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Protect Inherited IRA Assets From Creditors With a Trust

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As aging baby boomers prepare to leave their wealth to the next generation, they will want to look closely at how certain assets will be treated once transferred to their heirs.

In many cases, a large portion of assets passed down will be in the form of [IRA accounts](#), which will then become inherited IRAs. Unfortunately for the children of baby boomers, these inherited retirement assets will not come with the same asset-protection perks their parents enjoyed.

Not retirement assets

The Supreme Court decided in 2014 in [Clark v. Rameker](#) that inherited IRAs are not retirement assets and should not be treated as such by creditors.

The decision has far-reaching implications for those who are bequeathed [IRAs](#). It means that the special rules that apply to retirement assets – protecting them from creditors – do not cover inherited IRAs. In most states, for instance, inherited IRA assets will be completely open to creditors in cases of bankruptcy, divorce and otherwise.

This is an important consideration for anyone who expects to pass down or inherit an IRA. Spouses who inherit IRAs outright can roll the inherited IRA into their own IRAs. Assets handled this way are afforded the same creditor protection and tax treatment as traditional IRA assets. But that is not true for other heirs.

Alternative options

Fortunately, there are still options to protect the assets of inherited IRAs from creditors in the case of non-spouse heirs, such as naming a trust as a beneficiary. There are two types of trusts that can be used:

1. Conduit trusts

With this option, a trust is created with a trustee who is not the beneficiary. The trust itself is named the beneficiary of the IRA funds. And an individual – an heir – is, in turn, named the beneficiary of the trust.

When the account holder dies and the IRA becomes an inherited IRA, it sits inside the trust, and the trustee immediately begins to distribute the required minimum distributions – which can be calculated based on the beneficiary’s life expectancy – to the beneficiary each year. Because the funds are immediately distributed to the beneficiary, they are taxed at the beneficiary’s tax rate.

With this option, the assets are protected from creditors because they are not legally owned by the beneficiary but rather by the trust. Distributions may be available to the beneficiary’s creditors, but the bulk of IRA assets are protected.

When there are multiple beneficiaries, usually each one has an individual conduit trust. Setting up a conduit trust may also be a good option for spendthrift beneficiaries because there is some control over the distribution of assets. However, the trustee may also distribute more than the required minimum distribution amount if he or she chooses.

2. Accumulation trusts

As with a conduit trust, an accumulation trust is created with a separate trustee and beneficiary. But unlike a conduit trust, the trustee is not required to distribute the required minimum distributions to the beneficiaries. Thus, the trust can accumulate funds. The accumulated funds stay in the trust and can be distributed at the trustee’s discretion. But keep in mind that if earnings exceed \$12,150 in a year, the trust is taxed at the top tax bracket rate.

This may be a particularly attractive option if the beneficiary is unreliable (likely to spend all the money or spend it irresponsibly) or at a high risk of being sued, because the trustee can decide not to distribute funds to the beneficiary. In this way, the trust protects the beneficiary from him- or herself as well as protecting the assets from creditors. Similarly, if the beneficiary has a judgment entered against him for damages, the assets in the trust are not subject to being taken by the plaintiff to satisfy the judgment.

Get help

Both of these trusts are typically used strictly to control or hold inherited money, so other contributions generally are not made. But it should also be noted that beneficiaries cannot make contributions to an inherited IRA, regardless of whether or not it is put in a trust.

Arranging for these trusts is a complex process (even more so in cases of multiple beneficiaries). You'll definitely want to work with an estate-planning attorney to ensure that it is done properly and that your trust meets the necessary requirements. That said, these options should be given serious consideration by anyone planning to leave a significant IRA to an heir.

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