



## U.S. Supreme Court Rules Inherited IRAs are not Protected in Bankruptcy— Is it Time to Review Your Retirement Plan Beneficiary Designations?

The U.S. Supreme Court ruled in June that an inherited IRA is not protected from creditors' claims in bankruptcy. The unanimous decision in *Clark v. Rameker* held that Individual Retirement Account assets inherited by a non-spouse are not "retirement funds" so are not protected under federal bankruptcy laws.

### IRA Owner Died Naming Individual as Beneficiary

In this case, Ruth Heffron established a traditional IRA in 2000 and named her daughter Heidi as the account's sole beneficiary. When Ruth died in 2001, Heidi inherited her IRA, which was worth just over \$450,000; Heidi elected to take monthly distributions. In 2010, when the account was valued at approximately \$300,000, Heidi and her husband filed for Chapter 7 bankruptcy, and identified the inherited IRA as a "retirement account" exempt from creditors' claims. The bankruptcy trustee claimed that this exemption did not apply and that the inherited IRA should be available to satisfy creditor claims along with their other assets. The Supreme Court took the case to resolve a conflict between two federal appeals courts that come to opposite conclusions on this issue. The Supreme Court has now ruled that federal bankruptcy law does not protect an IRA inherited by a non-spouse beneficiary.

### Why Inherited IRAs Are Not Protected from Creditor Claims in a Federal Bankruptcy

Surprisingly, federal bankruptcy code does not define "retirement funds," leaving courts to determine the plain meaning of the term. The Court reasoned that inherited IRA accounts do not function like ordinary IRA or Roth IRA accounts because the beneficiary of an inherited IRA:

1. can never add funds to the account;
2. must withdraw money from the account regardless of how close he or she is to retirement; and
3. can withdraw the entire account balance at any time without penalty (assuming, of course, that an individual and not a trust was named as a beneficiary).

The bankruptcy code shields some assets from creditors to protect debtor's essential needs and to provide a "fresh start." The Court ruled that protecting inherited IRAs from creditor claims would instead allow a "free pass" in light of a debtor's ability to withdraw and use inherited IRA funds after bankruptcy on nonessentials such as a vacation home or sports car. The Court was not willing to shield inherited IRAs from creditors.

### Impact on Estate Planning – and Are Spousal Inherited IRAs and Rollover IRAs Also at Risk?

Workers who fund IRAs may never consider whether the beneficiaries they name will ever face bankruptcy. But some named beneficiaries will in fact face claims by creditors (and predators), whether through litigation, insufficient insurance coverage, or other adverse circumstances. When a spouse is the named beneficiary, the most common result is that the surviving spouse elects rollover treatment, and the inherited IRA is transformed into one treated as if that surviving spouse had funded it himself or herself. Only a surviving spouse can enjoy this special rollover option – it is not available to non-spouse beneficiaries.

For tax purposes, the surviving spouse can use his or her own life expectancy to calculate annual required minimum distributions (which begin at age 70-1/2) to try to stretch out minimum distributions over a longer period. Because investments held in the IRA can grow free of income taxes, including capital gains, the strategy is that more assets accumulate income-tax free for a longer period, thereby helping achieve a greater investment return over time versus taxable investment accounts where returns get a tax "haircut." Under some circumstances, a surviving spouse will not elect rollover treatment and simply treat the account as an inherited IRA like other non-spouse beneficiaries.

The Supreme Court's *Clark* decision creates questions about the creditor protection status of spousal inherited IRAs...and even whether spousal rollover IRAs are protected from creditors' claims. The beneficiary in *Clark* was the owner's daughter, but the case does not address what

the result would be if a surviving spouse is a beneficiary. It would seem that the interpretation of current law that rollover IRAs (once rolled over) offer heightened asset protection for surviving spouses. But if the surviving spouse is subject to creditor claims at the time of the rollover election, a creditor could assert that the act of making a rollover election is a voidable fraudulent conveyance because it would intentionally defeat a preexisting creditor claim.

We expect that the Supreme Court will ultimately have to rule on these unresolved issues.

### What About State Laws Protecting Inherited IRAs from Creditor Claims?

Some state laws expressly protect inherited IRAs from creditors and garnishments. The *Clark* case deals with whether an exemption is available under federal bankruptcy law, but there are several states, such as Alaska, Arizona, Idaho, Missouri, North Carolina, Ohio and Texas, where the beneficiary of an inherited IRA who is a resident of that state could claim that the inherited IRA is protected. In the case of bankruptcy, the debtor-beneficiary would have to qualify to file for bankruptcy in one of those states by:

- a. having been domiciled there for at least two years before the filing of the bankruptcy petition, and
- b. electing out of federal bankruptcy exemptions and into state law exemptions.

Whether the state law “backup plan” will work to protect an inherited IRA is subject to many variables, and betting whether such state laws will protect an inherited IRA from the claims of a debtor-beneficiary’s creditors could lead to unhappy and even disastrous results.

### Trusts Can Help Provide Asset Protection for Inherited IRAs

It may be years before there is clarity regarding these questions. Meanwhile, many clients find that these unanswered questions are simply one more reason to name a trust as the IRA beneficiary and retirement plan benefits as an effective estate planning solution. Distributing IRA and retirement plan assets to a trust may help minimize the access of creditors and pred-

tors to inherited retirement plan assets. And, depending upon the needs of a particular beneficiary and the wishes of the client, the trust can help extend the life of the inherited retirement account by having the trustee make distribution decisions. Without a trust, adult beneficiaries who are named individually as the beneficiary of an IRA or retirement plan account typically can completely withdraw the inherited IRA or retirement plan account assets.

### To Spouse First, Then to a Trust

A trust can also be structured by an original IRA or retirement account owner so that a surviving spouse can benefit from the IRA or retirement plan and then, upon the death of the surviving spouse, the original account owner’s wishes regarding remainder beneficiaries will control rather than those of a surviving spouse. If a surviving spouse is named individually as the IRA beneficiary or retirement plan account, the surviving spouse can name future beneficiaries. But if a trust is named as the beneficiary, the beneficiaries named by principal (the account owner who established the trust) will control.

It is not a new idea to name a trust as the beneficiary of an IRA or retirement plan account. But the trust must be prepared by a qualified estate planning attorney experienced in drafting trusts designed to hold inherited IRA and retirement plan assets. Your Hilliard Lyons Financial Consultant would be happy to talk with you about your IRA and retirement plan assets and how to pass them on to beneficiaries effectively.

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Should you have questions about the information contained in this Investment Update or regarding your investments, please contact your Hilliard Lyons Trust Company Portfolio Manager.

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