Retirement Plans: The Overlooked Component of an Estate Plan

By Bob Prior

Estate planning covers a wide range of issues, including leaving proper instructions on how to leave your assets to your loved ones when you die. Individuals often spend a lot of time and effort planning how to distribute their assets under their will or trust. They may take care to plan for the needs of a surviving spouse, or take steps so that their children's inheritance is protected from potential lawsuits or divorce. However, it is not unusual in planning to overlook what is often one of the largest assets an individual may have: Their retirement plan.

Qualified plans (employer sponsored plans like 401ks) and Individual Retirement Accounts are tax-favored savings accounts created by Congress to provide incentives to Americans to save for retirement. Contributions to the plans are generally made with before-tax dollars, the assets in the plan grow tax free, and income taxes are paid when withdrawals are made. Generally, withdrawals may be taken without penalty as early as age 59 and must begin no later than age 70 (at which time minimum distributions must be taken each year based on life expectancy).

The Roth IRA is the opposite of a traditional IRA regarding taxes. Contributions to Roths are made on an after tax basis, but there is no income tax paid upon withdrawal.

An IRA, like life insurance, does not pass to your beneficiaries through your will or trust; rather, it is left to the persons you designate on forms provided by the plan custodian. If you fail to designate a beneficiary, typically your estate becomes the beneficiary and must pay out to your heirs (with taxes being withheld) over a five year period. If you properly designate your beneficiaries, then the tax savings continues. A spouse beneficiary can treat the IRA as his/her own IRA. A non-spouse beneficiary holds the account as an inherited IRA and can typically take withdrawals over his/her remaining life expectancy.

In addition to the tax-favored treatment of IRAs, they are also afforded asset protection. If you are sued or file bankruptcy, then state and federal laws protect your IRA funds from your creditors.

One of the overlooked planning issues related to IRAs involves leaving your IRA to non-spouse beneficiaries (an "inherited IRA"). As a preliminary matter, while the inherited IRA beneficiary is permitted to withdraw plan assets over his/her life expectancy, he/she is not required to. Thus, if you have a child who is not a good money manager or has substance abuse issues, designating him/her as an IRA beneficiary may be problematic. He/she could withdraw all of the funds at one time, pay a large portion in taxes, and use the funds for destructive purposes.

Additionally, the asset protection features of an IRA do not apply to inherited IRAs. In the recent U.S. Supreme Court decision of *Clark v. Rameker*, the Court ruled that funds in an inherited IRA are not considered "retirement funds" and thus are not

exempt from the debtor's bankruptcy estate. As a result, a debtor's bankruptcy trustee may consider the inherited IRA to be an asset of the bankruptcy estate and available to satisfy creditors claims. In light of this decision, if you leave a large IRA to your children and they later get sued or go through a divorce, the IRA is generally not protected.

Proactive planning can ensure an inherited IRA is preserved for the beneficiary, rather than on destructive spending or creditors. In light of the Court's decision in *Clark v. Rameker*, a complete estate plan should always consider the potential of a retirement plan trust to protect the beneficiaries of inherited IRAs from creditors. A retirement plan trust is a special type of trust that is designed to protect the inherited IRA from future creditors of the beneficiary, and allow the IRA assets to continue to grow tax deferred by ensuring that the trust qualifies as a "designated beneficiary."

A retirement plan trust is structured so that the asset protection features of general irrevocable, third-party trusts apply. Assets in the trust are protected from a beneficiary's creditors. The trust is then funded with retirement assets from a plan participant at death. Importantly, the IRA assets are allowed to grow tax deferred within the trust because the trust is carefully drafted so that it qualifies as a "designated beneficiary" and may thus take out minimum distributions as measured against the beneficiary's life expectancy.

A complete estate plan has many components. If a large component of your estate is a qualified plan or IRA, you should always consider whether a retirement plan trust is appropriate.

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