AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Feature

By Donald R. Lassman and Jeffrey Cymrot

# Supreme Court in *Clark v. Rameker*: Inherited IRAs Are Not Exempt

**Donald R. Lassman**
*Law Office of Donald R. Lassman
Needham, Mass.*

**Jeffrey Cymrot**
*Sassoon & Cymrot LLP
Boston*

*Donald Lassman is a chapter 7 trustee and sole practitioner in Needham, Mass., He is also a co-author of* Reaffirmation Agreements in Consumer Bankruptcy Cases, Second Edition *(ABI, 2010). Jeffrey Cymrot is a principal with Sassoon & Cymrot LLP in Boston.*

On June 12, 2014, the U.S. Supreme Court unanimously decided *Clark v. Rameker*,[1] a ruling that states that funds in inherited individual retirement accounts (IRAs)[2] are not exempt from consideration in a bankruptcy case.[3] Writing for the Court, Justice Sonia Sotomayor declared that "[t]he text and purpose of the Bankruptcy Code make [it] clear that funds held in inherited IRAs are not 'retirement funds' within the meaning of § 522(b)(3)(C)'s bankruptcy exemption."[4] The decision resolved conflicting decisions issued by the Fifth and Seventh Circuit Courts of Appeals and established a clear limit on what bankruptcy law considers to be retirement funds.

## The Circuit Split

Ruth Heffron set up a traditional IRA in 2000 and named her daughter, Heidi Clark-Heffron, as beneficiary. When Heffron died a year later, her IRA, then valued at $450,000, passed to her daughter, who elected to take monthly distributions from the account. Nine years later, Clark-Heffron and her husband filed a chapter 7 petition and sought to exempt the inherited IRA, then worth about $300,000, pursuant to § 522(b)(3)(C). The chapter 7 trustee, **William J. Rameker** (Murphy Desmond SC; Madison, Wis.), objected to the exemption, and Hon. **Robert D. Martin** of the U.S. Bankruptcy Court for the Western District of Wisconsin sustained the objection. Hon. Barbara B. Crabb of the U.S. District Court for the Western District of Wisconsin reversed, and on appeal, the Seventh Circuit Court of Appeals reversed the district court's decision. Hon. Frank Easterbrook authored the opinion for the court of appeals:

> [B]y the time the Clarks filed for bankruptcy, the money in the inherited IRA did not represent *anyone's* retirement funds. They had been Ruth's, but when she died, they became no one's retirement funds. The account remains a tax-deferral vehicle until the mandatory distribution is completed, but distribution precedes the owner's retirement. To treat this account as exempt under § 522(b)(3)(C) and (d)(12) would be to shelter from creditors a pot of money that can be freely used for current consumption.[5]

Previously, another inherited IRA case, *In re Chilton*, found its way to the Fifth Circuit Court of Appeals with facts similar to those in *Clark*. Robert Gregg Chilton and Janice Elaine Chilton inherited an IRA worth $170,000 from Ms. Chilton's mother, Shirley Jean Heil. When the Chiltons filed a chapter 7 petition, they sought to exempt the inherited IRA from the bankruptcy estate pursuant to § 522(d)(12), which is identical to § 522(b)(3)(C).

The chapter 7 trustee, **Christopher J. Moser** (Quilling, Selander, Lownds, Winslett and Moser PC; Dallas), objected, and the bankruptcy court sustained the objection. The district court reversed, and the trustee subsequently appealed to the Fifth Circuit Court of Appeals. The court of appeals affirmed the district court's decision,[6] aligning itself with decisions from several other federal courts[7] and reasoning that

1 *Clark v. Rameker*, __ U.S. __, 134 S. Ct. 2242, 189 L. Ed. 2d 157 (2014).

2 Inherited IRAs are defined by statute as an "individual retirement account or individual retirement annuity [that] shall be treated as inherited if — (I) the individual for whose benefit the account or annuity is maintained acquired such account by reason of the death of another individual, and (II) such individual was not the surviving spouse of such other individual." 26 U.S.C. § 408(d)(3)(C)(ii). This statutory definition limits inherited IRAs to instances whereby the deceased holder and the surviving beneficiary are not spouses.

3 Section 522(b)(3)(C) exempts from the bankruptcy estate "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."

4 *Clark*, 134 S. Ct. at 2246.

5 *In re Clark*, 714 F.3d 559, 561 (7th Cir. 2013).

6 *In re Chilton*, 674 F.3d 486 (5th Cir. 2012).

7 The Fifth Circuit Court of Appeals found support in the following cases: *In re Nessa*, 426 B.R. 312, 314 (B.A.P. 8th Cir. 2010); *In re Kuchta*, 434 B.R. 837, 843-44 (Bankr. N.D. Ohio 2010); *In re Tabor*, 433 B.R. 469, 476 (Bankr. M.D. Pa. 2010); *In re Thiem*, 443 B.R. 832, 843-44 (Bankr. D. Ariz. 2011); *In re Weilhammer*, No. 09-15148-LT7, 2010 WL 3431465, at *4-*6 (Bankr. S.D. Cal. Aug. 30, 2010); *In re Stephenson*, 2011 WL 6152960, at *2-*3, 2011 U.S. Dist. LEXIS 142360, at *7-*8. *See also In re Hamlin*, 465 B.R. 863, 872 (B.A.P. 9th Cir. 2012), and *In re Seeling*, 471 B.R. 320, 322-23 (Bankr. D. Mass. 2012).

[t]he plain meaning of the statutory language refers to money that was "set apart" for retirement. Thus, the defining characteristic of "retirement funds" is the purpose [that] they are "set apart" for, not what happens after they are "set apart." Here, there is no question that the funds contained in the debtors' inherited IRA were "set apart" for retirement at the time Heil deposited them into an IRA. This reasoning finds further support from 11 U.S.C. § 522(b)(4)(C), which provides that "a direct transfer of retirement funds from one fund or account that is exempt from taxation under section ... 408 ... of the Internal Revenue Code of 1986 … shall not cease to qualify for exemption under ... subsection (d)(12) by reason of such direct transfer." In other words, the direct transfer of "retirement funds" does not alter their status as "retirement funds." As we see no reason to interpret the statutory language differently from its plain meaning, we hold that the $170,000 contained in the inherited IRA constitute "retirement funds" as that phrase is used in section 522(d)(12).[8]

Section 522(b)(3)(C) and (d)(12) incorporate the same two-prong test for retirement account exemption: The funds must be (1) "retirement funds" and (2) in an account that is exempt from taxation. The Fifth and Seventh Circuit Courts of Appeals agreed that inherited IRAs meet the second prong because they are exempt from taxation, but they reached very different results about the meaning of the phrase "retirement funds."[9] The Supreme Court granted *certiorari* to resolve the conflict over the first prong.

## Plain Meaning Does Not Lead Plainly to a Result

The *Clark* decision merits closer scrutiny. The majority of lower courts that had evaluated whether to exempt inherited IRAs employed the same legal analysis method that the Supreme Court used — plain or ordinary meaning — and came to the wrong conclusion. The Bankruptcy Code does not define the phrase "retirement fund," so the Supreme Court gave the phrase its ordinary (or plain) meaning: "Section 522(b)(3)(C)'s reference to 'retirement funds' is ... properly understood to mean sums of money [that are] set aside for the day [that] an individual stops working."[10]

Three legal characteristics of inherited IRAs led the Supreme Court to conclude that its funds were not objectively set aside for retirement purposes.[11] First, the holder of an inherited IRA cannot invest money in the account.[12] "Inherited IRAs are thus unlike traditional and Roth IRAs, both of which are quintessential 'retirement funds.' For where inherited IRAs categorically prohibit contributions, the entire purpose of traditional and Roth IRAs is to provide tax incentives for accountholders to contribute regularly and over time to their retirement savings."[13]

Second, holders of inherited IRAs must withdraw money from the accounts without regard to their age or years to go before retirement.[14] The fact "[t]hat the tax rules governing inherited IRAs routinely lead to their diminution over time, regardless of the holder's proximity to retirement, is hardly a feature [that] one would expect of an account set aside for retirement."[15] Lastly, a person holding an inherited IRA may withdraw the entire amount for any purpose at any time without receiving a tax penalty.[16]

**Those who favor creditors' interests over those of a debtor's should count the *Clark* decision as a win ... post-*Clark*, debtor's counsel must be sure to determine not only whether a debtor has a retirement account, but also determine its source.**

After focusing on the distinctive legal characteristics of an inherited IRA, the Court examined whether its reading of the text "is consistent with the purpose of the Bankruptcy Code's exemption provisions."[17] Answering with a resounding "yes," the Court cited the balance that the Bankruptcy Code strikes between a debtor's right to a fresh start and a creditor's right to fair treatment and delivered this analysis:

> Allowing debtors to protect funds [that are] held in traditional and Roth IRAs comports with this purpose by helping to ensure that debtors will be able to meet their basic needs during their retirement years. At the same time, the legal limitations on traditional and Roth IRAs ensure that debtors who hold such accounts (but who have not yet reached retirement age) do not enjoy a cash windfall by virtue of the exemption — such debtors are instead required to wait until age 59½ before they may withdraw the funds penalty-free.
>
> The same cannot be said of an inherited IRA. For if an individual is allowed to exempt an inherited IRA from her bankruptcy estate, nothing about the inherited IRA's legal characteristics would prevent (or even discourage) the individual from using the entire balance of the account on a vacation home or sports car immediately after her bankruptcy proceedings are complete. Allowing that kind of exemption would convert the Bankruptcy Code's purposes of preserving debtors' ability to meet their basic needs and ensuring that they have a "fresh start." We decline to read the retirement funds provision in that manner.[18]

In sum, after reviewing the legal attributes of inherited IRAs, the Court declined to grant them exempt status because to do so would upset the balance between a debtor's right to a fresh start and a creditor's right to fair treatment. The

8 *In re Chilton*, 674 F.3d at 486, 489.

9 *See* 26 U.S.C. § 408(e)(1).

10 *Clark*, 134 S. Ct. at 2246. *Compare In re Chilton*, "'[R]etirement' is defined as 'withdrawal from office, active service, or business"; 'fund' is defined as 'a sum of money or other resources the principal or interest of which is set apart for a specific objective or activity.'" *In re Chilton*, 674 F.3d at 488-89 (quoting *Webster's Third New Int'l Dictionary* 921, 1939 (1993)).

11 *Clark*, 134 S. Ct. at 2247. A debtor's plan for use of the funds in an inherited IRA has no bearing on an inherited IRA's legal attributes, which are objective.

12 *Clark*, 134 S. Ct. at 2247 (citing 26 U.S.C. § 219(d)(4)). More specifically, the accountholder gets no deduction from tax for such investments and risks making the contributions exceed the maximum allowed. *See also* 26 U.S.C. § 408(d)(3)(C), which denies rollover treatment to inherited IRAs.

13 *Clark*, 134 S. Ct. at 2247.

14 *Id.* (citing 26 U.S.C § 408(a)(6) and 26 U.S.C § 401(a)(9)(B)). *See also* 26 U.S.C § 408(d)(3)(C), which denies rollover treatment to inherited IRAs.

15 *Clark*, 134 S. Ct. at 2247.

16 *Id. See also* 26 U.S.C. § 408(d).

17 *Clark*, 134 S. Ct. at 2247.

18 *Id.* at 2247-48 (internal citations omitted).

Court easily dispatched the principal argument advanced by the *Clark* petitioners that § 523(b)(3)(C) and (d)(12) do not specify that the retirement funds at issue must be the debtor's retirement funds.[19] First, it referred to "ordinary usage," which dictates that a statutory reference to a person's retirement funds means that the funds set aside for the person's retirement, "not that they were set aside for that purpose at some prior date by an entirely different person."[20]

Second, the Court noted that the petitioners' argument would render a substantial portion of § 522(b)(3)(C)'s text superfluous because Congress could have phrased the exemption to cover any "fund or account that is exempt from taxation under" the sections enumerated in the statute.[21] Instead, Congress phrased the statute to require that, in addition to being exempt from taxation, the account must consist of retirement funds.[22] The Court concluded that the petitioner's argument "flouts the rule that 'a statute should be construed so that effect is given to all [of] its provisions so that no part will be inoperative or superfluous.'"[23]

The Court adopted a plain meaning for the undefined term "retirement fund" in the Bankruptcy Code, compared the meaning so derived with the statutory attributes in the Internal Revenue Code that characterize and define an inherited IRA, and checked the conclusion derived — an inherited IRA is not a retirement fund — against the purpose of the Code's exemption provisions. The decision rejects a forced and literal construction that would render a portion of § 522(b)(3)(C) as superfluous.

## The Decision's Implications

Those who favor creditors' interests over those of a debtor's should count the *Clark* decision as a win. Certainly, post-*Clark*, debtor's counsel must be sure to determine not only whether a debtor has a retirement account, but also determine its source. *Clark* may not result in an immediate expansion of the range of retirement assets that a trustee may administer, as inherited IRAs are not frequently encountered because the statutory definition of "inherited IRAs" limits them to instances where the deceased holder and the surviving beneficiary are not spouses. However, with a vast transfer of wealth expected to occur as the "baby boomer" generation ages and assets are passed onto family members, spouses and non-spouses alike, inherited IRAs will likely become much more prevalent and more problematic for debtor's counsel. abi

*Reprinted with permission from the ABI Journal, Vol. XXXIII, No. 10, October 2014.*

*The American Bankruptcy Institute is a multi-disciplinary, non-partisan organization devoted to bankruptcy issues. ABI has more than 13,000 members, representing all facets of the insolvency field. For more information, visit abi.org.*

---

19 "After all, [as] petitioners point out, the 'initial owner' of the account 'set aside the funds in question for retirement by depositing them in a' traditional or Roth IRA." *Clark*, 134 S. Ct. at 2248 (internal citations and quotations omitted). *Id.* at 2248. The *Chilton* court had found it persuasive that the statute does not explicitly limit "retirement funds" to those that belong to the debtor. *See, e.g., Nessa*, 426 B.R. at 314. Accordingly, "retirement funds" "can include the funds that others had originally set aside for their retirement," as is the case with inherited IRAs. *In re Chilton*, 674 F.3d at 489.

20 *Clark*, 134 S. Ct at 2248.

21 *Id.*

22 *See In re Chilton*, 674 F.3d at 488 ("We must decide whether inherited IRAs satisfy the two requirements of section 522(d)(12).").

23 *Clark*, 134S. Ct. at 2248 (quoting *Corley v. United States*, 556 U.S. 303, 304, 129 S. Ct. 1558, 173 L. Ed. 2d 443 (2009)).