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## Inherited IRAs: Exemption Issues under the Code

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An individual has two goals when filing for bankruptcy: (1) obtaining relief from creditors, the relief coming in the form of a discharge injunction; and (2) retaining as much property as the law permits the debtor to retain in furtherance of the “fresh start,” the relief coming in the form of exemptions. An individual debtor commencing a bankruptcy case creates an estate comprised of property “wherever located and by whomever held.”<sup>2</sup> Such property includes all legal or equitable interests of the debtor with certain exceptions not applicable to individual retirement accounts (IRAs). Upon commencement of a case, the individual debtor has the right to exempt property of the estate from the reach of creditors, and these exemptions are enumerated in 11 U.S.C. § 522.



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IRAs first appeared in the 1970s when Congress enacted far-reaching pension and retirement reform measures in the Employee Retirement Income Security Act of 1974 (ERISA).<sup>3</sup> Traditional IRAs are routinely included on Schedule

B in individual consumer bankruptcy cases and are typically exempt on Schedule C.

An individual who originates an IRA may designate beneficiaries to receive the balance in the account if the originator

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dies before the account is fully depleted. As individuals with IRAs die, their IRAs pass to beneficiaries. Inherited IRAs are IRAs that are received by individuals from someone other than their spouses, and are treated differently than IRAs under the Tax Code.<sup>4</sup> Inherited IRAs are becoming increasingly common in bankruptcy filings, and issues are now arising over whether this new type of IRA is exempt. This article examines whether inherited IRAs should be treated differently than IRAs under the Bankruptcy Code.<sup>5</sup>

## Cover Feature

### Tax Code's Statutory Scheme: IRAs and Inherited IRAs

Section 408 of the Tax Code defines an IRA as a “trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries.”<sup>6</sup> The account is created by a written document that meets all of the following requirements:

- The trustee or custodian must be a bank, federally insured credit union, savings and loan association, or an entity approved by the IRS to act as trustee or custodian.
- The trustee or custodian generally cannot accept contributions of more than the deductible amount for the year.<sup>7</sup>

- Contributions, except for rollover contributions, must be in cash.
- The beneficiary must have a non-forfeitable right to the amount at all times.
- Money in the account cannot be used to buy a life insurance policy.
- Assets in the account cannot be combined with other property, except in a common trust or investment fund.
- The beneficiary must start receiving distributions by April 1 of the year following the year in which the beneficiary shall have reached age 70 1/2.<sup>8</sup>

Moreover, as a general proposition, IRA accounts are not subject to taxation.<sup>9</sup>

An inherited IRA is defined and treated differently by the Code than a traditional IRA. It is an IRA acquired as a result of the death of an individual who is someone

other than the individual's spouse.<sup>10</sup> The distribution rules applying to an inherited IRA are less advantageous than the rules applying to a traditional IRA. An IRA beneficiary created by his or her deceased spouse has many options when it comes to taking distributions, including transferring the funds to the beneficiary's own IRA (such a transfer is known as a “rollover distribution”). A rollover distribution has the effect of subjecting the transferred funds to normal IRA distribution rules as if the surviving spouse was the creator of the IRA account.<sup>11</sup> A non-spousal beneficiary of an inherited IRA does not have this option.<sup>12</sup> Rather, such a beneficiary must maintain the account in the decedent's name and take a distribution of all benefits within either five years or, if an election is made, over the ben-

<sup>1</sup> The authors acknowledge Elizabeth Barletta and Michael S. Rosen, who helped research this article.

<sup>2</sup> 11 U.S.C. § 541(a).

<sup>3</sup> See, e.g., Senate Report 93-383 to the Employee Retirement Income Security Act of 1974, P.L. 93-406 1974 U.S.C.C.A.N. 4889, 5012-5020, 1973 WL 12551, 120-27.

<sup>4</sup> 26 U.S.C. § 1001, *et seq.* “Tax Code” means the Internal Revenue Code of 1986, as amended, and the rules and regulations promulgated under it.

<sup>5</sup> IRAs inherited by spouses have unique policy considerations and legal issues that are beyond the scope of this article.

<sup>6</sup> 26 U.S.C. § 408(a).

<sup>7</sup> However, rollover contributions and employer contributions to a simplified employee pension (SEP) can be more than this amount.

<sup>8</sup> Internal Revenue Service Publication 590; see also 26 U.S.C. § 408(a).

<sup>9</sup> 26 U.S.C. § 408(e)(1).

<sup>10</sup> 26 U.S.C. § 408(d)(3)(C).

<sup>11</sup> 26 U.S.C. § 408(d)(3)(A).

<sup>12</sup> 26 U.S.C. § 408(d)(3)(c).

efficiary's remaining life expectancy in accordance with IRS tables.<sup>13</sup> Therefore, while a spouse enjoys the same tax treatment for inherited retirement funds that his or her spouse enjoyed, inherited IRA beneficiaries such as the originator's children or siblings do not receive the same tax treatment as the originator's spouse may receive.

No recipient of the inheritance may make contributions to the account.<sup>14</sup> Finally and significantly, both types of beneficiaries may withdraw funds from the account at any time without penalty.

## Code's Statutory Scheme: Exemptions and Inherited IRAs

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) substantially expanded debtors' rights to exempt their interests in IRAs by adding several new statutory protections to §522. Section 522(b)(1) allows a debtor to elect between exempting property set out in § 522(d), commonly known as the Bankruptcy Code exemptions, or an alternative-exemption scheme. The alternative-exemption scheme, typically referred to as the state exemption scheme, allows debtors to "exempt [property] under Federal law, other than subsection (d)...or State or local law."<sup>15</sup> The Bankruptcy Code exemption scheme, as it relates to IRAs, centers on § 522(d)(12), which allows a debtor to exempt "[r]etirement 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."<sup>16</sup> The alternative exemption scheme, at § 522(b)(3)(C), adopts verbatim (d)(12)'s language.

Section 522(b)(4) affords additional protections to IRAs under either exemption scheme. Subparagraph C of this section provides favorable treatment for direct transfers between retirement accounts,<sup>17</sup> while subparagraph D provides favorable treatment for certain distributions between retirement accounts.<sup>18</sup>

## Case Law on Inherited IRAs

Inherited IRAs have recently begun to generate considerable attention in the

courts.<sup>19</sup> While there is a divergence of opinion on whether inherited IRAs are exempt, the courts agree that a two-pronged analysis is required, namely, are the funds (1) "retirement funds" that are (2) "exempt from taxation"? There are two leading cases construing the federal exemption scheme, one upholding the (d)(12) exemption and the other overruling the exemption.

### Inherited IRAs Are Exempt

In *In re Nessa*,<sup>20</sup> which is currently the only appellate-level case available, the debtor elected the Bankruptcy Code exemptions under § 522(d), and the chapter 7 trustee objected, asserting that the funds in the debtor's IRA, which had been inherited from the debtor's father, did not constitute "retirement funds" because the funds were not contributed by the debtor. The funds were the father's retirement funds, not the debtor's, in whose hands the funds were merely an inheritance or a gift.

The *Nessa* court readily disposed of this argument, finding that the plain language of § 522(d)(12) does not require that the funds in the inherited IRA be comprised of the debtor's retirement funds. The court also noted that a contrary ruling would render § 522(b)(4)(C) meaningless since it provides that funds directly transferred from one retirement fund that is exempt to another, also exempt, do not lose their exempt status by reason of the transfer.

The trustee also alleged that the debtor's IRA was not exempt from taxation because of the differences between the statutory treatment regarding the use, distribution and taxation of funds in an IRA vs. an inherited IRA. The court readily disposed of this argument, finding that 26 U.S.C. § 408(e)(1) permits exemption of "any" IRA from taxation and that the section "does not distinguish

between an inherited IRA and traditional types of IRAs."<sup>21</sup>

### Inherited IRAs Are Not Exempt

In *re Chilton*<sup>22</sup> denied exempt status to an inherited IRA. In *Chilton*, the debtor claimed that the Bankruptcy Code provided exemptions for an IRA inherited from her mother. The court first looked at whether the funds in the inherited IRA were retirement funds, focusing on the debtor's ability to withdraw the funds from an inherited IRA without regard to age or retirement status. The court concluded that funds in inherited IRAs were not retirement funds because the debtor did not contribute the funds for retirement purposes and the funds were readily available to the debtor without regard to the debtor's retirement.

The Court then looked at whether the inherited IRA was tax-exempt under 26 U.S.C. §§ 401, 403, 408, 408A, 414, 457 or 501(a) of the Tax Code. The debtors argued that the inherited IRA was exempt from taxation under § 408(e). The court disagreed, stating that because an inherited IRA is a "vehicle for receiving distribution from a tax-exempt account," it does not fit within the definitional scope of § 408(e), which pertains to the taxability of funds, not distributions.<sup>23</sup> Simply stated, the court suggested that an inherited IRA should be analyzed, for tax purposes, as a distribution and not as an account. Since § 408(e) provides an exemption from taxation for accounts, inherited IRAs do not fall within its scope.

### Which Interpretation Is Correct?

*Does an inherited IRA contain retirement funds?* The *Chilton* court observed that the Bankruptcy Code does not define the term "retirement funds."<sup>24</sup> Following standard rules of statutory construction, it looked for the plain meaning that Congress intended when enacting the language-exempting retirement funds and concluded that "funds contained in an inherited IRA are not funds intended for retirement purposes but instead are distributed to the beneficiary of the account without regard to age or retirement status."<sup>25</sup> The *Nessa* court found that (d)(12)'s plain language does not require the debtor to have contributed the funds in the inherited IRA.<sup>26</sup>

The court's view in *Nessa* is not persuasive. An inherited IRA is akin to a

<sup>13</sup> 26 U.S.C. §§ 401(a)(B), 402(a)(1)(A) and 408 (a)(6).

<sup>14</sup> 26 U.S.C. § 402(c)(1)(A)(ii) and 408(d)(3)(C).

<sup>15</sup> 11 U.S.C. § 522(b)(3).

<sup>16</sup> 11 U.S.C. § 522(d)(12).

<sup>17</sup> Providing that a "direct transfer of retirement funds from [one] fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457 or 501(a)...shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such direct transfer." 11 U.S.C. § 522(b)(4)(C).

<sup>18</sup> Providing that "any distribution that qualifies as an eligible rollover distribution within the meaning of section 402(c)...shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such distribution." 11 U.S.C. § 522(b)(4)(D).

<sup>19</sup> Cases permitting an exemption for an inherited IRA: *In re Weillhammer*, 2010 WL 3431465 (Bankr. S.D. Cal. 2010) (exemption upheld based on 11 U.S.C. § 522 (b)(3)(C)); *In re Tabor*, 433 B.R. 469 (Bankr. M.D. Pa. 2010) (exemption upheld based on 11 U.S.C. § 522(b)(3), and *In re Nessa's* interpretation of (d)(12)); *In re Kuchta*, 434 B.R. 837 (Bankr. N.D. Ohio 2010) (exemption claim based on Ohio law overruled and upheld under 11 U.S.C. § 522 (b)(3)(C)); *In re Nessa*, 426 B.R. 312 (8th Cir. B.A.P. 2010) ((d)(12) exemption upheld); and *In re Thiem*, 2011WL 182884 (Bankr. D. Ariz. 2011) (exemption upheld based on Arizona law and 11 U.S.C. § 522(b)(3)).

Cases denying an exemption for an inherited IRA: *In re Ard*, 435 B.R. 719 (Bankr. M.D. Fla. 2010) (exemption based on Florida law overruled); *In re Klipsch*, 2010 WL 2293957 (Bankr. S.D. Ind. 2010) (exemption based on Indiana law overruled); *In re Chilton*, 426 B.R. 612 (Bankr. E.D. Tex. 2010) ((d)(12) exemption overruled); *Robertson v. Deeb*, 16 So.3d 936 (Fla. App. 2 Dist. 2009) (exemption based on Florida Law overruled); *In re Mullican*, 417 B.R. 389 (Bankr. E.D. Tex. 2008) (exemption overruled because debtor acted in bad faith); *In re Jarboe*, 365 B.R. 717 (Bankr. S.D. Tex. 2007) (exemption based on Texas law overruled); *In re Taylor*, 2006 WL 1275400 (Bankr. C.D. Ill. 2006) (exemption overruled based on nonbankruptcy issue); *In re Navarre*, 332 B.R. 24 (Bankr. M.D. Ala. 2004) (exemption based on Alabama law overruled); *In re Greenfield*, 289 B.R. 146 (Bankr. S.D. Cal. 2003) (exemption based on California law overruled); and *In re Sims*, 241 B.R. 467 (Bankr. N.D. Okla. 1999) (exemption based on Oklahoma law overruled).

<sup>20</sup> 426 B.R. 312 (8th Cir. B.A.P. 2010) (inherited IRA deemed exempt).

<sup>21</sup> *Id.* at 315.

<sup>22</sup> 426 B.R. 612 (Bankr. E.D. Tex. 2010) (inherited IRA not exempt under § 523(d)(12)).

<sup>23</sup> *Id.* at 621.

<sup>24</sup> *Id.* at 617.

<sup>25</sup> *Id.* at 617-18.

<sup>26</sup> *In re Nessa*, 426 B.R. 314-15.

revocable gift or inheritance that the beneficiary may acquire upon the donor's death. Before the donor's death, the account is a retirement plan for him or her but not for the beneficiary, since the donor may revoke the gift at any time or deplete the funds by withdrawals for his or her own benefit such that the account may never pass to the beneficiary. The beneficiary has no control whatsoever over his or her donor's contingent gift. A noncontingent property interest arises once the donor dies; even then, the inherited IRA account does not operate as the beneficiary's retirement plan since the beneficiary may make tax-free withdrawals without penalty even if he or she has not reached retirement age.

The *Nessa* court's view has another shortcoming. The two Bankruptcy Code provisions providing for the exemption of retirement funds are identical, beginning with the phrase "retirement funds" and then reciting a list of Tax Code provisions governing retirement funds or accounts. Since the list is exclusively made of retirement accounts, why did Congress insert the phrase "retirement funds" at the beginning of each exemption provision? Stated another way, what else could be in a retirement account (*i.e.*, the accounts on the list of statutory provisions) except retirement funds? A fundamental rule of statutory construction is that a law should not be construed so as to read out any word. The phrase "retirement funds" must mean something. The *Nessa* court would make the qualifying term "retirement fund" superfluous.<sup>27</sup> On the first prong of the analysis, namely whether the inherited IRA contains retirement funds, *Chilton* has it right.

*Is an inherited IRA tax-exempt?* To the extent that funds in an inherited IRA are in a fund or account that is exempt from taxation under §§ 401, 403, 408, 408A, 414, 457 or 501(a) of the Internal Revenue Code of 1986, they satisfy the second prong of the analysis. *Nessa* relies on 26 U.S.C. § 408(e)(1), which exempts any IRA account from taxation.<sup>28</sup> The *Chilton* court disagrees, stating that there is a difference between the tax treatment of "accounts" and the tax treatment of "distributions."

The *Nessa* court's view is more persuasive. Section 408(e) states that "any" IRA is exempt from tax. An inherited

IRA and an IRA may not be identical, but an inherited IRA is a type of independent retirement account. On this second prong, *Nessa* has it right.

*Evaluation of Cases.* If a debtor asserting a (d)(12) or (b)(3)(C) exemption fails to satisfy either prong of the test, a bankruptcy court should deny the exemption. Inherited IRAs do not appear to satisfy the first prong of the analysis, and therefore, a bankruptcy court should deny the exemption for an inherited IRA.

## State Exemption Schemes

Courts have thus far denied exempt status to inherited IRA's under state law, but not uniformly. *In re Ard*<sup>29</sup> exemplifies the manner in which bankruptcy courts have assessed a debtor's claim to exempt an inherited IRA using the state-exemption scheme and overruled the claim. In *Ard*, the debtor's inherited IRA arose from her father and she sought to exempt it under Florida law. In pertinent part, Florida state law exempts "a plan or governing instrument...exempt from taxation" under 26 U.S.C. § 408 from the claims of attaching creditors.<sup>30</sup> The *Ard* court found that an inherited IRA's tax-exempt status differed from the IRA when held by the original owner such that the former no longer qualified for the exemption from garnishing creditors.<sup>31</sup> The court concluded that

[the] funds in the original [decedent's] IRA account did not retain the same tax-exempt status after being distributed to Ms. Ard. The tax consequence of this inherited IRA have nothing to do with her age or retirement status; she cannot contribute additional funds to the account. As a result, the inherited IRA does not qualify as an exempt account under Section 222.21(2).<sup>32</sup>

Accordingly, the *Ard* court overruled the exemption.<sup>33</sup> In sum, our overview reveals that most courts interpreting state law exemption statutes for retirement accounts focus primarily on the different tax treatment afforded to inherited IRAs and conclude that inherited IRAs simply do not comport with the policy of retirement account protection to manifest in state law exemption statutes.<sup>34</sup>

<sup>29</sup> 435 B.R. 719 (Bankr. M.D. Fla. 2010).

<sup>30</sup> *Id.* at 720 (quoting § 222.21(2), Florida Statutes).

<sup>31</sup> *Id.* at 721 (citing *Robertson v. Deeb*, 16 So.3d 936 (Fla. 2d DCA, 2009)).

<sup>32</sup> *Id.* at 722.

<sup>33</sup> *Id.*

<sup>34</sup> See *In re Jarboe*, 365 B.R. 717 (Bankr. S.D. Tex. 2007) (inherited IRA not exempt under Texas law because it is not retirement plan; money may be removed from account at any time); *In re Kirchen*, 344 B.R. 908 (Bankr. E.D. Wis. 2006) (nature of IRA changed upon death of donor from tax deferred to immediately payable); *In re Taylor*, 2006 WL 1275400 (Bankr. C.D. Ill. 2006) (inherited IRA treated differently for tax purposes than traditional IRA); *In re Greenfield*, 289 B.R. 146 (Bankr. S.D. Cal. 2003) (debtor used funds in an inherited IRA for nonretirement purposes).

In an important exception, *In re Thiem*,<sup>35</sup> the bankruptcy court held that an inherited IRA is exempt under both state law and, following *Nessa*, under 11 U.S.C. § 522(b)(3). The court found that the Arizona exemption statute, by its plain language, protected an IRA's beneficiary.<sup>36</sup> The court also declined to follow *Chilton* when it held that § 522(b)(3) exempts the debtor's inherited IRA even though she neither originated nor contributed to the retirement fund.<sup>37</sup>

## Conclusion

Inherited IRAs are becoming more common in bankruptcy filings and may represent a larger part of the typical consumer debtor's bankruptcy estate in the future. A debtor's ability to preserve and protect an inheritance from creditors will depend in large part on the courts' willingness to ascribe to inherited IRAs the retirement characteristics exhibited by the original plan or account from which the inheritance arose. ■

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<sup>27</sup> *In re Chilton*, 426 B.R. 612 at 617 ("The debtors' argument violates a fundamental tenet of statutory construction—that all the words of a statute should be given meaning—by reading the word 'retirement' out of 'retirement funds.'").

<sup>28</sup> *Id.* at 315.

<sup>35</sup> 2011WL 182884 (Bankr. D. Ariz. 2011).

<sup>36</sup> *Id.* at \*7.

<sup>37</sup> *Id.* at \*9.