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## NOTE

# Are They or Aren't They "Retirement Funds"? The Case for Including Funds from an Inherited IRA in a Debtor's Bankruptcy Estate

*Clark v. Rameker*, 134 S. Ct. 2242 (2014).

JENNIFER SALISBURY\*

### I. INTRODUCTION

Individual Retirement Accounts ("IRAs")<sup>1</sup> are booming. As of mid-2013, an estimated 46 million – more than three out of every ten – U.S. households owned at least one type of IRA.<sup>2</sup> As of the end of 2013, IRA assets totaled \$6.5 trillion, accounting for 28% of U.S. retirement assets.<sup>3</sup> While IRA investments are increasing in popularity, there were still over 1 million bankruptcy filings in the United States in 2013.<sup>4</sup> Of those, 728,833 (68%) were non-business debtors filing for Chapter 7 bankruptcy.<sup>5</sup>

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\* B.S.B.A., University of Missouri, 2007; M.B.A., University of Missouri, 2009; J.D. Candidate, University of Missouri School of Law, 2016; Associate Member, *Missouri Law Review*, 2014–2015. I would like to extend my sincere gratitude to Professor Michelle Arnopol Cecil for providing guidance, insight, and encouragement throughout the writing process of this Note.

1. 26 U.S.C.A. § 408 (West 2014).

2. *IRA Investors*, INV. CO. INST. (2014), [http://www.icifactbook.org/fb\\_ch7.html#ira](http://www.icifactbook.org/fb_ch7.html#ira) (last visited May 26, 2015).

3. *Individual Retirement Accounts*, INV. CO. INST. (2014), [http://www.icifactbook.org/fb\\_ch7.html#individual](http://www.icifactbook.org/fb_ch7.html#individual) (last visited May 26, 2015).

4. There were 1,071,932 total bankruptcy filings in 2013. *U.S. Bankruptcy Courts – Business and Nonbusiness Cases Commenced, by Chapter of the Bankruptcy Code, During the 12-Month Period Ending December 31, 2013*, U.S. COURTS, available at [http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2013/1213\\_f2.pdf](http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2013/1213_f2.pdf) (last visited May 26, 2014). This number is lower than in each of the previous five years. See *Annual Business and Non-Business Filings by Year (1980–2012)*, AM. BANKR. INST. (2014), <http://news.abi.org/sites/default/files/statistics/Total-Business-Consumer1980-2013.pdf>.

5. *U.S. Bankruptcy Courts – Business and Nonbusiness Cases Commenced, by Chapter of the Bankruptcy Code, During the 12-Month Period Ending December 31, 2013*, U.S. COURTS, available at [http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2013/1213\\_f2.pdf](http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2013/1213_f2.pdf) (last visited May 26, 2014). Chapter 7 bankruptcy provides for liquidation of an individual debtor's assets; comparatively, other types of bankruptcy

When a debtor files for Chapter 7 bankruptcy<sup>6</sup> in the United States, a bankruptcy estate is created by operation of law.<sup>7</sup> Once the estate is created, the Bankruptcy Code establishes what property and funds of the debtor are includable in the estate and what property may be excluded.<sup>8</sup> However, determining which property and funds can be included in the estate does not end the inquiry. Some property and funds that are included may still be exempted from the estate<sup>9</sup> for the debtor's fresh start.<sup>10</sup>

A bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case."<sup>11</sup> However, there are some retirement funds that may be excluded from the bankruptcy estate, including: qualified education IRAs,<sup>12</sup> qualified employee benefit plans,<sup>13</sup> qual-

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include: Chapter 9 Municipality Bankruptcy, Chapter 11 Reorganization under the Bankruptcy Code, Chapter 12 Family Farmer or Family Fisherman Bankruptcy, Chapter 13 Individual Debt Adjustment, and Chapter 15 Ancillary and Other Cross-Border Cases. *Liquidation Under the Bankruptcy Code*. U.S. COURTS, <http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter7.aspx> (last visited May 26, 2014).

6. Chapter 7 bankruptcy provides for "liquidation of a debtor's assets. *Liquidation Under the Bankruptcy Code*, *supra* note 5.

7. 11 U.S.C.A. § 541(a) (West 2014).

8. *Id.* § 541.

9. 11 U.S.C. § 522 (2012).

10. See Schwab v. Reilly, 130 S. Ct. 2652, 2667 (2010) ("[E]xemptions in bankruptcy cases are part and parcel of the fundamental bankruptcy concept of a 'fresh start.'").

11. § 541(a)(1).

12. The funds must be placed in the IRA:

not later than 365 days before the date of the filing of the petition in a case under this title, but –

(A) only if the designated beneficiary of such account was a child, stepchild, grandchild, or stepgrandchild of the debtor for the taxable year for which funds were placed in such account;

(B) only to the extent that such funds –

(i) are not pledged or promised to any entity in connection with any extension of credit; and

(ii) are not excess contributions (as described in section 4973(e) of the Internal Revenue Code of 1986); and

(C) in the case of funds placed in all such accounts having the same designated beneficiary not earlier than 720 days nor later than 365 days before such date, only so much of such funds as does not exceed \$6,225.

*Id.* § 541(b)(5).

13. The funds must be withheld by an employer from the wages of employees for payment as contributions or received by an employer from employees for payment as contributions to a plan which is subject to Title I of the Employee Retirement Income Security Act of 1974 or under an employee benefit plan which is a governmental plan under Section 414(d) of the Internal Revenue Code of 1986. *Id.* § 541(b)(7)(A)(i)(I).

ified deferred compensation plans,<sup>14</sup> and qualified tax-deferred annuities.<sup>15</sup> Further, of those retirement funds that are included in a debtor's bankruptcy estate, there are seven types of retirement funds that may then be exempted out of the estate to contribute to the debtor's fresh start.<sup>16</sup> Those funds include: (1) qualified pension, profit sharing, or stock bonus plans;<sup>17</sup> (2) qualified annuity plans;<sup>18</sup> (3) IRAs;<sup>19</sup> (4) Roth IRAs;<sup>20</sup> (5) retirement plans for defined controlled groups of employees;<sup>21</sup> (6) deferred compensation plans of state and local governments and tax-exempt organizations;<sup>22</sup> and (7) retirement plans established and maintained by defined tax-exempt or government organizations.<sup>23</sup>

In 2014, the Supreme Court of the United States decided the case of *Clark v. Rameker*, where it faced the undecided issue of whether an IRA inherited by a debtor prior to filing for bankruptcy may be exempted from the debtor's bankruptcy estate as part of her fresh start.<sup>24</sup> In reaching its decision in *Clark*, the Court addressed Bankruptcy Code Section 522(b)(3)(C),<sup>25</sup> which exempts from a bankruptcy estate a debtor's retirement funds, including those in a traditional or Roth IRA.<sup>26</sup> At issue in *Clark* was the potential exemption of an inherited IRA from a bankruptcy estate.<sup>27</sup>

This Note first discusses the subsequent history of *Clark*. Next, it discusses the legal history of both non-inherited and inherited IRAs leading up to the *Clark* decision. Then, it details the Court's decision in *Clark*. Finally, it concludes with a comparison of state and federal exemption schemes, using

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14. The funds must be withheld by an employer from the wages of employees for payment as contributions or received by an employer from employees for payment as contributions to a plan which is covered under Section 457 of the Internal Revenue Code of 1986. *Id.* § 541(b)(7)(A)(i)(II).

15. The funds must be withheld by an employer from the wages of employees for payment as contributions or received by an employer from employees for payment as contributions to a plan which is covered under section 403(b) of the Internal Revenue Code of 1986, "except that such amount under this subparagraph shall not constitute disposable income as defined in section 1325(b)(2)." *Id.* § 541(b)(7)(A)(i)(III).

16. 11 U.S.C. § 522(b)(3)(C) (2012).

17. 26 U.S.C.A. § 401 (West 2014).

18. 26 U.S.C. § 403 (2012).

19. 26 U.S.C.A. § 408.

20. 26 U.S.C. § 408A.

21. 26 U.S.C.A. § 414.

22. *Id.* § 457.

23. *Id.* § 501.

24. *Clark v. Rameker*, 134 S. Ct. 2242, 2244 (2014).

25. *Id.*

26. 11 U.S.C. § 522(b)(3)(C) (2012) (exempting from a debtor's 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"). Traditional IRAs are covered under 26 U.S.C. § 408. Roth IRAs are covered under 26 U.S.C. § 408A.

27. *Clark*, 134 S. Ct. at 2244.

Missouri as an example, calling for reform of Bankruptcy Code Section 522(b)(3).

## II. FACTS AND HOLDING

In 2001, Heidi Heffron-Clark inherited a traditional IRA from her mother, Ruth Heffron, upon her death.<sup>28</sup> Heffron had established the traditional IRA one year prior, in 2000, naming Heffron-Clark as the sole beneficiary.<sup>29</sup> At the time of inheritance, the IRA was worth just over \$450,000.<sup>30</sup> Upon inheritance, Heffron's traditional IRA became an inherited IRA in Heffron-Clark's name, and Heffron-Clark chose to take monthly distributions from the account.<sup>31</sup>

In October of 2010, Heffron-Clark and her husband ("Petitioners") filed a Chapter 7 bankruptcy petition, identifying the inherited IRA as exempt from the bankruptcy estate under U.S.C. § 522(b)(3)(C).<sup>32</sup> At the time of the bankruptcy filing, the IRA's value had decreased to approximately \$300,000.<sup>33</sup> The Chapter 7 bankruptcy trustee for the estate, Rameker, and unsecured creditors of the estate claimed that the funds from the inherited IRA were not exempt from bankruptcy because they "were not 'retirement funds' within the meaning of the statute."<sup>34</sup> In December of 2010, Rameker filed an objection to exemption in the U.S. Bankruptcy Court for the Western District of Wisconsin, claiming that the funds from the inherited IRA were non-exempt property of the bankruptcy estate.<sup>35</sup>

A hearing in bankruptcy court was held in February of 2011, and the parties agreed to submit the matter on briefs.<sup>36</sup> Petitioners claimed that the funds from the inherited IRA were exempt under both Wisconsin Statute Section 815.18(3)(j)<sup>37</sup> and Bankruptcy Code Section 522(b)(3)(C).<sup>38</sup> Rameker

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28. *Id.* at 2245.

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. Objection to Exemption, Motion for Turnover, and Motion for Stay, *In re Clark*, 466 B.R. 135 (2012) (No. 10-18035-7), 2010 WL 9600072.

36. *In re Clark*, 450 B.R. 858, 860 (Bankr. W.D. Wis. 2011).

37. WIS. STAT. ANN. § 815.18(3)(j) (West 2012) (exempts from a debtor's bankruptcy estate "[a]ssets held or amounts payable under any retirement, pension, disability, death benefit, stock bonus, profit sharing plan, annuity, individual retirement account, individual retirement annuity, Keogh, 401-K or similar plan or contract providing benefits by reason of age, illness, disability, death or length of service and payments made to the debtor therefrom"). 11 U.S.C. § 522(b)(3)(C) (2012) (exempts from a debtor's 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,

argued that the funds did not qualify as "retirement funds" because Heffron-Clark could not make any contributions to the inherited IRA, the funds were not required to be held until retirement without a tax penalty, and Heffron-Clark could take distributions as she pleased with no tax implications.<sup>39</sup> Petitioners countered by arguing that because the inherited IRA was once referred to as a "retirement account," the funds remaining were still "retirement funds."<sup>40</sup> They also argued that the plain meaning of Section 522(b)(3)(C) did not specify that "retirement funds" include only funds set aside for a *designated person's* retirement; instead, the statute requires only that the funds be set aside for *some person's* retirement.<sup>41</sup>

Because the Bankruptcy Code does not define the term "retirement funds," the bankruptcy court had to determine whether the funds from the inherited IRA did in fact constitute "retirement funds."<sup>42</sup> The court deferred to the "common or ordinary meaning" of "retirement fund," and stated that *Webster's Ninth New Collegiate Dictionary* defined "retirement" as the "withdrawal from one's position or occupation or from active working life."<sup>43</sup> Thus, the court stated that in order for funds to qualify as "retirement funds" under the statute, the funds "must be held in anticipation of 'withdrawal from one's position or occupation.'"<sup>44</sup>

Deciding against a leading case from the U.S. Court of Appeals for the Eighth Circuit, *In re Nessa*,<sup>45</sup> the bankruptcy court reasoned that the inherited IRA did not contain any person's "retirement funds" because the funds were no longer being held in anticipation of any person's retirement.<sup>46</sup> Further, the court reasoned that Congress did not intend for inherited IRAs to be characterized as "retirement funds."<sup>47</sup> The court used examples to illustrate its reasoning: the owner of an inherited IRA cannot contribute any additional funds to the account, cannot roll the funds into her own IRA, and "must begin taking monthly distributions immediately, regardless of age or employment status, from the account in accordance with the IRS distribution guidelines."<sup>48</sup> In direct contrast, a holder of an IRA "can make tax deferred contributions to their account for purposes of saving for their retirement," and he or she "cannot withdraw, without penalty, funds from their account prior to a designated

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414, 457, or 501(a) of the Internal Revenue Code of 1986"). This Note discusses only the federal statute.

38. *Clark*, 450 B.R. at 860.

39. *Id.* at 862.

40. *Id.* at 862–63.

41. *Id.* at 863.

42. *Id.*

43. *Id.*

44. *Id.*

45. *In re Nessa*, 426 B.R. 312 (B.A.P. 8th Cir. 2010). For a short discussion of *Nessa*, see *infra* Part III.C.

46. *Clark*, 450 B.R. at 863.

47. *Id.* at 864.

48. *Id.*

retirement age.”<sup>49</sup> The bankruptcy court ultimately held that funds in an inherited IRA did not qualify as retirement funds, and thus were not exempt from a bankruptcy estate.<sup>50</sup>

In 2012, Petitioners filed an appeal with the U.S. District Court for the Western District of Wisconsin.<sup>51</sup> The district court quickly pointed out that the bankruptcy court’s ruling was very much a minority opinion, as it was consistent with just one other case.<sup>52</sup> All other cases, including the leading Eighth Circuit case, *Nessa*, ruled that funds in an inherited IRA were “retirement funds.”<sup>53</sup> The reasoning behind those cases was that “retirement funds” need only to have been “accumulated for retirement purposes originally.”<sup>54</sup> In deciding the case at hand, the district court agreed with the majority view of the Eighth Circuit, holding that the retirement fund exception does not distinguish between a retirement fund *earned* by Heffron-Clark herself and a retirement fund *inherited* by Heffron-Clark, and thus the funds in the inherited IRA are “retirement funds.”<sup>55</sup> The district court reversed and remanded the bankruptcy court’s decision.<sup>56</sup>

In 2013, the U.S. Court of Appeals for the Seventh Circuit heard the case on appeal.<sup>57</sup> The Seventh Circuit agreed with the bankruptcy court and followed the same reasoning, finding that because inherited IRAs do not have the same qualifications and characteristics as IRAs, they do not qualify as “retirement funds.”<sup>58</sup> Thus, the Seventh Circuit reversed the district court’s decision, agreeing with the outcome of the bankruptcy court.<sup>59</sup>

In 2014, upon a grant of certiorari,<sup>60</sup> the Supreme Court of the United States heard the instant case.<sup>61</sup> The unanimous Court affirmed the Seventh Circuit’s decision, holding that the funds in the inherited IRA were not “retirement funds” within the meaning of the statute.<sup>62</sup>

### III. LEGAL BACKGROUND

The path to *Clark v. Rameker* has taken twenty-two years, and the one constant along the way has been the discussion of retirement funds held in IRAs. In 1992, in *Patterson v. Shumate*, the Supreme Court of the United

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49. *Id.*

50. *Id.* at 866.

51. *In re Clark*, 46 B.R. 135 (W.D. Wis. 2012).

52. *Id.* at 136.

53. *Id.* at 139.

54. *Id.*

55. *Id.* at 141.

56. *Id.* at 142.

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

58. *Id.* at 562.

59. *Id.*

60. *Clark v. Rameker*, 134 S. Ct. 678 (2013).

61. *Clark v. Rameker*, 134 S. Ct. 2242 (2014).

62. *Id.* at 2249–50.

States held that Employee Retirement Income Security Act ("ERISA") funds are excluded from a debtor's bankruptcy estate under Bankruptcy Code Section 541(c)(2).<sup>63</sup> Then, in 2005, in *Rousey v. Jacoway*, the Court held that IRAs are exempt from a debtor's bankruptcy estate under Section 522(d)(10)(E).<sup>64</sup> Later in 2005, Congress passed legislation that specifically exempted IRAs from a bankruptcy estate.<sup>65</sup> However, none of these decisions addressed inherited IRAs. Consequently, the determination of whether inherited IRAs may be exempted from a bankruptcy estate has been left to the states and lower courts.

### A. What Is an IRA?

IRA is an initialism for "individual retirement account."<sup>66</sup> Investing in an IRA is one way to save for retirement, and there are tax benefits afforded to the owner in that her gain is either tax-free or tax-deferred. Three types of IRAs are relevant to this Note: traditional, Roth, and inherited.

A traditional IRA allows the owner to defer paying tax on the gain that has accrued on her investment until the funds are withdrawn in retirement. The owner invests with funds that are fully or partially deductible on that year's tax return;<sup>67</sup> thus, taxes are paid on the entire amount when it is withdrawn in retirement.<sup>68</sup> Withdrawals from traditional IRAs prior to the owner reaching age 59 ½<sup>69</sup> are subject to a 10% tax penalty, in addition to normally applicable taxes.<sup>70</sup> However, waiting to withdraw from a traditional IRA until the owner is between the ages of 59 ½ and 70 ½ eliminates the 10% tax

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63. *Patterson v. Shumate*, 504 U.S. 753, 765 (1992). For a short discussion of *Patterson*, see *infra* Part III.B.1.

64. *Rousey v. Jacoway*, 544 U.S. 320, 326 (2005). For a discussion of *Rousey*, see *infra* Part III.B.2.

65. The exemption for IRAs is capped at \$1,245,475. 11 U.S.C. § 522(n) (2012); see *infra* Part III.B.3.

66. See 26 U.S.C.A. § 408 (West 2014) (titled "Individual retirement accounts"); *id.* § 408A (with an abbreviated title of "Roth IRAs").

67. *Id.* § 219(a).

68. *Id.* § 408(d)(1) ("Except as otherwise provided in this subsection, any amount paid or distributed out of an individual retirement plan shall be included in gross income by the payee or distributee, as the case may be, in the manner provided under section 72.").

69. 26 U.S.C.A. § 72(q)(2)(A) (West 2015). There are additional exceptions to the 10% penalty in subparagraph (2). *Id.* § 72(t)(1)(2).

70. Unless a taxpayer can point to an exemption, any amount received from a retirement plan covered under § 4974(c) is subject to a 10% penalty. *Id.* § 72(t)(1)(2). IRAs are described in § 408(a) and thus are covered under § 4974(c). 26 U.S.C. § 4974(c)(4) (2012).



penalty.<sup>71</sup> Finally, once an owner reaches 70 ½ years of age, she must start taking minimum required distributions from a traditional IRA.<sup>72</sup>

A Roth IRA is funded with money that has already been taxed.<sup>73</sup> However, it does provide a tax benefit in that the earnings that accrue on this after-tax investment may never be taxed to the owner, even upon withdrawal, unlike a traditional IRA.<sup>74</sup> In order for a Roth IRA withdrawal to be tax-free and penalty-free, however, a five-year aging requirement must be satisfied.<sup>75</sup> In addition, one of the following three requirements must be met: (1) the owner is past the age of 59 ½; (2) the owner is dead or disabled; or (3) the owner makes a qualified first-time home purchase.<sup>76</sup> Otherwise, a non-qualified withdrawal from a Roth IRA is subject to income taxation and a 10% tax penalty.<sup>77</sup> Unlike traditional IRAs, Roth IRAs do not have a minimum distribution requirement.<sup>78</sup>

Finally, an inherited IRA is a traditional or Roth IRA left to a beneficiary after its owner's death.<sup>79</sup> If an IRA is inherited by a spouse, the surviving spouse has three options: (1) treating the IRA as her own by designating herself as the account owner; (2) treating the IRA as her own by rolling the funds over into her own IRA;<sup>80</sup> or (3) treating herself as a beneficiary, leaving the funds in an inherited IRA.<sup>81</sup> However, if an IRA is inherited by a non-spouse, the non-spouse does not have either of the first two options above of treating the IRA as her own.<sup>82</sup> This leaves the non-spouse just one option: to leave the funds in an inherited IRA.<sup>83</sup>

71. I.R.S. PUB. 590, 56 (2013).

72. *Id.* at 43.

73. *Id.* at 39.

74. 26 U.S.C. § 408A(d)(1) (“Any qualified distribution from a Roth IRA shall not be includible in gross income.”).

75. In order to be a qualified distribution, a withdrawal must be made at least five taxable years after an individual's or an individual's spouse's initial contribution to the Roth IRA. *Id.* § 408A(d)(2)(B).

76. *Id.* § 408A(d)(2)(A).

77. Unless a taxpayer can point to an exemption, any amount received from a retirement plan covered under § 4974(c) is subject to a 10% penalty. *Id.* § 72(t)(1)(2). IRAs are described in § 408(a) and thus are covered under § 4974(c). *Id.* § 4974(c)(4).

78. *Id.* § 408A(c)(5).

79. I.R.S. PUB. 590, 18 (2013).

80. *Id.* at 22. An inheriting spouse also has the option to roll an inherited IRA, to the extent it is taxable, into: (a) Qualified employer plan; (b) Qualified employee annuity plan (section 403(a) plan); (c) Tax-sheltered annuity plan (Section 403(b) plan); or (d) Deferred compensation plan of a state or local government (Section 457 plan). *Id.* at 3.

81. *Id.* at 23.

82. *Id.*

83. *Id.*

The contribution and withdrawal rules are vastly different for inherited IRAs compared to traditional and Roth IRAs.<sup>84</sup> The beneficiary of an inherited IRA is restricted from contributing funds to the IRA.<sup>85</sup> Further, the beneficiary may withdraw funds from an inherited IRA at any time, and those withdrawals are not subject to a tax penalty.<sup>86</sup> Not only is the beneficiary *allowed* to withdraw funds, she is *required* to take withdrawals.<sup>87</sup> The beneficiary must choose one of two withdrawal options: (1) to withdraw the full balance in the inherited IRA within five years of the original owner's death; or (2) to take minimum required distributions on an annual basis.<sup>88</sup>

### B. Legal History of Bankruptcy and Non-Inherited IRAs

In 1992, the Supreme Court of the United States first decided the issue of inclusion or exclusion of retirement funds from a debtor's bankruptcy estate in *Patterson v. Shumate*, holding that ERISA-qualified funds may be excluded from a debtor's bankruptcy estate.<sup>89</sup> However, the *Patterson* decision did not encompass retirement funds held in an IRA.<sup>90</sup> Then, in 2004, the Court received an opportunity to rule definitively on IRA funds in *Rousey v. Jacoway*, holding that, while IRA funds may be included in a debtor's bankruptcy estate, they may then be exempted.<sup>91</sup> Then, in 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), which provides a bankruptcy exemption for traditional and Roth IRA balances.<sup>92</sup>

#### 1. ERISA and the Bankruptcy Code: *Patterson v. Shumate*

A bankruptcy estate is created when a debtor files for relief under the Bankruptcy Code.<sup>93</sup> All property and funds in which the debtor has an interest at the time of filing are includable in the debtor's bankruptcy estate, un-

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84. *Clark v. Rameker*, 134 S. Ct. 2242, 2245 (2014).

85. 26 U.S.C.A. § 219(d)(4) (West 2014).

86. *Id.* § 72(t)(1)(2) (West 2015) (exempting from the 10% withdrawal penalty "distributions which are made to a beneficiary (or to the estate of the employee) on or after the death of the employee"). IRAs are described in Section 408(a) and thus are covered under Section 4974(c). 26 U.S.C. § 4974(c)(4) (2012).

87. I.R.S. PUB. 590, 36–38 (2013).

88. *Id.* at 9, 71.

89. *Patterson v. Shumate*, 504 U.S. 753 (1992). For a short discussion of *Patterson*, see *infra* Part III.B.1.

90. *Id.*

91. See *infra* Part III.B.2.

92. See *infra* Part III.B.3.

93. 11 U.S.C.A. § 541(a) (West 2014). For a more thorough discussion of bankruptcy estates, see *supra* Part I.

less she can point to specific exclusionary provisions,<sup>94</sup> which are interpreted narrowly by the courts.<sup>95</sup> Even if property or funds are includable, they can potentially be exempted from the estate.<sup>96</sup>

In 1974, Congress enacted ERISA to “encourage employees to save for their retirement and to ensure that employees’ anticipated pension benefits be available to them upon retirement.”<sup>97</sup> One way in which ERISA protected employees’ pension benefits was to disallow those benefits from being assigned or alienated for the benefit of creditors.<sup>98</sup> Then, in 1978, Congress enacted the Bankruptcy Reform Act,<sup>99</sup> giving broad powers to the bankruptcy estate trustee to include in the bankruptcy estate all “legal and equitable interests of the debtor in property as of the commencement of the case.”<sup>100</sup>

With two directly conflicting federal laws, a question arose: How does one comply with the broad inclusion provisions of the Bankruptcy Code, while satisfying the non-assignment and non-alienation provisions of ERISA?<sup>101</sup> Not surprisingly, there is no simple answer to that question. Whether an ERISA-qualified fund was included in a bankruptcy estate depended on which federal circuit heard the case.<sup>102</sup> In 1992, the Court granted certiorari in *Patterson v. Shumate* in order to resolve the issue.<sup>103</sup>

In *Patterson*, the Court disagreed with the petitioner’s argument that Congress intended to limit Bankruptcy Code Section 541(c)(2) to restrictions on transfer that are enforceable only under state spendthrift trust law,<sup>104</sup> holding that “an ERISA-qualified pension plan may be excluded from the proper-

94. 11 U.S.C.A. § 541. For a more thorough discussion of property that is included in a bankruptcy estate, see *supra* Part I.

95. Michelle M. Arnopol, *Including Retirement Benefits in a Debtor’s Bankruptcy Estate: A Proposal for Harmonizing ERISA and the Bankruptcy Code*, 56 MO. L. REV. 491, 493 (1991).

96. 11 U.S.C. § 522 (2012). For a more thorough discussion of property that can be exempted from a bankruptcy estate, see *supra* Part I.

97. Arnopol, *supra* note 95, at 491.

98. *Id.* at 492.

99. Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified at 11 U.S.C. §§ 101–1329 (1988)).

100. 11 U.S.C.A. § 541(a)(1) (West 2014). For policy considerations, see *infra* Part V.A.

101. Nancy E. Blackwell, *To Include, Exclude, or Exempt – That is the Question!: An Individual’s Pension Benefits in Bankruptcy and the Potential Effect of H.R. 3804*, 60 UMKC L. REV. 291, 292 (1991).

102. See, e.g., *In re Goff*, 706 F.2d 574 (5th Cir. 1983); *In re Graham*, 726 F.2d 1268 (8th Cir. 1984); *In re Daniel*, 771 F.2d 1352 (9th Cir. 1985), *cert. denied*, 475 U.S. 1016 (1986); *In re Lichstrahl*, 750 F.2d 1488 (11th Cir. 1985); *In re Moore*, 907 F.2d 1476 (4th Cir. 1990); *In re Lucas*, 924 F.2d 597 (6th Cir. 1991), *cert. denied*, 111 S. Ct. 2275 (1991).

103. *Patterson v. Shumate*, 502 U.S. 1057 (1992).

104. A spendthrift trust is one that “restrains voluntary and involuntary alienation of all or any of the beneficiaries’ interests.” RESTATEMENT (THIRD) OF TRUSTS § 58 (2003).

ty of the bankruptcy estate pursuant to Section 541(c)(2).<sup>105</sup> The Court acknowledged that its holding would not encompass IRAs, but did suggest that IRAs could be exempted under Section 522(d)(10)(E).<sup>106</sup> Thus, the definitive status of IRAs in bankruptcy remained unanswered.

## 2. IRAs Are Included in the Bankruptcy Estate, but Can Be Exempted: *Rousey v. Jacoway*

The lower courts did not consistently embrace the Court's suggestion that IRAs could be exempted from a bankruptcy estate. The U.S. Courts of Appeals for the Second, Fifth, Sixth, and Ninth Circuits followed the Court's suggestion that IRAs are exempt from the bankruptcy estate.<sup>107</sup> However, when the Eighth Circuit heard the case of *In re Rousey*, it declined to follow the Court's suggestion. Instead, it held that the Rouseys could not exempt their IRAs from their bankruptcy estate.<sup>108</sup>

In 2004, the Supreme Court of the United States agreed to settle the circuit split when it granted certiorari in *Rousey v. Jacoway*.<sup>109</sup> In 2005, the Court heard the case, revisiting its discussion in *Patterson*, and reaffirming its statements by expressly determining that IRAs are included in bankruptcy estates, but are exemptible under Section 522(d)(10)(E) of the Bankruptcy Code.<sup>110</sup> Section 522(d)(10)(E) exempts from a bankruptcy estate "a payment under a stock bonus, pension, profitsharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service."<sup>111</sup> The statute limits the exemption "to the extent reasonably necessary for the support of the debtor and any dependent of the debtor."<sup>112</sup>

105. *Patterson v. Shumate*, 504 U.S. 753, 765 (1992). At the time *Patterson* was decided, the statute stated: "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." 11 U.S.C. § 541(c)(2) (1998). The language of § 541(c)(2) remains unchanged in the current version. 11 U.S.C.A. § 541(c)(2) (West 2014). For policy considerations of ERISA, see *infra* Part V.B.

106. *Patterson*, 504 U.S. at 762–63.

107. See *In re Dubroff*, 119 F.3d 75, 80 (2d Cir. 1997); *In re Carmichael*, 100 F.3d 375, 380 (5th Cir. 1996); *In re Brucher*, 243 F.3d 242, 243–44 (6th Cir. 2001); *In re McKown*, 203 F.3d 1188, 1190 (9th Cir. 2000).

108. *In re Rousey*, 347 F.3d 689, 693 (8th Cir. 2003).

109. *Rousey v. Jacoway*, 124 S. Ct. 2817 (2004).

110. *Rousey v. Jacoway*, 544 U.S. 320, 326 (2005).

111. 11 U.S.C. § 522(d)(10)(E) (2012). The language of the statute was the same in 2004. 11 U.S.C. § 522(d)(10)(E) (2000).

112. The exemption is disallowed if:

- (i) such plan or contract was established by or under the auspices of an insider that employed the debtor at the time the debtor's rights under such plan or contract arose;
- (ii) such payment is on account of age or length of service; and

The Court in *Rousey* first stated that the statutory language in Section 522(d)(10)(E), “on account of,” is equivalent to the phrase “because of,” and thus the statute requires that “the right to receive payment be ‘because of’ illness, disability, death, age, or length of service.”<sup>113</sup> Withdrawals from IRAs are subject to a substantial 10% tax penalty if they are taken before the owner reaches 59 ½ years old.<sup>114</sup> The Court reasoned that the tax penalty effectively limits an owner’s right to the full balance of his or her IRA until he or she reaches the age of 59 ½.<sup>115</sup> Therefore, the Court concluded that the right to payment from an IRA is “on account of” age.<sup>116</sup>

With the second requirement of Section 522(d)(10)(E) satisfied, the Court moved to the first requirement.<sup>117</sup> The Rouseys argued that an IRA is a “similar plan or contract” to a stock bonus, pension, profitsharing, or annuity plan or contract because they all share the same “primary purpose” in giving Americans a tool to save for their retirement.<sup>118</sup> The Court reasoned that, to be “similar,” an IRA must be “like, though not identical to, the specific plans or contracts listed in [Section] 522(d)(10)(E), and consequently must share characteristics common to” a stock bonus, pension, profit-sharing, or annuity plan or contract.<sup>119</sup>

The Court reasoned that the common thread among a stock bonus, pension, profit-sharing, or annuity plan or contract is that “they provide income that substitutes for wages earned as salary or hourly compensation.”<sup>120</sup> That similarity logically followed the other types of payments exemptible under Section 522(d)(10), all of which relate to income that substitutes for wages.<sup>121</sup> However, the Court reasoned, the included plans are only alike in the fact that they provide income that substitutes for wages.<sup>122</sup> In all other respects, the included plans are different in more respects than they are similar.<sup>123</sup>

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(iii) such plan or contract does not qualify under section 401(a), 403(a), 403(b), or 408 of the Internal Revenue Code of 1986.

11 U.S.C. § 522 (2012).

113. *Rousey*, 544 U.S. at 326–27.

114. *Id.* at 328.

115. *Id.*

116. *Id.* at 329.

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.* at 331.

121. *Id.* The other types of plans exemptible are: “(A) a social security benefit, unemployment compensation, or a local public assistance benefit; (B) a veterans’ benefit; (C) a disability, illness, or unemployment benefit; and (D) alimony, support, or separate maintenance, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor.” 11 U.S.C. § 522(d)(10) (2012).

122. *Rousey*, 544 U.S. at 331.

123. *Id.*

The Court then examined the characteristics of income derived from the Rouseys' IRAs, finding that such income also substituted for wages.<sup>124</sup> First, the Rouseys were required to start taking minimum distributions once they each reached the age of 70 ½.<sup>125</sup> That is an age at which most IRA owners are likely to be retired and no longer earning wage income.<sup>126</sup> Second, money held in IRAs is tax-deferred until the year it is withdrawn, so it is only treated as income in the withdrawal year.<sup>127</sup> That tax treatment encourages owners to wait until retirement to withdraw funds from an IRA so that their taxes are deferred as long as possible.<sup>128</sup> Third, an unqualified withdrawal from an IRA before the owner reaches the age of 59 ½ is subject to a 10% penalty.<sup>129</sup> That penalty restricts pre-retirement access to funds held in an IRA.<sup>130</sup> Finally, an owner's failure to take the required minimum distributions from his or her IRA results in a 50% tax penalty on those funds.<sup>131</sup> For these reasons, the Court concluded that the first requirement of Section 522(d)(10)(E) was also met because, similar to the included plans, IRA income substitutes for wages.<sup>132</sup>

The Court in *Rousey* ultimately concluded that the Rouseys' IRAs satisfied both requirements of Section 522(d)(10)(E) because they "confer[red] a right to receive payment on account of age, and they are similar plans or contracts to those enumerated in [Section] 522(d)(10)(E)."<sup>133</sup> This decision settled the circuit split with the Court adopting its own suggestion that IRAs may be exempted from a debtor's bankruptcy estate under Bankruptcy Code Section 522(d)(10)(E).<sup>134</sup>

### 3. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

Quickly after *Rousey* was decided, Congress took the status of IRA funds a step further, enacting legislation under Section 522(b)(3)(C)<sup>135</sup> that

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124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.* Or, in the case of a Roth IRA, qualified withdrawals are never taxed. 26 U.S.C. § 408A(d)(1) (2012) ("Any qualified distribution from a Roth IRA shall not be includible in gross income.").

128. *Rousey*, 544 U.S. at 331–32.

129. *Id.* at 332.

130. *Id.*

131. *Id.*

132. *Id.* at 331.

133. *Id.* at 334–35.

134. *Id.* at 334.

135. Lawrence R. Ahern, III, *Homestead and Other Exemptions Under the Bankruptcy Abuse Prevention and Consumer Protection Act: Observations on "Asset Protection" After 2005*, 13 AM. BANKR. L. REV. 585, 597 (2005).

provides a bankruptcy exemption for traditional and Roth IRA balances.<sup>136</sup> The amended legislation applies to all bankruptcy filings after October 16, 2005.<sup>137</sup> Section 522(b)(3)(C) exempts “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.”<sup>138</sup> IRAs are covered under Sections 408 and 408A of the Internal Revenue Code and thus are covered under Section 522(b)(3)(C).<sup>139</sup> Section 522(n) caps the exemption at \$1,245,475.<sup>140</sup>

Section 522(b)(2) gives states the option to opt-out of the federal bankruptcy exemptions provided for under Section 522(d) of the Bankruptcy Code.<sup>141</sup> Based on this opt-out provision, the *Rousey* opinion applies only to those states that have chosen to allow debtors the option of choosing either the federal exemption scheme or the exemption scheme in their state of domicile.<sup>142</sup> However, there is no opt-out provision for states in Section 522(b)(3),<sup>143</sup> thus making IRAs exempt from the bankruptcy estate by debtors in all fifty states.

### C. Legal History of Inherited IRAs

A minority of state legislatures have chosen to address the issue of whether inherited IRAs are exempt from a bankruptcy estate. Alaska, Arizona, Florida, Missouri, North Carolina, Ohio, and Texas all protect inherited IRAs from debtors’ bankruptcy estates under state law.<sup>144</sup> For example, a portion of Missouri’s statute, effective August 28, 2013, exempts from a bankruptcy estate “[a]ny money or assets, payable to a participant or beneficiary from, or any interest of any participant or beneficiary in, a retirement

136. *Id.* at 599.

137. James L. Boring et al., *Protection of Inherited IRAs*, 36 ACTEC L.J. 577, 580 (2010).

138. 11 U.S.C. § 522(b)(3)(C) (2012).

139. 26 U.S.C.A. § 408 (West 2014); 26 U.S.C. § 408A (2012).

140. Except that the amount may be increased “if the interests of justice so require.” 11 U.S.C. § 522(n) (2012). This dollar amount is adjusted every three years by the Judicial Conference of the United States to reflect the change in the Consumer Price Index for All Urban Consumers. *See id.* § 104.

141. *Id.* § 522(b)(2) (“Property listed in this paragraph is property that is specified under subsection (d), unless the State law that is applicable to the debtor under paragraph (3)(A) specifically does not so authorize.”).

142. To date, thirty-two states have opted out of the federal exemption scheme. WILLIAM HOUSTON BROWN ET AL., BANKRUPTCY EXEMPTION MANUAL § 4:2 (2012 ed.).

143. 11 U.S.C. § 522(b)(3)(C).

144. *See* ALASKA STAT. ANN. § 09.38.017(a)(3)(A) (West 2012); ARIZ. REV. STAT. ANN. § 33-1126.B (2012); FLA. STAT. ANN. § 222.21(2)(c) (West 2012); MO. ANN. STAT. § 513.430.1(10)(f) (West 2015); N.C. GEN. STAT. ANN. § 1C-1601(a)(9) (West 2012); OHIO REV. CODE ANN. § 2329.66(A)(10)(e) (West 2012); TEX. PROP. CODE ANN. § 42.0021(a) (West 2012).

plan . . . including an inherited account or plan . . . whether such participant's or beneficiary's interest arises by inheritance . . . ."<sup>145</sup> However, the remaining forty-three states have no specific statute for inherited IRAs.

Like the states, the federal courts of appeals have not been consistent in their rulings regarding exclusion and exemption of inherited IRAs from a bankruptcy estate. The Seventh Circuit created a new split in the circuits when it ruled in *In re Clark* that inherited IRAs are not necessarily "retirement" funds just because the word "retirement" is in their title.<sup>146</sup> Instead, the court said that the word "retirement" in the title simply designates the funds' source, not their present status.<sup>147</sup> Funds are designated as "retirement funds" only when they are actually held for the owner's retirement.<sup>148</sup>

Prior to *In re Clark*, the two leading cases from other circuits had provided the opposite result.<sup>149</sup> In 2010, the Eighth Circuit ruled in *In re Nessa* that funds in a debtor's inherited IRA did not have to be the debtor's retirement funds to satisfy the bankruptcy exemption requirements under Bankruptcy Code Section 522(b)(4)(C).<sup>150</sup> That court ruled that it is enough that the funds were at some point "retirement funds."<sup>151</sup> In 2012, the Fifth Circuit followed the Eighth Circuit's reasoning in *In re Chilton*.<sup>152</sup> However, the court in *Chilton* went even further and looked to *Webster's Dictionary* for the definitions of "retirement" and "fund" in order to ascertain the plain language of the exemption statute.<sup>153</sup> What it found was that "retirement funds" must have been "set apart" for retirement, and what happens to those funds after they are set apart was irrelevant.<sup>154</sup> Thus, the Eighth and Fifth Circuits declined to limit the statute beyond its plain language in determining that inherited IRAs do qualify as "retirement funds" under the Bankruptcy Code.<sup>155</sup> As

145. MO. ANN. STAT. § 513.430.1(10)(f).

146. *In re Clark*, 714 F.3d 559, 561–62 (7th Cir. 2013).

147. *Id.* at 561.

148. *Id.*

149. *Seventh Circuit Rejects Bankruptcy Exemption for an Inherited IRA, Creating a Split Among the Circuits*, RIA PENSION & BENEFITS WEEK NEWSLETTER Vol. 19, No. 17 (Apr. 29, 2013).

150. *In re Nessa*, 426 B.R. 312, 315 (B.A.P. 8th Cir. 2010). It includes "an inherited account or plan . . . qualified under Section 401(a), 403(a), 403(b), 408, 408A, or 409 of the Internal Revenue Code of 1986." MO. ANN. STAT. § 513.430.1(10)(f) (West 2015).

151. *In re Nessa*, 426 B.R. at 314–15.

152. *In re Chilton*, 674 F.3d 486, 490 (5th Cir. 2012) (quoting 26 U.S.C. § 408(e)(1) (2012) ("The statute's expansive language, which provides that '[a]ny individual retirement account is exempt from taxation under this subsection . . .', indicates that section 408 is the exempting section for all individual retirement accounts.")).

153. *Id.* at 488–89.

154. *Id.* at 489.

155. *Supreme Court to Decide Whether Bankruptcy Protection Applies to Inherited IRAs*, FED. TAXES WEEKLY ALERT Art. 9, Vol. 59 (December 5, 2013).



a result, the Court granted certiorari in *Clark v. Rameker* to decide the issue.<sup>156</sup>

#### IV. INSTANT DECISION

In *Clark*, the petitioners, who had inherited an IRA from a parent, asserted that funds in the inherited IRA were exempt from the reach of creditors in their Chapter 7 bankruptcy proceeding because they were once retirement funds, regardless of whether the funds currently sat in an account designated for retirement.<sup>157</sup> The Court disagreed with that argument, reasoning that the term “retirement funds” has an implication that those funds were currently set aside for retirement.<sup>158</sup> The Court found that the term does not indicate that those funds were at one point set aside for retirement.<sup>159</sup> To illustrate the flaw in Petitioners’ argument, the Court used the following example: “[I]f an individual withdraws money from a traditional IRA and gives it to a friend who then deposits it into a checking account, that money should be forever deemed ‘retirement funds’ because it was originally set aside for retirement.”<sup>160</sup> Petitioners’ logic would make that example correct.<sup>161</sup> But, the Court stated, “That is plainly incorrect.”<sup>162</sup>

Further, the Court reasoned that if any funds that were at one time designated as “retirement funds” were forever held to be “retirement funds,” Bankruptcy Code Section 522(b)(3)(C) would no longer be necessary.<sup>163</sup> The statute’s exemption includes “retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under [the enumerated sections] of the Internal Revenue Code.”<sup>164</sup> The Court pointed out that any funds that are exempted from bankruptcy under the statute have at some point in time been “retirement funds.”<sup>165</sup> Thus, the Court reasoned that using the terminology “retirement funds” in the statute actually gives the statute two elements.<sup>166</sup> First, the funds must be “retirement funds,” and second, the funds must be held in a covered account.<sup>167</sup> Using Petitioners’ logic, the statute need only read, “[Any] fund or account that is exempt from taxation under [the enumerated sections].”<sup>168</sup> Thus, Petitioners’ logic would make the first element of the statute unnecessary, which would conflict with the rule

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156. *Clark v. Rameker*, 134 S. Ct. 678 (2013).

157. *Clark v. Rameker*, 134 S. Ct. 2242, 2248 (2014).

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.*

168. *Id.*

that "a statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous."<sup>169</sup>

Petitioners next argued that, because Section 522(b)(3)(C)'s language does not specifically say "debtor's interest" like other subsections of the statute do,<sup>170</sup> Congress must have meant to exclude any person's funds that originated as "retirement funds" instead of just the debtor's.<sup>171</sup> The Court was again quick to disagree with Petitioners' argument.<sup>172</sup> The Court reasoned that Congress's use of the term "debtor's interest" in other subsections was not meant to limit the exemption to a debtor's assets rather than the assets of another.<sup>173</sup> Rather, it was simply meant to "set a limit on the value of the particular asset that a debtor may exempt."<sup>174</sup> Thus, the Court argued, the lack of the term "debtor's interest" was of no issue because Congress "imposed a value limitation on the amount of exemptible retirement funds in a separate provision."<sup>175</sup>

Petitioners then argued that Congress intended for the interpretation of "retirement funds" to be inclusive rather than exclusive.<sup>176</sup> They reasoned that because Section 522(b)(3)(C) starts with a broad category, "retirement funds," and follows with limiting language, "to the extent that," the broad category is not meant to be limiting language.<sup>177</sup> The Court found two flaws in this argument.<sup>178</sup> First, the Court pointed out that while Petitioners' argument may be sound in some instances, their interpretation of the structure of the statute "is not the only way in which the phrase may be used."<sup>179</sup> The Court illustrated this with another example: "A tax break that applies to 'non-profit organizations to the extent that they are medical or scientific' would not apply to a for-profit pharmaceutical company because the initial broad category ('nonprofit organizations') provides its own limitation."<sup>180</sup> Thus, the Court argued that, under the statute, funds must be both "retirement funds" and in a qualifying account exempt from taxation under one of the enumerated Tax Code sections.<sup>181</sup> Second, the Court argued that Petitioners' logic would again render the first element of the statute unnecessary, which would again conflict with the rule that "a statute should be construed so that

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169. *Id.* (quoting *Corley v. United States*, 556 U.S. 303, 314 (2009)).

170. *See, e.g.*, 11 U.S.C. §§ 522(d)(1)–(6) (2012) (exempting from a debtor's bankruptcy estate "the debtor's interest" or "the debtor's aggregate interest" in specified property).

171. *Clark*, 134 S. Ct. at 2248–49.

172. *Id.* at 2249.

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.*

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

effect is given to all its provisions, so that no part will be inoperative or superfluous.”<sup>182</sup>

Petitioners’ final argument was that funds in inherited IRAs are “retirement funds” because the holder of the funds has the option to leave the majority of its value intact until retirement “if she invests wisely and chooses to take only the minimum annual distributions required by law.”<sup>183</sup> The Court argued that the simple possibility that the funds could be held and used for retirement purposes does not equate to inherited IRAs bearing the legal characteristics of retirement funds.<sup>184</sup> The Court again illustrated its point with an example: “Were it any other way, money in an ordinary checking account (or, for that matter, an envelope of \$20 bills) would also amount to ‘retirement funds’ because it is possible for an owner to use those funds for retirement.”<sup>185</sup>

For the above reasons, the Court affirmed the Seventh Circuit’s decision that funds in an inherited IRA are not “retirement funds” for the purpose of Bankruptcy Code Section 522(b)(3)(C).<sup>186</sup>

## V. COMMENT

The Court came to the correct conclusion in *Clark*. However, while the decision is not subject to the opt-out provision of the Bankruptcy Code,<sup>187</sup> the decision still does not reach all debtors. The policy objectives of both the Bankruptcy Code and ERISA support disallowing funds in inherited IRAs from being exempted from debtors’ bankruptcy estates.<sup>188</sup> Thus, there is a need for statutory reform to ensure that, regardless of a debtor’s state of domicile, he be unable to exempt from his bankruptcy estates funds in an inherited IRA.

### A. Policy Objectives of the Bankruptcy Code

The Bankruptcy Code has two primary, but competing, objectives.<sup>189</sup> The first goal is to give a debtor a fresh start following bankruptcy by giving “an honest debtor a new opportunity in life without the pressure and discouragement of substantial indebtedness.”<sup>190</sup> The second goal is to attempt to “provide an equitable distribution of the debtor’s property to his creditors and

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182. *Id.* (quoting *Corley v. United States*, 556 U.S. 303, 314 (2009)).

183. *Id.*

184. *Id.* at 2250.

185. *Id.*

186. *Id.*

187. For a discussion of the opt-out provision, see *supra* Part III.B.3.

188. For a discussion of debtors’ bankruptcy estates, see *supra* Part I.

189. Arnopol, *supra* note 95, at 502.

190. *Id.* (quoting B. WEINTRAUB & A. RESNICK, BANKRUPTCY LAW MANUAL 1–3 (1986)).

maximize the return to creditors without hindering the debtor's need for a fresh start."<sup>191</sup>

To attempt to harmonize those two competing purposes, the Bankruptcy Code first includes in a debtor's bankruptcy estate "all legal or equitable interests of the debtor in property as of the commencement of the case."<sup>192</sup> Once the bankruptcy estate is established, the debtor may then exempt from the estate certain specified property necessary for her fresh start.<sup>193</sup> Included in the Bankruptcy Code as exemptible property is up to \$1,245,475 in a qualified retirement fund, including an IRA.<sup>194</sup>

### B. Policy of Excluding Retirement Funds

Congress specifically exempted a debtor's retirement funds from his or her bankruptcy estate, recognizing that the expanded exemptions for retirement funds would decrease the amount of a debtor's estate available to a creditor.<sup>195</sup> The stated purpose of the expansion was "to expand the protection for tax-favored retirement plans or arrangements that may not be already protected under Bankruptcy Code Section 541(c)(2) pursuant to *Patterson v. Shumate* or other state or Federal law."<sup>196</sup> Congress went one step further, making sure that the expanded exemption would be available to all debtors, including those domiciled in an opt-out state.<sup>197</sup> But, the question is: Why did Congress protect a debtor's retirement funds from the reach of creditors?

Since the passage of ERISA,<sup>198</sup> Congress has shown a desire to encourage saving for retirement.<sup>199</sup> Part of the stated purpose of ERISA is to:

[A]chieve a strengthening of the role played by private retirement plans within the fabric of our economic and social structures. Its most important purpose will be to assure American workers that they may look forward, with anticipation, to a retirement with financial security

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191. *Id.*

192. 11 U.S.C.A. § 541(a)(1) (West 2014). For a discussion of bankruptcy estates, see *supra* Part I.

193. 11 U.S.C. § 522 (2012).

194. Except that the amount may be increased "if the interests of justice so require." *Id.* § 522(n). This dollar amount is adjusted every three years by the Judicial Conference of the United States to reflect the change in the Consumer Price Index for All Urban Consumers. *See id.* § 104. For a more thorough discussion of exemptible property, see *supra* Part I, III.B-C.

195. H.R. REP. NO. 109-31(I), at 43 (2005).

196. H.R. REP. NO. 109-31(I), at 63-64 (2005).

197. *Id.* at 43. "[T]his provision ensures that the specified retirement funds are exempt under state as well as Federal law." *Id.* at 64. For a discussion of opt-out states, see *supra* Part III.B.3.

198. *See supra* Part III.B.1.

199. *See Arnopol, supra* note 95, at 502.

and dignity, and without fear that this period of life will be lacking in the necessities to sustain them as human beings within our society.<sup>200</sup>

Understandably, all debtors will at some point reach retirement age. While some debtors may have many working years left at the time of their bankruptcy filing, a rising number of debtors are already near retirement age at the time of filing.<sup>201</sup> Thus, for those debtors, they could be left with little to nothing to survive on during their retirement years if their retirement funds were not exempted from their bankruptcy estate. Those debtors would not be able to have “a retirement with financial security and dignity.”<sup>202</sup> Congress has an incentive to protect debtors’ retirement funds to an extent, to assist those debtors during retirement, and prevent those debtors from having to rely solely or primarily on funds from government assistance. However, there must be a balance between allowing a debtor who has filed for bankruptcy to still retire with financial security and dignity, and protecting creditors who have extended credit to the debtor.

### C. *Inherited IRAs Are Akin to a Windfall*

Bankruptcy Code Section 541(a)(5) is known as the “windfall” clause.<sup>203</sup> It includes in a debtor’s bankruptcy estate any interest in property that the debtor receives within 180 days of filing for bankruptcy, if the property would have been included had the debtor had an interest in it at the time of filing.<sup>204</sup> The statute specifically includes bequests, devises, and inheritances.<sup>205</sup> Bequests, devises, and inheritances are not “earned” by the recipient, and thus can all be considered “windfalls” to the recipient.<sup>206</sup>

When considering what property may be included from a debtor’s bankruptcy estate, the needs of creditors to be repaid the credit they extended to the debtor must be weighed against the needs of the debtor to live outside of poverty in retirement. With an IRA that a debtor funded and grew herself, she arguably has justifiable reliance on the promise under ERISA that those funds would be preserved for her retirement. Thus, it is logical for the bal-

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200. H.R. REP. NO. 93-533, at 8 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4639, 4646.

201. See Bob Calandra, *Bankruptcies Up for Older Adults*, AARP (Jan. 6, 2011), [http://www.aarp.org/money/credit-loans-debt/info-01-2011/bankruptcies\\_up\\_for\\_older\\_americans\\_.html](http://www.aarp.org/money/credit-loans-debt/info-01-2011/bankruptcies_up_for_older_americans_.html).

202. H.R. REP. NO. 93-533, at 8 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4639, 4646.

203. *Postpetition Transactions and Bankruptcy Code § 549*, 1 BANKRUPTCY LAW FUNDAMENTALS § 10:21 (2014).

204. 11 U.S.C.A. § 541(a)(5) (West 2014).

205. *Id.*

206. Paul J. Mastrangel, *The Family Jewels*, 73 MICH. B.J. 552, 552 (1994).

ance to tip in favor of a debtor being allowed to keep an IRA that she built up herself.<sup>207</sup> However, that logic fails when applied to inherited IRAs.

Inherited IRAs, in contrast, are comprised of IRA funds that someone other than the debtor contributed to and grew. Further, because an inheritance only occurs upon the death of an individual, it is not normally something with predictable timing. Thus, because the debtor cannot argue that she had any justifiable reliance on the funds in an inherited IRA, it is a windfall for the debtor. Thus, it is logical for the balance to tip in favor of creditors in regard to inherited IRAs.

#### *D. Missouri Exempts Retirement Funds, Including Inherited IRAs*

The unanimous Court in *Clark* reached the correct conclusion, holding that inherited IRAs are not exempt under Bankruptcy Code Section 522(b)(3)(C), but followed different reasoning from above.<sup>208</sup> As discussed, the *Clark* decision applies to debtors in all states, even those in states that have chosen to opt-out of the federal bankruptcy exemption scheme.<sup>209</sup> However, there are debtors to which *Clark* does not apply: those who live in states that have elected to enact their own bankruptcy exemption law that exempts inherited IRAs. Missouri is an example of both an opt-out state and a state that specifically exempts inherited IRAs from a debtor's bankruptcy estate.

Missouri is an opt-out state for bankruptcy exemption purposes. This means that Missouri has chosen to use Bankruptcy Code Section 522(b)(2) to opt-out of the federal bankruptcy exemption scheme in Section 522(d), leaving Missouri residents just one exemption option when filing for bankruptcy in Missouri: exemptions under Missouri law together with exemptions under federal law, other than those under Section 522(d).<sup>210</sup> However, debtors wishing to exempt retirement funds from their bankruptcy estates in Missouri are at an advantage because Missouri's treatment of retirement funds is more favorable than that of the Bankruptcy Code for two reasons. Missouri does

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207. For a similar argument, see Arnopol, *supra* note 95, at 553 ("While excluding retirement benefits, regardless of size, from a debtor's bankruptcy estate certainly promotes the purpose of ERISA, it does so at the expense of bankruptcy creditors. Allowing a debtor to retain over \$945,000 in retirement benefits in bankruptcy . . . hardly provides an equitable distribution to creditors, one of the most fundamental policy objectives of the Bankruptcy Code.").

208. *Clark v. Rameker*, 134 S. Ct. 2242, 2249–50 (2014).

209. 11 U.S.C. § 522(b)(2) (2012) ("Property listed in this paragraph is property that is specified under subsection (d), unless the State law that is applicable to the debtor under paragraph (3)(A) specifically does not so authorize."). For a discussion of the opt-out provision, see *supra* Part III.B.3.

210. MO. REV. STAT. § 513.427 (2000) ("[N]o such person is authorized to claim as exempt the property that is specified under Title 11, United States Code, Section 522(d).").

not cap its retirement fund exemption, and Missouri also specifically allows exemption of inherited funds.<sup>211</sup>

Missouri allows an unlimited exemption of “any money or assets” held in an IRA, including an inherited IRA, three or more years prior to the commencement of the bankruptcy proceeding.<sup>212</sup> Further, Missouri allows an unlimited exemption of “any money or assets” held in an IRA three or more years prior to the commencement of the bankruptcy proceeding.<sup>213</sup> By contrast, the federal exemption for IRAs is capped at \$1,245,475.<sup>214</sup> Further, the *Clark* decision disallowed inherited IRAs from being exempted from a debtor’s bankruptcy estate under the federal exemption scheme.<sup>215</sup>

Missouri is one of seven states to specifically allow debtors to exempt their inherited IRAs from their bankruptcy estates,<sup>216</sup> and *Clark* does nothing to change that result. Thus, the question is whether, as a matter of policy, the federal bankruptcy exemption for retirement funds should preempt any conflicting state laws.

### *E. The Need for Statutory Reform*

The decision in *Clark* conflicts with the laws of seven states, and because policy considerations support the Court’s decision, that conflict needs to be resolved. There are two possible resolutions: amend each of the seven states’ statutes exempting inherited IRAs, or amend the federal statute to preempt any state law.

#### 1. Option 1: Amend State Statutes That Conflict with *Clark*

Missouri again serves as a perfect example. Missouri’s bankruptcy laws allow for many categories of exemptions, including: a debtor’s homestead,<sup>217</sup> household items, a wedding ring and other jewelry, any other property of any kind, professional books or tools of the trade, motor vehicles, and a mobile home used as a personal residence.<sup>218</sup> Each of those categories has maximum exemption amounts.<sup>219</sup> Missouri also allows an exemption for “[a]ny pay-

211. MO. ANN. STAT. § 513.430.1(10)(f) (West 2015).

212. *Id.*

213. *Id.*

214. 11 U.S.C. § 522(n) (2012) (except that the amount may be increased “if the interests of justice so require”). This dollar amount is adjusted every three years by the Judicial Conference of the United States to reflect the change in the Consumer Price Index for All Urban Consumers. *See id.* § 104.

215. *Clark v. Rameker*, 134 S. Ct. 2242 (2014).

216. The seven states are: Alaska, Arizona, Florida, Missouri, North Carolina, Ohio, and Texas. *See sources cited supra* note 144. For a discussion of the state exemption laws, see *supra* Part III.C.

217. MO. REV. STAT. § 513.475.1 (Cum. Supp. 2013).

218. MO. ANN. STAT. §§ 513.430.1(1)–(6) (West 2015).

219. *Id.*

ment under a stock bonus plan, pension plan, disability or death benefit plan, profit-sharing plan, nonpublic retirement plan . . . or annuity or similar plan or contract on account of illness, disability, death, age or length of service . . . .<sup>220</sup> That exemption is allowed "to the extent reasonably necessary for the support of such person and any dependent of such person."<sup>221</sup>

While Missouri's IRA exemption excludes IRA contributions made within the three years prior to the commencement of the bankruptcy proceeding,<sup>222</sup> the exemption includes any and all IRA contributions and earnings on those contributions up to that date.<sup>223</sup> A debtor with the ability to strategically plan his bankruptcy years in advance is able to use IRA investments to shelter unlimited funds from his future bankruptcy estate. Further, a debtor is able to shelter unlimited funds in IRAs that he or she may have inherited. Thus, not only does Missouri specifically exempt inherited IRAs, but its exemption of them is unlimited. With caps on the majority of other categories, why are debtors able to exempt from bankruptcy unlimited funds from both their own IRAs and inherited IRAs?

As discussed above, there does not appear to be a policy justification for allowing a debtor to exempt inherited IRAs from her bankruptcy estate. Further, even if a policy argument could be made, the Court made a thorough and correct argument for why funds in inherited IRAs do not qualify as retirement funds. Thus, the seven states that currently exempt inherited IRAs from a debtor's bankruptcy estate could amend their statutes to remove the inclusion of inherited IRAs. Missouri Revised Statutes Section

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220. MO. ANN. STAT. § 513.430.1(10)(e).

221. The exemption is disallowed if:

a. Such plan or contract was established by or under the auspices of an insider that employed such person at the time such person's rights under such plan or contract arose;

b. Such payment is on account of age or length of service; and

c. Such plan or contract does not qualify under Section 401(a), 403(a), 403(b), 408, 408A or 409 of the Internal Revenue Code of 1986, as amended, (26 U.S.C. 401(a), 403(a), 403(b), 408, 408A or 409);

except that any such payment to any person shall be subject to attachment or execution pursuant to a qualified domestic relations order, as defined by Section 414(p) of the Internal Revenue Code of 1986, as amended, issued by a court in any proceeding for dissolution of marriage or legal separation or a proceeding for disposition of property following dissolution of marriage by a court which lacked personal jurisdiction over the absent spouse or lacked jurisdiction to dispose of marital property at the time of the original judgment of dissolution[.]

*Id.*

222. *Id.* § 513.430.1(10)(f). The three-year look back period is to attempt to prevent fraudulent pre-filing planning by debtors. See Frank W. Koger & Sheryl A. Reynolds, *Is Prefiling Engineering Prudent Planning or Section 727 Fraud? (Or, When Does a Pig Become a Hog?)*, 93 COM. L.J. 465 (1988).

223. § 513.430.1(10)(f).



413.430.1(10)(f), for example, could be amended to remove the following language: “[I]ncluding an inherited account or plan and whether such participant’s or beneficiary’s interest arises by inheritance, designation, appointment, or otherwise.”

However, amending the seven states’ statutes does not prevent other states from adding their own statutes to exempt inherited IRAs from a debtor’s bankruptcy estate. An easier and more comprehensive solution is to amend the federal statute to preempt any state statutes.

## 2. Option 2: Amend the Federal Statute to Preempt State Law

For a simple and comprehensive solution, Bankruptcy Code Section 522(b)(3) should be amended in two ways. First, *Clark* should be codified in Section 522(b)(3)(C) by adding the following language after “of the Internal Revenue Code of 1986”: *with the exception of inherited accounts or plans, or when a beneficiary’s interest arises by inheritance*. Second, the flush language of Section 522(b)(3) should be amended by adding the following language after the words “subsection (d)”: *Notwithstanding subparagraph (A) above, no state or local law shall amend or expand subparagraph (C) above*.

This solution would accomplish two goals. First, it would codify *Clark*, specifically disallowing inherited IRAs from being exempted from debtors’ bankruptcy estates under the federal bankruptcy exemption scheme. Second, it would preempt state law by disallowing state or local law to amend or expand Section 522(b)(3)(C). This would both preempt the statutes of the seven states that currently exempt inherited IRAs from a debtor’s bankruptcy estate and would prevent any future states from adding a statute to exempt inherited IRAs from a debtor’s bankruptcy estate. This solution would harmonize the policy of ERISA by protecting debtors’ retirement funds and the policy of the Bankruptcy Code by allowing creditors to access debtors’ funds that are akin to a windfall.

## VI. CONCLUSION

While the Supreme Court reached the correct result in *Clark v. Rameker*, the ruling at first glance appears to be a narrow decision that applies only to the eighteen states<sup>224</sup> that have not opted out of the federal bankruptcy exemption scheme via Bankruptcy Code Section 522(b)(2). That is not the case however. The *Clark* decision impacts bankruptcy debtors in all fifty states, unless the state specifically allows the exemption of an inherited IRA from a debtor’s bankruptcy estate. The exemption of inherited IRAs is contrary to the policy of the Bankruptcy Code because an inherited IRA is akin to a

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224. The eighteen states are: Alaska, Arkansas, Connecticut, Hawaii, Kentucky, Massachusetts, Michigan, Minnesota, New Hampshire, New Jersey, New Mexico, New York, Pennsylvania, Rhode Island, Texas, Vermont, Washington, and Wisconsin. See BROWN ET AL., *supra* note 142.

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windfall to the debtor. Thus, the federal bankruptcy exemption scheme should be amended to disallow the exemption of inherited IRAs from a debtor's bankruptcy estate and to preempt any state law that may specifically allow debtors to exempt funds from inherited IRAs.



