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Protecting Retirement Accounts from Creditors

Individual retirement accounts were always believed to be protected from creditors. On June 12, 2014, the Supreme Court decided otherwise.

Here are the facts: Ruth Heffron died owning an IRA. Ruth had not designated a spouse as beneficiary of her IRA. She would have been allowed to “roll” the account into her own IRA. Instead, Ruth designated her daughter, Heidi, as the beneficiary. Heidi, and any non-spouse beneficiary of a retirement account, receives it as an “inherited IRA.” Thereafter, Heidi filed for bankruptcy. She identified the inherited IRA she had received from her mother as an “exempt” resource, not subject to her creditors’ claims. The trustee in bankruptcy and the unsecured creditors objected, arguing that the funds in the inherited IRA were not protected “retirement funds” within the meaning of the bankruptcy statute.

The matter ultimately reached the Supreme Court which concluded that funds in an inherited IRA are not “retirement funds” as that term is defined by statute and are therefore not insulated from creditors’ claims. In support of its conclusion, the Court identified three distinguishing characteristics of inherited IRAs.

First, the original IRA owner can make contributions to the account while the beneficiary of an inherited IRA may not invest additional funds into that account. Secondly, owners of an IRA are not required to take distributions until they attain the age of 701/2 years while beneficiaries of an inherited IRA must take required minimum distributions annually, commencing with the year after the original account holder’s death, regardless of the beneficiary’s age. Lastly, holders of an inherited IRA may withdraw the entire balance at any time without penalty. In contrast, the original IRA owner is penalized for taking distributions before attaining the age of 591/2 years.

There is a way to safeguard assets in an IRA so that, when they are inherited, they are not exposed to creditors of the non-spouse beneficiary. First, a trust is established by the original account owner, naming the non-spouse as beneficiary. Then, the trust is named as the beneficiary of the IRA upon the original account owner’s death. In this way, the age of the non-spouse beneficiary will determine the required annual minimum distribution and the funds in the inherited IRA will be protected from the non-spouse beneficiary’s creditors. This type of trust can also be implemented or beneficiaries who are under the age of majority, immature or incapable of managing

their affairs. It allows beneficiaries who receive governmental benefits, such as Medicaid or supplemental Security Income, to insulate the inherited IRA from consideration in determining his or her eligibility for benefits, allowing the distributions to supplement, rather than replace, the governmental benefits and to enhance the beneficiary's quality of life.

This strategy must be implemented during the lifetime of the original account owner. If you are the owner of an IRA and have named or wish to name a nonspouse as the primary or contingent beneficiary, contact our office for a consultation to discuss whether a retirement rust is an appropriate mechanism for the protection of these assets.