

# AMERICAN BANKRUPTCY INSTITUTE JOURNAL

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## Feature

BY PAUL MURPHY

### Fifth Circuit Rules that Inherited IRAs Are Exempt under Code

**Editor's Note:** For additional perspective on inherited IRAs, read the May 2011 cover article and a letter to the editor published in the July/August 2011 issue.



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On March 12, 2012, the Fifth Circuit Court of Appeals issued its decision in *In re Chilton*, affirming a judgment from the U.S. District Court for the Eastern District of Texas and holding that inherited individual retirement account (IRA) funds are exempt from the bankruptcy estate pursuant to 11 U.S.C. § 522(d)(12).<sup>1</sup> The ruling was the first of its kind at the circuit court of appeals level, addressing an issue of first impression that bankruptcy and district courts have grappled with of late,<sup>2</sup> and stands to help clarify the difference of opinion among the courts regarding Bankruptcy Code exemptions for inherited IRAs.

In *In re Chilton*, debtors Robert Chilton and Janice Chilton inherited an IRA worth \$170,000 from Ms. Chilton's mother.<sup>3</sup> They established an IRA account as an "inherited IRA" under the Internal Revenue Code (IRC) to receive distributions from their inheritance.<sup>4</sup> In their subsequent chapter 7 petition, they sought to exempt the inherited IRA from the estate pursuant to § 522(d)(12).<sup>5</sup> The chapter 7 trustee objected to the exemption, arguing that although § 522(d)(12) allows debtors to exempt retirement funds when those funds are in an account that is exempt from taxation under certain IRC sections, inherited IRA funds do not qualify as "retirement funds" within

the meaning of § 522(d)(12) and are not contained in the type of tax-exempt account specified in the statute.<sup>6</sup> The bankruptcy court sustained the trustee's objection, and the debtors appealed.<sup>7</sup> The district court reversed the bankruptcy court's ruling, citing to several cases decided subsequent to the bankruptcy court's ruling.<sup>8</sup> An appeal to the Fifth Circuit followed.

The Fifth Circuit began its analysis by citing the language of § 522(d)(12) to frame the issue as "the exemption in the Bankruptcy Code for '[r]etirement funds to the extent that those funds are in a fund or account that is exempt from taxation section 401, 403, 408, 408A, 414, 457 or 501(a) of the Internal Revenue Code of 1986.'" As such, the court recognized that the validity of an exemption claimed under § 522(d)(12) depends on the satisfaction of two requirements: (1) the funds sought to be exempt must be retirement funds and "(2) those retirement funds must be in an account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457 or 501(a) of the [IRC]."<sup>10</sup>

Addressing the first prong, the court noted that the phrase "retirement funds" is not defined in the Bankruptcy Code.<sup>11</sup> The court examined the plain meaning of the words as defined in *Webster's Dictionary*,<sup>12</sup> and as analyzed and employed by other courts.<sup>13</sup> Then citing to three recent district

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*; see also *Chilton v. Moser (In re Chilton)*, 444 B.R. 548, (E.D. Tex. 2011) (overruling *In re Chilton*, 426 B.R. 612 (Bankr. E.D. Tex. 2010), and citing *In re Nessa*, 426 B.R. 312, (8th Cir. B.A.P. 2010); *In re Kuchta*, 434 B.R. 837 (Bankr. N.D. Ohio 2010); *In re Tabor*, 433 B.R. 469 (Bankr. M.D. Pa. 2010); *In re Thiem*, 443 B.R. 832 (Bankr. D. Ariz. 2011); and *In re Weillhammer*, No. 09-15148-LT 7, 2010 WL 3431465 (Bankr. S.D. Cal. Aug. 20, 2010), each supporting the position that an inherited IRA is exempt under the Bankruptcy Code.

<sup>9</sup> *In re Chilton*, 674 F.3d 486, 488 (5th Cir. 2012); 11 U.S.C. § 522(d)(12).

<sup>10</sup> *Id.* at 488.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 489. The court cited to *Webster's Third New Int'l Dictionary* 921, 1939 (1993) for the plain meaning of "retirement" defined as "withdrawal from office, active service or business," and "fund" defined as "a sum of money or other resources the principal or interest of which is set apart for a specific objective or activity."

<sup>1</sup> *In re Chilton*, 674 F.3d 486 (5th Cir. 2012).

<sup>2</sup> Cases holding that an inherited IRA is exempt include *In re Nessa*, 426 B.R. 312, (8th Cir. B.A.P. 2010); *In re Kuchta*, 434 B.R. 837 (Bankr. N.D. Ohio 2010); *In re Tabor*, 433 B.R. 469 (Bankr. M.D. Pa. 2010); *In re Thiem*, 443 B.R. 832 (Bankr. D. Ariz. 2011); and *In re Weillhammer*, No. 09-15148-LT 7, 2010 WL 3431465 (Bankr. S.D. Cal. 2010). Cases holding that an inherited IRA is not exempt include *In re Ard*, 435 B.R. 719 (Bankr. M.D. Fla. 2010); *In re Klipsch*, 435 B.R. 586 (Bankr. S.D. Ind. 2010); and *In re Chilton*, 426 B.R. 612 (Bankr. E.D. Tex. 2010).

<sup>3</sup> *In re Chilton*, 674 F.3d 486, 488 (5th Cir. 2012).

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

court judgments reversing bankruptcy court decisions on this issue, the Fifth Circuit concluded that inherited IRAs are “retirement funds” as that term is used in § 522(d)(12).<sup>14</sup> The court was persuaded by the reasoning in the three recent district court decisions—namely that the plain meaning and defining characteristic of “retirement funds” is that they are sums of money “set apart” for retirement (not necessarily by or for the debtor), and that such retirement funds do not lose their status or otherwise cease to qualify for exemption under § 522(d)(12) when directly transferred from one exempt account to another.<sup>15</sup>

Having concluded that the \$170,000 contained in the debtors’ inherited IRA constitutes “retirement funds,” the Fifth Circuit next considered whether the inherited funds are in an account that is exempt from taxation under § 401, 403, 408, 408A, 414, 457 or 501(a) of the IRC.<sup>16</sup> The court dismissed the trustee’s argument that 26 U.S.C. § 402(c)(11)(A) renders the inherited IRA exempt by initially noting that § 402(c)(11)(A) merely provides exemption for the transfer itself, not the distributions from same,<sup>17</sup> and then examining the IRC provisions that may render the inherited IRA exempt subsequent to the inheritance. With this in mind, the court observed that 26 U.S.C. § 408(d)(3)(C)(2) defines “individual retirement accounts” to encompass “inherited IRAs,”<sup>18</sup> but also cited to the expansive language of 26 U.S.C. § 408(e), which provides that “[a]ny individual retirement account is exempt from taxation under this subsection.”<sup>19</sup> Accordingly, the court concluded that § 408 of the IRC is the exempting section for all individual retirement accounts.<sup>20</sup> Again citing to the same three recent district court decisions that addressed the “retirement funds” issue, the Fifth Circuit held that inherited IRAs, such as that held by the Chiltons, are exempt from taxation by reason of 26 U.S.C. § 408(e).<sup>21</sup>

Concluding that the debtors’ inherited IRA is “retirement funds” contained in an account that is exempt from taxation under 26 U.S.C. § 408, the Fifth Circuit Court of Appeals affirmed the district court’s judgment, holding that such inherited IRAs are exempt from the bankruptcy estate pursuant to 11 U.S.C. § 522(d)(12).<sup>22</sup> The Fifth Circuit’s decision in *Chilton* essentially assigns the characteristics of the originating IRA to the inherited IRA, satisfying the requirements of § 522(d)(12) and affording debtors protections for their inheritances from creditors. **abi**

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13 *Id.* at 489 (citing for support that inherited IRAs fall within the plain meaning of “retirement funds”: *In re Nessa*, 426 B.R. 312, (8th Cir. B.A.P. 2010); *In re Kuchta*, 434 B.R. 837 (Bankr. N.D. Ohio 2010); *In re Tabor*, 433 B.R. 469 (Bankr. M.D. Pa. 2010); *In re Thiem*, 443 B.R. 832 (Bankr. D. Ariz. 2011); and *In re Weillhammer*, No. 09-15148-LT7, 2010 WL 3431465 (Bankr. S.D. Cal. Aug. 20, 2010)).

14 *Id.* at 489 (citing *In re Chilton*, 426 B.R. 621, 616 (Bankr. E.D. Tex. 2010), *rev’d*, 444 B.R. 548 (E.D. Tex. 2011); *In re Clark*, 450 B.R. 858 (Bankr. W.D. Wis. 2011), *rev’d*, 466 B.R. 135 (W.D. Wis. 2012); and *In re Stephenson*, No. 11-cv-10848, (E.D. Mich. Dec. 12, 2010), as three recent bankruptcy court decisions, each concluding that an inherited IRA was not exempt from the bankruptcy estate and each of which was reversed on appeal. In support of their appellate decisions, each district court held that funds in an inherited IRA are “retirement funds.”

15 *Id.* at 489 (citing 11 U.S.C. § 522(b)(4)(C), which provides that “[a] direct transfer of retirement funds from 1 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, or otherwise, shall not cease to qualify for exemption under paragraph (3)(C) or subsection (d)(12) by reason of such direct transfer.”).

16 *Id.* at 489; 11 U.S.C. § 522(d)(12).

17 *Id.* at 490. 26 U.S.C. § 402(c)(11)(A) provides:

(11) Distributions to inherited individual retirement plan of nonspouse beneficiary.

(A) In general.—If, with respect to any portion of a distribution from an eligible retirement plan described in paragraph (8)(B)(iii) of a deceased employee, a direct trustee-to-trustee transfer is made to an individual retirement plan described in clause (i) or (ii) of paragraph (8)(B) established for the purposes of receiving the distribution on behalf of an individual who is a designated beneficiary (as defined by section 401(a)(9)(E) of the employee and who is not the surviving spouse of the employee—

- (i) the transfer shall be treated as an eligible rollover distribution,
- (ii) the individual retirement plan shall be treated as an inherited individual retirement account or individual retirement annuity (within the meaning of section 408(d)(3)(C)) for purposes of this title, and
- (iii) section 401(a)(9)(B) (other than clause (iv) thereof) shall apply to such plan.

18 *Id.* at 490; citing to 26 U.S.C. § 408(d)(3)(C)(2), which provides:

(ii) Inherited individual retirement account or annuity. An individual retirement account or individual retirement annuity 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.

19 *Id.* at 490 (citing to 26 U.S.C. § 408(e)).

20 *Id.*

21 *Id.* The court again cited to *In re Chilton*, 426 B.R. 612, 616 (Bankr. E.D. Tex. 2010), *rev’d*, 444 B.R. 548 (E.D. Tex. 2011); *In re Clark*, 450 B.R. 858 (Bankr. W.D. Wis. 2011), *rev’d*, 466 B.R. 135 (W.D. Wis. 2012); and *In re Stephenson*, No. 11-cv-10848, 2011 WL 233990 (E.D. Mich. Dec. 12, 2010), as three recent bankruptcy court decisions, each concluding that an inherited IRA was not exempt from the bankruptcy estate, and each of which was reversed on appeal. In support of their appellate decisions, each district court held that inherited IRAs are exempt from taxation under 26 U.S.C. § 408(e), which, in turn, is a section listed under 11 U.S.C. § 522(d)(12).

22 *Id.*