The Wealth Counselor

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How to Protect Inherited IRAs After the Clark v. Rameker Decision

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From [Henry Weatherby]

Weatherby & Associates, PC

34 Jerome Avenue
Suite 310
Bloomfield CT 6022
860-769-6938

Our firm focuses our practice on Estate Planning, Business Planning, Trust Administration, Probate and Elder Law. We help families preserve and protect assets and values; we help business owners maximize their businesses' value.

In a landmark, unanimous *9-0* decision handed down on June 12, 2014, the United States Supreme Court held that inherited IRAs are not "retirement funds" within the meaning of federal bankruptcy law. This means they are therefore available to satisfy creditors' claims. (See *Clark, et ux v. Rameker*, 573 U.S. ______ (2014))

The Court reached its conclusion based on three factors that differentiate an inherited IRA from a participant-owned IRA:

1. The beneficiary of an inherited IRA cannot make additional contributions to the account, while an IRA owner can.

2. The beneficiary of an inherited IRA must take required minimum distributions from the account regardless of how far away the beneficiary is from actually retiring, while an IRA owner can defer distributions at least until age 70 1/2.

3. The beneficiary of an inherited IRA can withdraw all of the funds at any time and for any purpose without a penalty, while an IRA owner must generally wait until age 59 1/2 to take penalty-free distributions.

These factors characterize an inherited IRA as money that was set aside for the original owner's retirement and not for the designated beneficiary's retirement. This simple analysis has sent shock waves through the estate planning and financial advisory worlds, because its logic is also applicable to all inherited defined contribution retirement plan accounts, so inherited 401(k) and 403(b) accounts are also affected. What can be done to protect inherited IRAs from creditors? Could the *Clark* decision put IRAs inherited by spouses at risk? Could state law still protect inherited IRAs? In this issue we will answer these questions and provide guidelines for you and your team to follow when advising clients who or what to name as the beneficiaries of their IRAs.

What Can Be Done to Protect Inherited IRAs From Creditors?
In view of the *Clark* decision, clients must thoughtfully reconsider any outright beneficiary designations for their retirement accounts if they want to insure that the funds will remain protected for their beneficiaries after death. By far the best option for protecting an inherited IRA is to create a Standalone Retirement Trust for the benefit of all of the intended IRA beneficiaries. If properly drafted, this type of trust offers the following advantages:

- Protects the inherited IRA from each beneficiary's creditors as well as predators and lawsuits
- Insures that the inherited IRA remains in the family bloodlines and out of the hands of a beneficiary's spouse, or soon-to-be ex-spouse
- Allows for experienced investment management and oversight of the IRA assets by a professional trustee
- Prevents the beneficiary from gambling away the inherited IRA or blowing it all on exotic vacations, expensive jewelry, designer shoes and fast cars
- Enables proper planning for a special needs beneficiary
- Permits minor beneficiaries, such as grandchildren, to be immediate beneficiaries of the inherited IRA without the need for a court-supervised guardianship
- Facilitates generation-skipping transfer tax planning to insure that estate taxes are minimized or even eliminated at each generation

Downsides to tying up an IRA inside of a trust include compressed tax brackets which max out at $12,150 of income (in 2014), ongoing accounting and trustee fees, and the sheer complexity of administering the trust year after year. In addition, a well-drafted trust can be completely derailed by an uncoordinated IRA beneficiary designation. Therefore, all of the pros and cons of a Standalone

Retirement Trust must be carefully considered before committing to this strategy.

Planning Tip: In most cases a standard revocable living trust agreement will not be well-suited to be named as the beneficiary of an IRA. This is because in order to provide all of the benefits listed above and avoid mandatory liquidation of the inherited IRA over a period as short as five years, the trust agreement must be carefully crafted as a “See Through Trust.” A See Through Trust insures that the required minimum distributions can either remain inside the trust (an “*accumulation* trust”), or be paid out over the oldest trust beneficiary’s life expectancy (a “*conduit* trust”).

Thus, a Standalone Retirement Trust that has specific provisions for administering retirement accounts, and that is separate and distinct from a client’s revocable living trust that has been drafted to address the entire gamut of the client’s non-retirement assets, is the preferable type of IRA trust beneficiary. If your clients have not considered a Standalone Retirement Trust before the *Clark* decision, then the time is now to educate them about its far-reaching consequences and how a Standalone Retirement Trust can benefit their IRA beneficiaries.

Could the *Clark* Decision Put IRAs Inherited by Spouses at Risk?
The *Clark* decision dealt with an IRA inherited by the daughter of the owner. What if the IRA was instead inherited by the spouse of the owner, would the decision have been different?

When a spouse inherits an IRA, he or she has three options for what to do with it:

1. The spouse can cash out the inherited IRA and pay the associated income tax.

2. The spouse can maintain the IRA as an inherited IRA.

3. The spouse can roll over the inherited IRA into his or her own IRA, after which it will be treated as the spouse’s own IRA.

In scenario 1 the cashed-out IRA will not have any creditor protection since the proceeds will become comingled with the spouse’s own assets. Extending the Supreme Court’s rationale to scenario 2, the inherited IRA will not be protected from the spouse’s creditors since the spouse is prohibited from making additional contributions to the account, may be required to take distributions prior to reaching age 70 1/2, and can withdraw all of it at any time without a penalty. In scenario 3, a rollover is not automatic, and even after a rollover is completed, the inherited funds were certainly not set aside by the spouse for his or her own retirement before the rollover was initiated.

As a result of the *Clark* decision, will an IRA inherited by a spouse lose its qualification as a “retirement fund” under federal bankruptcy law once it is actually inherited by the spouse? Could the rollover of an inherited IRA into the spouse’s own IRA now be considered a fraudulent transfer under applicable state law? Unfortunately the answers to these questions are not clear at this time.

Planning Tip: Provisions can be made in a Standalone Retirement Trust for the benefit of a spouse. This may be important for many reasons aside from creditor protection, including a second marriage with a blended family or, when coupled with disclaimer planning, for a spouse who eventually needs nursing home care and seeks to qualify for Medicaid. A layered IRA beneficiary designation which includes a Standalone Retirement Trust and disclaimer planning can offer a great deal of flexibility for clients who want to insure that their hard-saved retirement funds stay in their family’s hands and out of the hands of creditors and predators.

Could State Exemptions Still Protect Inherited IRAs?

In the wake of the *Clark* decision, a handful of states – including Alaska, Arizona, Florida, Idaho, Missouri, North Carolina, Ohio and Texas – have either passed laws or had favorable court decisions that specifically protect inherited IRAs under state bankruptcy exemptions for federal bankruptcy purposes. If the IRA beneficiary is lucky enough to live in one of these states, then the beneficiary may very well be able to protect their inherited retirement funds by claiming the state exemption instead of the federal exemption.

Planning Tip: Caution should be used in relying on state exemptions to protect a beneficiary’s inherited IRA. People are more mobile than ever and may need to move from state to state to find work, pursue educational goals, or be closer to elderly family members in need of assistance. Aside from this, federal bankruptcy laws now require a debtor to reside in a state for at least 730 days prior to filing a petition for bankruptcy in order to take advantage of the state’s bankruptcy exemptions. Therefore, long-term planning should not rely on a specific state’s laws but instead should take a broad approach.

The Bottom Line

Given the amount of wealth held inside retirement accounts, planners have got to become adept at helping their clients figure out who or what to name as the beneficiary of these special assets. The *Clark* decision has amplified the need to become knowledgeable about the pros and cons of all of the different beneficiary choices for retirement assets.

This is certainly not one-size-fits-all planning and can only be done on an individual, case by case basis. We are here to answer all of your questions about protecting beneficiaries of retirement accounts through Standalone Retirement Trusts, disclaimer planning, and layered beneficiary designations.

Weatherby & Associates, PC 34 Jerome Avenue Suite 310 Bloomfield CT 6022 Website