



INHERITED IRAs

SURPRISE! *That “Stretch IRA” you’re leaving your children may not be protected from their creditors*

Americans have more wealth tied up in tax-favored retirement plans than ever before—an estimated \$8.4 trillion, in fact. That’s more than 15% of the total net worth of all U.S. households.

If the favorable tax treatment afforded retirement plans has fueled their popularity and generated wealth previously unheard of for the nation’s workers, it’s also created a challenge for estate planners. Because so many taxpayers won’t consume their entire nest egg in a lifetime, their retirement assets will likely pass to the next generation as an inheritance.

You might think that the benefits available to one generation would be inherited by the next. After all, the tax consequences are certainly the same. But what happens if a beneficiary has creditors? Could those creditors reach an inherited IRA?

The answer is: it depends. Federal law protects your ERISA-qualified, employer-provided plans, including 401(k), pension, and profit-sharing plans. But protection for Individual Retirement Accounts is a matter of state law. While most states exempt initial owner and spousal IRAs from creditor claims, there’s a growing body of case law that questions the exemption of inherited IRAs once in the hands of the next generation.

Yet, with proper planning, it may be possible for a parent to leave their IRA to children or grandchildren and continue creditor protection.

One proposed strategy calls for establishing a separate IRA “irrevocable inheritance trust” that is designated as the beneficiary of the parents’ retirement accounts. The thinking goes that, while the trust is irrevocable, the designation isn’t. So if circumstances change, a new irrevocable trust can be designated the beneficiary as long as the trust contains a “spendthrift” provision that prevents creditors from reaching it.

Another option involves customizing an often overlooked section of the standard IRA form, Article VIII. The IRS provides a place in this section to incorporate “see attached” language. So long as it doesn’t violate the less-restrictive IRS rules for IRAs, the custodian should recognize the inserted attachment. Language could be as simple as: *A designated beneficiary’s interest in this IRA shall not be subject to liabilities or creditor claims, assignment, or anticipation.*

Coupled with this attachment would be a provision designating a trust as the beneficiary of the IRA. Michigan law prevents establishing a spendthrift trust to protect one’s own assets from creditors. But a spendthrift trust can be established that protects the trust assets from claims of the next generation’s creditors.

With a spendthrift trust as beneficiary of an IRA, the IRA’s assets are shielded from your beneficiary’s creditors. Federal bankruptcy law specifically excludes assets held by these spendthrift trusts from being subject to a bankruptcy proceeding.



What to do? If asset protection for IRA beneficiaries is an important consideration, use either a trustee IRA or name a spendthrift trust as beneficiary. And if your circumstances

should change? The new Michigan Trust Code recognizes the appointment of a “trust protector” who could modify the terms of the otherwise irrevocable trust, thus making it more flexible.

Clearly, federal and state laws governing tax-deferred retirement plans make this a complex issue. Call us if you’d like some help.

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