Protecting IRA Benefits From The Beneficiary’s Creditors And Other Predators

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On June 12, 2014, the United States Supreme Court held in Clark v. Rameker that “inherited IRAs” are not retirement funds in the Bankruptcy Code and are, therefore, not exempt from the claims of the IRA beneficiary’s creditors in bankruptcy. An “inherited IRA” is an IRA that is bequeathed by the IRA owner to the intended beneficiary of that IRA.

In Clark, the Supreme Court ruled that assets in an “inherited IRA” are not retirement funds for three reasons: first, the holder of an inherited IRA cannot contribute additional funds to the account; second, holders of inherited IRAs are required to receive distributions from the accounts regardless of their age; and third, the holder of an inherited IRA can withdraw the entire balance of the account at any time regardless of age and use the funds for any purpose without a 10% premature distribution penalty. These reasons underlie the notion that the funds in the inherited IRA represent contributions made by the IRA owner for the IRA owner’s retirement, not for the retirement of the beneficiary.

This decision has implications for an IRA owner who plans to leave IRA funds outright to an individual beneficiary (an “inherited IRA”) who has or is prone to having creditor problems that may lead to bankruptcy. The IRA owner should instead consider placing the IRA in a trust for the intended beneficiary for distribution over that beneficiary’s life expectancy. The Internal Revenue Code allows the IRA benefits to be placed in a trust and distributed over the life expectancy of the beneficiary named in the trust by the IRA owner if the trust meets several requirements. The requirements are:

- First, the trust must be valid under state law.
- Second, the trust must be irrevocable upon the death of the IRA owner.
- Third, the IRA trustee or custodian must receive a copy of the trust instrument.
- Fourth, the beneficiaries of the trust must be identifiable from the trust instrument; and Fifth, all trust beneficiaries must be individuals.

The IRS will treat the individual beneficiary as a “designated beneficiary” who may then receive distributions from the trust over the beneficiary’s life expectancy.

Placing the IRA funds inside a well-structured asset protection trust with a spendthrift provision and that also complies with the minimum distribution rules of Internal Revenue Code Section 401(a)(9) should safely remove those benefits from the reach of the beneficiary’s creditors.

The trust may also provide additional benefits to the beneficiary such as safeguarding the trust’s assets (IRA) from the beneficiary’s spouse in the event of a divorce, preserving the trust assets during the beneficiary’s life expectancy instead of allowing the beneficiary to squander the entire trust assets on gambling or profligate spending, and providing for a special needs beneficiary by preserving that beneficiary’s continued eligibility for government benefits.