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Trust now may be needed to protect inherited IRA

BY DEBORAH ELKINS

Estate-planning lawyers are contacting clients about a big change in the law when it comes to protecting retirement funds meant to pass by inheritance.

Until recently, clients who had Individual Retirement Accounts as part of their assets passing at death could count on those retirement funds being protected from creditors during bankruptcy – not only for the IRA owners, but also for those who inherited the IRAs.

Inherited IRAs are no longer protected in bankruptcy, the U.S. Supreme Court said on June 12, in *Clark v. Rameker*.

Lots of clients have IRAs, so lots of clients may be affected.

IRAs are the largest component among U.S. retirement assets, with \$5.68 trillion for the first quarter of 2013, according to a report from the Investment Company Institute.

Lawyers are telling their clients to take another look at setting up a trust to protect retirement fund assets. In the past, the extra expense and administrative inconvenience may have deterred clients from using a trust for retirement fund assets. *Clark* has recast that calculation.

No 'free pass'

Clark involved a joint Chapter 7 bankruptcy filed by a married couple who were trying to shield a \$300,000 Individual Retirement Account the wife had inherited from her mother. Although "retirement funds" are protected under 11 U.S.C. § 522, that protection only applies to funds belonging to the original owner, the unanimous court said.

That decision caught many lawyers by surprise.

"It really is an about-face. IRAs have carried really powerful statutory asset

protection" that presumably extended to inherited retirement funds, said Virginia Beach estate-planning lawyer Kenneth A. Dodl.

"IRAs are sort of sacrosanct in bankruptcy," said Richmond bankruptcy lawyer David K.

Spiro. "A lot of people thought this case would go the other way."

A Virginia statute "piggybacks" on the federal bankruptcy statute and has been interpreted to provide the same protection, said Richmond estate-planning lawyer M. Eldridge Blanton III. Everyone assumed the protection also covered inherited IRAs, but the Supreme Court "quite unequivocally said no."

The policy reason for the bankruptcy protection is maintaining some assets for a debtor's "fresh start," according to Spiro.

But that policy worked against the debtors in *Clark*. The "retirement funds" exemption should not be read to convert the bankruptcy objective of protecting debtors' basic needs into a "free pass" for a debtor who inherits the funds, the high court said.

Treating inherited IRAs the same way really doesn't fit the "fresh start" rationale, Spiro said. The rules with inherited IRAs are different.

"If you have an inherited IRA, you can take out any money you want without penalty, and you can't make ongoing contributions to the IRA. So the IRA doesn't really operate like a traditional IRA" created by a debtor, Spiro said.

"We often use standalone trusts as a vehicle for owning an IRA or a 401(k)," said Virginia Beach estate-planning lawyer Scott Alperin. "It's a separate trust vehicle specifically designed to hold retirement funds."

"People can design a trust to provide



DODL



ALPERIN

access to assets for needs, but protect the assets from creditors," Dodl said. The standalone trust has to be properly drafted because IRA distribution rules will apply through the trust.

Dodl said that for a client who has a significant amount

of IRA assets, a standalone trust will enable a trustee to keep the required minimum distribution in trust. It's valuable for the client who doesn't want to dump a large amount of cash in the lap of the beneficiary.

The "prototypical client" for such a trust has a "reasonably large IRA and children known to be irresponsible or in a profession that might give them exposure to lawsuits," Blanton said.

There's no bright line for deciding to use a trust, Blanton said. An IRA valued at \$1 million may clearly need trust protection, an IRA valued at \$100,000 may trigger at least a look at the issue.

Today, self-funded plans – IRAs, 401(k)s or 403(b)s – are the primary retirement savings vehicles for most people.

Of workers with pension coverage in 2010, 68 percent had only defined-contribution plans, and only 19 percent had a traditional, defined benefit pension, according to the Boston College Center for Retirement Research. That represents a major shift from 1983, when 62 percent of pension-covered employees had traditional pensions, while 12 percent had only defined-contribution plans.

Estate-planning lawyers say the reasoning in *Clark* likely will be applied to other kinds of self-funded retirement funds, such as 401(k)s and 403(b) plans.

Alperin said he does not see any "distinguishing factor" that would dictate a different treatment for those additional types of retirement funds.