



TRUSTS & ESTATES



Retirement Plan Trusts Headline IRA Forecast

The good news and bad news about inherited individual retirement accounts

Marc Cusano | Jul 15, 2014

Trying to predict how the Supreme Court will rule in a given matter is like trying to predict New England weather; you never know what you're going to get, and what you get, you don't always understand. On June 12, 2014, in *Clark, et ux v. Rameker*, 573 U.S. ____ (2014) the high court unanimously ruled that inherited individual retirement accounts aren't retirement funds within the meaning of federal bankruptcy law. In other words, the nine justices concluded with certainty that a retirement account can be both a retirement account and not a retirement account. New England weather indeed.

This ruling shifts the focus from the bankruptcy law context to the estate-planning realm, in which retirement plans inherited from a decedent won't benefit from the same shield of creditor protection that's afforded to such plans during the decedent's lifetime. The issue now becomes how to protect these inherited plans and avoid the consequences of failing to do so.

Surviving Spouse

If the beneficiary is a surviving spouse, there's good news and bad news and the forecast is cloudy. The good news is that a spousal beneficiary possesses the unique right to roll over inherited retirement benefits into their own retirement plan. In that case, the spouse may make additional contributions to the plan, the 10

percent penalty applies to early withdrawals and no minimum distributions are required until age 70½. These three common retirement plan features formed the three-pronged test used by the court in *Clark* to define a retirement plan. And, they likely save the day for the spouse and result in protection of the plan balance from creditors.

The bad news is the cloudy forecast. If the spouse instead takes the benefits as a spousal inherited IRA and not a rollover to his own plan, the *Clark* ruling might apply, meaning the retirement account isn't really a retirement account under federal bankruptcy law and therefore not protected from creditors. Here we go again with that New England weather. Because the spouse can't make additional contributions, must take required minimum distributions (RMDs) immediately and can withdraw from the plan at any time without penalty, all protection is probably lost as all three prongs of the test are met. The *Clark* decision was silent as to spousal beneficiaries, so we can only speculate about its application.

Non-Spouse

For a non-spouse beneficiary, there's also good news and bad news, but the forecast is clear. The good news is the clarity provided by *Clark*: Inherited IRAs are vulnerable to creditors. That's not entirely good news, but the remedy is: protect the retirement funds with a retirement plan trust (RPT).

Trust Protection

The preferred type of RPT to protect the inherited IRA is referred to as an “accumulation trust.” When the RPT is structured as an accumulation trust, beneficiaries can enjoy not only protection of the plan balance, but also protection of the annual distributions required from the account. Provisions would be included to permit the trustee full discretion over whether to accumulate the RMDs in trust as opposed to passing them out immediately to the beneficiary. These provisions ensure asset protection over the funds in the account.

Because the trustee enjoys the full discretion over whether and when distributions will be made, the beneficiary can’t force a distribution from the trust and, therefore, neither can a creditor of the beneficiary.

The alternate type of RPT, a conduit trust, doesn’t permit the accumulation of required distributions from the plan but instead requires that they be distributed out immediately to the beneficiary where, in most states, the protection of the trust is lost. The trust conduits or channels the RMDs to the beneficiary, and they become available to the beneficiary’s creditors and predators, regardless of whether the trustee is given discretionary distribution authority. Even so, the plan balance will remain protected.

Additionally, a conduit trust automatically qualifies as a designated beneficiary (DB) under the IRS safe harbor provisions. If a trust isn’t a DB, then the retirement funds will be depleted over five years instead of the beneficiary’s life expectancy. However, if properly drafted, an accumulation trust may also qualify for this favorable treatment.

The Trust That Keeps On Giving

In addition to creditor protection, a properly drafted RPT can provide a myriad of asset protection advantages, such as:

- **Divorce/family protection.** Keeps the retirement funds within the family and out of reach of the beneficiary's spouse and children from a previous marriage.
- **Lawsuits.** Protects the funds in the event of a lawsuit against the beneficiary.
- **Spendthrift protection.** Prevents a reckless beneficiary from squandering the funds on expensive jewelry, fast cars or exotic vacations.
- **Special needs planning.** Protects the funds for a special needs beneficiary without jeopardizing their state assistance.
- **Minor beneficiaries.** Allows minor beneficiaries to enjoy the funds without the need for a court appointed guardian or conservator.

Considerations

There are considerations with an RPT that shouldn't be overlooked, such as the aforementioned status as a DB, as well as higher income tax rates for a trust. It's by no means a one-size-fits-all approach. However, if protection is the name of the game for the client, then practitioners better learn to play.

Therein lays the bad news. There's liability reserved for the practitioner who neglects to educate clients about the negative *Clark*-related consequences of leaving retirement funds outright to beneficiaries and not in trust, especially if other aspects of the client's plan incorporate asset protection. Clients who indicate even the smallest desire to protect their beneficiaries must be made aware of *Clark* and the RPT remedy. If retirement

funds are left outright to beneficiaries, practitioners can no longer rely upon the federal cavalry to save the day. A do-nothing approach will leave both parties exposed.

RPTs, a staple in the arsenal of seasoned estate planners, are the weapon of choice to provide asset protection to beneficiaries and liability protection to practitioners.

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