WISEMAN · BRAY PLLC

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Creditors, Taxes, and Retirement Assets: Can I have my cake and eat it, too?

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As a general rule, it is always better to have retirement assets than not, even in this economy, even though this area of the law changes frequently, and even though the rules can be extremely complicated. Even better, what if you can have the retirement assets, and minimize or eliminate the taxes, and protect your beneficiaries from their creditors.

The first portion of the dilemma is what might prevent you from having retirement assets. Although the obvious answer might be the stock market or declining income, what about the possibility of losing retirement assets to a creditor? In most states, retirement accounts are protected at least to some degree from the claims of creditors. However, as more people are using retirement assets for wealth accumulation and wealth transfer, does that protection extend to an inherited retirement account and the creditors of your beneficiaries? Moreover, with the increase in bankruptcy filings and the state of the economy, are we going to see less protection for retirement accounts? The answer is not quite so clear, but there are three recent bankruptcy cases that are worth mentioning on this issue.

An inherited IRA is often, and was in these cases, an IRA established by a parent with the parent's funds, that becomes an inherited IRA of the child's at the parent's death. In all three cases, the child claimed the inherited IRA as an exempt asset when the child filed bankruptcy. In both *In re Nancy A. Nessa* and *In re Merri Simpson Tabor*, the bankruptcy courts found that inherited IRAs were retirement funds, even though the debtor in bankruptcy did not contribute the funds, and were exempt from taxation under the Internal Revenue Code.

Importantly, the courts found that the transfer from the original owner to the beneficiary at the owner's death did not change the characterization of the funds as retirement funds. The results in *In re Robert Greg Chilton and Janice Elaine Chilton* were not as favorable for the bankruptcy debtor. The court held that the inherited IRA did not contain retirement funds contributed by the debtor in bankruptcy because the funds were contributed by her parent. Therefore, the IRA was not exempt from the claims of Ms. Chilton's creditors.

So, if you have retirement assets, who do you leave them to and what is the best way to do that? Inherited IRAs can be effective to reduce income taxes by stretching the benefits out over the beneficiary's life expectancy and allowing for additional tax-deferred growth. To enhance the creditor protection to avoid the problems in the cases above, you can leave the retirement benefits in trust, but the trust must qualify as a designated beneficiary under the tax code for the benefits to be stretched out over a beneficiary's life expectancy. Drafting the trust so that it can qualify as a designated beneficiary is possible, but the IRS does not al-

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low much leniency, as evidenced by a recent private letter ruling, PLR 201021038. In this ruling, the children of the deceased IRA owner petitioned the Probate Court and got a judgment approving the modification of the trust so that the trust could qualify as a designated beneficiary.

The IRS denied the modification and said the trust did not qualify as a designated beneficiary. Therefore, the children were not allowed to modify the trust even though they had judicial approval from the local Probate Court after their parent's death. Since the trust was not a designated beneficiary and the post-death modification was not allowed, the children were not allowed to stretch out the payout of the retirement account.

The potential solution for both of these problems is a retirement benefits trust. The retirement benefits trust is the beneficiary of retirement assets and the entire trust is carefully drafted so that it qualifies as a designated beneficiary. Moreover, it allows for accumulation of the required minimum distributions as they are distributed out of the retirement account to the trust, and the accumulation is protected from the creditors of the beneficiary if drafted properly. In the right circumstances, a retirement benefits trust can provide significant tax benefit and asset protection for your beneficiaries.

So, the answer is that you can have your cake and eat it, too, but only with proper planning and careful execution. If you would like to learn more about planning for your retirement assets, please contact our office.

SPECIAL NEEDS TRUST ALERT!

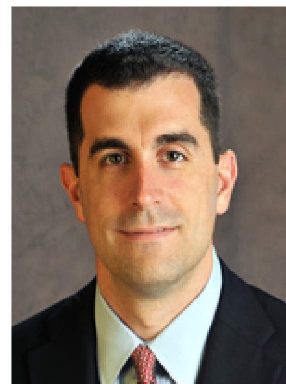
In June, 2010, Social Security issued a new Program Operations Manual System (POMS) regarding early termination provisions in special needs trusts that becomes effective October 1 but is retroactive for all trusts created on or after January 1, 2000. Many trusts contain an early termination provision that allows for the trust to be terminated if the beneficiary is no longer eligible for benefits. The goal is to keep the government from continuing to deny benefits based upon the trust. Under the new POMS, such early termination clauses will be rendered ineffective and the trust assets will be considered a countable resource UNLESS the trust also provides that the state will be repaid up to the total benefits provided, no one other than the trust beneficiary benefits from the trust termination AND the power to terminate is given to someone other than the trust beneficiary. If you or a loved one has a special needs trust, please contact our office to see if this could affect your special needs trust.

ANNOUNCING THE MAINTENANCE PROGRAM

Based on clients' requests and in order to better serve our clients, we will be starting an annual maintenance program January 1, 2011. Be looking for more information to follow in the next couple of months!

Disclaimer We are obligated by ethical rules to state that this Newsletter is an advertisement. Certifications of Specialization are available to Tennessee lawyers in many areas of practice, including the areas of Civil Trial, Criminal Trial, Business Bankruptcy, Consumer Bankruptcy, Creditor's Rights, Medical Malpractice, Legal Malpractice, Accounting Malpractice, Elder Law, Estate Planning and Family Law. Listing of related or included practice areas in this Newsletter does not constitute or imply a representation of certification of specialization.

Pursuant to recently-enacted U.S. Treasury Department Regulations, we are now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including attachments and enclosures, is not intended or written to be used, and may not be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.



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