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U.S. Supreme Court Highlights New Concerns in Naming IRA Beneficiary

Christopher Combest and David J. Slenn*

A recent U.S. Supreme Court decision provided clarity as to the treatment of inherited IRAs in bankruptcy. The decision provides valuable guidance on how the beneficiaries of IRAs should be designated, for spouses and non-spouses alike, to minimize future creditor issues. Consequently, before designating an individual as beneficiary of an IRA, several issues should be considered. The authors of this article discuss the case and the issues to be considered when designating an IRA beneficiary.

Before Ruth Heffron passed away in 2001, she named her daughter, Heidi Heffron-Clark, as the beneficiary of her individual retirement account ("IRA"). What seemed like a simple part of Ruth's estate planning resulted in a U.S. Supreme Court decision that would cause many to reconsider how to address IRA beneficiary designations for creditor protection purposes. Heidi, a Wisconsin resident, filed for bankruptcy nine years after her mother's death. The issue arose as to whether Heidi's inherited IRA would be exempt from creditor claims in bankruptcy. Specifically, Section 522 of the United States Bankruptcy Code provides that "*retirement funds*" are exempt "*to the extent that those funds are in a fund or account that is exempt from taxation under Section . . . 408 . . .* of" the Internal Revenue Code of 1986 ("Internal Revenue Code") (emphasis added).

BACKGROUND

It should come as no surprise that if the mother, Ruth, filed for bankruptcy, the IRA would be exempt, since Ruth held the IRA as her retirement fund, and the IRA was exempt from tax under Section 408 of the Internal Revenue Code. However, the bankruptcy court was faced with deciding whether the same protection afforded to Ruth would also apply to Heidi. The bankruptcy court held that, while the IRA funds constituted Ruth's "retirement funds" when in her possession, once they passed to Heidi, the IRA was not Heidi's—or, indeed, anyone's—"retirement funds" within the meaning of the above-quoted language

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of the Bankruptcy Code. Furthermore, the bankruptcy court held that the IRA in Heidi's hands was not exempt from taxation under Section 408 of the Internal Revenue Code. Thus, according to the bankruptcy court, Heidi's inherited IRA was not exempt in her bankruptcy case, and the nearly $300,000 in that inherited IRA was to be made available to pay Heidi's creditors.

CIRCUIT COURT SPLIT AND SUPREME COURT'S DECISION

Heidi appealed, but the Seventh Circuit Court of Appeals affirmed the bankruptcy court's result: Heidi could not exempt the IRA she inherited from her mother. However, because a contrary result had been reached by the Fifth Circuit Court of Appeals in the 2012 case of *In re Chilton*, the Seventh Circuit's decision created a conflict as to whether inherited IRAs were exempt in bankruptcy.

This conflict between the Fifth and Seventh Circuit Courts set the stage for an appeal to the nation's highest court, and, on June 12, 2014, Justice Sonia Sotomayor delivered the opinion for a unanimous Supreme Court in *Clark v. Rameker*.[1] Unfortunately for Heidi, the Supreme Court agreed with the Seventh Circuit in finding that an inherited IRA is not exempt in bankruptcy. In so holding, the Supreme Court observed that, unlike the original owner, the owner of the inherited IRA:

1. may withdraw funds from an inherited IRA at any time, without paying a tax penalty;
2. must withdraw the IRA within five years of the original owner's death or take minimum required distributions; and
3. may not make contributions to the IRA.

These differences, along with public policy considerations, were enough to result in the denial of an exemption for Heidi's inherited IRA.

Despite the unfortunate outcome for Heidi, the Supreme Court provided clarity as to the treatment of inherited IRAs in bankruptcy. This clarity provides valuable guidance on how the beneficiaries of IRAs should be designated, for spouses and non-spouses alike, to minimize future creditor issues. Consequently, before designating an individual as beneficiary of an IRA, several issues should be considered.

STATE LAW PROTECTIONS FOR INHERITED IRAS

The Bankruptcy Code permits individual debtors to elect to exempt from

[1] 134 S. Ct. 2242, 189 L. Ed. 2d 157 (2014).

distribution to their creditors either (1) property provided for in Section 522(d) of the Bankruptcy Code itself; or (2) property provided for by the exemption law of the state where the individual is domiciled (subject to certain timing requirements). However, even if the debtor chooses to use the exemptions available under the relevant state's law, separate subsections of Bankruptcy Code Section 522 provide, in addition, for the exemption of "retirement funds," using the language quoted above.

Heidi sought, in her bankruptcy case, to exempt the nearly $300,000 remaining in the IRA she inherited from her mother, relying on that "retirement funds" exemption language. The Supreme Court's decision prevented her from doing so, rendering that entire amount subject to the claims of her creditors. Thus, after *Clark v. Rameker*, the beneficiary of an inherited IRA can no longer rely on the Section 522 "retirement funds" exemption to protect the inherited IRA in bankruptcy.

However, as noted above, individuals in bankruptcy are entitled to claim their state-law exemptions. While most states (like Wisconsin, where Heidi filed her bankruptcy case) do not exempt inherited IRAs, some states (e.g., Florida and Arizona) specifically provide that inherited IRAs are exempt. Thus, had Heidi resided in one of the handful of states that specifically provide protection for inherited IRAs, and had she chosen to rely on that state's exemption law, Heidi's IRA could have been exempt in bankruptcy.

One should carefully consider whether reliance on the state protection creates a false sense of security. If a parent resides in Florida or Arizona, but the child inherits the parent's IRA and resides in a state that does not specifically protect inherited IRAs (e.g., Wisconsin, Illinois, and Indiana, among others), the inherited IRA could be subject to the claims of creditors in bankruptcy. Since many children move out of the state where their parents reside, it is important not to assume any particular state law would protect a beneficiary.

DESIGNATING A TRUST AS AN IRA BENEFICIARY

Given the uncertainty of a beneficiary's eventual domicile for bankruptcy purposes, designating a trust as an IRA beneficiary provides a potentially safer alternative. Under Section 541(c) of the Bankruptcy Code, if a trust contains a "restriction on the transfer of a beneficial interest of the debtor" that is "enforceable under applicable nonbankruptcy law"—that is, a "spendthrift" clause—the beneficial interest is excluded from the beneficiary's bankruptcy estate and, therefore, is not available for distribution in the bankruptcy case to the beneficiary's creditors. For this reason, many individuals choose to designate a trust, instead of an individual, to be the beneficiary of an IRA.

FEDERAL TAX LAW ISSUES WITH TRUSTS AS IRA BENEFICIARIES

If an individual names a trust as a beneficiary of an IRA, careful consideration should be given to how the trust is structured. Not only must the trust contain the appropriate spendthrift restrictions on transfer (creating a so-called "spendthrift trust"), but the Internal Revenue Code provides that only *individuals* can be beneficiaries of an IRA for federal income tax purposes.

However, there are exceptions within the Internal Revenue Code that provide a safe harbor when a trust is designated as a beneficiary. The safe harbor essentially permits one to "see-through" the trust and treat the beneficiary as the owner of the IRA for federal income tax purposes.

By qualifying for a safe harbor, the beneficiary may defer income tax on distributions from the IRA by taking required minimum distributions based on the beneficiary's life expectancy. To further complicate matters, there are variations in the manner a trust may meet the see-through safe harbor; determining which variation is best would depend on the circumstances. While the see-through safe harbor applies for *federal income tax purposes*, the fact that the trustee of a spendthrift trust owns the IRA provides the beneficiary with protection for *state law creditor purposes*. Thus, despite the complexities involved, designating a trust as a beneficiary could achieve optimal results from both a tax and creditor protection perspective.

IRA DESIGNATION OPTIONS FOR SPOUSES

The Supreme Court's analysis supports the conclusion that if a beneficiary spouse rolls an IRA over from the deceased spouse, the beneficiary spouse's IRA should be treated as a retirement fund. Thus, if the beneficiary spouse winds up in bankruptcy, the rollover IRA should be exempt. Notwithstanding this presumed protection in bankruptcy, many have questioned whether the conversion of an inherited IRA to a rollover IRA would be subject to challenge by a creditor or bankruptcy trustee under fraudulent transfer or similar laws. As a result, the use of a trust for a surviving spouse should be considered. In this situation, the benefits of asset protection through the use of a spendthrift trust should be weighed against the loss of certain tax benefits associated with a rollover IRA.

TRUST BENEFITS OUTSIDE OF BANKRUPTCY

Even if a beneficiary does not file for bankruptcy, he or she could still encounter creditor issues (e.g., lawsuit, divorce). If his or her state law does not

provide protection for inherited IRAs, the use of a spendthrift trust, if structured properly, should provide creditor protection. Note that while the spendthrift trust laws vary by state, as a general rule, it is much better, for creditor protection purposes, to have a beneficiary's assets held in trust versus held individually by the beneficiary.

Clark v. Rameker provides an important reminder of the necessity to review IRA designations in light of a beneficiary's circumstances—whether inside or outside of bankruptcy.