Court Rules No Bankruptcy Exemption for Certain Retirement Plan Assets Acquired in Divorce

The U.S. Bankruptcy Appellate Panel for the 8th Circuit has ruled in *Lerbakken v. Sieloff and Associates* that bankruptcy creditors may access certain retirement plan assets obtained through a divorce. Normally, individuals who file for bankruptcy protection may keep all of their qualified retirement plan assets—and up to around $1.3 million in IRA assets. But the 8th Circuit has ruled that retirement assets received in a divorce—including those obtained through a qualified domestic relations order (QDRO)—may not always enjoy these special protections. This surprising decision reminds us that all recipients of these types of assets should carefully consider the best way to treat them—*before* bankruptcy is even on the radar.

Earlier Supreme Court Ruling Considered

In 2014, the Supreme Court ruled in *Clark v. Rameker* that a nonspouse's inherited (or beneficiary) IRA did not receive special protection, called a "bankruptcy exemption," because it was not considered a retirement fund within the meaning of the bankruptcy statute. The Court took into account several factors that are unique to inherited IRAs.

.

- IRA beneficiaries cannot contribute to inherited IRAs.
- Beneficiaries must take annual distributions, potentially years before retirement.
- Distributions are never subject to an early distribution penalty tax.

The Court found that these factors demonstrated that inherited IRAs are not intended to provide for retirement. The Court reasoned that, because the bankruptcy statute provides an exemption for *retirement* assets, and because inherited IRAs are not intended for retirement, they are not covered by the exemption.

The 8th Circuit Court Ruling

In *Lerbakken v. Sieloff and Associates*, the individual filing for bankruptcy (Brian Lerbakken, the "debtor") received a divorce decree and domestic relations order granting him both a portion of his former wife's 401(k) plan assets and the entire value of her IRA. The court stated that he never attempted to qualify the domestic relations order and that "Lerbakken has undertaken no other action to obtain title or possession of the accounts." A few years after the divorce decree was issued, he filed his bankruptcy petition.

Relying on the *Clark* decision, the U.S. Bankruptcy Court for the District of Minnesota ruled in May 2018 that the retirement assets were not exempt from creditors. This ruling was appealed, and the 8th Circuit Panel affirmed the lower court. It ruled that, like inherited IRAs, assets acquired through a divorce are not primarily retirement assets, and so do not qualify for the exemption.

Why Did the Court Rule This Way?

The 8th Circuit Panel provided only limited insight into its reasoning. In its opinion, the court indicated that the bankruptcy statute requires a two-part test. For the retirement assets to be considered exempt, they must

- be for the retirement of the debtor, and
- they must be held in an account exempt from taxation under the Internal Revenue Code.

Retirement funds not meeting this test do not qualify for the exemption. The court ruled that Lerbakken's assets were not for his retirement, using the *Clark* opinion to support its finding that "the exemption is limited to individuals who create and contribute funds into the retirement account." The court also found that the debtor's interest in the assets in question was nothing more than a property settlement, and thus not subject to special protection.

The Supreme Court reasoned that, because inherited IRAs are not intended to provide for a beneficiary's retirement, they are not subject to the distinctive protections that retirement assets receive in bankruptcy. The 8th Circuit Panel may have understood that most individuals who receive retirement plan funds through a divorce treat those assets quite differently from inherited IRA assets. In practice, most of them will move those assets into an IRA or other eligible plan that they hold in their own name, thus treating them *as their own retirement funds*. But the debtor in this case, Mr. Lerbakken, did nothing at all with his ex-spouse's retirement funds. He simply left them alone. And this allowed the 8th Circuit Panel to conclude that the retirement assets obtained through this divorce were functionally the same as inherited IRAs.

Who Will This Ruling Affect?

The U.S. Court of Appeals for the 8th Circuit covers Minnesota, Iowa, Missouri, Arkansas, North Dakota, South Dakota, and Nebraska. The 8th Circuit is the only one to have ruled on this issue so far, but other courts could certainly adopt this interpretation of the law if a similar case arises. If Mr. Lerbakken were to appeal the ruling, the U.S. Court of Appeals for the 8th Circuit would hear the appeal. But based on his circumstances, it seems unlikely that he will appeal.

So this *Lerbakken* ruling could affect individuals filing for bankruptcy protection anywhere in the United States—if they have retirement assets that were initially obtained through a divorce. The practical importance of the ruling, however, may be minimal. The decision properly addresses the unique facts in this case, but it does not address how a bankruptcy filer with divorce assets may be able to shield retirement funds from creditors. If Mr. Lerbakken had contributed the divorce assets into his own retirement account through a permissible transfer or rollover, would this court have ruled differently? It seems quite possible.

Case Implications

Bankruptcy trustees are required to zealously seek all appropriate debtor assets in order to pay the creditors of the bankruptcy estate. The *Lerbakken* ruling may catch the eyes of these trustees, who will likely seek to challenge any future exemptions that are claimed under similar circumstances. But the *Lerbakken* facts are unusual. Typically, individuals who receive retirement assets from a former spouse will take *some* action, perhaps moving assets into their own retirement plans. But most will not simply sit on their hands, letting assets languish "unclaimed" in the former spouse's IRA or 401(k) plan.

This case reminds us that this ruling could have been avoided entirely. Had Mr. Lerbakken been advised of the importance of carefully considering the merits of moving his ex-spouse's retirement funds into his own account, these assets might have been protected. Keep in mind that there may be good reasons not to treat all retirement assets obtained in a divorce as one's own. For example, the recipient may need to take some assets directly from the former spouse's 401(k) plan in order to avoid the 10% early distribution penalty. Your clients can make the best decisions in each circumstance only by fully understanding the consequences of their actions. So even if this case has created some uncomfortable ripples in the industry, it may contain some valuable lessons to share.

Ascensus will monitor progress on similar cases and will release ongoing analysis of this issue.
Visit ascensus.com for the latest developments.