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

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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*, 134 S. Ct. 2242 (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 2018 – 37%). However, this can normally be mitigated if the Standalone Retirement Trust is a "conduit" trust and if the Trustee has discretion to distribute the income out of the trust to the beneficiary which will cause the income to be taxed to the beneficiary at his or her tax rate.

Other possible downsides include 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.

> *Planning Tip:* Many advisors incorrectly believe that the "stretch-out" will be blown if a trust is named as the beneficiary. If the trust is designed properly the "stretch-out" can be preserved. As discussed above using the trust technique will not only permit the "stretch-out" but will offer all of the benefits a trust permits, including asset and divorce protection, professional management (if desired), and blood-line protection (again, if desired by the client).

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. It is good for the team of advisors to discuss this important planning option with their clients.

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