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On Inherited IRAs, Beware the Pitfalls of Trust Transfers

Estate planners should take care to avoid missteps that can lead to taxable events; a fiduciary responsibility

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Pat Simasko is an adviser and partner at Simasko Law in Mount Clemens, Mich. Voices is an occasional feature of edited excerpts in which wealth managers address issues of interest to the advisory community. **As told to Alex Coppola.**

Pat Simasko, adviser and partner at Simasko Law in Mount Clemens, Mich. … There are so many moving parts in estate planning that it's critical for advisers and attorneys to work in concert. PHOTO: SIMASKO LAW

I've seen a number of instances in the past few years in which poor communication between advisers and a client's attorney has resulted in missteps that have jeopardized a client's inheritance. These mistakes are specifically related to a 2014 landmark ruling by the Supreme Court that says that assets held in inherited individual retirement accounts are no longer protected from creditors and can be seized during events such as divorce or bankruptcy.

In the light of that ruling, designating a trust rather than an individual as the beneficiary of a qualified account has become a popular and effective asset-protection strategy. The issue is that the creation of that trust is only one step in the process.

Where my firm has seen some advisers and attorneys get tripped up is in the actual transfer of assets from the former owner of the IRA into the trust itself. That's because the 60-day rollover rule—which allows someone to make tax-free distributions from a qualified account if they reinvest those assets in another qualified account within 60 days—doesn't apply in the case of inherited IRAs. Should those assets pass to an individual before they go into the trust, that distribution is taxable as ordinary income regardless of whether it's reinvested within the required window. An attorney unfamiliar with that rule and the nuances of claiming that money could potentially cost clients tens of thousands of dollars.

My firm has also seen cases where a misunderstanding on the part of the IRA's custodian results in the claim being processed incorrectly and a distribution being made to a non-qualified account, resulting in a taxable event for the client.

In both cases, the responsibility for these missteps falls equally to attorneys and advisers.

While a lawyer will always handle the execution of legal documents and trusts, it's incumbent upon advisers to explore the potential complications of any decision that may affect their client. In fact, it's their fiduciary duty under the Labor Department rule to thoroughly investigate such moves, ensuring that they're completed properly.

In the case of an inherited IRA, the adviser should sit down with attorneys to review each step of the transition process. Together they may need to walk the representative at the institution that holds the IRA through their asset-claiming needs, verifying that the institution understands how to handle the transfer.

There are so many moving parts in estate planning that it's critical for advisers and attorneys to work in concert to ensure the best outcomes for clients. There's too much at stake for estates not to be executed perfectly.

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