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A Better Way to Leave Behind Your IRA

Consider naming a trust as your beneficiary, but watch out for tax issues and RMD complications.

By Robert K. Altshuler, JD CLU CHFC from PlanningCore Wealth Advisors LLC, | July 2016

Inherited individual retirement accounts are one of the most complex assets to deal with during estate administration. I learned this firsthand from my recent experience dealing with my father's estate.

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As a partner in a wealth management firm, I have significant knowledge and experience in dealing with this issue. Yet even to me, depending on the circumstances of how the deceased named beneficiaries, the administration and set-up of these accounts can seem complicated. Concerns regarding creditor protection versus the benefits of stretching the tax deferral of the IRA for future generations come into play. To complicate matters further, investment firms differ on how they will handle stretch provisions and required minimum distribution (RMD) calculations if a trust is the beneficiary of an IRA, which may be the case when creditor protection is a priority for estate planning.

Under federal law, inherited IRAs for a non-spouse beneficiary are not necessarily creditor-protected, meaning that the beneficiary's creditors can lay claim to the funds you left behind. This was the decision in the 2014 U.S. Supreme Court case, *Clark v. Rameker*. The Supreme Court held that assets in an inherited IRA for a beneficiary who is not the spouse of the IRA owner are not creditor-protected if that non-spouse beneficiary files for bankruptcy.

There is an important exception to this rule, however. If the IRA beneficiary lives in a state that has established a specific bankruptcy exemption for inherited IRAs, then the inherited IRA is creditor-protected, despite the Supreme Court ruling. States that currently offer creditor protection for inherited IRAs are Alaska, Arizona, Florida, Missouri, North Carolina, Ohio and Texas. Other states may eventually add laws to protect inherited IRAs from creditor's claims as well.

Naming a Trust as a Beneficiary

Michelle Tran, estate planning attorney with Clark Hill in Scottsdale, Arizona, advises that another way to protect IRA assets from a beneficiary's creditors, or from the beneficiary's own inability to manage the inherited funds, is to name a trust as the beneficiary of the IRA rather than naming the beneficiary directly. Assuming that the trust has appropriate spendthrift provisions, while the IRA funds are in the control of the trustee of the trust, the IRA funds are outside the control of the beneficiary and, thus, beyond the reach of his or her creditors.

Naming a trust as a beneficiary can have tax issues of its own, however. Under many circumstances, when an individual is named as the beneficiary of an IRA, the beneficiary can calculate the RMD that must be taken each year from the IRA based on the beneficiary's life expectancy. The longer the funds are in the IRA, the longer they grow tax-free and the longer the taxes on the distributions are deferred. This process of taking an IRA out over the longest period of time possible to defer taxes is often referred to as "stretching" an IRA. When a trust is named as the beneficiary of an IRA, stretching the RMDs becomes more complex.

To qualify for the stretch, the trust must include language required by the Internal Revenue Code to be treated as a qualified "designated beneficiary." In addition, if the trust has multiple beneficiaries, the IRS will look to the life expectancy of the trust's oldest beneficiary to determine the RMD unless these benefits are properly segregated among the trust beneficiaries. Finally, many IRA custodians will not allow inherited IRA proceeds payable to a trust to be "stretched," even if the trust complies with all of the required tax laws. In these cases, a five-year payout of the IRA to the trust will generally occur. Sometimes changing IRA custodians can help to avoid this result.

Be prepared for significant paperwork and delays in setting up the new inherited IRA accounts and eventual funding of the accounts from the deceased plan. Make sure to confirm if any documents need to be signature guaranteed before sending them to the investment firm. Processing of these accounts is based on receipt and can take several weeks to complete. Resubmitting documents can push you back in the queue.

If there are multiple beneficiaries inheriting an IRA that has a trust named as beneficiary, a letter from the trustees may be required to provide direction on how to split the proceeds to the non-spouse inherited IRA beneficiaries. In my personal experience, there was not a standard investment form for this direction. Additionally, you will need to provide the relevant provisions of the trust to the investment company and provide direction on who is the oldest living named beneficiary to set up RMDs for maximum stretch as previously discussed.

Some investment firms and brokerage companies offer a fairly new product called a "trusteed IRA," in which the brokerage company manages the inherited IRA as trustee for the benefit of the named beneficiaries. There is less flexibility in structuring beneficiary payout provisions in a trusteed IRA than there are in a trust created by the IRA owner, but this is often a viable solution for many people who do not want to have the IRA proceeds in the direct control of their beneficiaries and wish to stretch the payout period.

How best to structure your IRA beneficiary designations and your corresponding estate planning documents will depend on the unique needs of your family and other beneficiaries. Therefore, consulting with a qualified estate planning attorney and other financial professionals is critically important in this complex area of law.

SEE ALSO: What Is My IRA Required Minimum Distribution?

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This article was written by and presents the views of our contributing expert, not the Kiplinger editorial staff.