The Trusteed IRA

Helping to Reverse an 80-percent Failure Rate

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Advisors have been perplexed for years trying to find successful ways to maintain existing business when the current generation of clients dies. In fact, recent studies by TD Ameritrade and Pershing have shown that roughly 80 percent of individual retirement account (IRA) assets will be lost when a client passes away.[1] Increasingly, investment advisors and custodians are being forced to look for alternative methods to retain IRA assets and accounts.

A growing number of advisors are turning to the trusteed IRA as a possible remedy to counteract IRA withdrawal trends. This instrument helps investment advisors retain management and control of IRA deposits, generating fees for the duration of the IRA's lifetime. It also is an attractive investment option for clients that provides increased customization of the terms of the IRA.

In the process of trying to solve the age-old problem of multigenerational client retention, many advisors have found that, while not perfect, the trusteed IRA can add substantial additional benefits such as asset protection for nonspouse beneficiaries, reduced legal costs and administrative needs, protection for intended beneficiaries in cases of remarriage, and ease of adoption, a lack of which has prevented many clients and advisors from addressing these issues in previous years.

The Current IRA Market

The IRA market has grown substantially over recent years as the baby-boomer generation prepares for retirement. With nearly 40.4 percent of all U.S. households investing in at least one IRA, total IRA assets topped $5.4 trillion in the fourth quarter of 2012 (Holden and Schrass 2012). This amount represents more than one-quarter of the total $19.5-trillion retirement market in the United States and has grown at an average rate of 10 percent annually since 1990.[2]

Such rapid growth makes this asset class highly coveted by financial institutions and investment advisors. As more money continues to move into the retirement sphere, investment advisors can use IRA accounts to increase the size of their investment portfolios. This in turn will generate higher revenue for advisors through trading and investment advisory fees. However, the benefits of IRA accounts for advisors go beyond simply being a lucrative revenue source. Advisors also are able to make asset allocation decisions for their portfolios without the fear that the IRA funds will be withdrawn on a whim. Because of punitive penalties for withdrawing the assets before the age of 59½ and tax incentives for waiting until 70½, IRA assets are stable investment sources that allow advisors to invest with a long-term horizon in mind.

However, current trends show that IRA withdrawals will increase significantly over the next decade, both in dollar amount and as a percentage of total retirement income, as the baby-boomer generation enters retirement. Total IRA withdrawals increased to $189.8 billion in 2007 from just $23.7 billion in 1988 (Sabelhaus and Schrass 2009) and rose to $227.5 billion in 2008, which is the last year for which these statistics have been reported.[3] Similarly, although they held only 45.7 percent of IRAs nationwide in 2004, taxpayers age 55 and older controlled 72.7 percent of the total IRA assets.[4] And these withdrawals will continue to increase as the retiring population begins to draw down their accounts to pay for retirement. These trends pose a large potential problem for investment advisors managing the IRA assets because funds withdrawn from accounts or passed on when account holders pass away are seldom kept with the same institution.[5]

Consider the trusteed IRA as a possible remedy to counteract these IRA withdrawal trends. This instrument helps investment advisors retain management and control of IRA deposits, generating fees for the duration of the IRA's lifetime. It is also an attractive investment option for clients that provides increased customization of the terms of the IRA.

The Trusteed IRA

An IRA may take one of two distinct legal forms: a custodial IRA (IRC §408(h)) or a trusteed IRA (IRC§408(a)). While both forms receive identical tax treatment, the trusteed IRA combines the asset-protection advantages of a trust with the ease and tax-deferral advantages of the IRA to create an effective, multifaceted estate-planning instrument. With this instrument, the owner creates a trust within the IRA to serve as the beneficiary of the IRA assets upon the owner's death and directs a trustee to distribute assets in strict accordance with the owner's guidelines. Because the beneficiary has no power to pull or redirect the funds, the investment advisor and trustee can be confident that they will retain the IRA assets both during the client's lifetime and after the client's death.

Although the overall effectiveness of the trusteed IRA depends on the flex-

ibility of the provider, clients may want to choose a trusteed IRA over a more-traditional IRA for many reasons:

1) Remarriage Does Not Lead to Unintentional Disinheritance

Under a traditional custodial IRA format, the client's primary beneficiary will gain control of the IRA assets upon the client's passing. The beneficiary is then free to designate his or her own beneficiaries for the assets, which may or may not correspond to the client's wishes. For example, the client may designate his or her spouse as the primary beneficiary and children as the contingent beneficiaries of the IRA. Upon the client's death, the spouse will receive the assets; however, he or she then has no obligation to leave any assets to the client's children. He or she could remarry and name a new spouse, or perhaps children from a past marriage, as the ultimate beneficiaries and the client's children would receive nothing.

A trusteed IRA resolves this problem and maintains control of the chain of beneficiaries to the IRA assets. The trustee distributes the assets in strict accordance with the client's guidelines, allowing the client to name contingent beneficiaries that cannot be changed by the primary beneficiary.

2) Distribution Controls Create True Stretch IRAs

Under a typical custodial IRA format, the designated beneficiary gains total control of the client's IRA assets upon the client's death. The beneficiary may then withdraw any portion or all of the IRA assets at any time after the grantor's death. This has proved to be problematic: Estimates show that approximately 80 percent of IRA assets are withdrawn from custodial accounts by beneficiaries within two years of the grantor's death.[6] This may undermine the client's intent, whether intentionally or unintentionally, to allow the IRA assets to accumulate on a tax-deferred basis for as long as possible and to provide the beneficiaries with an income stream for years to come.

The trusteed IRA allows the client to limit the beneficiary's access to the IRA funds by giving the responsibility to distribute assets to the trustee. While the client has no control over the payment of the required minimum distributions, he or she can determine whether the trustee should make any additional payments, whether to provide for the beneficiary's health and support, or to restrict distributions until the beneficiary reaches a certain age. In essence, the client can use the trusteed IRA to create a pension plan for his or her beneficiaries.

3) Avoid Legal Fees and Administrative Hassle

Depending on the trusteed IRA provider, the client can establish trust specifications from a wide range of options. These options include designating the beneficiaries and the payment of funds upon death. By choosing a set of pre-drafted options that are included in the IRA setup, the client may be able to avoid hiring a lawyer and paying legal fees to draft a separate trust agreement to serve as beneficiary of the IRA assets. Similarly, a trusteed IRA allows for easier and less-expensive accounting each year. Under a trusteed IRA arrangement, the beneficiaries need to submit only Form 1099-R annually. This is cheaper and less complex than if a separate trust was created, which would require Forms 1099-R, 1041, and K-1 each year (Morrow 2009).

4) Avoid Potential Problems with Naming a Separate Trust as Beneficiary

While it is possible to name a separate trust as the beneficiary of an IRA, many potential pitfalls could undermine the client's positive intentions. The trusteed IRA should be created in a manner so that all of the involved parties, including the IRA owner, investment advisor, custodian, trustee, and attorneys, agree that the trust's provisions comply with all applicable laws. Otherwise, any conflicting interpretations could cause the assets to be distributed before they have maximized their tax-deferred accrual.

For example, the IRS has "four minimum distribution trust rules" that must be closely followed in naming a trust as a beneficiary:

1. The trust must be valid under state law.
2. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the IRA owner.
3. The beneficiaries of the trust are identifiable.
4. A copy of the trust documents are provided to the IRA custodian by October 31 of the year immediately following the year in which the IRA owner died.[7]

Furthermore, Treasury regulations stipulate that all trust beneficiaries must be individuals. Noncompliance with any of the aforementioned rules may cause the IRA to be distributed under the "five-year rule," thus undermining the client's intentions for the IRA to continue to be accumulated on a tax-deferred basis for as long as possible.[8]

A trusteed IRA helps avoid these potential problems because the pre-drafted trust terms have already been approved and are already in compliance with IRS regulations.

5) Provide Disability Protection

Under some types of trusteed IRAs, the trust is created as soon as it is named as the designated beneficiary. This may provide the client additional protection in case of disability. Because the trusteed IRA has a trustee already in place, this trustee can use and direct assets for the client's benefit if he or she becomes incapacitated. The trustee is able to intercede on the client's behalf, taking over the administration and distributions, and ensuring that the client does not get stuck in a financial gray zone.

Without this provision, the client may need to go through a lengthy guardianship proceeding in the courts to gain durable power of attorney.

6) Ensure Professional Administration of IRA Assets

A trusteed IRA reduces the risk of financial mismanagement by utilizing a professional corporate trustee. This removes the administration burden from family members and lowers the risk that mistakes would be made that could unintentionally cause the assets to lose their protected and tax-deferred status.

7) Create Greater Creditor Protection

There is currently some legal debate on whether inherited IRAs receive the same creditor protection that is awarded to the initial IRA owner. Under the Internal Revenue Code, only two elements are required for an IRA to be exempt from creditors (up to $1 million)[9]:

1. The amount the debtor seeks to exempt must be in retirement accounts; and
2. Those retirement funds must be in an account that's exempt from taxation under IRC § 401, 403, 408, 408(A), 414, 457 or 501(a).

In re Nessa stipulated that inherited IRAs are protected, regardless of the fact that ownership has changed, because inherited IRAs still fulfill the above requirements in name and in substance.[10] However, *In re Chilton* came to an opposite conclusion, stating that inherited IRAs are not the same as normal IRAs because holders of inherited IRAs can withdraw funds regardless of their retirement status and age. Because the funds are not necessarily intended to be used for retirement purposes, they lose their creditor protection.[11] It is ultimately up to each state to determine whether ordinary inherited IRAs retain their exemption.

In light of this confusion, it could be advisable for owners in states with unfavorable or inconsistent inherited IRA rulings to utilize a trusteed IRA (Ward and Merric 2012). These instruments can provide stronger asset protection by including specific spendthrift language in the trust document that excludes the trust from any potential creditor claims. IRA trusts derive their protection from trust law rather than the specific exemption statutes of a state. The trusteed IRA also would help protect clients if they later move to a state with unfriendly legal precedent.

Downsides to a Trusteed IRA

Although a trusteed IRA can cement a client's control over IRA beneficiaries and distributions while saving the cost and administrative hassle of having to prepare a separate trust, some downsides must be considered before choosing this estate-planning option.

1) Higher Fees and Required Minimums

In general, the trusteed IRAs are more practical for IRAs with larger account balances. Due to the administrative requirements involved, custodians/trust companies may require larger minimum balances (generally more than $600,000) and charge higher service fees than for traditional IRAs. Depending on the size of the client's IRA, the benefits of having a trusteed IRA may or may not offset the additional cost.

However, it is important to note that the trusteed IRA still may be cheaper than designating a separate trust as the IRA beneficiary. The client will be paying distinct trustee and investment fee expenses. While the trusteed IRA, like other trusts, still can utilize third-party investment managers, these responsibilities often can be combined to save cost with only one fee.

2) Can Be Unnecessary in Some Circumstances

Depending on the circumstances, a trusteed IRA may not be the most-efficient solution. The IRA assets may, for example, be needed to pay estate taxes or be better used to realize more-immediate goals. In general, if the retirement plan needs to be withdrawn shortly after the owner's death, there is little point in taking the administrative steps to set up the trusteed IRA.

3) Be Careful Not to Fire Yourself

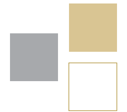
There is no set standard or restrictions on the terms that a trusteed IRA can contain. Each provider has its own set of provisions and modifications; however, the instrument is only as flexible as the provider allows. Some advisors will find that utilizing broker–dealer or custodian-specific trusteed IRAs leads to immediate or eventual takeover of the respective IRA account by the broker–dealer or custodian, which effectively means that by employing the strategy with such limitations, the advisor has fired him or herself and turned over that business to the in-house trust department. If customized terms are required, it may be best to draft them as a separate trust.

Similarly, because each provider creates its own unique set of dispositive terms, it may be difficult for the advisor to move the IRA after the trust is created and find another provider that will accept the same trust terms. This could lock you into a financial institution for the duration of the trust's life.

An alternate solution to this problem is to use an independent third-party corporate trustee that is broker–dealer- or custodian-agnostic to implement the trusteed IRA strategy, creating a trust only upon the client's passing. This enables you to advise the client to modify the terms of the trust and avoid being locked into a particular financial institution.

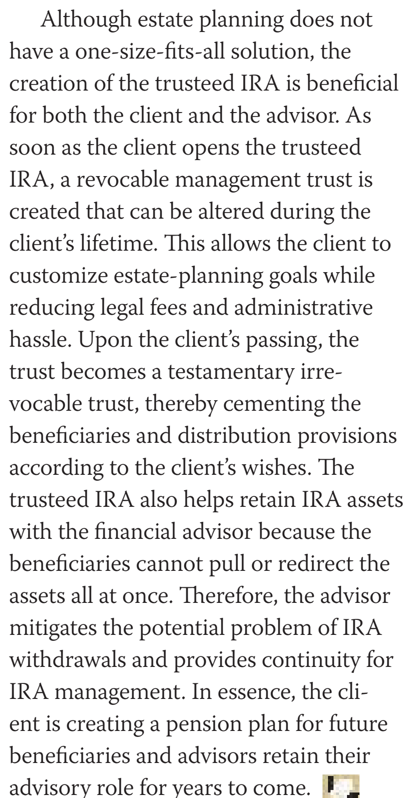
Conclusion

Advisors have long struggled over the challenges of maintaining working relationships from one generation to the next, and traditional methods of working with estate-planning attorneys



to create complex trusts to facilitate the transition have proven so tedious that the rate of adoption is virtually zero. The trusteed IRA is becoming increasingly common as the market becomes more aware of its existence and advantages, in particular its ease of adoption. This instrument is currently offered by many large custodians and trustees, including Merrill Lynch, Northern Trust, KeyBank, and USAA. Other custodians also may provide the trusteed IRA when teamed with a noncustodial trust services provider. Furthermore, because the trusteed IRA complies with federal tax laws under IRS Code 408(a) and Treasury Regulation § 1.401(a)(9)-4, it can be created in any state in the country. However, it is important to note that the trust still must comply with the specific trust laws in the state where it was created. Because each state has different legislative, reporting, and duration provisions, special care should be taken in selecting the trust's situs to ensure favorable trust laws given the client's circumstances.

Although estate planning does not have a one-size-fits-all solution, the creation of the trusteed IRA is beneficial for both the client and the advisor. As soon as the client opens the trusteed IRA, a revocable management trust is created that can be altered during the client's lifetime. This allows the client to customize estate-planning goals while reducing legal fees and administrative hassle. Upon the client's passing, the trust becomes a testamentary irrevocable trust, thereby cementing the beneficiaries and distribution provisions according to the client's wishes. The trusteed IRA also helps retain IRA assets with the financial advisor because the beneficiaries cannot pull or redirect the assets all at once. Therefore, the advisor mitigates the potential problem of IRA withdrawals and provides continuity for IRA management. In essence, the client is creating a pension plan for future beneficiaries and advisors retain their advisory role for years to come.



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Endnotes

1. Pershing, LLC (www.pershing.com) and TD Ameritrade Institutional (www.tdameritrade.com).
2. See "Frequently Asked Questions about Individual Retirement Accounts," Investment Company Institute. http://www.ici.org/faqs/faq/faqs_iras.
3. Pershing, LLC and TD Ameritrade Institutional.
4. In Sabelhaus and Schrass (2009), figure 17, page 19: Most IRA Assets Are Held by Taxpayers Aged 55 or Older.
5. Pershing, LLC and TD Ameritrade Institutional.
6. Pershing, LLC and TD Ameritrade Institutional.
7. Determination of the Designated Beneficiary, 26 C.F.R. § 1.401(a)(9)-4.
8. Required Distribution Where Employee Dies Before Entire Interest is Distributed, 26 C.F.R. § 1.401(a)(9)(B)(ii).
9. Exemptions, 11 U.S.C. § 522(b)(3)(C) (2012).
10. *Gene W. Doeling v. Nancy A. Nessa*, No. 10-6009 (8th Cir. Apr. 9, 2010) (LexisNexis).
11. *Chilton v. Moser*, No. 11-40377 (5th Cir. Mar. 12, 2012) (Lexis Nexis).

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