



# The Wealth Counselor

A monthly newsletter for wealth planning professionals

## Asset Protecting Inherited IRAs

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Americans hold nearly \$15 Trillion in IRAs and qualified retirement plans. Qualified retirement plan accounts are asset protected under federal law. IRAs are protected to at least some extent under state law. Many wrongly believe that these accounts will remain asset protected after their owners die. This issue of *The Wealth Counselor* first reviews the asset protection of qualified plans and IRAs, and the required distribution rules for account owners. Next it discusses the alarming concurrence of courts that inherited IRAs are not asset protected. Finally, it explores how Retirement Plan Trusts can provide that asset protection, along with the required distribution rules for these trusts.

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### The Need for Retirement Planning

Qualified retirement plans (here referred to as "qualified plans") and IRAs are ever increasing in importance in U.S. household wealth. According to the Investment Company Institute, at the end of the second quarter 2009, Americans held approximately \$14.5 Trillion in their IRAs and qualified plans, up from \$10.5 Trillion at the end of 2002.

IRAs account for more than 10% and qualified plans for 24% of all household financial assets, up from a combined 14% in 1978. More than 41% of all U.S. households have at least one IRA.

Premature plan owner deaths and minimum required distribution rules designed to never force a retiree to exhaust their IRAs and qualified plans, will combine to transfer a significant portion of those assets to the owners' beneficiaries. How they reach the beneficiaries is not governed by the owner's will or trust. It is determined by each account's beneficiary designation.

**Planning Tip:** IRAs and qualified plans are an ever increasing segment of the assets passed on at death. Clients need good counsel both as to how to best plan for that event and in implementing that planning.

#### **Asset Protection of Qualified Plans and IRAs**

Asset protection for owner's qualified plan accounts is provided under federal law while any that exists for IRAs is provided only under state law.

#### ***ERISA Protection for Qualified Plans***

ERISA (the federal Employee Retirement Income Security Act of 1974) provides protection from creditors for all qualified plan assets while they remain inside the plan. ERISA's asset protection for qualified plan distributions, however, depends upon whether the plan is a pension plan (complete protection) or a welfare benefit plan (no protection). Under ERISA, a "pension" plan is any "plan, fund or program which...provides retirement income to employees." Defined benefit pension, profit sharing, and 401(k) plans are all "Pension" plans under that definition. ERISA's protections are the same in bankruptcy court and outside of bankruptcy.

ERISA's protection also extends to an owner's IRA assets that were rolled over from a qualified plan.

#### ***Non-Bankruptcy Protection for IRAs***

ERISA does not govern IRAs and Roth IRAs. Any non-bankruptcy protection afforded for them comes under state law, which varies widely from state to state. That protection goes all the way from unlimited protection to protection of a specified amount to protection of a court-determined amount reasonably necessary for the debtor and any dependents. Also some state statutes may not protect Roth IRAs or IRAs converted to Roth IRAs.

#### ***Bankruptcy Protection for IRAs***

Bankruptcy law only protects up to \$1 Million of IRAs that were not created by rollover from a qualified plan.

**Planning Tip:** Do not combine an IRA rolled over from a qualified plan with one that was not. Doing so can jeopardize the client's asset protection in bankruptcy.

**Planning Tip:** ERISA provides unlimited protection for assets inside a qualified plan and for distributions from a pension plan, whereas state law determines the extent of protection for IRAs and Roth IRAs. Thus, in some instances it may be beneficial from an asset protection perspective to roll an IRA into an ERISA-protected plan, when possible.

#### **Asset Protection of Inherited IRAs**

Many courts have held that the protections available for IRAs do not extend to inherited IRAs. Courts in Alabama, California, Florida, Illinois, Texas, and Wisconsin have all

ruled that inherited IRAs have no asset protection, whether in or out of bankruptcy. It is important to note that Texas and Florida statutes generally provide the highest level of asset protection for IRAs, so the decisions there and the general trend are doubly alarming.

A consistent theme in these decisions is that Congress did not contemplate asset protection for anyone other than the worker (or the worker's spouse after a spousal rollover); its goal was to ensure the availability of assets during the owner/participant's retirement. Given this reasoning, it seems likely that more courts will find that inherited IRAs provide no asset protection.

**Planning Tip:** Clients have worked hard to accumulate assets in their IRAs. In the case of Roth IRAs, they have even paid the income tax on the contributions to the plans. Those who want to provide asset protection to the recipients of their other assets are likely to also want to provide that protection for the recipients of their IRA and qualified plan assets. However, they are mostly unaware that the asset protection they have will not extend to their beneficiaries.

### **The Fox Guarding the Hen House**

A second major problem in planning for qualified plans and IRAs is the "found money" syndrome.

Those who put the money in IRAs and qualified plans are often loath to take out even the required minimum distributions. Their beneficiaries often do not share that inhibition. Instead, they view their inherited IRA or qualified plan account as found money to be withdrawn and spent. Too often that spending is for the unwise and imprudent satisfaction of material desires and whims.

The symptom of this syndrome that the advisor typically sees is the rapid loss of assets under management. The collateral consequence for the beneficiary is the loss of a trusted advisor relationship that was built and relied on by their benefactor.

The good news is that the "found money" syndrome can be prevented.

### **The Retirement Plan Trust**

Can your clients asset protect their beneficiaries' inherited IRAs and qualified plan accounts and ensure that their beneficiaries receive the maximum stretch out benefit of tax-free compounded growth? The answer is a resounding, "YES!" The Retirement Plan Trust can do just that.

The Retirement Plan Trust is designed to weave carefully through the many pitfalls that exist in the law. To understand what that means, it is helpful to start with an understanding of the rules governing when withdrawals from qualified plans and IRAs must begin, the minimum rate at which withdrawals must take place once they are required to begin, and the rights of various classes of beneficiaries to "roll over" an

inheritance from a qualified plan or IRA to another IRA.

### **Qualified Plan and IRA Withdrawals by the Owner/Participant**

#### ***Required Beginning Date (RBD)***

As a general rule, a qualified plan participant or IRA owner must commence RMDs upon attaining his or her RBD. That RBD is generally the April 1 following the calendar year in which the owner/participant attains age 70 1/2.

#### ***Required Minimum Distribution (RMD)***

Generally, once the RBD has been reached, an account owner/plan participant's RMD is determined by dividing the prior year's December 31 aggregate IRA and qualified plan account balances by the owner's life expectancy factor. The life expectancy factor comes from the Uniform Table published by the IRS unless the participant/owner's spouse is more than 10 years younger than the participant/owner. If there is that age disparity, the RMD factor is taken from the Joint and Last Survivor Table published by the IRS.

**Planning Tip:** As a result of the Worker, Retiree and Employer Recovery Act of 2008 (which became law in 2009), there are no RMDs that must be taken in 2009 except those associated with an RBD of April 1, 2009.

**Planning Tip:** Under Notice 2009-82, participants have until November 30, 2009, or 60 days following the withdrawal (whichever is later) to roll over any distribution taken in 2009 that it turns out was not required to be taken. The rollover can be by deposit in other IRAs of the participant or by restoration to the account(s) from which the distribution was taken.

#### **Withdrawals After the Owner/Participant's Death**

After the owner/participant's death, when RMDs must begin and how much they must be is determined by different sets of rules. Those rules can be established in the qualified plan document as long as they are no more lenient than those established by the IRS for IRAs.

Historically, many qualified plans did not offer inheritors the option to stretch their withdrawals out over their actuarially determined life spans. Employers, finding no benefit in administering accounts for beneficiaries of deceased employees, often required inherited benefits to be immediately distributed or taken within just a few years.

To ensure that beneficiaries of qualified plan participants could take advantage of the maximum stretch opportunities allowed by the tax laws, Congress has now required that, effective January 1, 2010, all qualified plans must offer plan participants' beneficiaries the option of rolling their inherited accounts over into an IRA or a Roth IRA. Therefore, we will discuss only the rules for distributions from inherited IRAs and inherited Roth IRAs (which are the same).

**Planning Tip:** A non-spousal rollover must be trustee to trustee, and not one involving a distribution to the beneficiary. Also, a non-spousal rollover must not be into the beneficiary's IRA. Failure to adhere to these rules, like putting the account in the name of the beneficiary, is a taxable event!

### **What Rules Apply?**

The rules on how rapidly withdrawals must be taken from an inherited IRA differ depending on who or what the beneficiary is. There are a series of questions that guide that determination.

### ***Question Number One - Can the Account Be Divided into a Separate Account for Each Beneficiary?***

If, under the beneficiary designation, before December 31 of the year following that of the participant/owner's death a separate account can be and is established for each beneficiary, a separate determination will be made for each account. If, however, the separation cannot be made, the distribution rule that applies to the whole account is the one that would be applicable to the least privileged beneficiary.

### ***Question Number Two - Is There a "Designated Beneficiary"?***

The least stretch opportunity is afforded to the beneficiary that is or the class of beneficiaries that contains a beneficiary that is other than a "designated beneficiary."

A "designated beneficiary" is a beneficiary that is:

- Named as a beneficiary under the terms of the plan or by an affirmative election by the owner/participant; and
- An individual who is alive on the owner/participant's date of death.

A "designated beneficiary":

- Need not be specified by name, but must be identifiable on the owner/participant's date of death;
- May be a member of a class of beneficiaries capable of expansion or contraction (e.g., my children or grandchildren) so long as the members of the class may be determined on the owner/participant's date of death; and
- May be an individual among those named as beneficiaries of a "qualifying trust."

To be a "qualifying trust," a trust must meet four simple requirements:

1. It must be valid under state law;
2. It must be irrevocable upon death of owner;
3. All beneficiaries of the trust must be identifiable from the trust instrument; and
4. The Trustee must provide a copy of the trust to the plan or IRA custodian by October 31 of the year following the participant/owner's death.

Examples of named beneficiaries that cause the "designated beneficiary" question to be answered in the negative are the owner/participant's estate, a charity, an entity (e.g., a corporation, partnership, or LLC), and an individual who was not alive at the death of the participant.

The "designated beneficiary" determination has to be made by December 31 of the year following that of the participant/owner's death.

**Planning Tip:** If the beneficiary is a trust, the Trustee may be able to take actions that will make it a "designated beneficiary." For example, if the trust calls for a distribution of a specific amount to a charity, if that distribution is made before the determination date, the charity would no longer be a beneficiary and thus would not be considered in making the "designated beneficiary" determination.

***Question Number Three - Did Death Occur Before the Owner/Participant's RBD?***

The next question has to do with when the owner/participant died. Was it before the date on which the owner/participant was legally required to begin taking distributions (the RBD)? The owner/participant's RBD is April 1 of the year following that in which the owner/participant attains age 70 1/2.

The answers to those two questions will determine which cell of the following grid applies:

Required Minimum Distributions (RMDs)

	Death <b>Before</b> Required Beginning Date	Death <b>On or After</b> Required Beginning Date
"Designated Beneficiary"	Life Expectancy Rule	Life Expectancy Rule
"Non-Designated Beneficiary"	Five Year Rule	Participants' "Ghost" Life Expectancy Rule

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***Life Expectancy Rule***

If the Life Expectancy Rule applies, the beneficiary's RMD in the year following the owner/participant's death will be an amount equal to the account balance on the December 31 following the owner/participant's death divided by the beneficiary's actuarial life expectancy, as determined by the IRS Single Life Table, at the time of the owner/participant's death. The first RMD withdrawal must be taken by the December 31 following the first anniversary of the owner/participant's death.

In each subsequent year, the beneficiary's RMD will be the account balance as of the

prior December 31 divided by a number that is one less than the previous year's divisor.

#### *Five Year Rule*

If the Five Year Rule applies, every penny of the account must be withdrawn by the December 31 following the 5th anniversary of the owner/participant's death.

Withdrawals can be made at any time in the period so long as the account is emptied by that date.

#### *"Ghost" Life Expectancy Rule*

At the time of the owner/participant's death, he or she still had an actuarial life expectancy under the IRS table. That is referred to as his or her "ghost" life expectancy. If the "Ghost" Life Expectancy Rule applies, the beneficiary can take the distributions the owner/participant would have been required to take if still living.

**Planning Tip:** The Five Year Rule is a worst case. It is *only* applicable if (a) the owner/participant died before his or her Required Beginning Date; *and* (b) there is no "designated beneficiary." The Five Year Rule used to come into play more frequently. As a consequence, there is lingering confusion among advisors over its applicability.

#### **Question Number Four - Is the Beneficiary the Surviving Spouse?**

The final question that must be asked is whether the beneficiary is the participant/owner's surviving spouse. If the answer is, "No," the beneficiary has to take distributions in each year at least equal to that determined by applying the appropriate rule from the above table. However, if the answer is "Yes," the beneficiary has the additional right to roll over the plan account into his or her own IRA.

Only a surviving spouse can, through a trustee to trustee transfer, roll an IRA or qualified plan account over into his or her own IRA. Once rolled over, the surviving spouse uses the Uniform Table to determine his or her RMDs as if the surviving spouse established the account initially. RMDs from a rolled over IRA or qualified plan must commence by the surviving spouse's RBD.

A surviving spouse's right to roll over into his or her own IRA can be exercised at any time after the participant's death. Taking RMDs and other distributions does not affect the surviving spouse's right to roll over whatever is left.

**Planning Tip:** Delaying the rollover to the surviving spouse's own IRA until the surviving spouse attains age 59 1/2 will avoid early withdrawal penalties. The trade off is that the surviving spouse must take RMDs until that date arrives.

#### **Benefits and Detriments of Creating a Retirement Plan Trust to Be the Beneficiary of an IRA or Qualified Plan**

The Retirement Plan Trust, like any estate planning technique, is not a panacea. One size definitely does not fit all. To determine whether a Retirement Plan Trust is an appropriate

option for a particular client requires a weighing of benefits against disadvantages.

### ***Retirement Plan Trust Benefits***

Establishing a Retirement Plan Trust and naming it as the beneficiary of an IRA or qualified plan can provide a number of benefits. These include:

- Spendthrift protection - Protecting the individual trust beneficiary from his or her temptation to waste "found money."
- Predator protection - Even if the individual beneficiary does not have spendthrift tendencies, there are many out there whose interest lies in separating the beneficiary from their money and property.
- Creditor protection - Ours is a litigious society in which we never know who is going to be the target of a lawsuit. A trust makes the beneficiary a less attractive "target."
- Divorce protection - With the national divorce rate above 50%, it is impossible to determine which marriages will stand the test of time. A Retirement Plan Trust keeps the inherited IRA from being divided or even lost in a divorce.
- Government benefits protection - As with divorce, whether a healthy beneficiary will suffer some catastrophe that makes him or her dependent on needs-based government programs is unpredictable. Inheriting an IRA can easily disqualify someone from receiving needs-based government benefits until the IRA is exhausted.
- Providing consistent investment management (often from the participant's investment advisor).
- Estate planning.
- Control over use of the retirement plan/IRA assets (e.g., to fund education, start a business, or buy the beneficiary's first home or, in the case of a mixed family, to prevent diversion away from the owner/participant's descendants).

**Planning Tip:** The Retirement Plan Trust can begin as a revocable trust and become irrevocable on the owner/participant's death. This provides the flexibility of planning and control that clients prefer.

### ***Retirement Plan Trust Disadvantages***

The disadvantages of using trusts generally are all applicable to Retirement Plan Trusts. These are: the legal costs to create the trust and the trustee fees to administer it; the compressed tax brackets applicable to trusts, and the need to file income tax returns if the trust accumulates income; and greater complexity. However, the Retirement Plan Trust can be designed to mitigate these disadvantages, such as by making it revocable until the owner/participant's death.

**Planning Tip:** The benefits of using a trust generally outweigh the costs, particularly from an asset protection perspective. This is especially true in the context of inherited IRAs, which otherwise have no asset protection.

### **Retirement Plan Trust Distribution Provisions**

The IRS regulations describe two types of trusts that are the beneficiaries of qualified plans and IRAs: (1) Conduit Trusts, and (2) Accumulation Trusts.

#### ***The Conduit Trust***

The term "Conduit Trust" does not appear in the law or the regulations. It is a term that practitioners use for a particular kind of trust described in the examples given in the IRS regulations. In that example, the trust required the trustee to immediately distribute to the beneficiaries ALL amounts taken from the IRA. This trust is called a Conduit because it serves merely as a vehicle to get the distributions to the beneficiaries and the Trustee has no discretion in the matter beyond deciding how much to take out of the IRA or plan account. The Conduit Trust is an IRS "safe harbor" that automatically qualifies as a "designated beneficiary."

The compressed brackets of the trust are not a problem because the IRA distribution income is entirely attributed to the beneficiaries. On the other hand, a Conduit Trust is not a good choice for a beneficiary in need of asset protection or remaining eligible to receive needs-based government benefits.

A final advantage of the conduit trust is the opportunity it affords to name non-individuals as successor beneficiaries. In a conduit trust, the "designated beneficiary" test is made only by looking at the first tier of lifetime beneficiaries - the ones who will be beneficiaries on the participant/owner's death.

**Planning Tip:** Make an IRA or qualified plan payable to multiple conduit sub-trusts in a Retirement Plan Trust by specifically naming the subtrusts on the beneficiary designation form. That allows using the life expectancy of each subtrust's beneficiary, rather than that of the trust's oldest beneficiary, in determining the RMD for each subtrust.

#### ***The Accumulation Trust***

Under an Accumulation Trust, the trustee has the discretion to determine when (and perhaps whether) to make distributions from the trust. That discretion is independent from the requirement to take distributions from the qualified plan or IRA. The trustee may distribute the RMDs and other IRA distributions, but is not required to do so.

With Accumulation Trusts, the key issue is to determine which beneficiaries are "countable" for determining whether the trust qualifies as a "designated beneficiary" and whose life expectancy governs. The regulations tell us that all beneficiaries are countable unless such beneficiary is deemed to be a "mere potential successor" beneficiary, with little guidance as to what constitutes a "mere potential successor." While there are a number of IRS Private Letter Rulings ("PLRs") that provide insight into the IRS thinking about accumulation trusts, it must be borne in mind that each PLR is only applicable to the particular taxpayer to whom it was issued.

**Planning Tip:** If there is a chance that an accumulation trust beneficiary can die before outright distribution of the entire account, we must examine the contingent beneficiaries to determine if the trust qualifies as a designated beneficiary and to determine the governing life expectancy.

**Planning Tip:** Accumulation Trusts also require the drafting attorney to limit powers of appointment and adopted beneficiary provisions so that the beneficiary cannot appoint the property to or, by adoption include, someone older than the "designated beneficiary." Additionally, there are technical considerations, such as limitations on the formula funding clause (which defines how the trustee will fund the marital and credit shelter trusts) as well as limitations on payment of debts, taxes and expenses from the retirement account.

**Planning Tip:** Accumulation Trusts give the trustee much more flexibility in making distributions, but at the cost of limiting potential downstream beneficiaries. The client's desired downstream beneficiaries may have a shorter life expectancy or may not qualify as a "designated beneficiary."

### ***Having It Both Ways***

A recent PLR (number 200537044) gives guidance as to how the attorney team member can draft the Retirement Plan Trust as a Conduit Trust initially, so that we have certainty as to the life expectancy factor, while giving a Trust Protector the ability to "toggle" the trust to an Accumulation Trust, if necessary. This toggle affords the client even more flexibility than does an Accumulation Trust.

### **Can the Retirement Plan Trust Be Part of the Client's Will or Revocable Trust?**

While it may be possible to pull a ski boat with a Prius, it is not the vehicle of choice for that task. In the same way, while it is technically possible to adjust a trust in a will or a revocable living trust so that it will meet the stringent requirements for a being "designated beneficiary," the task is not an easy one and it is fraught with risks. Creating a Retirement Plan Trust that is a separate trust designed specifically for the purpose of being the beneficiary of IRAs and qualified plans also gives the client much more flexibility as to the downstream beneficiaries under the client's will or revocable trust.

Thus, while a Retirement Plan Trust can be part of the client's revocable trust or will, the drafting difficulties highlighted here show why a stand-alone Retirement Plan Trust is a better option, particularly for larger IRAs and qualified plans.

**Planning Tip:** "Larger" is a relative term, but advisors should consider the stand-alone Retirement Plan Trust for any client whose retirement accounts aggregate at least \$200,000.

### **Conclusion**

Given the amount of wealth in qualified plans and IRAs, much of which will be transferred at our clients' deaths, it is incumbent on the planning team to educate our

clients as to the issues these assets involve and to work together to provide comprehensive planning that meets each client's particular needs. A Retirement Plan Trust, particularly a stand-alone Retirement Plan Trust, can offer unique benefits, including asset protection for beneficiaries and protection of beneficiaries against "found money" syndrome.

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