Tuesday, June 17, 2014

US Supreme Court: Inherited IRAs not safe from Bankruptcy!!!

The US Supreme Court recently ruled that inherited IRAs are not "retirement accounts" for purposes of bankruptcy protection. Normally, a tax qualified retirement account is not available to creditors in a bankruptcy action. The Court ruled, however, that an inherited IRA, that is, an IRA inherited from someone other than a spouse, does not qualify for such protection. See Clark v. Rameker

What does this mean for estate planners? If a client has a large IRA and wishes to provide a retirement pool for his or her heirs, an inherited IRA is a very good tool. However, if that IRA is available to creditors or if the heirs can take the money out prematurely- called a "blow out"- the plan may fail. An answer to this problem is an IRA conduit trust, sometimes called an IRA Trust,an IRA Beneficiary Trust, an IRA inheritance trust, a stand alone IRA trust or an IRA protection trust.

If children and grandchildren who inherit IRA funds keep the funds in the IRA over their lives and only take the required minimum distributions each year (the “stretch-out”), the amount of money that can be earned, accumulated and paid to the beneficiaries can be staggering. To illustrate how this compounding can work, I have calculated how much money a beneficiary can receive from a parent's $100,000 IRA account; I have used two different ages (10 and 35) for the beneficiary and have assumed that the account averages an annualized 8% return:

Age	Years Paid Out	Paid Out	Remaining in Account	Total
35	49	$1,223,584	$5,046	$1,228,630
10	70	$4,279,898	$1,083,614	$5,363,512

This wealth accumulation strategy only works if the beneficiaries retain the inherited funds inside the IRA account. If a beneficiary takes all of the funds out of the IRA account at the time of the client's death (called a “blow-out” because it blows the stretch-out), this wealth accumulation technique will be lost. One of the reasons to create an IRA Beneficiary Trust is because it can insure the stretch-out and can prevent a blow-out. This blow-out happens more often than you may think. The beneficiaries may not be aware of the tax rules and their distribution choices, so they may immediately withdraw the IRA's at the first opportunity (or worse yet, do a prohibited rollover!). If the “stretch-out” isn't done properly by the beneficiaries and income taxes are paid up front shortly after the IRA's are inherited, the heirs may lose hundreds of thousands of dollars (or more). Even if you assume that your beneficiaries will do the right thing (that is, keep the funds in the IRA account for their lives to maximize the income tax “stretch-out” of the IRA's), the IRA's may still be seriously exposed to one or more of the following threats that can arise years after:

1. Divorce.
2. Poor spending habits
3. needs-based governmental programs