How to Protect an IRA From Heirs' Creditors

When a person declares bankruptcy, an individual retirement account (IRA) is one of the assets that is beyond the reach of creditors, but what about an IRA that has been inherited? Resolving a conflict between lower courts, the U.S. Supreme Court recently (and unanimously) ruled that funds held in an inherited IRA are *not* exempt from creditors in a bankruptcy proceeding because they are not really retirement funds. *Clark v. Rameker* (U.S., No. 13-299, June 13, 2014).

This ruling has significant estate planning implications for those who intend to leave their IRAs to their children. If the child inherits the IRA and then declares bankruptcy sometime in the future, as a result of the Supreme Court ruling, the child's creditors could take the IRA funds.

Fortunately, there is a way to still protect the IRA funds from a child's potential creditors. The way to do this is to leave the IRA not to the child but to a "spendthrift" trust for the child, under which an independent trustee makes decisions as to how the trust funds may be spent for the benefit of the beneficiary. However, the trust cannot be a traditional revocable living trust; it must be a properly drafted IRA trust set up by an attorney who is familiar with the issues specific to inherited IRAs.

Not related to the Supreme Court decision, but still on topic, in the State of Indiana, it is possible for a spouse to leave an IRA to a Special Needs Trust for their surviving spouse, created under their own Last Will and Testament, which would not terminate or prevent a spouse's Medicaid eligibility and would be protected from future recovery claims by the state.

The key with both of these possibilities is to make sure that the trust has been properly created by an attorney educated in these issues, such as an elder law attorney. If you are considering one of these options, please call our office to see how we can assist you in this process.