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Trusteed IRAs vs. Trusts as Beneficiaries:
Which Strategy is Right for You?

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You may have noticed a flurry of recently headlines involving "Trusteed IRAs" as many financial organizations have been promoting them as their latest and greatest IRA strategy. So, what is this new IRA trend and is it right for you?This article will examine some of the critical rules in using IRAs and qualified retirement plans for wealth transfer planning, common misperceptions in this area, and why naming a trust as Beneficiary may be the only way to accomplish some of the client's planning objectives. To completely cover this subject would require volumes; accordingly, as the title indicates, this article is a primer on the subject and only covers the fundamentals.

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Naming IRA Beneficiaries

First and foremost, it's important to note that money in individual retirement accounts are not typically covered by a will. Instead, an IRA inheritance is distributed according to beneficiary designation forms that you fill out when you open the accounts or later amend. It is critical to make sure that your beneficiaries are periodically reviewed and kept current. IRA beneficiaries are impossible to change once the owner passes away.

Individuals as Beneficiaries

AIRAs are often structured where the beneficiary is named as a specific individual. In this scenario, your beneficiary takes control of the IRA assets upon your death. There are many risk associated with this strategy, for example:

- You have no control over how the IRA is later used or distributed. If your beneficiary wants to withdraw the entire IRA and pay the income tax or to later name someone else as the ultimate beneficiary of your IRA assets, they can do so because they have complete control.
- Minor children cannot inherit an IRA. They must be 18 years old. If your beneficiary is a minor, and no trustee arrangement has been created, then the IRA will generally be put into the control of someone decided on by a court (who may not manage or distribute it as you'd intended), until the minor turns 18, when at such time the minor will have sole control over the IRA (and can spend all of it immediately (and pay all of the income taxes in one year).
- Your beneficiary may be a spendthrift, have a drug or alcohol abuse problem and wind up squandering the IRA assets.
- Your IRA could also become available to the beneficiary's creditors and/or ex-spouse(s).

Trusts as Beneficiaries vs Trusteed IRAs

Some people elect to name a Trust, not an individual, as the beneficiary of their IRA and other retirement accounts to protect against risks like the ones mentioned above. However, growing number of financial institutions are touting trusteed IRAs as an alternative to naming a Trust as a beneficiary.

A trusteed IRA is a form of Individual Retirement Account where, quite simply, the IRA itself becomes like a trust with the financial institution serving as the trustee. (This is different from the traditional custodial IRA, in which the financial institution merely holds the assets on behalf of the IRA owner, who retains full legal control of the account.)

- **Cost:** Trusteed IRAs are generally less expensive than hiring an attorney to draft a Trust. However, there will still be a set-up fee, as well as ongoing fees, with trusteed IRAs. Given that trusteed IRAs typically require the use of the trust company's managed account services, and may charge additional trustee administration fees as well, the trusteed IRA will often

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end up being far more expensive than having a separate Trust drafted. And ironically, the fact that investment minimums (or outright fee minimums) are so common for trusteed IRAs means it's unlikely to be cheaper than just drafting a separate trust for a small account (where the minimum trusteed IRA fee comes to bear), nor is the trusteed IRA likely to be cheaper for a large account (where the trust drafting fee is much smaller than paying ongoing trust management fees on a sizable asset base).

- **Owner Incapacitated:** If the IRA owner becomes incapacitated, trusteed IRAs have provisions that allow the trustee (the Financial Institution) to continue managing the IRA. Performing tasks like making required minimum distributions (RMD) would continue without interruption. By contrast, with a custodial IRA, all activity freezes when the IRA owner becomes incapacitated, until and unless a guardian is appointed or a Power of Attorney document is provided by an attorney-in-fact. If proper estate planning is done by the IRA owner, there will be a power of attorney in place for this contingency.

> *"While a trusteed IRA can offer many estate planning benefits... the reality is that all of these things can be accomplished by a using a Trust as Beneficiary."*

- **Guaranteed Successor Beneficiaries:** Both trusts and trusteed IRAs allow you to name successor beneficiaries. In the event that your primary beneficiary dies, this contingency ensures that your assets only wind up where you would want them to (ex: not in the hands of an ex-spouse or step-children, etc.).
- **Ensuring the "Stretch":** Both trusts and trusteed IRAs can ensure that the IRA assets will continue to accumulate on a tax-deferred (or potentially tax-free) basis for as long is allowable. (It is impossible to guarantee the stretch if your beneficiary is an individual and inherits complete control over the IRA.)
- **Protection from Creditors:** Trusteed IRAs can provide a higher level of protection against creditors than leaving an IRA outright to an individual, however, they are not as effective as individual Trusts that the IRA owner creates himself or herself. Trusteed IRAs must pay out the RMDs each year to the beneficiary, and there's no way to protect the RMD funds, so a creditor could gain access to them that way. Alternatively, with a Trust, the Trustee could elect to keep the RMDs in the Trust, instead of paying them out, thus protecting the RMDs from the beneficiary's known creditors.
- **Appointing Trustees:** Only a financial institution can be in charge of a trusteed IRA. However, a Trust is a separate entity from the IRA provider, so when a Trust is used as a beneficiary, family members or others can be appointed as a Trustee or Co-Trustee.
- **Unhappy Beneficiaries:** With a trusteed IRA, the trustee is the IRA provider, so the IRA often has restrictions in place that prevent beneficiaries from switching to a new financial institution. This means that if future beneficiaries are unhappy with the trusteed IRA provider, there may be no effective way to change providers after the death of the original IRA owner. By contrast, with a Trust, the Trustee has the authority to decide which financial advisors or money managers are associated with the account (ability to hire/fire). Accordingly, it is perhaps no surprise that a growing number of IRA custodians are rolling out trusteed IRA alternatives – it's a path to virtually "guaranteeing" that they will retain control of the IRA account after the death of the original IRA, without little or no ability to ever be fired in the future.
- **Flexibility:** With a trusteed IRA, it will be more difficult, if not impossible, for a beneficiary to receive more than the RMD, if necessary. However, with a Trust, the Trustee can be given the flexibility to distribute additional amounts from the IRA to the beneficiary, for medical emergencies, to help buy a house, or other purposes you would approve.
- **Filing Taxes:** Without question, tax reporting is a simpler process using a trusteed IRA. The beneficiary of the trusteed IRA simply reporting distributions as they occur using Form 1099-R. With a Trust as beneficiary, the Form

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1099-R is sent to the Trust, which in turn files an annual Form 1041 for trust income tax reporting, and then must distribute a Form K-1 to any beneficiary to report his/her share of RMD income if/when the RMDs are passed through to that beneficiary.

The Bottom Line

While a trusteed IRA can offer many estate planning benefits and seem like an appealing and simple option for those with small or moderate IRAs, the reality is that all of these things can be accomplished by a using a Trust as Beneficiary, which may likely be a less expense and more flexible solution, while offering additional estate planning advantages and protections as well, such as robust asset protection, control of the distribution of assets or sheltering estate taxes.

In order to determine the best way to decide which strategy is best for you, talk to an experienced estate planning attorney who will listen carefully to your needs and wishes, understands the complex financial and tax considerations associated with IRA planning (and how to draft and administer an IRA Trust), has in-depth knowledge of estate law, tax laws and strategies, and who is willing to work along with your other trusted advisors.

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