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# When is an IRA not a retirement plan?

*Hint: It's a trick question.*

In 2000 Ruth Heffron established a traditional IRA, probably by rolling over a lump sum distribution from her employer's retirement plan. At her death the next year, the IRA was worth $450,000. Heidi Heffron-Clark, Ruth's daughter, was the sole beneficiary of the account. She began taking monthly distributions from it.

Fast forward to October 2010, when Heidi and her husband filed for bankruptcy. Some assets are exempt from creditor claims in a bankruptcy proceeding, among them "retirement funds" from qualified plans, as enumerated in the tax code. Because inherited IRAs are among these, the couple identified the inherited IRA, then worth $300,000, as an exempt asset. In so doing, they set off a legal controversy that ultimately landed in the U.S. Supreme Court.

**Different courts, different answers**

The bankruptcy court rebuffed the claim for protection of the inherited IRA, because those funds are not distributed during retirement. In fact, such funds are required to be distributed, regardless of the age or the wishes of the beneficiary. The district court reversed the decision of the bankruptcy court, ruling that the language of the bankruptcy law covers any account containing funds "originally" "accumulated for retirement purposes." Then the Seventh Circuit Court of Appeals reversed that ruling, stating that "inherited IRAs represent an opportunity for current consumption, not a fund of retirement savings." However, in a similar case in another part of the country, the Fifth Circuit Court of Appeals reached the opposite conclusion. The U.S. Supreme Court stepped in to resolve the ambiguities.

**Unanimous decision**

Although it may seem obvious to nonlawyers that something called an "Individual Retirement Account" is for retirement, whether inherited or not, words can be slippery things in the hands of lawmakers. In June the high court ruled unanimously that, in the context of a bankruptcy proceeding, an inherited IRA is not a retirement fund. Three characteristics distinguish inherited IRAs from other tax-favored retirement accounts:

• *Contributions of new money to inherited IRAs are prohibited.* All other retirement funds encourage more saving.

• *Distributions from inherited IRAs are required, regardless of how far off retirement may be.* Either minimum distributions must be made over the life of the beneficiary, or the entire fund must be disbursed within five years of the death of the owner.

• *No penalty on withdrawals.* Most retirement plan distributions trigger a 10% tax penalty if made before the owner reaches age 59 ½. That tax provision encourages IRA owners to wait until retirement for their distributions. In contrast, there is no 10% penalty for withdrawals from inherited IRAs, regardless of the age of the beneficiary. Accordingly, this is a pot of money that can be used freely for current consumption.

**A trust alternative**

For those who are concerned about protecting inherited IRA funds from the creditors of beneficiaries, there is an alternative to consider. The IRA may be made payable to a qualified trust for the benefit of the heir, rather than to the beneficiary directly. The minimum distribution rules still will apply, but such an arrangement may provide for stronger asset protection.

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