

Whether Non-Spousal Inherited Retirement Accounts Are Exempt Under the Bankruptcy Code

Kimberly Tracey, J.D. Candidate 2015

Cite as: *Whether Non-Spousal Inherited Retirement Accounts Are Exempt Under the Bankruptcy Code*, 6 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 29 (2014).

Introduction

Recently, the Court of Appeals for the Seventh Circuit, in *In re Clark*, adopted a new approach to the treatment of non-spousal inherited individual retirement accounts (hereinafter referred to as IRAs) in bankruptcy cases.¹ This case exemplified a typical situation in which a debtor inherits a non-spousal IRA, and then files for bankruptcy.² Often times this debtor will claim that the non-spousal, inherited IRA is a “retirement account” that is exempt from the bankruptcy estate under sections 522(b)(3)(C) and (d)(12) of the Bankruptcy Code.³ However, frequently the trustee managing the bankruptcy estate will object to the debtor’s proposed exemption, claiming that the non-spousal inherited IRA is not a “retirement account” under the the Bankruptcy Code.⁴ Currently, the circuits have split as to whether non-spousal inherited IRAs are exempt “retirement funds.”⁵

¹ *In re Clark*, 714 F.3d 562 (7th Cir. 2013).

² See e.g. *id.*; see also *In re Chilton*, 674 F.3d 486, 489 (5th Cir. 2012); see also *In re Nessa*, 426 B.R. 312, 314 (B.A.P. 8th Cir. 2010); *In re Hamlin*, 465 B.R. 863, 872 (B.A.P. 9th Cir. 2012).

³ *Id.*

⁴ *Id.*

⁵ Nick Brown, *U.S. high court to chart fate of inherited IRAs in bankruptcy*, THOMPSON REUTERS (NOV. 26, 2013), <http://www.reuters.com/article/2013/11/26/ira-bankruptcy-idUSL2N0JB1SZ20131126>.

The majority of circuits have held that non-spousal inherited IRAs are “retirement funds” and are therefore exempt from the bankruptcy estate under sections 522(b)(3)(C) and (d)(12).⁶ Recently, however, in *In re Clark*, the Seventh Circuit disagreed with the majority approach and held that a non-spousal inherited IRA was not exempt because it was not considered a “retirement fund” under the Internal Revenue Code.

In November 2013, the Supreme Court decided to hear the case of *Clark v. Rameker* in order to resolve the circuit split. If the Court sides with the Seventh Circuit, it will prevent debtors from exempting non-spousal inherited IRAs. Such a holding would significantly affect debtors who own non-spousal inherited IRAs and would need to be taken into consideration when such debtors decide whether or not to file for bankruptcy.

I. TREATMENT OF RETIREMENT FUNDS IN BANKRUPTCY

A. EXEMPTIONS IN BANKRUPTCY GENERALLY

Property of the estate is made up of “all legal or equitable interests of the debtor in property as of the commencement of the case.”⁷ In a bankruptcy case, property of the estate is used to satisfy creditors’ claims in accordance with the priority scheme under the Bankruptcy Code.⁸ The concept of an exemption under the Bankruptcy Code allows individual debtors to keep some property post-bankruptcy.⁹ Essentially, all of the debtor’s assets go into the bankruptcy estate, and then certain property is given back to the debtor. This allows the debtor to survive post-bankruptcy and prevents him from depending on the state for assistance.

⁶ See e.g., *In re Chilton*, 674 F.3d at 489; see also *In re Nessa*, 426 B.R. at 314; *In re Hamlin*, 465 B.R. at 872.

⁷ BARRY E. ADLER, DOUGLAS G. BAIRD, THOMAS H. JACKSON, BANKRUPTCY CASES, PROBLEMS, AND MATERIALS 191 (Robert C. Clark et al. eds., 4th ed. 2007).

⁸ See *id.*

⁹ See *id.* at 583.

Section 522(d) of the Bankruptcy Code provides a federal list of exempt property that individual debtors can retain after coming out of bankruptcy.¹⁰ If the State does not pass an exemption law then the federal exemptions will apply.¹¹ States can also choose to opt out of the federal exemptions, in which case the state’s exemptions will apply instead of the federal exemptions.¹² States can also pass their own exemption laws but not opt out of the federal exemptions, in which case the debtor can choose between the state and federal exemptions.¹³

Most state and federal exemptions have caps on the amount of property that can be claimed as exempt.¹⁴ For example, under section 522(d) of the Bankruptcy Code, the debtor’s aggregate interest in real property or personal property used as a residence¹⁵ is exempt up to \$22,975.

Moreover, section 522(d) of the Bankruptcy Code exempts the debtor’s right to receive social security benefits, veteran’s benefits, disability benefits, alimony, and payments under a stock bonus.¹⁶ Section 522(d)(12) of the Bankruptcy Code also exempts “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.”¹⁷ This exemption for retirement funds was at issue in *In re Clark*.¹⁸

B. EXEMPTION OF RETIREMENT FUNDS UNDER SECTIONS §522 (b)(3)(C) AND 522(d)(12) OF THE BANKRUPTCY CODE

¹⁰ See 11 U.S.C § 522(d) (2012) (listing property exempt from the bankruptcy estate).

¹¹ See *id* at § 522(b)(2) (providing that property listed under section 522(d) is exempt unless applicable state law specifically does not authorize it).

¹² *Id.*

¹³ *Id.*

¹⁴ See *e.g.*, *id* at § 522(d) (listing cap amounts on exemptions for real property, personal property, motor vehicles, household furnishings, jewelry, tools of the trade, life insurance contracts, etc.).

¹⁵ See *id* at § 522(d)(1).

¹⁶ See *id* at § 522(d)(11).

¹⁷ See *id* at § 522(d)(12).

¹⁸ See *Clark*, 714 F.3d at 562.

Section 522(b)(3)(c) of the Bankruptcy Code provides that a debtor must satisfy two requirements in order to claim an IRA account as exempt: (1) the funds that the debtor is attempting to exempt must be “retirement funds,” and (2) those funds must be in an account that “is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.”¹⁹ Section 522(d)(12) of the Bankruptcy Code similarly provides that “retirement funds” are exempt if they are held in an account that is free from taxation under the sections of the Internal Revenue Code listed in section 522 (b)(3)(c).²⁰

However, the Bankruptcy code does not define the term “retirement funds.” Section 408 of the Internal Revenue Code defines a retirement account exempt from taxation as “a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries.”²¹ Therefore, it is well settled that debtors can exempt their own IRAs under sections 522(b)(3)(C) and (d)(12) of the Bankruptcy Code.²²

Occasionally, individuals will inherit an IRA from their spouse, parent, grandparent, or other decedents with whom they had a relationship. It is undisputed that spousal inherited IRAs are exempt from the bankruptcy estate because they are essentially identical to the original IRA in the hands of the debtor. However, there is a conflict between the circuits regarding the treatment of non-spousal inherited IRAs in bankruptcy.

If the decedent leaves the IRA to his or her spouse, the account can either be kept separate or the spouse can roll it over into his or her own IRA.²³ No matter which option the spouse chooses, the inherited IRA will remain as “retirement funds.”²⁴ As such, the inherited IRA

¹⁹ See 11 U.S.C. § 522(b)(3)(C) (2012) (section 522(d)(12) sets out the same two requirements).

²⁰ *Id.*

²¹ 26 U.S.C. § 408(a) (2012).

²² See 11 U.S.C. § 522(b)(3)(C), (d)(12) (stating that retirement funds exempt from taxation under section 408 are also exempt from the bankruptcy estate).

²³ See *Clark*, 714 F.3d at 560.

²⁴ *Id.*

is in the same form in the spouse's possession as it was in the decedent's possession. Those funds can grow tax free while in the IRA and will be taxed at an ordinary rate when withdrawals begin.²⁵ Furthermore, the living spouse is subject to the same restraints on the way that they can use the funds as the original owner.²⁶ The spouse cannot withdraw the money until he or she is 59 ½ years old, unless he or she pays a penalty tax, and the spouse is required to start making withdrawals before they are 70 ½ years old.²⁷ Essentially, the IRA is treated the same in the hands of the living spouse as it was in the hands of the decedent.

In contrast, non-spousal beneficiaries may not treat inherited IRAs as their own or roll the funds over into their own IRAs.²⁸ Instead, the funds must be set up in the original owner's name for the benefit of the beneficiary.²⁹ Furthermore, the new owner may not contribute his or her own funds to the non-spousal inherited IRA.³⁰ Finally, as the Seventh Circuit pointed out in *In re Clark*, non-spousal inherited IRAs are subject to mandatory distributions that must begin within a year of the original owner's death and be completed in no less than five years.³¹

II. CONFLICT BETWEEN THE CIRCUITS REGARDING THE TREATMENT OF NON-SPOUSAL INHERITED IRAS

A. MAJORITY VIEW CONCERNING THE TREATMENT OF NON-SPOUSAL INHERITED IRAS.

Although the Bankruptcy Code does not define the term "retirement funds," the majority of circuits have held that an inherited IRA falls within the meaning of such term.³² For example,

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ See 26 U.S.C. § 408(d)(3)(C).

²⁹ See Michael Cooper, *Non-Spouse Inherited IRAs: How to Avoid Making Common Mistakes*, FINANCIAL PLANNING ASSOCIATION, (April 19, 2010),

<http://www.fpanet.org/ToolsResources/ArticlesBooksChecklists/Articles/Retirement/NonSpouseInheritedIRAsAvoidMakingCommonMistakes/>.

³⁰ See *id.*

³¹ See *Clark*, 714 F.3d at 559; see also Internal Rev. Serv. Pub. 590, Cat. No. 15160X, at 35 (Jan. 7, 2010).

³² See 11 U.S.C § 522(d)(12) (2012) (section 522(b)(3)(C) sets out the same two requirements).

in *In re Chilton*, Gregg Chilton and Janice Elaine Chilton inherited an IRA worth \$170,000 from Mrs. Chilton's mother.³³ The debtors attempted to exempt the inherited IRA from the bankruptcy estate under section 522(d)(12), but the chapter 7 trustee objected the proposed exemption.³⁴ Similarly, in *In re Nessa* the debtor, Nancy A. Nessa, inherited an IRA from her father and transferred the IRA to her own account.³⁵ The debtor attempted to exempt the funds under section 522(d)(12). Again, like the trustee in *Chilton*, the trustee in *Nessa* also objected the exemption.³⁶

In both *In re Chilton* and *In re Nessa*, the United States Court of Appeals for the Fifth Circuit and the Bankruptcy Appellate Panel for the Eighth Circuit both held that the non-spousal inherited IRAs were still considered "retirement funds" when inherited by the debtor because the IRAs had originally been held for retirement.³⁷ In addition, the *Chilton* and *Nessa* courts also held that the transfer of a non-spousal inherited IRA was tax exempt under section 408(e)(1) of the Internal Revenue Code.³⁸ That section of the Internal Revenue Code states "earnings from assets held in an IRA are not subject to taxation in the IRA when earned but rather are subject to taxation when distributions are made."³⁹ The *Chilton* and *Nessa* courts noted that this taxation scheme did not change when the IRAs were inherited from the decedents, and therefore, the accounts were still exempt.⁴⁰ The court in *Nessa* also examined section 552(b)(4)(C) of the Bankruptcy Code. This provision provides that a transmission of retirement funds from an

³³ See *Chilton*, 674 F.3d at 487.

³⁴ See *id.*

³⁵ See *id.*

³⁶ See *id.*

³⁷ See *Chilton*, 674 F.3d at 489; see also *Nessa*, 426 B.R. at 314 (finding that debtor's father's IRA account simply morphs into inherited IRA account under 26 U.S.C. § 408(d)(3)(C)); 26 U.S.C. § 408(d)(3)(C) (2012).

³⁸ See *Chilton*, 674 F.3d at 490; *Nessa*, 426 B.R. at 315.

³⁹ 26 U.S.C. § 408(e)(1) (2012).

⁴⁰ See *Chilton*, 674 F.3d at 490; *Nessa*, 426 B.R. at 315.

account that is exempt from taxation under section 408 of the Internal Revenue Code “shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such direct transfer.”⁴¹ In this analysis, the court pointed out that the transfer itself from the decedent’s IRA to the debtor’s account would not prevent the debtor from exempting those funds in bankruptcy.

B. THE SEVENTH CIRCUIT ADOPTS A NEW APPROACH TO THE TREATMENT OF NON-SPOUSAL INHERITED IRAS.

In *In re Clark*, the Seventh Circuit adopted the minority view that non-spousal inherited IRA’s were not exempt from the bankruptcy estate. Heidi Heffron Clark and her husband, Brandon Clark, owned a pizza shop in their small town of Soughton, Wisconsin.⁴² Like other small business owners, the Clarks have faced financial hardships over the past decade, which forced them to close shop and file for bankruptcy.⁴³ The couple owed approximately \$700,000 to their mortgage lenders, trade creditors, landlord, and other creditors.⁴⁴ Heidi Clark had inherited an IRA worth almost \$300,000 from her mother. The Clarks claimed that the non-spousal inherited IRA was exempt from the bankruptcy estate because it was considered retirement funds under sections 522(b)(3)(C) and (d)(12).⁴⁵ William Rameker, the chapter 7 trustee, and Resul and Zinije Adili, d/b/a Kegonsa Plaza, a judgment creditor, objected to the Clark’s exemption for the inherited IRA.⁴⁶ The bankruptcy court concluded that the Clark’s non-

⁴¹ *Nessa*, 426 B.R. at 315.

⁴² *See id.*

⁴³ *See id.*

⁴⁴ *In re Clark*, 450 B.R. 858, 860 (Bankr. W.D. Wis. 2011) *rev’d and remanded*, 466 B.R. 135 (W.D. Wis. 2012) *rev’d*, 714 F.3d 559 (7th Cir. 2013).

⁴⁵ *See id.*

⁴⁶ *See Clark*, 466 B.R. 135, 136 (D. Wis. 2012), *rev’d* 714 F.3d 559 (7th Cir. 2013).

spousal inherited IRA did not contain “retirement funds” and therefore disallowed the Clark’s exemption.⁴⁷ The district court reversed.⁴⁸

The Seventh Circuit reversed the district court and affirmed the bankruptcy court. In so ruling, the Seventh Circuit distinguished the non-spousal inherited IRA as “a time-limited tax-deferral vehicle, but not a place to hold wealth for use after the new owner's retirement.”⁴⁹ Specifically, the Seventh Circuit noted that under the Internal Revenue Code, a non-spousal inherited IRA is subject to mandatory distribution that must begin within a year of the original owner’s death and be completed in no less than five years.⁵⁰ Furthermore, the court noted that no new contributions may be made to the account.⁵¹ Consequently, the Seventh Circuit opined that the non-spousal inherited IRA was not a “retirement fund” under the Bankruptcy Code in the hands of the debtor, and as a result, the court held that the non-spousal inherited IRA was not exempt.⁵² In reaching such a holding, the court declared that “to treat this account as exempt under [section] 522(b)(3)(C) and (d)(12) [of the Bankruptcy Code] would [allow the debtor] to shelter from creditors a pot of money that can be freely used for current consumption.”⁵³

Since the split emerged between the circuits, courts have declined to follow the Seventh Circuit’s decision in *Clark*. For example, in *In re Stephenson*, the United States District Court for the Eastern District of Michigan reversed the bankruptcy court’s finding in favor of the trustee.⁵⁴ The *Stephenson* court held that “[e]xemptions are to be construed by courts liberally in favor of the debtor, and the burden is on objecting parties to prove that an exemption is not validly

⁴⁷ See *Clark*, 450 B.R. 858, 866 (Bankr. D. Wis. 2011).

⁴⁸ See *Clark*, 466 B.R. at 142.

⁴⁹ See *Clark*, 714 F.3d at 560.

⁵⁰ See *id.* at 559.

⁵¹ See *id.*

⁵² See *id.* at 561

⁵³ See *id.*

⁵⁴ See *In re Stephenson*, 11-CV-10848, 2011 WL 6152960, *1 (E.D. Mich. Dec. 12, 2011).

claimed.”⁵⁵ Accordingly, the *Stephenson* court followed the holding in *Nessa*, and found that the plain language of section 408(e) of the Internal Revenue Code “exempts ‘any individual retirement account’ from taxation and does not distinguish between different types of IRAs, even if they have dissimilar distribution requirements.”⁵⁶ Likewise, in *In re Hamlin*, the United States Bankruptcy Appellate Panel of the Ninth Circuit also distinguished *Clark* from *Chilton* by pointing out that the amount inherited by the debtor in *Clark* was much greater than the money inherited by the debtor in *Chilton*.⁵⁷ The court found this to be an important difference because the court opined that the court in *Clark* was less likely to exempt such a large amount from the bankruptcy estate.⁵⁸

III. THE SUPREME COURT GRANT’S CERTIORARI IN IN RE CLARK

The Supreme Court will soon resolve the circuit split regarding whether non-spousal inherited IRAs are exempt “retirement fund” under sections 522(b)(3)(C) and (d)(12).⁵⁹ In November, the Court decided to hear the case in *Clark v. Rameker*. If the Court sides with the Seventh Circuit, then all debtors will be prevented from exempting their non-spousal inherited IRAs.⁶⁰ Debtors who own non-spousal inherited IRAs will have to take this into consideration when such debtors decide whether or not to file for bankruptcy. If a debtor inherits an IRA containing a substantial amount of assets, he may benefit from not filing for bankruptcy and instead using the non-spousal inherited IRA to pay off his debts. For example, if Heidi and Brandon Clark had known that their non-spousal inherited IRA would not be exempt from the bankruptcy estate they might have opted to pay off their creditors with their inheritance.

⁵⁵ *See id.* (following the holding from *In re Schramm*, 431 B.R. 397, 400 (B.A.P. 6th Cir.2010)).

⁵⁶ *See id.* at 3. *See also Nessa*, 426 B.R. at 315.

⁵⁷ *See Hamlin*, 465 B.R. at 872.

⁵⁸ *See id.*

⁵⁹ *See Brown supra* note 5.

⁶⁰ *See Clark*, 714 F.3d at 562.

Alternatively, if the Supreme Court does not adopt the Seventh Circuit’s approach, potential debtors might decide to file as soon as possible. This will allow them to protect the assets in their non-spousal inherited IRA before the mandatory withdrawal period beings, because those funds would be deemed exempt.

Conclusion

There is no definition for the term “retirement fund” in the Bankruptcy Code, however 11 U.S.C §522 (b)(3)(c) and (d)(12) maintain that retirement funds which are excused from taxation are exempt from the bankruptcy estate.⁶¹ Although courts have interpreted this statute consistently with regards to individual’s IRAs and IRAs inherited by spouses, treatment of non-spousal inherited IRAs in bankruptcy have created a rift between the Circuits. This divide will soon be solved by the Supreme Court, and will affect the decisions made by debtors all over the country. Especially during a time period where baby-boomers are leaving IRAs as inheritances.⁶²

⁶¹ See 11 U.S.C § 522(b)(3)(C), (d)(12) (2012).

⁶² See Brown *supra* note 5.

