



IRA Update: May 2011

Creditor Protection for Inherited IRAs

Federal bankruptcy law has widespread protections for IRAs in the case of bankruptcy. What happens when the IRA owner dies and the account is inherited by the beneficiary? Does the beneficiary of the IRA maintain the same level of creditor protection? This has been an issue that is playing out right recently in the courts.

Some states are upholding the language that states IRAs have protection in bankruptcy regardless of whether the IRA is held by the original owner or the beneficiary. These states that have ruled in favor of the beneficiary have been California (Federal Exemption), Minnesota, Pennsylvania, Ohio, and Arizona.

Other states have taken the opposite stance which is that the IRA ceases to be a retirement account once the beneficiary inherits mainly because the funds can be taken out at anytime and therefore does not maintain the same level of creditor protection. States that have ruled against beneficiaries include Indiana (State bankruptcy law was used, not federal), Texas (The US District Court later reversed the bankruptcy court option in Chilton v. Moser case), and Florida (decided under State bankruptcy law).

At this point, the issue is not clear as different states are ruling in different ways and we may have to wait until the Supreme Court rules on the issue. Rulings can vary based upon State, whether federal or state bankruptcy law is applied, as well as whether the creditor claim is bankruptcy as opposed to non-bankruptcy claims.

For IRA owners who are concerned about creditor claims and wish to enhance protection for beneficiaries may consider naming a trust as the IRA beneficiary however caution should be taken here. The IRA trust must be properly drafted to avoid creditor claims. IRA experts such as Seymour Goldberg CPA, MBA, JD of Goldberg & Goldberg, P.C. advise using separate stand alone irrevocable IRA Trusts that include spendthrift provisions for the maximum possible protection. IF this is something you are considering, you should first consult with your financial advisor who is properly trained in IRA rules along with your estate planning attorney to make final legal recommendations on course of action.

Powers of Attorney for IRA Transactions

Many Powers of Attorney (POA) give the agent-in-fact the ability to act in the place of the person for whom they have the power for most financial transactions. One area where the typical POA may fall short is with IRAs, and in particular distributions, spousal rollovers of IRAs, and Roth IRA recharacterizations.

For example, suppose an IRA owner is unable to act for herself in taking a required minimum distribution (RMD) from her IRA. Some IRA custodians may or may not accept the IRA owner's POA to take the RMD and not taking an RMD subjects the IRA owner to a 50% penalty on the amount that should have been distributed. The POA would require specific language allowing the agent to request distributions from the IRA on behalf of the account owner as would it be equally important to know in advance that the IRA custodian will accept a POA in the first place as some do not.

Another issue is an agent-in-fact having the ability to rollover a decedent's IRA to the surviving spouse's IRA. Some states allow this, and some may not. In addition, state laws generally do not allow an agent to name beneficiaries of the surviving spouse's IRA. This poses a problem supposing that the agent can complete the rollover, the agent will be unable to name beneficiaries. Without named beneficiaries, the funds will be distributed according to the default provision of the IRA custodian when no beneficiary is named which is often the account owner's estate. If the beneficiary of an IRA is the estate, then the stretch IRA can be severely limited. If the surviving spouse already has an IRA with named beneficiaries and the account is rolled over into the existing IRA, then naming new beneficiaries would be a moot point. For these issues to be planned for, the POA should specifically grant the agent the ability to roll over a decedent's IRA to a surviving spouse as well as the ability to designate beneficiaries such as a class of individuals (children or grandchildren of the decedent, etc.) If the agent of the POA is also a potential beneficiary, this should also be specified to avoid any appearances of impropriety on the part of the agent.

Roth IRA conversions can be recharacterized back to an IRA up to October 15th of the year following the year of conversion. Most POA's however do not permit the agent to complete a recharacterization unless the agent is specifically authorized to do so. If the IRA dropped in value after the conversion such that it would be beneficial to recharacterize, the ability for the agent to recharacterize would result in tax savings.

It is therefore critical to make sure that any Power of Attorney has specifically spelled out for the agent to handle these specific situations. If you have questions on this type of planning, contact me and/or your estate planning attorney for further discussion.

Sincerely,

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