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Ownership Status of Inherited Retirement Accounts in Bankruptcy

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Introduction

Immediately upon filing a petition for relief under title 11 of the United States Code (the “Bankruptcy Code”), a bankruptcy estate is created by operation of law that consists of the debtor’s assets from which the creditors will be repaid.1 The Bankruptcy Code states that the estate includes “all legal or equitable interests of the debtor in property as of the commencement of the case.”2 This broad language reflects Congress’s intent that there be sufficient assets in the estate to protect the interests of creditors.3

Despite this broad legislative language, there are certain categories of property that the debtor may retain possession of and does not become part of the bankruptcy estate. One such category, known as exempt property, does not become property of the estate if the debtor asserts the applicable exemption4 with respect to that property.5 One such exemption allows for a debtor

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4 If the debtor wishes to keep property that is eligible for an exemption, the debtor must assert that claim. In re Way, 2 B.R. 372, 373 (Bankr. N.D. Ohio 1980). If the debtor does not assert the applicable exemption with respect to the relevant property, then the exempt-eligible property will become property of the estate. Id.
to retain “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.”

A second category of property that does not go into the bankruptcy estate is described in section 541(c)(2) of the Bankruptcy Code. The section states “[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.” If the retirement account in question is subject to a transfer restriction “under applicable nonbankruptcy law,” then the debtor may keep the account without needing to claim an exemption.

These rules do not provide any qualifying language regarding the source of the retirement account thus raising the issue as to the applicability of these rules to a retirement account that is inherited by a debtor. First, this memorandum outlines the necessary elements for the successful use of a section 522(b)(3)(C) exemption for inherited retirement accounts. Second, this memorandum clarifies which laws are included in “applicable nonbankruptcy law,” and may thus serve as the source of a transfer restriction for the purpose of excluding an inherited retirement account from the bankruptcy estate under section 541(c)(2). The final section of the memorandum explains that an inherited retirement account may be retained by a debtor if it is subject to a transfer restriction under “applicable nonbankruptcy law,” even if the account would not qualify for an exemption.

I. The Bankruptcy Code Allows an Exemption for Inherited Retirement Accounts if the Funds Contained Within Such Accounts are Objectively for Retirement

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7 11 U.S.C. § 541(c)(2).
The Bankruptcy Code states that “an individual debtor may exempt from property of the estate . . . retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under . . . the Internal Revenue Code.”

There are two distinct requirements under this section for the funds in the account to qualify for an exemption: “[(1)] The funds must be ‘retirement funds,’ and [(2)] they must be held in a covered account.”

Retirement funds are defined as “sums of money set aside for the day an individual stops working.” Whether funds actually meet this definition must be determined objectively.

Applying this rule to an inherited Individual Retirement Account (“IRA”), the Supreme Court determined that the funds in such an account are objectively not retirement funds as to the beneficiary. The Court came to this conclusion based on three aspects of the legal characteristics of an inherited IRA: (1) holders of inherited IRAs may not contribute money to the account; (2) holders of inherited IRAs must withdraw some or all of the funds from the account, even if they have not yet reached retirement; and (3) holders of such accounts may withdraw any and all funds from the account and use it in any way they choose, even if for a purpose unrelated to retirement. These considerations are not limited to IRAs and apply to other types of accounts.

Where, for example, a debtor has the ability to withdraw funds from an

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9 11 U.S.C. § 522(b)(1) and (3)(C).
11 Id. at 127.
12 Id. at 128.
13 Id. at 124.
14 The Court also offered a policy consideration in support of their conclusion. Specifically, the construction of the Bankruptcy Code’s exemption provisions “effectuate a careful balance between the interests of creditors and debtors,” while allowing debtors to meet their basic needs. Clark at 129. If the funds are not meant to allow debtors to “meet their basic needs,” then the interests of the creditors are superior, and the funds would go to the estate. See id.
15 Id. at 128.

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annuity at any time, and for any purpose, such funds are objectively not retirement funds, and are thus ineligible for an exemption under section 522(b)(3)(C).\(^{17}\)

However, IRAs inherited by a spouse may be properly exempted under section 522(b)(3)(C) because such accounts receive different tax treatment than IRAs inherited from nonspouses, such as the beneficiary being allowed to make additional contributions.\(^{18}\) Because the legal characteristics of an IRA inherited from a spouse lead to an objective determination that the funds contained therein are for retirement, the exemption under section 522(b)(3)(C) applies.\(^{19}\) Therefore, the applicability of section 522(b)(3)(C) to retirement accounts, inherited or not, depends on being able to prove that the contested funds are objectively for retirement.

A. The Objective Analysis Requirement of Inherited Retirement Funds is Limited to Federal Exemptions

The Bankruptcy Code allows for state law to govern what property is subject to an exemption.\(^{20}\) Therefore, where a debtor uses a state exemption that does not refer to “retirement funds” there is no requirement that the funds must objectively be for retirement.\(^{21}\) For example, the applicable Rhode Island state exemption statute grants an exemption for “[a]n individual retirement account or individual retirement annuity as defined in the Internal Revenue Code, 26 U.S.C. §§ 408 and 408A, and the payments or distributions from such an account or annuity.”\(^{22}\) Because the statutory language lacks any mention of “retirement funds,” the Supreme Court of

\(^{17}\) Id.
\(^{19}\) See In re Pacheco, 537 B.R. 935, 940 (Bankr. D. Ariz. 2015).
\(^{21}\) See In re Kapsinow, 220 A.3d 1231, 1237 (R.I. 2019).
\(^{22}\) 9 R.I. GEN. LAWS § 9-26-4(11).
Rhode Island concluded that a debtor may use the state exemption to exempt an inherited IRA, even absent any objective showing that the funds constitute “retirement funds.”

B. Funds that are not Objectively Retirement Funds Will Still be Exempted Under Section 522(b)(3)(C) if no Challenge to the Exemption is Timely Made

If no timely objection is made by a “party in interest” to the claimed exemption, then the property is exempt, even if the objection would be otherwise successful. The burden is on the objecting party to prove that the property at issue is not exempt. Moreover, an objection must be raised within the statutory timeframe to be considered. In cases of uncertain application, “exemptions should be construed liberally in favor of the debtor.” Thus, even under the federal exemptions, a debtor still may retain possession of an inherited IRA if they claim an exemption and no party in interest raises a timely objection. For example, an untimely objection brought against a debtor’s exemption of an inherited IRA failed. While the debtor’s claimed exemption of his inherited IRA would have been denied on the merits, the fact that claimed exemptions are presumptively valid under section 522(l) of the Bankruptcy Code, and that the statutory timeframe in which to bring an exemption had passed, the bankruptcy court ruled that the debtor’s inherited IRA was exempt from the estate.

II. Debtors may Retain an Inherited Retirement Account Without an Exemption if it is Subject to a Transfer Restriction Under Applicable Nonbankruptcy Law

23 In re Kapsinow, 220 A.3d at 1236.
29 Id. at 515–16.
30 Id. at 519.
The Bankruptcy Code allows debtors to retain possession of certain types of accounts that are subject to a transfer restriction “under applicable nonbankruptcy law,” even if the account is not eligible for an exemption. The scope of “applicable nonbankruptcy law” encompasses both state and federal law. However, a caveat to this rule that is relevant to accounts subject to a transfer restriction under ERISA is that the account must be in the “hands of the plan administrator” at the time the debtor files for bankruptcy in order to be protected by the transfer restriction. Additionally, any funds withdrawn before filing for bankruptcy will become estate property, even if the money came from an account that was subject to a transfer restriction “under applicable nonbankruptcy law.” Therefore, a debtor may retain possession of an inherited retirement account that is subject to a transfer restriction by state or federal law.

III. A Debtor may use a Section 541(c)(2) Exclusion Even Where a Section 522(b)(3)(C) Exemption Fails

While inherited IRAs cannot be excluded from the estate based on a section 522(b)(3)(C) exemption, that does not necessarily mean that the account will necessarily become estate property. Such an account may still be excluded from the estate based on applicable nonbankruptcy law under section 541(c)(2) of the Bankruptcy Code. However, the “applicable

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32 Patterson v. Shumate, 504 U.S. 753, 758 (1992) (holding that transfer restrictions on qualified accounts under the Employee Retirement Income Security Act of 1974 (“ERISA”) constitutes “applicable nonbankruptcy law”). Lower courts have applied this expansive reading of section 541(c)(2) when evaluating a debtor’s right to exclude ERISA-qualified plans from the estate. For example, In re Reed dealt with a debtor who sought to exclude his pension plan from the bankruptcy estate. 985 F.2d 1026, 1026 (9th Cir. 1993). The court easily resolved the issue in light of Patterson and held that since the pension plan was ERISA-qualified, the attendant transfer restriction was sufficient to allow the plan to be excluded under section 541(c)(2). In re Reed, 985 F.2d at 1027.
34 Id. at *15.
35 See Id. at *16–17 (holding that an inherited 401(k) account is excluded from the bankruptcy estate under section 541(c)(2) of the Bankruptcy Code because it is subject to a transfer restriction under ERISA).
36 In re Andolino, 525 B.R. 588, 591 (Bankr. D.N.J. 2015) (“The court will not take the proverbial ‘leap’ in linking the U.S. Supreme Court’s ruling that an inherited IRA is not exempt from the estate, to an automatic determination that an inherited IRA is necessarily included in the bankruptcy estate.”)
37 Id. at 594.
nonbankruptcy law” that was analyzed in In re Andolino was a state exemption statute.\(^38\) Other states with different statutory exemption requirements will have to be independently evaluated to determine if an exclusion based on section 541(c)(2) would be justified.\(^39\)

**Conclusion**

The Bankruptcy Code provides two options to allow debtors to retain possession of inherited retirement accounts in bankruptcy. The first option is to use the exemption found in section 522(b)(3)(C). This exemption will only be effective if the legal characteristics of the inherited account leads to the conclusion that the funds contained in the account are objectively retirement funds.\(^40\) However, even if the account does not technically qualify for the exemption, the debtor will still successfully retain possession of the account if no timely objection to the exemption is raised.\(^41\) The second option allows for an automatic exclusion of the account, if it is subject to a transfer restriction “under applicable nonbankruptcy law.”\(^42\) The debtor may attempt to use both options in order to retain possession of an inherited retirement account in bankruptcy.\(^43\)

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38 Id.
41 Bricker, 521 B.R. at 519.
42 11 U.S.C. § 541(c)(2).
43 See In re Andolino, 525 B.R. at 594.