Chapter 5

Retirement Funds and Accounts

Chapter 5 takes a focused look at 2012 developments in the treatment of retirement accounts in consumer cases. Two point/counterpoint articles examine whether funds held in a 401(k) account should be considered “income” when computing the debtor’s current monthly income. The final two articles in the chapter examine *Chilton v. Moser (In re Chilton)*, an important decision from the Fifth Circuit holding that debtors may exempt an inherited IRA.

A. 401(k) Account Funds Should Be Considered Income at Time of Deposit

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It is conceivable that no change made by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) has created more work for the consumer bankruptcy practitioner than the concept of current monthly income (CMI). CMI is used to determine eligibility to file under chapter 7, the applicable commitment period under chapter 13 and disposable income for "above-median" debtors in both chapters. Section 101(10A) defines CMI as effectively all income received during the six months prior to the month of filing, without including Social Security benefits. While this does not sound complicated at first blush, ambiguity arises due to the fact that "income" is not defined in the Bankruptcy Code, nor has it ever been defined by the Code.

When Are Funds Received?

Distributions from 401(k) retirement plans are particularly problematic because as a general rule, the funds contained in such plans are derived from the owner's wages. There is little question that wages constitute income at the time they are earned. However, wages contributed to a 401(k) plan are not taxed until they are withdrawn from the 401(k) account as a distribution. Nonetheless, the Office of the U.S. Trustee argues that contributions to 401(k) plans should be included in gross income figures listed on the means test because § 101(10A) specifically states that CMI shall be defined without reference to how such income is taxed. Thus, the fact that income tax is deferred on such contributions should not be relevant to the question of when the income is earned. Oddly, the U.S. Trustee has typically sought to have funds contributed to a 401(k) plan included in income a second time when such funds are withdrawn.

When Are Funds "Possessed"?

No court has held that funds contributed to 401(k) plans should be counted both at the time they are earned and at the time they are withdrawn. However, courts are split on the question of when to count such income. In *DeThample*, the court opted for the latter approach, reasoning that income was defined as "a gain or recurrent benefit that derives from capital or labor."[1] This proposition has been repeatedly recognized by a variety of appellate courts.[2] Chief Judge Robert E. Nugent held that the "gain" occurred at distribution because "the debtor did not have possession or use of these funds until they were distributed."[3] This conclusion is dubious and has been followed in only one other standing decision.[4]

It's All About Control

The reasoning of *DeThample* is flawed because 401(k) contributions are generally elective and must be available to the employee in cash if the election is not made.[5] Thus, at the front end the debtor has possession of the funds immediately upon earning them.[6] As stated in *Simon v. Zittel*, "the employee's decision to deposit the earnings into a retirement account rather than spend it in another fashion illustrates the control the employee has over the funds."[7] On the other hand, at the back end, *Simon* compared 401(k) accounts to bank accounts, noting that in the case of the latter, the depositor had to write a check to access the funds, while in the case of the former, the depositor had to pay taxes and penalties, but the funds were equally accessible in both cases.[8] The owners of 401(k) accounts always have the ability to withdraw the funds at any time, both in the form of loans (in many cases) or in the form of distributions

1 *In re DeThample*, 390 B.R. 716, 720-21 (Bankr. D. Kan. 2008) (citation omitted).

2 *See, e.g., Blausey v. U.S. Trustee*, 552 F.3d 1124, 1133 (9th Cir. Cal. 2009).

3 390 B.R. at 720.

4 *In re Mendelson*, 412 B.R. 75, 84 (Bankr. E.D.N.Y. 2009) (adopting reasoning of *DeThample*).

5 *See* I.R.C. § 401(k) and 26 C.F.R. § 1.401(k)-1(e)(2).

6 A different conclusion may apply to employer contributions to such accounts, particularly where vesting does not immediately occur. *See In re Coverstone*, 2011 Bankr. LEXIS 1614, 10-11 (Bankr. D. Idaho April 21, 2011) (holding that because majority of debtor's pension plan revenues were from funds contributed by his employer, payments constituted income at time of distribution).

7 *Simon v. Zittel*, 2008 Bankr. LEXIS 834, 7 (Bankr. S.D. Ill. 2008).

8 *Id*. at 7-8.

(subject to tax penalties). Thus, a better analogy can be made to funds deposited into deferred annuities or certificates of deposit, where the depositor makes a certain savings election and is thereafter restricted from accessing the funds in some meaningful way. In either case, no court has held that funds deposited into such savings vehicles are earned when they are withdrawn (as opposed to when the depositor originally gained control over the source of the deposit).[9]

Majority Rules

The majority of courts have agreed with *Simon*, focusing largely on the issue of control.[10] These decisions include the Eighth Circuit Bankruptcy Appellate Panel ruling in *Zahn*, which reversed the lone decision upon which the court in *DeThample* had relied.[11] *Zahn* was decided in the context of individual retirement account (IRA) contributions, and the court noted that "the money deposited into an IRA is received for use *prior* to the distribution."[12] Similarly, the *Wayman* court ruled that distributions (occurring during the six-month CMI period) from an IRA that had been transferred from husband to wife in the context of a divorce (before the six-month CMI period) did not constitute income because "the funds came within her care, custody and control" prior to the applicable period.[13] This is notable because the debtor never actually had possession of the cash until distribution, instead taking an already created IRA directly from her ex-husband. Again, the question is not whether restrictions are placed upon use of the funds, but rather the mere fact that the account (and funds in it) are within the debtor's control.

9 *C.f., In re Breeding*, 366 B.R. 21, 25 (Bankr. E.D. Ark. 2007) (liquidation of CD produced no "income" and citing *In re Moore*, 188 B.R. 671, 676 (Bankr. D. Idaho 1995) for proposition that "the mere conversion of the debtors' pre-conversion assets from one form to another (even cash) does not produce income"); *In re Crumley*, 428 B.R. 349, 362 (Bankr. N.D. Tex. 2010) (withdrawals from brokerage account were not income and did not need to be disclosed as such on statement of financial affairs).

10 *In re Zahn*, 391 B.R. 840 (B.A.P. 8th Cir. 2008); *In re Cram*, 414 B.R. 674, 681 (Bankr. D. Idaho 2009); *In re Marti*, 393 B.R. 697, 700 (Bankr. D. Neb. 2008); *In re Wayman*, 351 B.R. 808 (Bankr. E.D. Tex. 2006).

11 391 B.R. 840.

12 *Id*. at 845.

13 351 B.R. at 811.

But Wait, There's More....

In addition to being within a debtor's control both at the time they are earned and at the time a distribution is elected, 401(k) accounts are within a debtor's control during the life of the plan because such plans afford the participants control over how such funds are invested. While 401(k) investments are directed by a plan trustee, almost all of them provide some limited investment options for the account owners, such as bonds, large and small cap stocks, international stocks and various diversified funds. Only the account owner gets to make the election as to which funds to purchase, and those elections can be changed at will. On a minor point, employees pay Federal Insurance Contributions Act taxes on such contributions at the time the funds are earned. For these reasons and those stated, funds contributed to 401(k) plans must be considered income under § 101(10A) at the time they are earned, not when they are withdrawn.[14]

14 There remains an issue concerning gains realized during the lifetime of the retirement account. The increase in value of such accounts cannot easily be accounted for at any other time besides withdrawal. Fortunately, most 401(k) plan statements clearly reflect what portion of the account value is attributable to employee contributions, which should make it easy to identify the portion of withdrawals that qualify as "income."

B. 401(k) Funds Not "Income" until Disbursement

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Distributions from 401(k) accounts that are received within the six-month prepetition period must be included in calculating current monthly income (CMI) because the income is received for the first time when the funds are disbursed from the account. Under the Bankruptcy Code, CMI is defined as "the average monthly income from all sources that the debtor receives...without regard to whether such income is taxable...."[1]

The issue with 401(k) accounts involves looking at the possession, control and transfer of the funds as it passes step-by-step from the employer to the employee in order to determine that discrete moment in time when the debtor finally "receives" the income. Some assert that the income is "received" in the first instance when the wages were earned and the funds deposited in the account by his or her employer. The more logical approach is to find that the employee, lacking control and possession over the funds while in the account, "receives" the income for the first time upon disbursement. The issue has plagued and challenged the bankruptcy courts that have delved into the thicket, and not surprisingly, the decisions are discordant.

A 401(k) is an employer-based account. The employee earns the funds to be contributed but does not receive them at the time earned. Instead, the funds take a circuitous route, passing from the employer's bank account (to which the debtor has no access) in the form of a check or transfer to the retirement plan fund to the retirement plan's bank account where they sit (hopefully growing) and finally to the debtor upon distribution.[2]

1 11 U.S.C. § 101(10A).

2 An individual retirement account (IRA), on the other hand, is different. Such an account is funded by the individual's own assets, which he or she necessarily must have received prior to deposit in the IRA. In this sense, an IRA is akin to a bank account, a point made in *In re*

At what point in all of those transfers do we treat the debtor as having "received" the income? In the case of *In re Sanchez/In re Zahn*,[3] the bankruptcy court correctly found that the debtor did not "receive" the income until the final point of the route, and thus the income was received upon disbursement. The court stated that:

> [e]arnings that are contributed to a 401(k) plan are deferred as income and are received by the employee and taxed by the government at a later date, *i.e.*, when the funds are withdrawn.
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> ***
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> Simply stated, money contributed to a 401(k) plan is neither received for use by a taxpayer nor recognized as income for tax purposes until that money is withdrawn from the 401(k) plan.[4]

On the other hand, in the case of *Simon v. Zittel (In re Zittel)*,[5] the court rejected the *Sanchez/Zahn* position and found that the income was "received" at the time the funds were earned and deposited into the account. In *Simon*, the court stated:

> It is clear that income received by an employee and deposited into a retirement savings account is just as "received for use" as if those funds had been deposited into a checking or savings account. In fact, the employee's decision to deposit the earnings into a retirement account rather than spend it in another fashion illustrates the control the employee has over the funds. Simply put, once placed in a retirement account, the funds are unavailable to the wage earner only in the sense that there may be hoops to jump through to access them.

Zahn, 391 BR 840 (B.A.P. 8th Cir. 2008). The various decisions fail to consider the very real differences between 401(k) accounts and IRAs, which need to be taken into account. *But see In re Coverstone*, 2011 Bankr. LEXIS 1614 (Bankr. D. Idaho 2011) (court took time to consider differences between 401(k) account and pension plan).

3 2006 Bankr. LEXIS 1381 (Bankr. W.D. Mo. 2006). Some will immediately argue that *Sanchez/Zahn* was overruled by *In re Zahn,* 391 B.R. 840 (B.A.P. 8th Cir. 2008). However, it appears that the BAP incorrectly characterized the retirement accounts as IRAs, whereas if one looks at the schedules and the *Sanchez/Zahn* decision, the accounts are described as 401(k) accounts. Would *Zahn* have come out differently if the BAP correctly characterized the accounts? Did the characterization in each case affect the outcome?

4 *Sanchez/Zahn*, at *6 and *9.

5 2008 Bankr. LEXIS 834 (Bankr. S.D. Ill. 2008).

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> The presence of penalties and taxes, however, does not make the funds any more unavailable than funds in a checking account. Clearly, wages, once received by the debtor, are "received for use" and within the "care, custody and control" of the debtor until they are spent, no matter how they are allocated.[6]

Simon is not correct. Consider the following examples that illustrate different timing, receipt and control issues, which show how the position taken in *Simon* fails in application.

- A salesman may earn a commission pre-petition, but receive the check post-petition. Strangely, if income is received when earned as suggested in *Simon*, the commission income must be included in CMI at the time it was *earned* during the six-month period even though it was received much later.[7]

- Has the debtor "received" income if the debtor earns his or her wages and the employer cuts the debtor a check, but the debtor has not cashed it yet? In *Barnhill v. Johnson*,[8] the U.S. Supreme Court held that until a check is actually honored, there has been no transfer of property and until such point, all the debtor would have is a chose in action against the employer who wrote the check. The *Simon* holding is in conflict with *Barnhill*.

- What if the employer electronically deposits the funds into the debtor-employee's bank account? Has the debtor received his or her income? It would seem so, but not so fast. Money deposited in a bank establishes a debtor-creditor relationship in which the money deposited is considered a loan to the bank, and the property interest that a debtor has is a promise to pay from the bank—and again, the debtor has a chose in action against the bank for the return of the funds.[9] Again, no property has been transferred or "received" by the debtor until the funds are withdrawn.

6 *Simon*, at *7-*8.

7 For those who dismiss such an example out of hand, *see In re Burrell*, 399 B.R. 620, 622 (Bankr. C.D. Ill. 2008), for an enlightening discussion.

8 503 U.S. 393 (1992).

9 *See Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995); *Riverview Cooperative Inc. v.*

Furthermore, for all of *Simon*'s bluster about how a 401(k) account is similar to a bank account that the debtor has access and control over, one need only consider the Supreme Court's decision in *Rousey v. Jacoway*.[10] The Court rejected the argument that the retirement account was like a bank account and also rejected the notion that the debtor had access because they could withdraw the funds, noting that the penalties "erect...a substantial barrier to early withdrawal." Unlike *Simon*, the Court apparently had a different view about the access and control that a debtor has over his or her retirement account. These points demonstrate that intuitive conceptions about when income is "received" are in need of more refined thinking.

Conclusion

Saying that a debtor-employee "receives" his or her income when the income is earned and deposited into a 401(k) account is incorrect. At each point along the path to the debtor, one can show that the debtor never had the possession, use or access to the funds until such earnings were finally received upon disbursement. The bankruptcy court in *Sanchez/Zahn* was correct to say that the debtor finally "receives" his or her deferred earnings for the first time upon disbursement, and this decision is in accord with the Supreme Court's view of transfers, access and control of assets. Cases like *Simon* that suggest that the debtor has control over the funds prior to disbursement are problematic at best.

First National Bank & Trust Co. of Michigan, 417 Mich. 307, 317; 337 NW.2d 225 (1983).

10 544 U.S. 320 (2005). The author admits that the context of *Rousey* is different, but one cannot deny that the points raised were the same or similar.

C. Fifth Circuit Rules that Inherited IRAs Are Exempt under Code

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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).[1] 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,[2] 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.[3] They established an IRA account as an "inherited IRA" under the Internal Revenue Code (IRC) to receive distributions from their inheritance.[4] In their subsequent chapter 7 petition, they sought to exempt the inherited IRA from the estate pursuant to § 522(d)(12).[5] 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

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

2 Cases holding that an inherited IRA is exempt include *In re Nessa*, 426 B.R. 312, (B.A.P. 8th Cir. 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 Weilhammer*, 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).

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

4 *Id*.

5 *Id*.

not contained in the type of tax-exempt account specified in the statute.[6] The bankruptcy court sustained the trustee's objection, and the debtors appealed.[7] The district court reversed the bankruptcy court's ruling, citing to several cases decided subsequent to the bankruptcy court's ruling.[8] 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.'"[9] 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]."[10]

Addressing the first prong, the court noted that the phrase "retirement funds" is not defined in the Bankruptcy Code.[11] The court examined the plain meaning of the words as defined in *Webster's Dictionary*,[12] and as analyzed and employed by other courts.[13] Then citing to three recent district court judgments reversing bankruptcy court decisions on this issue, the Fifth Circuit concluded that

6 *Id.*

7 *Id.*

8 *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, (B.A.P. 8th Cir. 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 Weilhammer*, 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.

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

10 *Id.* at 488.

11 *Id.*

12 *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."

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, (B.A.P. 8th Cir. 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 Weilhammer*, No. 09-15148-LT7, 2010 WL 3431465 (Bankr. S.D. Cal. Aug. 20, 2010)).

inherited IRAs are "retirement funds" as that term is used in § 522(d)(12).[14] 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.[15]

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.[16] 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,[17] and then examining the IRC provi-

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—
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> > (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.

sions 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"[18] 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."[19] Accordingly, the court concluded that § 408 of the IRC is the exempting section for all individual retirement accounts.[20] 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).[21]

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).[22] 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.

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*.

D. Inherited IRAs: Exempt Asset or Windfall?

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An issue that seems to be arising with some frequency is whether funds in a Debtor's IRA account may be exempted under 11 U.S.C. § 522(d)(12) when the source of those funds is a rollover from a decedent's IRA. 11 U.S.C. § 522(d)(12) provides that retirement funds may be fully exempted "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."

Chilton v. Moser (In re Chilton), _F.3d_ 2012 WL 762924 (5th Cir.)

In a case of first impression at the circuit court level, the Fifth Circuit Court of Appeals held that an inherited IRA directly transferred to debtors pre-petition is exempt under 11 U.S.C. § 522(d)(12) because the funds in the IRA were set apart for retirement and exempt from taxation pursuant to 26 U.S.C. § 408(e).

Facts

The debtor's mother established an IRA account for herself and designated the debtor as the beneficiary. The debtor's mother died, and the assets in the account passed to the debtor, who, in compliance with all relevant tax laws, established an "inherited IRA" and had the assets transferred to the trustee of the inherited IRA. Shortly thereafter, the debtor filed a voluntary chapter 7 bankruptcy petition and claimed that the $170,000 in the inherited IRA was exempt from creditors under 11 U.S.C. § 522(d)(12). The bankruptcy trustee objected to the exemption, claiming that the funds were not "retirement funds" as to the debtor and that the inherited IRA account was not tax-exempt pursuant to any of the sections of the IRS Code set forth in § 522(d)(12). The bankruptcy court denied the exemption. *In re Chilton*, 426 B.R. 612 (Bankr. E.D. Texas

2010). That denial was reversed by the district court for the Eastern District of Texas. The district court was affirmed by the Fifth Circuit Court of Appeals.

Analysis

A bankruptcy exemption under 11 U.S.C. § 522(d)(12) must meet two requirements: (1) the amount the debtor seeks to exempt must be "retirement funds" and (2) those retirement funds must be exempt from income taxation under one of the Internal Revenue Code provisions specified in the bankruptcy statute. One of the specified IRS code sections is 408, which provides a tax exemption for IRAs.

The trustee argued before the bankruptcy court that an inherited IRA did not contain "retirement funds" because retirement funds are funds set apart for the specific objective of retirement. According to the trustee, the funds in an inherited retirement account are neither set apart for a specific objective of the beneficiary nor designated for retirement as to the beneficiary. The bankruptcy court agreed. The bankruptcy court then considered whether the funds in an inherited IRA are "in a fund or account that is exempt from taxation under section...408...of the Internal Revenue Code of 1986." The bankruptcy court found that an inherited IRA was a vehicle for receiving a distribution from a tax-exempt account rather than a tax-exempt account defined by section 408(e)(1) of the IRS Code.

The district court and the court of appeals disagreed with the bankruptcy court and held that an IRA account set up with funds inherited from someone else's IRA account satisfied both the "retirement funds" and "tax exempt" requirements of 11 U.S.C. § 522(d)(12). Those courts found that the defining characteristic of "retirement funds" is the purpose for which the funds are set apart, not what happens to the funds after they are set apart. Because the funds at issue in the case were set apart for retirement at the time they were deposited by the mother into the mother's IRA, they remained "retirement funds" when sitting in the inherited IRA.

The district and appellate courts also held that inherited IRAs do not lose their original status as retirement funds under federal law due to the transfer from one tax exempt account to another. An inherited IRA remains tax-exempt under § 408(e)(1) of the IRS Code.

The *Chilton* case is the first inherited IRA case taken up by a circuit court, although the Eighth Circuit BAP addressed the issue in *Doeling v. Neesa.*[1] The *Nessa* court held that inherited IRA accounts were exempt under § 522(d)(12).

The majority of bankruptcy courts that have considered the issue are in accord with the appellate court in *Chilton*.[2] These cases all focus on the plain meaning of the words "retirement funds" and find that because the funds were originally set aside from retirement, the funds remain "retirement funds" when transferred to a beneficiary. Each of these cases also holds that funds in the inherited IRA account are exempt from taxation. Therefore both requirements of § 522(d)(12) are satisfied. The only cases that have held that funds in an inherited IRA is not exempt under § 522(d)(12) have all been reversed on appeal.[3]

Notwithstanding the trend of the case law, trustees in the Sixth and Seventh Circuits should consider continuing to argue that inherited IRAs are *not* exempt under 11 U.S.C. § 522(d)(12). An argument can still be made that an inherited IRA is an inheritance, not a retirement fund. The focus of the case law has been that the status of a retirement account does not change upon distribution to a beneficiary if the beneficiary (debtor) rolls the account into a tax qualified IRA. The beneficiary (debtor) now has a "retirement fund" that may be exempted under 11 U.S.C. § 522(d)(12). An argument that has been ignored in the case law is that the IRS regulations that control inherited IRAs precludes an inherited IRA from being saved for the beneficiary's retirement.

The primary purpose of allowing beneficiaries of an IRA to roll the inherited IRA into another IRA is to defer the tax consequences of the inheritance. *Chilton*, 426 B.R. at 416. The bankruptcy court in *Chilton* explained:

> The inherited IRA must be set up and maintained in the name of the deceased IRA owner for the benefit of the beneficiary. *See* 26 U.S.C. § 402(c)(11)(A); Publication 590 at 20. The

1 *In re Nessa*, 426 B.R. 312 (B.A.P. 8th Cir. 2010).

2 *See In re Kuchta*, 434 B.R. 837 (Bankr. N.D. Ohio 2010); *Bierbach v. Tabor* (*In re Tabor*), 433 B.R. 469 (Bankr. M.D. Pa. 2010); *In re Thiem*, 2011 WL 182884 (Bankr. D. Ariz. Jan. 19, 2011); *In re Weilhammer*, 2010 WL 3431465 (Bankr. S.D. Cal. Aug. 30, 2010).

3 *See In re Chilton*, 426 B.R. 612 (Bankr. E.D. Tex. 2010), *rev'd*, 444 B.R. 858 (E.D. Tex. 2011); *In re Clark*, 450 B.R. 858 (Bankr. W.D. Wis. 2011), *rev'd*, No. 11-cv-482, 2012 WL 233990 (W.D. Wis. Jan. 5, 2012) (interpreting analogous provision 11 U.S.C. § 522(b)(3)(C)); *In re Stephenson,* 201 WL 6152960 (E.D. Mich. Dec. 12, 2010) (reversing oral pronouncement of bankruptcy judge that inherited IRA was not exempt from bankruptcy estate).

> beneficiary may make no contributions to the new account, nor may he or she rollover the inherited funds into another retirement plan. *See* 26 U.S.C. §§ 402(c)(11)(A)(ii), 408(d)(3). Beneficiaries of inherited IRAs may make withdrawals at any time, without penalty and must either start taking lifespan-measured withdrawals within one year or take the entire amount within five years. *See* 26 U.S.C. §§ 401(a)(9)(B)(ii), 402(c)(11)(A)(iii), 408(a)(6). *See also* Publication 590 at 37.[4]

The beneficiary pays the taxes on the withdrawal at the time of the withdrawal.

Because the IRS requires that a beneficiary liquidate an inherited IRA within five years of the rollover, an inherited IRA cannot be saved for retirement. While the "plain meaning" argument has a great deal of appeal for courts considering the issue, a "plain meaning" analysis could also support an argument that if funds are not for the purpose of retirement either when they are transferred or when they are withdrawn by the beneficiary, they are no longer, in reality, funds for retirement. Given that a "plain meaning" analysis supports arguments on both sides of the exemption issue, it may be appropriate to make an argument that Congress could not have intended for debtors to exempt funds that are essentially a windfall.

State Exemption Statutes

Most states have statutes that exempt funds in tax-qualified IRA accounts from the claims of creditors. Debtors who are required to use state exemptions because their state has "opted out" of the federal exemption scheme[5] or who choose to use state exemptions[6] may exempt funds in an inherited IRA under their respective state statutes. Courts are split as to whether an inherited IRA may be exempted under a state statute.

The cases that have held that an inherited IRA may be exempted under a state statute generally follow the same reasoning adopted by the Fifth Circuit in *Chilton*.[7] These decisions are all relatively recent and appear to reflect the same trend exhibited by the cases decided under 11 U.S.C. § 522(d)(12)

4 *In re Chilton,* 426 B.R. 612, 617 (Bankr. E.D. Tex. 2010).
5 (11 U.S.C. § 522(b)(2)).
6 (11 U.S.C. § 522(b)(3)).
7 *See In re Stephenson*, 2011 WL 6152960 (E.D. Mich.); *In re Weilhammer*, 2010 WL

There are, however, several cases in which the bankruptcy court has held that an inherited IRA may not be exempted under a state exemption statute.[8] These cases have generally distinguished an IRA established by the debtor with debtor's own contributions from an inherited IRA. Case law finds that the latter has more in common with an inheritance than it does with a retirement fund. These cases hold that an inherited IRA is not an IRA within the meaning of the applicable state exemption statute.

Conclusion

The trend in the case law is clearly to find that an inherited IRA may be exempted under either 11 U.S.C. § 522(d)(12) or a state exemption statute. Notwithstanding this trend, given how much money is at stake, it seems likely that trustees outside the Fifth and Eighth Circuits will continue to challenge the exemption of inherited IRAs.

3431465 (Bankr. S.D. Cal. 2010); *Bierbach v. Tabor* (*In re Tabor*), 433 B.R. 469 (Bankr. M.D. Pa. 2010); *In re Thiem*, 2011 WL 182884 (Bankr. D. Ariz. Jan. 19, 2011); *In re Kutcha*, 434 B.R. 837 (Bankr. N.D. Ohio 2010).

8 *See In re Navarre*, 332 B.R. 24 (Bankr. M.D. Ala. 2004); *In re Kirchen*, 344 B.R. 908 (Bankr. E.D. Wis. 2006); *In re Sims*, 241 E.D. Tex. 2008); *In re Greenfield*, 289 B.R. 146 (Bankr. S.D. Cal. 2003).

Chilton v. Moser (In re Chilton)

Summarized by Craig Geno
Craig M. Geno LLC

Citation: *Chilton v. Moser (In re Chilton),* Case No. 11-40377 (5th Cir. Mar. 12, 2012)

Ruling:

Affirms district court opinion.

Procedural Context:

On appeal to the Fifth Circuit.

Facts:

Debtors inherited an IRA worth $170,000. When they filed bankruptcy, they attempted to exempt the IRA, and the trustee objected. The bankruptcy court denied the exemption, but the district court reversed.

The Fifth Circuit affirmed the district court and followed the majority of courts in ruling that inherited IRAs are exempt. The IRA satisfied the two requirements of 11 U.S.C. § 522(d)(12) because it was a "retirement fund" and the funds in it were in a fund or account that is tax exempt under 26 U.S.C. § 408(e).

Judge(s): Benavides, Stewart and Graves.