

ESTATE PLANNING LAW UPDATE

June 2010

INHERITED IRAS: IS IT EVEN AN IRA?

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Much of society's wealth is now held in the form of IRAs. That means that lots of people will inherit assets as named beneficiaries of their parents' or grandparents' IRAs. It is now also possible to be named as the beneficiary of a decedent's qualified plan benefit, e.g., a profit sharing plan; a 401(k) plan, where the beneficiary can directly transfer, or "roll," that inherited qualified retirement benefit (trustee to trustee) into an *inherited* IRA. The benefit derived from an *inherited* IRA is that the IRA assets can continue to grow tax deferred, subject to required minimum distributions from the IRA over the beneficiary's life expectancy. This is commonly known as a *stretch* IRA. Another benefit is that IRA assets are usually exempt from creditor claims. However, confusion reigns since an IRA that a person accumulates for his or her own retirement is not treated the same from a legal standpoint as an *inherited* IRA where someone else did the retirement saving.

State Exemption Statutes

Under Michigan law an IRA owner may assert that his or her IRA is exempt from creditor claims. A creditor cannot force a distribution of IRA assets to satisfy the creditor's judgment

against the IRA owner. Many states have statutes similar to Michigan's that exempt IRAs from creditor claims.

A question exists whether the statutory exemption from creditor claims afforded IRAs will be extended to *inherited* IRAs. In a 2009 Florida decision (*Robertson v Deeb*) an *inherited* IRA was not protected under Florida's IRA creditor exemption statute because its Supreme Court found that the state's statutory exemption extended only to an IRA's assets if they are maintained in one particular fund or account. Because *inherited* IRAs are separate funds or accounts that are created when the original IRA owner dies, meaning the *inherited* IRA continues in the name of the decedent owner "for the benefit of..." another, the *inherited* IRA is not exempt from creditor claims. The Florida Court noted that the tax exempt status of an IRA changes dramatically when that IRA is distributed on the owner's death and becomes an *inherited* IRA held for the benefit of another.

Bankruptcy Code

Under the 2005 amendment to the federal Bankruptcy Act, a complete exemption for retirement funds from the bankrupt's estate is

granted, up to \$1 million, as adjusted by cost-of-living (\$1,171,650 as of 2010.) Accordingly, the Bankruptcy Code currently provides a \$1.17 million exemption available to *traditional* and Roth IRAs.

However, in a 2007 Bankruptcy Court decision (*Jarboe*) the Court distinguished an *inherited* IRA from a *traditional* IRA and concluded that an *inherited* IRA will not enjoy the \$1.0⁺ million bankruptcy exemption. Yet another Bankruptcy Court decision (*McClelland*) concluded that an *inherited* IRA was an exempt asset under a “plain reading” of the amended Bankruptcy Code. Earlier this year in another Bankruptcy Court decision (*Chilton*) the Court held that an *inherited* IRA “did not represent retirement funds” that were protected by the Bankruptcy Code’s creditor exemption since they are distributed to the named account beneficiary without regard to age or retirement status. But the most recent word on this evolving topic is a 2010 Bankruptcy Appeal Panel decision (*Nessa*) in which the panel found an *inherited* IRA to be exempt from the bankrupt-beneficiary’s estate, noting that the Bankruptcy Code does not specify that to qualify for the bankruptcy exemption the IRA’s funds must hold the *debtor’s* retirement funds.

So questions continue to linger under state creditor exemption statutes and the federal Bankruptcy Code whether an *inherited* IRA will be protected from the IRA beneficiary’s creditors.

Trust

If there is a strong desire to protect an *inherited*

IRA from the beneficiary’s creditors, then the IRA owner should take an additional protective step and make the IRA payable not to the named individual-beneficiary, but to a Trust that is established for the benefit of that named individual. Such a Trust will: (i) contain a *spendthrift* limitation authorized by the Michigan Trust Code; and (ii) give that Trustee the discretion to take withdrawals from the IRA and either expend those IRA distributions for the benefit of the named trust beneficiary or distribute the withdrawn IRA assets directly to the trust beneficiary. The Trust mechanism thus adds an additional layer of creditor protection because the trust beneficiary is not deemed to possess a “property interest” in the Trust, and the Trust contains a *spendthrift* clause that prohibits the trust beneficiary from voluntarily or involuntarily transferring that beneficiary’s interest in the Trust, making the Trust’s assets unreachable by creditors.

Until the courts clarify whether an *inherited* IRA will be afforded the creditor protection of state exemption statutes that is given to traditional IRAs, it may make sense for the IRA to be made payable to an irrevocable Trust for the benefit of a named beneficiary. Such a Trust will protect the *inherited* IRA in the event that the beneficiary has a judgment entered against him or her or subsequently files for bankruptcy. Consequently, an IRA made payable to the Trust for the benefit of the beneficiary will *not* be treated as an attachable property interest or an asset of the bankrupt’s estate.

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