White Paper Review

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Subject: Whitepaper review of Inherited IRA's now exposed to bankruptcy Creditors, after landmark Supreme Court Ruling on June 12th, 2014.

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Overview: The Lesser of Two Evils

In light of the fact that the 2014 administration budget, not implemented, has proposals to limit inherited IRA distributions to just 5 years on all accounts other than special situations--losing bankruptcy protection for inherited retirement funds is the lesser of two evils by far.

Yet, one wonders now, will this be a two-step process? With one shoe off for the most part (some states including Arizona have state bankruptcy law that say Inherited IRA's are still exempt*), will they actually implement a limited distribution plan? Perhaps changing from the current life expectancy of the beneficiary method and replacing it with the proposed 5 year rule that says the account must be paid out completely in that time period, unless you qualify for special exemptions?

* Legally deemed that state statute protects and exempts filings inside the exempt state, but conflicts if heir (beneficiary) resides outside the exempt state.

Only time will tell how this turns out, but seeing the need for government operating capital and the uncovering of "money" rocks that have been left alone in the past – the odds are fairly high that the term "inherited IRA" may be a distant memory a decade from now.

The most important question to ask:

Will they "grandfather" those inherited IRA plans that have already been established with the new owner?

The 2014 budget proposal still did that, so we hope so. Our firm has rescued countless millions of inherited dollars for clients over the years and we openly tell clients to tag their paper accounts well with big signs and notes for heirs – telling them NOT to cash in an inherited IRA account prematurely. It is a money machine as long as the RMD each year is less than the earnings in the account. The "growth" in spite of

withdrawals creates potential massive wealth coupled with ever increasing federal mortality tables that "stretch" payments for many years in the future since Americans are living longer then ever.

In fact, it would be deemed "malpractice" for any money adviser to cash in someone's inherited IRA, if future restrictions do NOT allow grandfathering. There won't be any grandfathering for bankruptcy protection any longer – but hopefully it is granted if the government forced 5 year liquidation rule is applied in the near future. (Perhaps by Executive Order with no discussion...)

Just try running the tax bill on your home tax software program for a couple earning $150,000 and then adding as sole beneficiary, 5 years of $400,000+ RMD on top of your normal annual marital income. Beyond forcing the new excise 3.8% tax, you would lose about ½ of a 2 million dollar inherited IRA by the time the IRS got done feasting on your good fortune inheritance. "Cruel and unusual punishment" would be a proper term for what the IRS would do to a large inherited IRA account.

And by the way, the IRS will need to do some major updating on retirement publications to clarify that your Inherited IRA is no longer an "IRA". It is now a hybrid, an oddball, a rarity, a lost in space artifact, a Non IRA, or something else. Perhaps they will soon call it an "Anti-IRA" to properly describe what an inherited IRA has now become.

History

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Bankruptcy Act) clarified much of prior uncertainty under pre-Act case law. It covered all regular retirement type accounts (that are not inherited accounts) with complete exemption from bankruptcy creditors. And made them exempt regardless if state or federal law was elected.

In this 2005 law, limits were stated. Basically any "real" retirement plan (Employer Qualified Retirement Plan or QRP) was fully exempt plus SEPs, SIMPLEs and 403(b) plans. Form qualified plan money rolled into an IRA was also exempt and the titling of "Rollover IRA" by the custodian was mandatory to make that distinction over regular IRA funds.

That is because IRAs and Roth IRAs were only exempt up to the first $1 million of value. Yet the law allowed the court to increase the exempt amount "in the interests of justice". (Whatever that means)

The 2005 law went cloudy and murky when it comes to inherited IRA accounts. The statute states that inherited funds are exempt to the extent those funds are in a fund or account that is "exempt" from taxation.

Prior to the 2005 law going into affect, court cases favored the debtor for the most part. At least when it came to ruling on assets up to the $1 million level of inherited IRA dollars in question. Two states ruled previously that inherited IRAs are exempt assets in bankruptcy. (Florida and Ohio)

Prior to the Supreme Court ruling last June 12th, 2014, only two Circuit Courts of Appeal have ruled on this issue. In the case of *In re Chilton* -- the fifth circuit affirmed the bankruptcy court's decision favoring the debtor, thus giving Louisiana, Mississippi, and Texas blanket coverage for exempt Inherited IRA status.

But just like the "flipside" conflicting rulings two hours apart that took place July 22nd, 2014 affecting the Affordable Health Care Act policyholders receiving "credits" for premiums in states with federally managed exchanges -- an opposite ruling also took place that said the opposite of what the fifth circuit affirmation ruled in favor of debtors.

In sharp contrast, Clark, Nos. 12-1241, 12-1255 (7th Circuit, April 23, 2013) pretty well ruled that retirement funds lose their character when the original owner dies. And therefore, they are not afforded any special creditor protection beyond what any other assets would be given.

This ruling further clarifies that inherited IRAs are not exempt from taxation due to the minimum distribution requirements which are "taxed' upon mandatory distribution. I am not sure they reasoned the one year delay in the year of death of the decedent does not require an RMD in their reasoning. (Only the remaining decedent RMD must be removed in the year of death)

The situation left after the second ruling was ripe for resolution by the US Supreme Court, which ruled mostly in favor of the prior reasoning presented by the 7th circuit ruling in 2013.

The Supreme Court ruling declared that inherited IRA funds are "NOT" retirement funds" within the meaning of the Bankruptcy Code and thus, <u>are not exempt</u> any longer from creditor reach during bankruptcy proceedings.

The reasoning of the Supreme Court that now exposes inherited accounts in bankruptcy court proceedings is threefold. First, the holder of inherited funds may never invest additional money in the account. Second, mandatory withdrawals (RMD's) are required within 1 year of the year of death no matter how far away the holder is from their own retirement age. And thirdly, the holder can withdraw "at will" any amount at any time, including the entire balance – and not have to pay a penalty (10% pre 59.5 age distribution penalty applies to all regular retirement accounts, including Roth accounts).

<u>Unanswered Questions Abound</u>

But regardless of the resolution this ruling brings up, numerous new questions amongst the best retirement experts in the U.S. now abound.

<u>Here is what people should know:</u>

1. Consider moving to an inherited IRA "friendly" bankruptcy state and establish residency before pulling the big "BK" move. The downfall is that it could be argued you made your move for this sole reason or did so to deliberately to defraud your creditors, (termed an illegal conveyance) and the quest could easily fail if challenged.

2. Be sure to instruct your spouse to do **a spousal rollover now every time** (with few exceptions) and don't let anyone set up an inherited IRA for a spouse, without being shown both sides. (Noting "spouse" is now re-defined by federal law to include same gender persons) The spousal rollover allows the spouse named as beneficiary to treat the deceased spouse's IRA as "their own" under IRS rules. The downfall is that some are arguing this could be construed as an "illegal transfer or conveyance" as previously mentioned. They suggest that the funds received "other than IRA" status upon the death of the first spouse, thus they could still be deemed reachable by bankruptcy creditors or court actions.

   My personal feeling is that this argument fills up a lot of seminars on the subject, but it is a "stretch" to assume or predict that the IRS, or any bankruptcy court could easily challenge a spouse who legitimately took over his or her deceased partner's retirement plan and treated it as their own. **And, please note that marital assets are afforded additional legal claims and rights regarding community or separate property law as well as strong death succession law (with or without a Will or Trust) that favors a spouse over any other person or entity.**

3. This applied before, but is mandatory now**. DON'T COMMINGLE** IRA type accounts that are "like kind". Don't commingle an IRA rollover, or spousal rollover with contributory retirement accounts. Keep them separate, even if some are smaller amounts.

   A Real Life Case: I have a current client fighting his former IRA custodian for commingling his inherited IRA with his traditional IRA into one account which could easily settle privately for damages caused. (Chief legal department head and assistant legal staff member agreed to discuss, a good sign.)

4. I have been often quoted prior to this landmark Supreme Court ruling to use a trust (stand alone or bypass trust) only in cases were children or heirs are spendthrift candidates or egregiously in and out of trouble. This new ruling was quickly addressed by law firms and document preparers who use a California based attorney's IRS approved stand alone Inherited IRA trust module to set up stand alone Inherited IRA trusts for their large IRA clients.

   Now, I have to agree at least for larger accounts, that the stand alone Inherited IRA trust may be required to afford any remaining bankruptcy protection. This "receptacle trust" named as first or primary beneficiary of inherited retirement accounts, with or without the option to become an accumulation trust, is paid direct as sole beneficiary upon your death. This is done instead of more typical naming your spouse or other persons as the designated beneficiary direct.
   Amazingly, even after the ruling, online statements by various law firms that use
   this approved IRS module maintain it still is rock solid and will continue to protect larger IRA accounts from creditor claims in bankruptcy court against beneficiaries named directly as beneficiaries of the special trust or trusts.

   The fact the trust instead is named would be the general reason this may still work and even the domicile of the trust or trustee may be a factor now, such as using the state of Arizona for domicile of the trust res and Trustee. Obviously, specific and precise legal wording is required for any protection to be afforded by current trusts named as primary beneficiary and "reviews" would now be mandatory for those trusts already established prior to this ruling.

   Though I have dragged my feet as an adviser and gotten by in the past by using a conduit trust for IRAs inside a living trust, this new ruling dictates the need for a stand alone vehicle even more, especially for larger IRA client accounts. But, future court rulings could also construe or rule the best stand alone IRA trust existing is nothing more than an another illegal conveyance to protect assets that have "changed" status the second death takes place and are forever after "Non-IRA" assets or "Anti-IRA" assets. In other words, the entity they name as beneficiary DOES NOT change the new found character of the IRA once death takes place, as the dollars now are classified as "Non IRA" dollars according to this new ruling. That may be clarified in the future no matter who or what your large IRA account is made payable to. (That would be a preemptive government legal "strike" to negate those best laid plans going on all across America now with large IRA holders and their legal advisers)

5. <u>Disclaimer language</u> in legal documents can't touch or affect the lowly one page (rarely more than that) simple beneficiary form which controls all beneficial assets, including all IRAs of every kind and description. (or Anti-IRA's* as now defined above) Be sure you use an Inherited IRA consultant to fill out your IRA or any other beneficiary form. The legal concept of disclaimer action is still applicable to named beneficiaries. Use up to 3 levels (primary, secondary, and tertiary) to customize options that will be available after your death. This not only gives inherited options based on the circumstances "then" (not now) for disclaimer options such as to disclaim to a trust listed in a secondary position on the form, but it also strengthens the overall success of the form as well. In

other words, if you name one person and they die before you, the IRA will default to paying the estate. (a real no-no and usually caused by adviser malpractice) Naming backup beneficiaries, just like you name backup heirs in your Will or Trust allows deeper estate planning results with less chance of mistakes when you actually die.

* My created term for Inherited IRAs since the decision.

Real Life Case: An active case I have right now had that very thing happen this year. Two brothers had to take possession of close to a million dollars of inherited retirement money that defaulted to the estates of their parents who both died young and just a few years apart. (About 50% of the retirement funds was in a GM employee 401-k plan that forces full taxation when the estate is named. Thus we had to settle with no use of the deceased parent's remaining life expectancy and the five year rule applied) The result is a HUGE tax bill this year and for next 4 years on other funds forced to payout out in just 5 years!

6. Lastly, a final "hot" issue is the conflict of a younger spouse taking the "inherited IRA option" versus treating a spouse's IRA as their own after the demise of the first spouse. This is in regards to younger surviving spouses who are still years away from the current 59.5 age they must reach to avoid the 10% premature distribution penalty. That penalty is imposed by the IRS on all regular traditional and Roth type IRA accounts.

   My "kind" advice to clients and fellow advisers is to not let this factor, when applicable; derail the beauty of "taking or distributing" a deceased spouse's retirement plan and treat it as your own by doing the spousal rollover. No matter how far away you are from the 59.5 finish line to avoid the penalty, the advantages now outweigh the disadvantages in light of the Supreme Court Ruling. (Especially if the surviving spouse is a klutz, bad driver, or big spender and may have a higher chance of being sued by a creditor or injured party)

   Obviously, the one advantage of receiving the payout as "inherited funds" versus as a "spousal rollover" is that you can avoid the penalty on RMD's even if you are just 45 years old and in need of replacement income your spouse used to provide to you. Even so, buying life insurance on each other while you still are insurable would be a better way to alleviate the need to tap retirement money in case one spouse dies prematurely. Life insurance pays out tax free money when the first spouse dies as well as when the surviving spouse passes away if you set it up correctly! Life insurance also allows tax-free money to pay off the taxable income from an IRA if you want to take a lump sum distribution, especially if the five year rule does become the law of the land in the future.

   Regardless of our best laid plans, taking the inherited option instead of the spousal rollover exposes hard earned IRA money to creditors now for the most part in most states since June 12th, 2014. But it also means you are forced to take annual payouts you may not even need. Over time, those forced RMD's along with market gyrations (if invested in variable accounts) can reduce principal to a dangerous level. The account could easily head "south" from too much trauma or too much money forced out because of the annual required distributions that increase every year no matter whose life expectancy they are tied to.

   Lost accounts are normally attributed to both controllable and uncontrollable future circumstances. For most heirs, keeping inherited money is difficult long term, especially if they have not been privy to "having money' prior to their inheritance event.
   A terminated IRA plan helps no one and is a lost opportunity for the "stretch" time period we still can do for clients who use our consulting services. Letting money "cook" for a full market cycle

without interruption is only an option if you treat a deceased spouse's IRA as your own, and roll it over into your own name.

Timing is also paramount as well in retirement planning. Only start withdrawing IRA money when the timing is "favorable" to you, or by age 70.5 when the IRS says you have to start taking RMDs (Yes, if you wait that long, they force you to start withdrawing).

For sudden emergency money, paying the penalty on a one time "partial withdrawal" won't break the bank compared to constant, regular, increasing RMD checks based on your ever increasing age and based on a single life expectancy chart with no recalculation allowed on inherited funds. (All those things can combine and kill an inherited IRA account)

Also remember, treating the IRA as you own means you get to keep the much more favorable "recalculation" option just like on your own IRA money. And, you can decide to "Pull the Trigger" and take from the account as you desire once you reach age 59.5. Or wait longer if you like. Obviously, disability waivers and other circumstances, including buying a first home with IRA money also allows penalty free withdrawals as well. Current IRS law and circumstance must be considered each time a retirement review is done.

But another option exists for those who reach age 55 and have already taken their deceased spouse's retirement plan and treated it as their own. You can invoke the "Substantially Equal Payments" option under Section 72(t) of federal law and start taking equal payments before age 59.5. This is easily done on fixed annuity type assets you can invest some or all of your spousal rollover funds into and be set up very quickly to allow early access without penalty.

Few advisers, especially stockbrokers, will mention this option. Mainly because insurance annuities are best suited to make periodic withdrawal payments, and the average broker prefers to keep all of your money under management in variable accounts. Our consulting practice has noticed that stockbrokers will still expect your heirs to stay with them, even after your death. That is until we discover they are mostly clueless on how to advice your heirs of your retirement account after your demise. The end result is that our firm has helped "fire" a lot of brokers over the years that can't stop their selfish desire to control and be paid on your money, even after you are no longer alive!

Let me know how I can help you with your Inherited IRA challenge or situation.

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