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Handling inherited IRA assets

Though its impact is remote, a high court decision highlights why it is best to be prepared

RETIREMENT WATCH

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Assets held in individual retirement accounts totaled more than $7 trillion at the end of the second quarter of 2014, the latest available data.

Based on our rapidly aging population and other factors, it's reasonable to assume significant and increasing numbers of those dollars will be passed along to the beneficiaries of IRA holders.

As most of us in the financial services industry are aware, the Supreme Court's recent decision in Clark v. Rameker held that assets in inherited IRAs cannot be considered "retirement funds" in the event of a Chapter 7 personal bankruptcy within the meaning of the statute protecting such funds.

This ruling represents an opportunity for advisers.

Odds are that Clark v. Rameker will affect very few of your clients or their beneficiaries, as it applies only to individuals who have inherited IRA assets and are declaring bankruptcy.

Consequently, given those odds, certain IRA account holders very likely will suggest that there's no reason to be concerned about what's going to happen to their IRA assets in the event one or more of their beneficiaries declares bankruptcy.

That argument can be countered with "better safe than sorry."

And the truth is, those of us who advise investors have a responsibility to assist them and their beneficiaries in being reasonably prepared for unanticipated bumps in the financial road.

A RULING offers an opportunity to have broader conversations with clients.

SPOUSAL IRAs

Clark v. Rameker involved a next-generation beneficiary and, in handing down its decision, the court was unclear how the assets in an inherited spousal IRA are to be treated if the surviving spouse declares bankruptcy.

Although this area remains clouded, strategies can be considered and deployed. If the surviving spouse has no immediate need for the inherited IRA assets, a potential solution may be to roll over the assets into his or her own IRA.

If the surviving spouse has not reached age 70½ but the deceased spouse had, rolling over the assets enables the spouse to delay taking distributions until 70½ rather than continuing to take the deceased spouse's required minimum distributions.

Surviving spouses under 59½ will be subject to the standard 10% early-withdrawal penalty if the assets are rolled into their own IRA before the distribution. If the assets are in an inherited IRA, however, surviving spouses can make penalty-free withdrawals, even when they are under 59½.

For many investors, especially high-net-worth investors, the most logical solution for addressing these and related considerations may lie within a retirement trust.

TRUST STRUCTURE

It's long established that certain types of trusts can be named an IRA beneficiary. However, they must be properly structured to realize the tax-deferred benefits of the IRA over the life of the beneficiary.

Once the question of whether state or federal law applies is resolved, an experienced trust and estate lawyer can draft a standalone retirement trust.

These instruments allow underlying beneficiaries of the trust to protect assets of the individual retirement account from all creditors and estate taxes, and provide controlled management of the assets with spendthrift protection.

Not surprisingly, these types of trusts can have downsides, including the application of the trust income tax rate rather than much lower personal income tax brackets, ongoing administration and other fees, and potential generation-skipping taxation if assets are transferred to a third generation.

We're not breaking new ground here. It's simply a matter of pointing out that, when addressing the issues that may arise from Clark v. Rameker, advisers have a real opportunity to discuss with donors — as well as, possibly, beneficiaries — a broader range of retirement issues and other long-term financial planning considerations.

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