Standalone Retirement Account Trusts

By: Steven Peck

On June 12, 2014, a unanimous U.S. Supreme court ruled that inherited individual retirement accounts (IRA) are not protected under the Bankruptcy Code. They ruled that these funds lose their character as “retirement funds” in the hands of the inheriting party. This also has implications for an inherited retirement account in regards to the beneficiary’s general creditors.

In Illinois, all forms of retirement accounts are protected from the creditors of the account holder. They are also protected up to $1 million dollars in bankruptcy proceedings. Most states only protect company sponsored plans covered under ERISA, such as 401k’s, but not IRAs. If the person is married, and the surviving spouse rolls over the account into their own IRA, it will now receive that protection as the spouse’s own IRA.

If the account is left to any other beneficiaries, it is then considered to be an “inherited IRA”. Only a few states have ruled that these are protected from the beneficiary’s creditors. Thus, if there is a lawsuit or divorce all of these funds could be at risk. In addition, if the account had to be liquidated to pay the claim, income taxes have to be paid on the amount cashed in. The marginal tax rate on a large liquidation in Illinois would approach 50%.

Even if there are no creditors, if the beneficiary is not good at managing and spending money, they could be tempted to cash in the account fairly quickly, again being subject to potentially close to 50% in income taxes. Their attitude may be that even so, they end up after taxes with over half the proceeds, which may be more money than they have ever seen before.

One definite benefit of an inherited IRA is that each beneficiary can potentially use their life expectancy for the payout schedule of their share. They can’t defer withdrawals until they’re $70^1/_2$ as with one’s own retirement account, but must start withdrawals the year after the owner’s death.

Many financial advisors will recommend taking advantage of this stretch-out opportunity. This is especially so when there are grandchildren who can be potential beneficiaries. For instance, a two year old grandchild has an approximate 80 year life expectancy. That means initial required minimum distributions will barely be one percent of the fund balance for that grandchild. Average investment returns should be much higher (say 5-6% before taxes) so the account will be growing for decades before the distributions will exceed the earnings.

One can still have the opportunity to take advantage of this stretchout of payments while still protecting the account from issues discussed above. Several years ago the IRS approved the concept of the standalone retirement account trust. This allows the trust created for each beneficiary to use their life expectancy for the distributions schedule.

If you only name a living trust as the beneficiary, then the life expectancy of the oldest beneficiary of the trust must be used as the distribution schedule for all the other beneficiaries. This isn’t a problem if the ages are close together. But it can be an issue if there is a significant age gap, such as when there are both children and grandchildren.

The usual strategy is to name the spouse personally as the primary beneficiary when there is a married couple and the retirement account trust as contingent beneficiary. Most likely, the account will flow through the trust of the surviving spouse.

When the other beneficiaries receive their shares, the trust is initially set up as what is called a “conduit” trust. This means that the required minimum distributions must be given to the beneficiaries. They could be tempted to spend the money immediately, or even if they didn’t but put it in an investment account, it could be available to creditors or disqualify someone from receiving government benefits.

However, with the use of the standalone trust, the law allows an election to change the conduit distribution requirement to an accumulation format. Distributions can be reinvested in a side account to accumulate creditor, divorce and estate tax protected. The trusts can be set up so some could be administered as conduits and others as accumulation type.

The power of growth in this format is tremendous. For example, let’s use the example of an account holder who dies at age 85 with $350,000 in the IRA. He or she has a two year old grandchild, who would have an 80 year life expectancy to pay out the IRA. If the account yielded a 4% after tax rate of return, at the grandchild’s death the side account would be worth over $10 million.

Even if some of the money was spent over the years, the potential account balance could still be in the millions instead of zero. These trusts should be considered by anyone with reasonably size retirement accounts.

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