Supreme Court Rules Inherited IRAs are Not Protected From Creditors

After this surprising ruling from the Supreme Court, IRA owners in most states will have to take additional steps to protect their heirs from creditors after they die.

By Stephen Fishman, J.D.

IRAs (Individual Retirement Arrangements) have many advantages. Among the lesser known benefits is legal protection of the funds in IRA accounts from claims of creditors when an IRA account owner files for bankruptcy. Under normal bankruptcy rules, funds in an IRA are not subject to creditor's claims—in technical parlance they are exempt from inclusion in the bankruptcy estate. This means that the IRA owner can go through bankruptcy, have all of his or her debts discharged, and retain all the money in his or her IRA. The purpose for this rule is to help debtors who go through bankruptcy obtain a fresh start. This rule applies to other types of retirement funds as well.

However, what happens when an IRA owner dies and the account is inherited by a person who later files for bankruptcy? Can the holder of the inherited IRA benefit from the IRA bankruptcy exemption? The United States Supreme Court says that, where the beneficiary is a person other than the account owner's spouse, the answer is "no."

The case involved Ruth Heffron who established a traditional IRA in 2000 and named her daughter, Heidi Heffron-Clark, as the sole beneficiary. When Ms. Heffron died in 2001, her IRA—which was then worth just over $450,000—passed to her daughter and became an inherited IRA. After their small business failed, Heidi and her husband filed for bankruptcy in 2010 and claimed that the inherited IRA was exempt from creditor's claims under federal law.

The Supreme Court, in a decision that surprised many, held that, after the death of an IRA owner, assets in an inherited IRA for a non-spouse beneficiary no longer constitute retirement funds for bankruptcy purposes; therefore, they are not protected from creditors' claims when a non-spouse beneficiary files for bankruptcy. (Clark v. Rameker, 134 S.Ct. 2242 (2014).)

The Supreme Court's decision sent shock waves among financial advisors and estate advisors. IRA owners in most states will now have to take additional steps to protect their heirs from creditors after they die. For example, an IRA owner may create a spendthrift trust and designate it as beneficiary of the inherited IRA, instead of the owner's heirs as individuals. The IRA owner's heirs can be made beneficiaries of the trust. Such a trust includes a spendthrift provision that typically provides that the beneficiaries cannot access the trust principal, or promise it to anyone else. Because the beneficiary cannot access trust funds, neither can his or her creditors. Thus, all the assets in such a trust, including inherited IRA funds, receive legal protection from the beneficiary's creditors after the IRA owner dies. For details, see the article "Spendthrift Trusts" in the Nolo Legal Encyclopedia.

However, IRA beneficiaries in some states are not subject to the Supreme Court's decision. This is because the individual states are allowed to establish their own bankruptcy exemptions that can differ from the federal exemptions that were the subject of the Supreme Court's decision. Seven states already have bankruptcy exemptions that exempt all inherited IRAs from creditor's bankruptcy claims: Arizona, Alaska, North Carolina, Missouri, Florida, Texas, and Ohio. It's likely that additional states will amend their own laws to exempt inherited IRAs from creditor's claims.