

# BURR ALERT

## Debtor's Estate Set to Expand or Contract Based on Supreme Court Ruling in *Clark v. Rameker*<sup>1</sup>

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Before the Supreme Court this term is the question of whether a beneficiary individual retirement account (an "Inherited IRA") is exempt from a debtor's bankruptcy estate under 11 U.S.C. § 522(b)(3)(C) and (d)(12)<sup>2</sup> of the Bankruptcy Code. The issue turns on 1) whether the funds in an Inherited IRA are "retirement funds," and 2) whether an Inherited IRA is considered tax exempt under the Internal Revenue Code (the "Tax Code").

### RELEVANT LAW

The primary provision at issue in *Clark v. Rameker*, pending before the Supreme Court, is § 522(b)(3)(C), which provides for the following exemption of property from a debtor's 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." The relevant provision under the Tax Code is § 408(e), which provides that "[a]ny individual retirement account is exempt from taxation under this subtitle."

### FACTS OF CLARK

In October 2010, the debtors, Heidi Heffron-Clark and her husband Brandon Clark, filed for bankruptcy protection under chapter 7 of the Bankruptcy Code in the United States Bankruptcy Court for the Western District of Wisconsin. Nine years prior to the bankruptcy filing, Heidi inherited her mother's individual retirement account ("IRA"). She then established an Inherited IRA and transferred the funds from her mother's IRA into the Inherited IRA. In January 2002, one month after establishing the Inherited IRA, Heidi and her husband began receiving monthly distributions from the account.<sup>3</sup> During this time, Heidi and her husband were not retired. When Heidi and her husband filed for bankruptcy, the value of the Inherited IRA was \$293,338.

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<sup>1</sup> (*In re Clark*), \_\_\_ U.S. \_\_\_ (2014).

<sup>2</sup> These two provisions are identical, and which section applies depends on whether state law exemptions (§ 522(d)(12)) or federal law exemptions (§ 522(b)(3)(C)) apply to the debtor.

<sup>3</sup> Distributions of an Inherited IRA must begin within one year of the original owner's death. See Tax Code § 401(a)(9)(B).

The debtors claimed that the Inherited IRA was exempt under 11 U.S.C. § 522(b)(3)(C)<sup>4</sup>, and the chapter 7 trustee and a judgment creditor objected to the exemption.<sup>5</sup>

## LOWER COURT DECISIONS

### United States Bankruptcy Court for the Western District of Wisconsin

The bankruptcy court held that an Inherited IRA is not exempt under § 522(b)(3)(C). First considering whether the funds in an Inherited IRA constitute “retirement funds,” the court noted that the Bankruptcy Code does not define the term, leading the court to look to its ordinary meaning. Based on the dictionary definition of the term “retirement,” the court concluded that retirement funds are those funds “held in anticipation of ‘withdrawal from one’s position or occupation.’” According to the court, once Heidi’s mother died and the funds were transferred into the Inherited IRA, they were no longer held in anticipation of anyone’s retirement, and the funds were in fact being distributed monthly per the Tax Code while the debtors were still employed. Therefore, the Inherited IRA was not “retirement funds.”<sup>6</sup>

The court also found that the Inherited IRA is not tax exempt under the Tax Code. The court explained that Congress created the Inherited IRA as a way to defer taxation, but subjected it to rules that do not apply to IRAs because the Inherited IRA was not meant to hold retirement savings. Among these additional rules are that no contributions may be made, the funds cannot be rolled over into the beneficiary’s own IRA, and distributions must begin immediately. The court further noted that it had found no primary legal source that would indicate that an Inherited IRA is tax exempt under § 408 of the Tax Code.<sup>7</sup>

### United States District Court for the Western District of Wisconsin

The district court reversed. Persuaded by the fact that Congress included a reference to “the debtor” in all exemption provisions in § 522(b) and (d) except for § 522(b)(3)(C) and (d)(12) on retirement funds, the court held that the funds do not have to be contributed by the debtor in order to be retirement funds, so long as the funds were originally set aside for retirement. The district court also found that an Inherited IRA is tax exempt under the Tax Code because, like an

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<sup>4</sup> The debtors also claimed that the Inherited IRA was exempt under Wis. Stat. § 815.18(3)(j). The bankruptcy court did not allow the exemption under the Wisconsin statute, and that issue was not challenged on appeal.

<sup>5</sup> *In re Clark*, 450 B.R. 858 (Bankr. W.D. Wis. 2011).

<sup>6</sup> The court was also not persuaded that § 522(b)(4)(C) regarding direct transfers of retirement funds supported the exemption because an Inherited IRA is not retirement funds and therefore is not covered by that provision. Section 522(b)(4)(C) provides that: “For purposes of paragraph (3)(C) and subsection(d)(12), the following shall apply: . . . A direct transfer of retirement funds from 1 fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, 501(a) of the Internal Revenue Code of 1986, under section 401(a)(31) 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.”

<sup>7</sup> *In re Clark*, 450 B.R. 858 (Bankr. W.D. Wis. 2011).

IRA, its principal and interest is not taxed until distributed. Additionally, any question on the tax exempt status was resolved in the district court's opinion by the language in Tax Code § 408 exempting *any* individual retirement account from taxation. Despite the holding, the district court noted that there may be a policy reason for not exempting Inherited IRAs,<sup>8</sup> but that amending the Bankruptcy Code is left to Congress.<sup>9</sup>

### United States Court of Appeals for the Seventh Circuit

The Seventh Circuit sided with the bankruptcy court and reversed the district court. Reviewing the differences between an IRA and an Inherited IRA, the court explained that an Inherited IRA is a means to defer taxation, not a place to save retirement funds. The court found it telling that the funds in an Inherited IRA cannot be held until the holder retires and must be distributed shortly after the creation of the account. Because the funds in an Inherited IRA represent an opportunity for current consumption, they are not funds for retirement. The court further noted that funds inherited from an IRA should not be given exempt status simply because they were inherited in that form instead of some other form, which would not have been exempt under the Bankruptcy Code.

The court also addressed the lack of a reference to “the debtor” in § 522(b)(3)(C) and (d)(12), reasoning that the phrase was omitted by Congress so that new value added to the debtor's retirement account during the bankruptcy, like by the debtor's employer, would be included in the exemption even though other new property that the debtor acquired during bankruptcy would not be exempt.<sup>10</sup>

### PETITION TO SUPREME COURT

Prior to *Clark*, all other courts, with the exception of one that was subsequently reversed, had found that an Inherited IRA falls under the exemption in § 522(b)(3)(C).<sup>11</sup> The leading prior case, *In re Nessa*, held that the term “retirement funds” applies to any account that contains funds that were originally set aside for retirement, and that there is no requirement that the funds be set aside by the debtor for his own retirement. The *Nessa* court also found support in

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<sup>8</sup> Specifically, the district court noted that “[i]t seems incongruous to allow the exemption from bankruptcy of an IRA worth more than a quarter-million dollars while limiting the exemption of a motor vehicle to \$3,450.”

<sup>9</sup> *Clark v. Rameker (In re Clark)*, 466 B.R. 135 (W.D. Wis. 2012).

<sup>10</sup> *In re Clark*, 714 F.3d 559 (7th Cir. 2013)

<sup>11</sup> See *In re Nessa*, 426 B.R. 312 (8th Cir. BAP 2010); *In re Stephenson*, No. 11-cv-10848, 2011 WL 6152960 (E.D. Mich. Dec. 12, 2011); *In re Johnson*, 452 B.R. 804 (Bankr. W.D. Wash. 2011); *In re Mathusa*, 446 B.R. 601 (Bankr. M.D. Fla. 2011); *In re Thiem*, 443 B.R. 832 (Bankr. D. Ariz. 2011); *In re Chilton*, 426 B.R. 612 (Bankr. E.D. Tex. 2010), *rev'd sub nom. Chilton v. Moser*, 444 B.R. 548 (E.D. Tex. 2011); *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 Weilhammer*, No. 09-15148-LT7, 2010 WL 3431465 (Bankr. S.D. Cal. Aug. 30, 2010).

§ 522(b)(4)(C)'s provision that retirement funds directly transferred from one account to another do not lose their status as retirement funds simply by reason of the transfer.

With the Seventh Circuit's decision in *Clark* in conflict with that of the Bankruptcy Appellate Panel for the Eighth Circuit in *Nessa*, the issue was ripe for consideration by the United States Supreme Court, which granted certiorari.<sup>12</sup>

Oral arguments were held before the Supreme Court on March 24, 2014, and a decision is expected later this year. Whatever the Supreme Court ultimately decides, the decision will have a significant impact on the amount of assets available for distribution to creditors, particularly in cases where the Inherited IRA has a high value and there are little to no other assets available for distribution.

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<sup>12</sup> *Clark v. Rameker (In re Clark)*, 134 S.Ct. 678 (2013) (mem.).