

## U.S. SUPREME COURT DENIES BANKRUPTCY PROTECTION FOR INHERITED IRAS

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The U.S. Supreme Court's recent decision in *Clark v. Rameker* has given individuals with IRAs a new reason to consider the use of trusts as their designated beneficiaries. On June 12, 2014, the Court's unanimous decision made clear that inherited IRAs do not receive bankruptcy protection under federal law.

### FEDERAL EXEMPTION

When a person files for bankruptcy, the Bankruptcy Code allows the debtor to exempt certain property from being turned over to creditors so that the debtor has some remaining assets to start over with post-bankruptcy. Most retirement assets are eligible for such an exemption. For example, a person who establishes a traditional IRA and then later files for bankruptcy can usually keep the IRA (up to a certain amount).

Until recently, the Court had not addressed whether an exemption is also available for IRAs inherited by a beneficiary that later files for bankruptcy. In its *Clark v. Rameker* ruling, the Court eliminated this ambiguity, finding that federal bankruptcy law does not allow an exemption for an inherited IRA.

The situation that gave rise to the dispute in *Clark v. Rameker* involved a woman who established a traditional IRA in 2000. Upon her death in 2001, her daughter inherited the IRA. When the daughter filed for Chapter 7 bankruptcy in 2010, she attempted to exempt the IRA. The Court's decision to deny the exemption was based on three important differences between the rules surrounding inherited IRAs compared to the rules surrounding traditional IRAs that are still held by the plan participant. These differences persuaded the Court that inherited IRAs should not receive the same bankruptcy protection afforded assets set aside for retirement by the person funding the IRA.

First, unlike a retirement fund into which a person contributes to save for the future, the holder of an inherited IRA may not make any contributions to the account. Second, the holder of an inherited IRA is required to immediately withdraw a portion of the account (either the entire balance over five years or minimum annual distributions based on the beneficiary's or original plan participant's life expectancy), regardless of the holder's age. Third, the holder of an inherited IRA may withdraw the balance of the account at any time and for any purpose, without any penalty—quite different from the rules surrounding a traditional IRA, which penalize withdrawals made before the plan participant reaches the age of 59½. Since inherited IRAs are not subject to the same restrictions as traditional IRAs still held by the plan participant, the Court found that inherited IRAs do not have the characteristics of a “retirement fund” and therefore should not receive bankruptcy protection.

### STATE EXEMPTION

Because bankruptcy debtors may opt to apply state law instead of the federal exemption addressed in *Clark v. Rameker*, many debtors will look to state law for protection. For example, Ohio and several other states still offer favorable bankruptcy protection for inherited IRAs. Ohio specifically exempts inherited IRAs from bankruptcy for debtors who reside in Ohio, regardless of the value of the inherited IRA account.

Still, reliance on state exemptions for planning purposes is not always reliable, as the laws of the state where the debtor lives will control. Therefore, if the debtor lives in a state with weaker or no protection, that state's laws will apply. For example, if the plan participant lived in Ohio but the beneficiary resides in a state other than Ohio that does not protect inherited IRAs, the account will not be protected in bankruptcy.

### **TRUST ALTERNATIVE**

Instead of relying on Ohio's exemption, individuals may take planning actions to provide reliable protection for inherited IRAs in the event of the beneficiary's bankruptcy. Generally, if the designated IRA beneficiary is a properly drafted trust held for the benefit of an individual, the trust can provide protection of the inherited IRA in the event the individual files for bankruptcy, regardless of the individual's state of residence.

### **ADDITIONAL INFORMATION**

Our estate planning attorneys will be pleased to meet with you to discuss whether a trust is an appropriate beneficiary for your retirement assets. Please contact your attorney at Tucker Ellis or any of the following attorneys.

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