a complex or simple estate plan, failure to properly address a retirement plan (IRA) beneficiary designation may cause havoc. Regardless of what a client's estate plan may say, the beneficiary designation under the client's IRA governs. This is also true for clients who have survived divorces. Although a divorce destroys an ex-spouse's interest under a will, in 2009 the Supreme Court held that although dissolution of a marriage agreement explicitly revoked a spouse's interest in planned benefits, the beneficiary designation which left the pension to a former spouse still governed.

For many clients, their largest asset is their retirement plan. IRAs, in particular, require special attention because they are subject to both estate taxes and income taxes. IRAs are often touted as wonderful asset-protection tools due to the protection afforded at the federal level and through the laws of most states. In 2005, the Supreme Court ruled that IRAs enjoy the same protection as Employee Retirement Income Security Act (ERISA) plans. However, Congress made subsequent revisions to the federal bankruptcy laws which limited that protection to the first $1 million, adjusted for inflation (the value for 2013 is $1,245,475).

While IRAs do provide a tremendous amount of asset protection for the plan participant, recent court decisions call into question whether the same is true for inherited IRAs. If the designated beneficiary of an IRA is the participant's spouse, the surviving spouse may roll over the IRA into her own IRA.

In those circumstances, the IRA would still be asset-protected because it would be treated as the surviving spouse's own IRA. However, with respect to individual beneficiaries other than a spouse, on April 23, in *In re Clark,* the 7th U.S. Circuit Court of Appeals created a split among the circuits as to whether or not an inherited individual retirement account may be shielded from creditors in a bankruptcy proceeding.

An inherited IRA cannot be treated as a retirement account of the beneficiary in the same way it is treated by the original owner. The beneficiary may not make contributions to the account or roll it over into their own account. In rejecting the reasoning underlying *In re Nessa* from the 8th Circuit, and *In re Chilton* from the 5th Circuit, the 7th Circuit in *Clark* held that inherited, nonspousal IRAs were not "retirement funds" within the meaning of the Bankruptcy Code and thus were not shielded from creditors in bankruptcy proceedings.

Clark, Chilton and *Nessa* each confronted the issue of whether money in an inherited IRA that was yet to be distributed to the beneficiary can be shielded from creditors in a bankruptcy proceeding. The debtors in those three cases were children of a decedent whose IRA passed to them, individually. These individuals then attempted to claim an exemption for the inherited IRA when they entered bankruptcy proceedings.

All three courts agreed that exemption from bankruptcy depends on both tax deferral status, which both inherited IRAs and IRAs held by the owner have (until funds are withdrawn) and their status as "retirement funds" under the Internal Revenue Code. These courts disagree as to the second point — whether or not an inherited IRA maintains its status as "retirement funds" under Section 408 of the Internal Revenue Code once it has passed to a beneficiary.

In *Nessa* and *Chilton*, the courts held that Section 522(d)(12) of the Bankruptcy Code, which exempts "retirement funds" from bankruptcy proceedings, does not draw a distinction between an IRA in the hands of the retirement account holder and an IRA in the hands of one who inherited it.

THE BUZZ

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As such, the debtors were allowed to retain the money yet to be withdrawn from their IRA. As the court stated in *Nessa*, " … even though the contents of the debtor's inherited account were the debtor's father's retirement funds, not the debtor's own retirement funds, they remain in form and substance, 'retirement funds.'" The courts in *Nessa* and *Chilton* seemed wary of reading their own conceptions about "retirement funds" into the vaguely written Bankruptcy Code, which does not even define the term.

This sharply contrasts the 7th Circuit's reasoning in *Clark* that "an inherited IRA does not have the economic attributes of a retirement vehicle, because the money cannot be held in the account until the current owner's retirement."

The 7th Circuit in *Clark* went on to state that the term "['retirement funds'] designates the fund's source, not the assets' current status." The court in *Clark* illustrates that point in several ways. For example, the court was doubtful that the funds would still be shielded from bankruptcy in *Chilton* or *Nessa* if the funds had been withdrawn by the debtor prior to the proceedings or withdrawn already by either the original owner before their death and then transferred to the beneficiary.

The 7th Circuit used several other illustrations to make the point that exemptions for beneficiaries in other areas of the Bankruptcy Code (joint tenancy, domicile) depend on how the exempted property was used by the beneficiary, not how it was used by the original owner. Ultimately, the court seemed primarily motivated to not permit the exemption because to do so "would be to shelter from creditors a pot of money that can freely be used for current consumption."

Mitchell D. Weinstein, a shareholder with Chuhak & Tecson P.C., notes, "The *Clark* decision is a significant blow to the asset protection afforded by IRAs and living trusts must now be used to keep an IRA protected after the owner's death." For this reason, clients are encouraged to consider passing retirement assets to non-spouse beneficiaries through a revocable living trust but are cautioned to examine the exact language of the trust.

A trust can qualify as a "designated beneficiary" of an IRA. When a trust is the beneficiary, typically the oldest trust beneficiary is used for purposes of determining the distribution period in calculating the required minimum distributions. However, if the trust includes specific "Stretch IRA Trust" or "Conduit Trust" language, the administrator looks through the trust to the life expectancy of each beneficiary.

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