How to Protect Your IRAs for Beneficiaries

Leon C. LaBrecque, JD, CPA, CFP®, CFA
Maria L. Avesian, JD

On June 12, 2014, in a unanimous decision, the U.S. Supreme Court held that funds from an inherited IRA are not protected under bankruptcy — a ruling that will have a significant impact on how you designate your IRA beneficiaries.

The Facts of the Case: Heidi Heffron-Clark inherited an IRA from her mother in 2001 with a time of death value of $450,000. Ms. Heffron-Clark started taking monthly distributions from the account. By 2010, Ms. Heffron-Clark and her husband had reduced the IRA to $300,000 and had filed for bankruptcy. They maintained that the inherited IRA was a retirement account under the bankruptcy law and therefore exempt from creditors claims in bankruptcy.[1,2]

The Ruling: The Court ruled that an inherited IRA does not qualify as retirement funds, and therefore is not exempt from claims of creditors against your children in bankruptcy, and potentially their spouses. The Court cited three reasons that lead to this conclusion:

1. The holder of an inherited IRA may not invest additional money in the account,
2. The holder of the account must withdraw funds regardless of how many years they are from retirement, and
3. The holder may withdraw the entire balance from the account, for any purpose, without penalty.

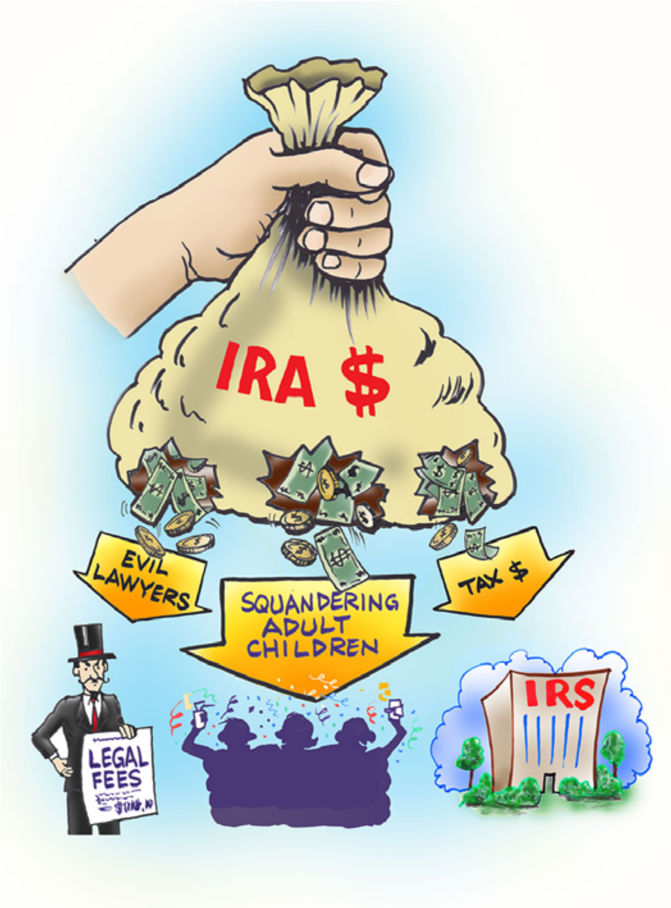
What This Means: The case sets a precedent that IRAs inherited by your children and other non-spouse beneficiaries will not be exempt from claims of creditors or bankruptcy. The ruling now requires that the legacy planning of your IRAs be looked at carefully. Until now, we had to worry about taxes or children running amok with funds from the IRA, we now also have to consider creditors.

Two Concerns: The first concern is to protect the IRA from the whims of the beneficiary. Inherited IRAs may be taken over the life expectancy of the beneficiary under the required minimum distribution (RMD) rules. This almost always results in the lowest taxes and the highest terminal value to the beneficiary. However, the beneficiary is under no obligation to take the distribution over their lifetime. If they do take it all at once, they would incur a substantial tax bill and shrink the size of the account.

The second concern — thanks to the new court decision — is the creditors of the beneficiary can now get to the IRA funds. This applies to joint creditors in a mutual bankruptcy, so potentially the debt of the spouse of a child or other beneficiary.

To state it more succinctly: before the case you had to worry that your daughter might withdraw your entire IRA to fund her boyfriend's brew-pub investment, or that your son might need

[1] Clark v. Rameker, No. 13-299 (U.S. 6/12/14), aff'g 714 F. 3d 559 (7th Cir. 2013)
[2] 11 U.S.C. section 522(b)(3)(C)



to use your IRA to make an emergency Corvette purchase. Now you have to worry about those things and that your IRA might pay for your son-in-law's bad debts, or your son and daughter-in-law's overdue car notes.

What to Do: IRA holders need to address this potential risk by choosing from a few options. For those with smaller IRAs, or mature and responsible beneficiaries, the choice may be to simply leave things as they are with proper beneficiary designations. The other approach is to create legal protection.

A way to protect and control an IRA for your non-spouse beneficiaries is to set up a separate trust known as an IRA beneficiary trust or spendthrift trust. For purposes of this paper, these types of trusts will be referred to simply as IRA trust(s). The complexities and rules regarding IRAs are beyond the scope of this paper. Your financial planning professional and plan provider(s) should provide this information.

IRA trusts were originally developed as a result of the IRS regulations governing the calculation of required minimum distributions from IRAs.[3] There are many private letter rulings by the IRS approving these types of trusts.[4] As of July 7th, 2014, these IRA trusts are valid, and in the event the law changes, can be revoked or amended.

IRA trusts are an excellent way to control and protect an inherited IRA for a child or grandchild. In addition to protecting an IRA from the bankruptcy of a beneficiary, IRA trusts can provide spendthrift protection and protect against lawsuits, general creditors and poor financial decisions of the beneficiary. The IRA trust can mandate required minimum distributions only (unless the trustee determines otherwise).

These special trusts can also provide extra protection and control of the IRA for the benefit of a disabled beneficiary as well (in the form of preserving Medicaid and Supplemental Security Income (SSI) benefits).

If you are looking to control and protect an IRA for your beneficiaries, this type of trust may be for you. An IRA trust protects the kids from the money and the money from the kids.

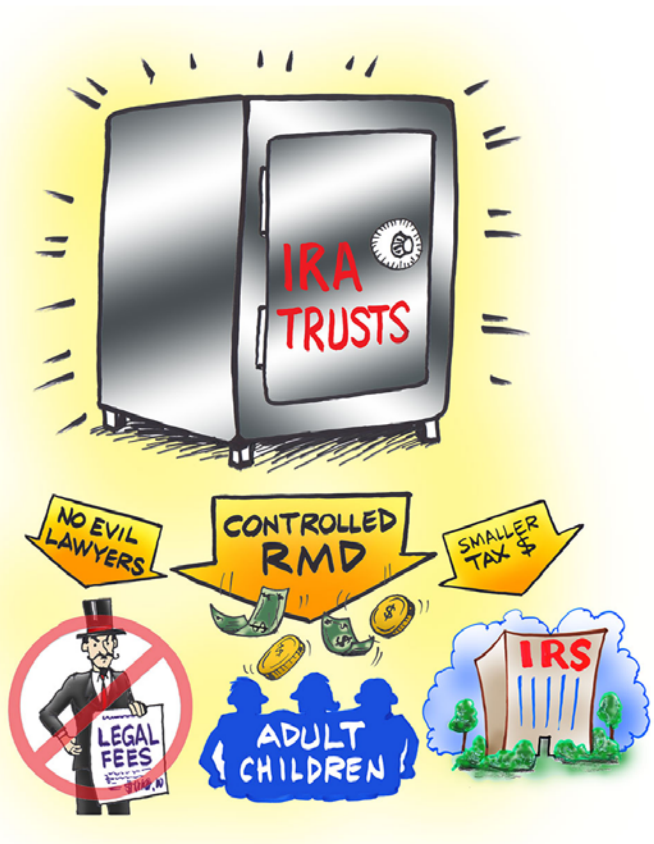
Example: To fully understand the advantages of an IRA trust, let's look at an example. John Doe is 75 and has an IRA worth $1 million from which he is currently taking RMDs. He wants to leave as much of his IRA as possible to his daughter, Jane and grandson, Jack. Jane, who is 49 years old, is a spendthrift and may cash out the IRA and spend all of the money. The other beneficiary, Jack is 19 years old and does not understand what an IRA is. John Doe has three options for designating Jane and Jack as beneficiaries of his IRA.

1 **Straight Beneficiary Designation:** One option is to complete a beneficiary designation form naming Jane as a primary beneficiary of 50% of the IRA and Jack as a primary beneficiary of 50% of the IRA. Using this option, upon John's death Jane and Jack would each receive their own separate inherited IRA, which would allow each of them to receive RMDs over their respective life expectancies. This would allow each of them to stretch the IRA to maximize the value of the IRA. A problem with this option is that either of the beneficiaries may cash in the IRA immediately upon John Doe's death, which would trigger substantial income taxes and a potential loss of the future value.

If Jane and Jack were both single with no itemized deductions or other significant income, they would each pay about $151,000 of federal income tax, plus about $21,000 of Michigan income tax if they each cashed in their share of the IRA.

Had they only taken the minimum distribution, assuming a 7% return, Jane's share of the IRA would grow to over $870,000 by the time she reached age 65. Assuming the same return, and distributions based on balances at the beginning of the year, Jane's RMD in the first year would be $14,245, growing to about $40,600 by age 65. At the end of the first year, her

[3] Internal Revenue Code §401 (a)(9)
[4] PLR 200537004



combined taxes on the minimum distribution would be about $2,700, while she maintained over $520,000 in her inherited IRA.

Given these assumptions, Jane would get about $328,000 after tax if she takes it all at once, compared to an after-tax lifetime cumulative stream of income of about $861,000 plus a tax-deferred IRA balance over $973,000 by the time she is 73.

2 **Revocable Trust:** A second option is to name John Doe's revocable living trust (not the same as the IRA trust) as the IRA beneficiary. The beneficiaries of the trust would be Jane and Jack. The revocable living trust must have appropriate pass-through language so that the trust qualifies as a designated beneficiary of an IRA.[5] The IRA would then pass through the trust and be carved into separate IRAs, one for Jane and one for Jack. The trust does allow for the IRA to be protected if one of the beneficiaries die, but does not prevent the beneficiaries from cashing out their individual IRA. Another disadvantage with this option is that, if the IRAs were not cashed out, the age of the oldest beneficiary would be used to calculate RMDs. Therefore, if Jack were to keep the inherited IRA, his RMDs would be based on Jane's age and they would both receive the same distribution.

3 **IRA Trust:** A final option is to set up an IRA trust with separate sub-trusts for Jane and Jack. Under this option the age of the beneficiary of each sub-trust would be used for calculating RMDs. Setting up an IRA trust with sub-trusts for each beneficiary is the best way to ensure the full stretch-out value of the IRA to both Jane, the spendthrift, and Jack the 19 year old with little financial knowledge. They get their required distribution, and possibly more, but in no event can they outlive the money on their own whim. The trust also builds the spendthrift wall to guard the trust against creditors. For example, if Jane ran into hard times and ran up her credit card debt and defaulted, the IRA trust would be protected from those claims.

Roth IRAs vs. Taxable IRAs: Roth IRAs have a unique characteristic to a beneficiary (from the primary Roth holder) in that the distributions are tax-free. For this reason, Roths usually provide a primary strategy of 'hold it as long as you can'. The beneficiary cannot usually obtain the equivalent benefit of a Roth if they make a withdrawal. From a planning aspect, stretching a Roth to the longest payout period and forcing that payout period, as well as protecting the Roth, makes eminent sense for larger Roths. In our example, Jane was 49. If the IRA she inherited from her father was a Roth, assuming the same 7% growth rate, by the time she reaches age 85 (her approximate life expectancy from IRS Table I), she would have taken over $1.87 million in tax-free distributions, and still have a tax-free balance of almost $686,000 ($2.53 million tax-free total). Jane's beneficiary unfortunately would be bound by the IRS 5-year rule — forcing her heirs to withdraw the balance of the IRA at the end of five years.

§401(k)s and Other Qualified Plans: Employer sponsored plans like §401(k) plans, or any of the other equivalents (i.e., §457s and §403(b)s), also have beneficiary problems. Tax logic indicates that there is no advantage to keeping money in an employer plan after age 59½ . You can name a spouse as the primary beneficiary and the IRA trust as the secondary (or the IRA trust in the event that there is no spouse). Qualified plans can be rolled to beneficiary IRAs and the IRA trust can protect them as well. If the account owner dies while still employed, the plan documents may have restrictions on who can be named a beneficiary. It is recommended you check with your plan administrator.

How the IRA Trust Works in Your Estate Plan: IRA trusts are an additional piece of your overall estate plan and are not meant to replace a revocable living trust or a will. There are also additional costs associated with IRA trusts. There are initial costs to set up the trust as well as future costs of administration and preparation of tax returns after your death. Ultimately, these additional fees may be minimal compared to protecting

[5] Treas. Reg. section 1.401(a)(9)-4, A-5(b),(1)-(4)

the future value of the IRA. Finally, if it is determined that an IRA trust is right for you, there is specific language that must be used on the IRA beneficiary designation forms. It is recommended that you meet with your estate planning attorney or financial planning professional to see if an IRA trust is right for you and if it is, to get assistance when completing beneficiary designation forms.

The IRA trust is an excellent estate planning tool in the right circumstances. There are a number of factors to assess to see if this is right for you, including the size of the IRA, whether or not your beneficiaries can properly manage the IRA, the spending habits of the beneficiaries, and potential for creditors with the beneficiaries.

FAQs

When should I use an IRA trust? Use an IRA trust if you want to control the IRA for your beneficiaries and protect it from creditors. IRA trusts have the control to protect your IRA from poor money management, spendthrift habits, lawsuits, bankruptcy, creditors, loss of government benefits, and in-laws from getting the IRA.

IRA trusts also allow non-spousal beneficiaries to potentially use their own life expectancy for RMDs and prevents beneficiaries from cashing in an inherited IRA.

What are the tax advantages? The trust can spread taxes out as distributions are made from the IRA trust. Bracket topping, or maximizing the lowest tax bracket possible for the beneficiary, is a very valuable tax planning technique that may be used by the trustee.

What is the tax effect of losing an IRA in bankruptcy? Since an inherited IRA to a non-spouse is unprotected, any distributions used to pay debt are taxable distributions and must be reported on Federal Form 1040 or 1041 (depending on the type of bankruptcy).

What is the dollar limitation covered under bankruptcy for a traditional IRA, Roth IRA, or an inherited IRA? For 2014, the amount covered under bankruptcy for traditional and Roth IRAs is $1,245,475. Inherited IRAs are not covered under bankruptcy. No limitation applies if the inherited IRA is owned by an IRA trust for the benefit of a beneficiary.

What is the difference between an inherited traditional IRA and an inherited Roth IRA? Although the non-spouse beneficiary of both an inherited traditional IRA and an inherited Roth IRA are required to take RMDs, only those distributions from a Roth IRA are tax free. A spousal beneficiary has different options.

How does the trust work? The IRA owner starts the process by creating a main revocable IRA trust that, on the owner's death, divides the IRAs into irrevocable sub-trusts for multiple beneficiaries. Upon completion of the trust, the owner completes beneficiary designation forms and submits them to the custodian of the IRA. It is important that the beneficiary form use specific language or the IRA trust may be void. Following the death of the IRA owner, the custodian of the IRA is notified and the IRA is transferred into the sub-trusts created under the IRA trust. Trust administration then begins, which involves preparing of annual accounts, calculating RMDs, collecting/paying out RMDs, and preparing and filing trust tax returns.

How can I make the beneficiary designation? An example of the language to use on the beneficiary designation form:

> "50% to the JANE DOE TRUST* and 50% to the JACK DOE TRUST*
>
> *established as a separate share under the JOHN DOE IRA TRUST dated MM/DD/YYYY"

Refer to your custodian for questions, as forms may vary by plan.

Can the trustee hold back funds in the trust? Typically, at least the RMDs are paid out to the beneficiary. The IRA trust can be either a conduit trust, which pays out the RMDs to the beneficiary, or it can be an accumulation trust, which gives the discretion to keep the RMDs in the trust. The type of trust that is best for you will depend on several factors that should be discussed with an estate planning attorney well-versed in IRA trusts and retirement planning.

Can the trustee distribute more funds to my children if needed? Yes, the trustee may be given the discretion to pay out more if needed. The trustee may also pay out more if it is prudent for tax planning.

Who is the trustee? What should I consider in a trustee? You can name an individual(s) or a corporate trustee. When naming an individual, consider someone that will follow the terms of the trust and will carry out their fiduciary duties as required by law. This does not mean the trustee cannot employ outside help, such as an accountant, financial advisor, or attorney. A corporate trustee will be able to administer the trust, but will charge higher fees and may not understand the needs of a beneficiary. You may also want to name an individual and a corporate trustee as co-trustees. Remember this is a personal decision that will vary depending on your situation and should be discussed with your attorney or financial planning professional.

How much are trustee fees? Individual trustees are not always paid. However, you can determine a fee such as an hourly rate. Hourly rates must be reasonable. What is considered reasonable varies depending upon the county. For example, an hourly rate of $45 in Oakland County is acceptable, whereas an hourly rate of $25 is acceptable in Wayne County. If a question arises over the rate charged, the probate court can be brought in. Corporate fees are usually a percentage of the assets being managed in the trust.

Can the trust administration fees be paid out of RMDs? Yes, ordinary administrative expenses (such as trustee and accountant fees) can be paid prior to distribution of the IRA withdrawal to the beneficiary.

Is there more paperwork to administer the trust upon my death? Upon the death of the IRA owner, there will be initial forms to complete with the IRA custodian so that separate inherited IRAs can be set up for each beneficiary. During administration, annual accountings and tax returns are required.

Can I use an IRA trust for a §401(k) or other plan? Usually §401(k)s and other employer-based plans require that all funds in such accounts be withdrawn within five years of the employee's death. If you have a §401(k) or similar plan with a former employee you may want to roll the assets into an IRA and then use the IRA Trust.

If my child is the beneficiary of my IRA trust and then passes away and it goes to my grandchildren, can the grandchildren use their own life expectancies for RMDs? No, the first non-spouse beneficiary sets the life expectancy for every beneficiary that inherits after him or her. The grandchildren would have to use the remaining life expectancy the parent would have had. In order for the grandchildren to use their own life expectancies, they would have to be named primary beneficiaries in the trust.

Do both spouses need separate IRA trusts? Assuming it is the first marriage for both, each spouse will have their own IRA trust that are mirror images of each other. Each spouse would then name each other as primary beneficiary of their own IRA and their own IRA trust as the contingent beneficiary. Using this approach the surviving spouse can roll over the deceased spouse's IRA into their own and then name the IRA Trust as the beneficiary.

Leon C. LaBrecque, JD, CPA, CFP®, CFA

Leon is a practicing attorney and financial planning expert that has specialized in servicing individuals, families, and small businesses in the areas of financial, estate, and tax planning for over 32 years. Under his leadership, LJPR has been recognized as a 'top adviser' by the likes of Barron's, The Financial Times and Crain's Detroit. LaBrecque's extensive career includes previous work at Arthur Andersen, Plante Moran, and Walsh College where he created the Master of Science in Finance program. He has also authored several proprietary retirement planning programs for several Fortune 500 companies and municipalities. LaBrecque's specialties include investment management for foundations and non-profit organizations, financial planning for automotive employees and retirees, and retirement planning for police officers and firefighters.

Maria L. Avesian, JD

Maria earned a Bachelor of Arts in Psychology from the University of Michigan, Ann Arbor and a law degree from the Detroit College of Law. She is a licensed attorney in the State of Michigan and is also a member of the Probate and Estate Planning Section of the Michigan Bar. Maria has been in private practice for over twenty years, primarily focusing on estate planning. She enjoys meeting with individuals and families to assist them with developing and implementing an estate plan specifically designed to meet their needs and the needs of their beneficiaries. The estate plans she develops reflect the client's personal wishes as well as the goals established by the client and their financial advisor.

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