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Planning Pointers

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Inherited IRAs – The Golden Egg Loses Some of Its Sheen

The named beneficiary of an Individual Retirement Account (IRA) or Roth IRA inherits a golden egg — an asset with uniquely valuable characteristics. In June, however, the United States Supreme Court in *Clark v. Rameker* issued a unanimous opinion that removed one of the beneficial characteristics of an "inherited IRA." The Court held that an inherited IRA is not exempt from a debtor's bankruptcy estate based on federal bankruptcy exemptions, meaning that funds held in a nonspouse beneficiary's inherited IRA are now available in bankruptcy proceedings to the claims of the account holder's creditors. It is unclear at this time how the Court's ruling in *Clark v. Rameker* affects spousal IRAs.

Assets held in qualified plans, such as pension plans, 401(k) plans, and 403(b) plans, are exempt from creditors under ERISA. Assets held in IRAs, however, are not protected under ERISA but do have protection from creditors under state laws and the federal Bankruptcy Code. Under the Bankruptcy Code, amounts held in an IRA, without regard to amounts rolled over from a qualified plan, are exempt up to $1,000,000 (adjusted for inflation to $1,245,575 in 2014). Because the Bankruptcy Code does not reference inherited IRAs, it was unclear before the Court's ruling in *Clark v. Rameker* whether inherited IRAs were protected in bankruptcy.

INHERITED IRAs

Upon the death of a participant in an ERISA plan or an IRA owner, the beneficiary can withdraw part or all of the account but is required to report those withdrawn funds as taxable income. As an alternative, the beneficiary can elect to treat all or part of the account as an inherited IRA.

Inherited IRAs differ from traditional IRAs in certain respects and have special rules:

- The beneficiary of an inherited IRA cannot make contributions to the IRA.
- The beneficiary of an inherited IRA generally must take distributions based on the beneficiary's life expectancy, commencing in the year following the year of the IRA owner's death. If an IRA owner dies after his or her required beginning date and the IRA owner was younger than the beneficiary, however, distributions can continue to be made based on the IRA owner's life expectancy.
- The beneficiary of an inherited IRA can take additional distributions at any time without being subject to the early distribution penalty applicable to other IRAs.
- The beneficiary of an inherited IRA that is not a Roth IRA is not subject to income tax on the IRA until taking a distribution. Distributions from an inherited Roth IRA are not subject to income tax as long as the Roth IRA existed for five years.
- If there are numerous beneficiaries of an IRA, each beneficiary can set up an inherited IRA with

his/her portion of the account.

- While an inherited IRA can be rolled over, it must be identified as an inherited IRA in the name of the deceased IRA owner.

An additional advantage of inherited IRAs in some jurisdictions has been that they were protected from a beneficiary's creditors. The Court's recent ruling has removed that advantage.

THE SUPREME COURT'S RULING

Heidi Heffron-Clark was the beneficiary of her mother's IRA, which she inherited after her mother's death. Ms. Heffron-Clark received distributions from the IRA for many years before filing for Chapter 7 bankruptcy with her husband. Under the Bankruptcy Code, IRAs are "retirement funds" that are exempt up to $1,245,575 from the bankruptcy estate. Ms. Heffron-Clark and her husband claimed that the inherited IRA qualified for the retirement fund exemption from the bankruptcy estate.

In *Clark v. Rameker*, the Court denied Ms. Heffron-Clark's claim that her inherited IRA was a retirement fund exempt from the bankruptcy estate based on the federal bankruptcy exemptions. The Court distinguished inherited IRAs from other IRAs that have been set aside for retirement. The Court reasoned that, because the beneficiary of an inherited IRA cannot make contributions to the IRA, it does not share an important purpose of other IRAs, which is to provide a tax incentive for retirement savings. Additionally, the distribution rules for inherited IRAs differ from the rules applicable to traditional IRAs. To encourage IRA growth until retirement, the IRS imposes an early distribution penalty for amounts withdrawn from a traditional IRA before age 59½. The beneficiary of an inherited IRA is not subject to this penalty and is free to take distributions earlier than is required of traditional IRAs without penalty. Further, the IRS requires distributions from an inherited IRA to be made over the life expectancy of the beneficiary, commencing in the year following the year of the IRA owner's death. The beneficiary may elect instead to continue to take distributions over the IRA owner's life expectancy. If the IRA owner dies before his or her required beginning date, the beneficiary may alternatively elect to have the entire account paid out within five years of the IRA owner's death. Based on these rules that distinguish an inherited IRA from other IRAs, the Court found that an inherited IRA is not a retirement fund for purposes of the federal bankruptcy exemption.

PLANNING IMPLICATIONS

Although some states protect inherited IRAs in bankruptcy, because beneficiaries may move from a state with an inherited IRA exemption to a state without an exemption, state exemptions may not necessarily be relied upon when planning for inherited IRAs.

An individual's IRA often constitutes a significant portion of the overall estate and generally is addressed in estate planning. IRA owners who plan properly can protect IRA beneficiaries from the consequences of the Court's decision in *Clark v. Rameker.* An IRA owner who has reason to believe that an IRA beneficiary may encounter creditor issues in the future may wish to consider naming a trust as beneficiary of the IRA to protect the assets of the IRA from the reach of the beneficiary's creditors. Assets held in a "spendthrift trust" for the benefit of an individual (in lieu of being owned outright by the beneficiary) that contains a restraint on a beneficiary's voluntary or involuntary alienation would be unavailable to the beneficiary's creditors in bankruptcy. Naming a trust as beneficiary can also prevent a beneficiary from cashing out the IRA immediately and can stretch out distributions.

If an appropriate designation of beneficiary is made and a trust agreement is correctly drafted and administered, the trust beneficiaries can be treated as designated beneficiaries of the IRA for distribution purposes, and distributions can be made from the IRA to the trust over the life expectancy of the oldest trust beneficiary. Proper planning and understanding of the IRA minimum required distribution rules can permit distributions to be stretched out over the maximum period allowed by law. This ability to stretch out IRA distributions allows a beneficiary to take advantage of the IRA's valuable tax-deferred growth and to defer income taxes on the inherited IRA.

If the IRA owner is married, consideration generally is given to naming his or her spouse as beneficiary. The IRA not only qualifies for the estate tax marital deduction, but a spouse also has the most flexibility when planning for future distributions. Because the Court's ruling did not address a spouse IRA beneficiary, we cannot draw any conclusions about a creditor's ability to reach the assets of a spousal-inherited IRA. If a spouse rolls over the IRA to an account in his or her own name rather than treating it

as an inherited IRA, it appears that the "rollover IRA" could be exempt from the bankruptcy estate under the retirement funds exemption, despite the ruling in *Clark v. Rameker.*

The Court's ruling will affect IRA planning for both account owners and beneficiaries, especially in situations where creditor problems are likely to arise. Account owners may wish to reconsider the beneficiary designations for their IRAs.

In addition to planning for protection from creditors, tax planning is an important consideration for IRA owners. After an IRA owner dies, the IRA is not only included in the IRA owner's taxable estate, but a non-Roth IRA is also subject to income taxes as the IRA is distributed.

Amounts rolled over from a qualified plan into an IRA are not subject to the $1,245,575 maximum IRA exemption under the Bankruptcy Code. Participants may wish to open a separate IRA for qualified plan rollovers so that such amounts can be separately accounted for and remain fully protected in the event of bankruptcy.

MORE IRA NEWS

Beginning in 2015, taxpayers will only be allowed to make one IRA rollover in any 12-month period. This is a change from the current rule, which limits rollovers to one *per account* in any 12-month period. For this purpose, a rollover occurs when a taxpayer withdraws money from an IRA and deposits it into another IRA within 60 days. Direct trustee-to-trustee transfers of IRAs, where a taxpayer does not control the funds, are not affected by this new rule.

Proposals by Congress and the Obama administration over the past few years have targeted IRAs. Proposals to cap the amount that a taxpayer can accumulate in IRAs and to accelerate the payout of inherited IRAs are intended to generate new tax revenue.

When making beneficiary designations for IRAs and qualified plan accounts, individuals may want to consider these recent developments and the Court's decision in *Clark v. Rameker*.

For more information or if you have questions regarding the matters discussed in this legal update, please contact a member of our Individual Clients Group:

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