The DAILY PLAN-IT™

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Tax-deferred growth, creditor and divorce protection - What's not to like?

One the most valuable assets people often want to pass down to loved ones is a tax deferred retirement account.

The most common way to pass assets down is via the beneficiary designations on IRAs, 401Ks, life insurance, and annuities. On the face of it, the intent is good; but the strategy is flawed. Meaning, it is simple, but it gives up control and, more importantly, protection.

Patient Creditor(s)

In most states, creditors can obtain a judgment and then wait to pounce when assets pass to their targets from a parent or grandparent. There are several court cases that highlight why beneficiary designations can turn into a trap for clients and a windfall for the creditors of their beneficiaries.

Here's just one example: A husband and wife file for bankruptcy. The wife's mother later dies, but before her death she named her daughter as the beneficiary of an IRA worth $300,000, no doubt hoping this would give the couple an opportunity to start over.

Mom's intent was great, but her planning was terrible. The creditors of the married couple argued in bankruptcy court that an IRA is exempt from bankruptcy only if the daughter was the **owner** and not the **beneficiary**.

The US Supreme Court unanimously ruled in Clark v. Rameker, 573 U.S. 122 (2014), that inherited IRAs are not protected from a beneficiary's creditors. As such, the entire inherited IRA in the Clark case was subject to the beneficiary's creditors, instead of being protected for the beneficiary.

A Lesson for Advisors

If we could go back in time, what would we tell that family to prevent such an outcome? The only solution that makes legal sense would be to create an **Inherited IRA Trust**.

The Inherited IRA Trust becomes the beneficiary of the mother's IRA. In this scenario, it creates a legal wall between a beneficiary and their creditors. It is legal and would have radically changed the outcome of this case for the benefit of the wife.

If designed and drafted properly, the Inherited IRA Trust would isolate the proceeds until the daughter is discharged from bankruptcy, and then she could receive the benefits.

Some worry whether a legal strategy like this is expensive.

We have all heard the whines of those who thought something was "too expensive" to do - no matter what it was that you were recommending. You can imagine hearing someone say: "But an IRA Trust would cost a lot of money!"

If they paid 10 percent of their assets to protect 90 percent, isn't that a good deal? In the legal case referred to earlier, the family paid $0 for zero legal protection and managed to keep ***nothing***.

The point is this: If you have clients who have struggling beneficiaries, you can be a hero by educating them on this strategy.

As always, if you have a question or concern about a specific case, please contact our office. We're here to help.