How to protect inherited IRAs

BY SUSAN RACEY and PETER IGEL

The U.S. Supreme Court’s recent decision in Clark v. Rameker has given individuals with IRAs a new reason to consider the use of trusts as IRA beneficiaries. The decision made clear that inherited IRAs do not receive bankruptcy protection under federal law.

Federal exemption

The Bankruptcy Code allows debtors to retain certain property to help start over. Most retirement assets, including traditional IRAs, are protected.

Until recently, it was unclear whether an IRA inherited by a beneficiary would be protected. The Court concluded that bankruptcy law does not exempt inherited IRAs.

In Clark v. Rameker, a woman established a traditional IRA. Upon her death, her daughter inherited the IRA. When the daughter later filed for bankruptcy, she attempted to exempt the IRA. The court denied the exemption due to differences between traditional IRAs, which are funded for retirement, and inherited IRAs, which are received as a result of the IRA owner’s death.

These differences persuaded the court that inherited IRAs should not receive the bankruptcy protection intended for assets set aside for retirement.

State exemption

Because bankrupt debtors may opt to apply state exemptions instead of the federal exemption addressed in Clark v. Rameker, many debtors will look to state law for protection. Fortunately for debtors, Ohio offers protection for inherited IRAs.

Still, reliance on state exemptions for planning purposes is not always dependable in our mobile society. For example, if a person funding an IRA lived in Ohio but one or more of the beneficiaries reside in another state that does not protect inherited IRAs, the IRA would not be protected in bankruptcy.

Trust alternative

Instead of relying on Ohio’s exemption, IRA owners may protect the IRA by naming a trust as the beneficiary. In the event of the beneficiary’s bankruptcy, the trust can protect the inherited IRA regardless of the individual’s state of residence.

Also, the same trust can protect the IRA against other creditors outside of bankruptcy in the event of a divorce.

Doug Mathey, president of BCG Wealth Advisers and a partner with BCG Legacy Advisers, says, “It’s more complicated than adding up account balances to see if clients have reached a magic number. To begin with, there are many factors that may be trickier to quantify.”

The top three legacy planning factors from our clients are:

■ How much is my business worth?
■ How much will I have after taxes?
■ Will I have enough to take care of my family and myself?

Defining a legacy is as simple as stating what you envision for the long term. How you foresee your retirement, things you wish to do in retirement, things you wish your family to have, and the ability to plan for potential health care problems or other unforeseen emergences that won’t burden anyone.

Achieving a desired level of a legacy plan is more complex. The company’s objectives, strategy and capabilities must be measured and aligned with the business owner’s objectives.

In creating your legacy plan, you must consider the financial implications as well as the timing of transfers and the potential for legal actions or changes in the law that might impact your plan.

Protecting Your wealth ... after taxes

When the tax man cometh, it can be quite a hit on your legacy plan. For many, income taxes are the single greatest expenditure on an individual’s personal income statement.

It’s very important to enlist a trusted advisor that can tap your assets in the right order to minimize your tax bill.

A good advisor will be able to:

■ Manage investments to maximize after-tax returns.
■ Work within a multi-dimensional tax system and coordinate a strategy to contemplate for regular, tax, alternative minimum tax, capital gains and qualified dividends tax, net investment income tax, and itemized deduction limitations.

■ Create a strategy for fund withdrawal to keep taxes low, projecting income and bracket management, and use investment vehicles that minimize income taxes (i.e., tax-managed mutual funds).

While investors can control the direction and returns of the market, they should be able to control for risk, expenses and taxes to a certain degree. Through strategic tax planning in conjunction with asset protection strategies, wealth can be protected and preserved for the benefit of heirs and possibly even a charitable legacy if you desire.

Preserving your legacy

A vast majority of clients are concerned first and foremost with preserving the wealth they accumulate so that their families may benefit. Ensuring that there are enough assets to reach personal and financial goals is the critical first step in retirement planning.

But don’t undermine the assessment of business and personal risks. You will need to implement strategies to avoid these risks. An advisor that has experience in the diversified steps of legacy planning.

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