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Inherited IRAs and Creditor Protection: The Supreme Court Speaks

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June 2014

On June 12, 2014, the U.S. Supreme Court unanimously ruled that *inherited IRAs* are not exempt from creditor claims in bankruptcy.

In *Clark v. Rameker*, the Supreme Court analyzed whether inherited IRAs should be treated as "retirement funds" for purposes of federal bankruptcy exemptions. The Supreme Court took this case because there was disagreement among federal appellate courts on the issue.

Federal law encourages saving for retirement by protecting "retirement funds" from creditors in bankruptcy. Generally speaking, a person can file bankruptcy and have his or her debts discharged, while leaving an IRA or other similar retirement assets owned by the debtor intact for the debtor's retirement. The Court had to decide whether this exemption for retirement funds should also extend to IRAs inherited from another person, which did not represent the debtor's own savings.

The Court noted three important distinctions between an inherited IRA account and other more traditional retirement assets: (1) Holders of an inherited IRA account *cannot* add additional assets; (2) Holders of an inherited IRA account are *required to withdraw* monies from the account regardless of whether they have reached retirement age; and (3) Holders of an inherited IRA account may withdraw assets from the account *at any time*, without an income tax penalty.

Based on these three distinctions, the Court ruled that persons who file bankruptcy may not use the federal exemption provisions to protect inherited IRAs from their creditors.

However, as usual, the devil is in the details! This ruling *does* mean that, going forward, inherited IRAs have fewer creditor protection characteristics. The decision does *not* mean that creditor protection is unavailable for inherited IRAs. Inherited IRAs can still likely be protected from creditors by at least two different means: (1) State law creditor exemptions; and (2) Leaving IRAs in trust for the intended beneficiary, rather than to the beneficiary himself/herself.

As to the first option (state law creditor exemptions), it appears that states opting out of the federal bankruptcy exemptions in favor of their own state-created exemptions may still create exemptions for inherited IRAs. The *Clark* decision only addressed the federal exemptions in non-opt out states. Currently, a limited number of states have such exemptions in place to cover inherited IRAs, including Florida, Alaska, Missouri, North Carolina, Texas, and our own state of Ohio (effective in early 2013).

Most states – at least for now – do not protect inherited IRAs. Additional state legislatures may pass similar laws after reading and understanding the *Clark* decision. However, it may be unwise to rely on a state exemption because the beneficiary inheriting the IRA may not live in the same state when the exemption is desired; state laws may change on this point; and/or additional court cases following the *Clark* decision may further erode creditor protection for inherited IRAs.

As to the second option (leaving assets in trust), the owner of the traditional IRA could opt to leave the IRA to a trust for the benefit of the intended beneficiary. If (this is a big if) the trust is drafted properly and contains appropriate creditor protection language (generally referred to as spendthrift language), the trust can help shield trust assets, including the IRA, from most creditors of the intended beneficiary. There are a variety of potential downsides to consider when naming a trust as beneficiary of an IRA, such as increased complexity, cost of creating and administering the trust, and potential increased income tax burdens, so this decision should not be made lightly.

It is best to consult with an attorney experienced in asset protection issues, estate planning, and income tax considerations specific to retirement assets when considering leaving retirement assets in trust, especially if your IRA is large and/or your intended beneficiary has known creditor concerns.

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