



## Viewpoint



Natalie B. Choate • APRIL 2015

# Using a Trusteed IRA to Protect, Preserve and Control Your IRA Assets

The first IRAs were created in 1975 and contained no more than that year's maximum contribution—just \$1,500. Decades later, through annual contributions (of ever-larger permitted amounts), rollovers from employer plans, and investment growth, IRAs have become a major financial asset (sometimes the largest asset) for many IRA owners. Yet many IRAs are still held in the simple custodial IRA format designed for small accounts.

For an individual who has amassed a significant balance in an IRA or whose IRA constitutes a significant percentage of the owner's wealth, the solutions that worked in the past may no longer be the best way to structure that IRA. The trusteed IRA can offer greater protection for this important asset during the owner's life (for example in case of the owner's disability) and an increased ability to control disposition of the IRA after the owner's death. When these goals are important, consider using a trusteed IRA.

This article explains how a trusteed IRA can help to protect and preserve the IRA, and help make sure the IRA works for the IRA owner and his or her beneficiaries in the manner the IRA owner chooses.

### WHAT IS A TRUSTEED IRA?

A trusteed IRA is exactly the same as a "regular" IRA except that the account assets are held in a trust rather than a "custodial account." The IRA provider (financial institution that administers the IRA) serves as the trustee of the account, rather than as a "custodian." Under the Tax Code, both types of IRA are considered identical.

Most IRAs are in the form of custodial accounts with the IRA provider serving as custodian. The duties of the custodian of IRA assets are limited to:

- Holding the account assets.
- Keeping track of deposits, distributions, and investment changes.
- Reporting to the IRA owner regarding the IRA investments.
- Filing required tax reports with the IRS.

Merrill Lynch Wealth Management makes available products and services offered by Merrill Lynch, Pierce, Fenner & Smith Incorporated (MLPF&S), a registered broker-dealer and member SIPC, and other subsidiaries of Bank of America Corporation (BoFA Corp.).

Investment products:

**Are Not FDIC Insured**

**Are Not Bank Guaranteed**

**May Lose Value**

---

With a trustee IRA, the bank or trust company holds the IRA assets as trustee rather than as custodian. In addition to all the same duties performed by a custodian, the trustee:

- Takes on investment responsibility for the account. A custodian never has investment responsibility.
- Can disburse funds for the benefit of the IRA owner, when authorized to do so by the owner—for example, paying the owner's bills directly if the owner is incapacitated. An IRA custodian cannot do this.
- Can continue to carry out the IRA owner's instructions after the IRA owner's death, restricting the rate at which the beneficiaries receive access to the funds. An IRA custodian cannot do this—beneficiaries of a custodial IRA have unlimited access to the inherited account.

IRAs generally must pay out a “required minimum distribution” (RMD) each year after the owner's death, and also (in the case of a traditional IRA) during the IRA owner's life after age 70½. Failure to pay out the “RMD” results in a substantial excise tax of 50% of the RMD that was not withdrawn. The trustee will compute and pay out that RMD each year as part of its duties. A custodian does not do this, leaving the IRA owner vulnerable to the excise tax when illness or any mishap causes failure to take the RMD.<sup>1</sup>

These and other features of the trust format lead to several potential advantages that the trustee IRA has over a custodial IRA. IRA owners who adopt trustee IRAs are usually seeking greater control after death; assistance in the event of disability; and possible protection of beneficiaries from creditors' claims.

## ADVANTAGES OF TRUSTEED IRAS

### 1. Control distributions after the owner's death

When an IRA owner dies, the account passes to his or her beneficiary. Under current tax law, the beneficiary of an IRA can continue the tax-deferred (or tax-free, in the case of a Roth) status of the IRA, by taking annual distributions from the account gradually over his or her life expectancy. The IRA owner may want his or her beneficiary to take advantage of this so-called “life expectancy” or “stretch” payout option. But what if the beneficiary doesn't see the advantage of that approach and would rather just take an immediate lump sum distribution of the entire account?

With a custodial IRA, the moment the owner dies, the beneficiary has complete and unlimited access to the account. For example, if a custodial IRA is left to a 25 year-old grandchild, the grandchild could withdraw it gradually over his or her life expectancy... or he or she could cash out the account immediately and spend it (or spend what's left after paying the income taxes).

With a trustee IRA, the IRA owner can assure that the beneficiary will not cash out the account prematurely, by giving the trustee control over when distributions are made to the beneficiary. The trustee must pay to the beneficiary the annual RMD (based on the beneficiary's life expectancy). Beyond that, the IRA owner decides (and specifies in the IRA trust document) what additional distributions, if any, the beneficiary will receive—for example, the IRA owner could specify that the beneficiary will receive additional distributions if needed for support or education, or in the trustee's discretion.

### Contrast with Custodial IRA

Although a custodial IRA generally cannot, itself, have a limited payout schedule for beneficiaries, the IRA owner could have his or her lawyer draft a separate trust instrument that would contain the restrictions the IRA owner wishes to place on the beneficiary's access to the funds. The IRA owner would then name that separate trust as beneficiary of the custodial IRA. This approach (custodial IRA payable to a separate trust created by the IRA owner) can accomplish the same results as the trustee IRA, but it has two complications:

- **Legal fees:** One is the legal fee needed to prepare the separate trust. While the IRA owner should expect to pay his or her legal advisor for estate planning advice even in connection with using a trustee IRA, it is probable that the fees for drafting a separate trust to be named as IRA beneficiary would be higher than the fees for reviewing and advising regarding adoption of a trustee IRA.
- **Risk of qualification as a see-through trust:** If the purpose of the trust is to assure that the beneficiary takes advantage of the “life expectancy payout method,” the trust must meet numerous IRS requirements to qualify as a “see-through trust.” Not all estate planning advisors are experienced in drafting trusts to meet these requirements. If the trust named as beneficiary does not qualify as a see-through trust the IRA will have to be distributed much more rapidly after the owner's death than would otherwise be the case. The risk of

---

not qualifying as a see-through trust (and therefore forfeiting potential deferral) does not exist with a trustee IRA, because the trust is, itself, an IRA. No separate see-through trust is needed.

## 2. Control disposition after the beneficiary's demise

Some IRA owners want to be sure that, if there is any money left in the inherited IRA when the original beneficiary dies, that money will pass to the owner's chosen successor beneficiaries, not to new beneficiaries chosen by the first beneficiary. This can be particularly important for individuals who want to provide for both a current spouse and children from a prior marriage. This goal is easily accomplished with a trustee IRA. With a custodial IRA it is impossible to do this, unless the IRA is left to a separate standalone trust (with all its drawbacks of cost and uncertainty).

## 3. Anticipating possible disability

The IRA owner, thinking ahead, will anticipate his or her possible future disability resulting from advanced age or illness. It is advisable to prepare for that eventuality by (1) nominating one or more persons or institutions to manage the individual's finances, (2) setting up a legal mechanism for the chosen person or institution to carry out that responsibility, and (3) setting the standards that person or institution should follow.

With a trustee IRA, the IRA trust document can fulfill all of these requirements with respect to the IRA assets. The IRA trustee, when it learns that the IRA owner has become disabled (or anytime upon the IRA owner's request) can assume responsibility for paying the IRA owner's expenses and bills directly from the IRA.

If the owner of a custodial IRA becomes disabled, the custodian cannot step in and assume greater financial responsibilities. The custodian could only respond to directions from either the holder of a power of attorney or a legal guardian or conservator in order for IRA funds to be used for the incapacitated IRA owner's benefit (and in order for the RMD to be distributed<sup>2</sup>). If the disabled IRA owner does not have a current power of attorney in place, expensive and lengthy court proceedings could be required to get a legal guardian or conservator appointed before the IRA funds could be used for the owner's benefit.

## 4. Concern about creditors of the beneficiary

During the IRA owner's lifetime, the IRA may have the protection of various federal and state laws designed to prevent creditors of the IRA owner from seizing the account to pay debts. Once the IRA owner dies, and the beneficiary owns the inherited account, this protection may be reduced or lost. For example, a recent Supreme Court case ruled that the bankruptcy exemption allowed for "individual retirement accounts" protects the IRA during the original owner's life, but expires upon his or her death. The inherited IRA is therefore an asset available to the beneficiary's creditors if the beneficiary suffers bankruptcy.

Generally, assets in a so-called "spendthrift trust" cannot be taken by the creditors of the trust beneficiary. Therefore if the IRA owner is concerned about potential creditors of his or her chosen beneficiary, the IRA owner should consider leaving the IRA in a protected spendthrift trust arrangement. There are two ways to accomplish this. One is for the IRA owner to have his or her lawyer draft a spendthrift trust for the benefit of the intended beneficiary, then name that trust (rather than the individual) as beneficiary of the IRA.

The other is to use a trustee IRA with a restricted payout. Assuming the trustee IRA contains a "spendthrift clause" (most do), the beneficiary's creditors generally cannot access the IRA. They could try to seize IRA distributions as they are received by the beneficiary, but they cannot (under existing laws as operated in most states) go after the IRA directly.

**Note:** *If you are concerned about potential exposure to creditors' claims for either yourself or your chosen beneficiary, you need to consult a lawyer who is expert in "asset protection planning." The brief general statements here cannot cover the many complexities of this subject.*

A trustee IRA is exactly the same as a "regular" IRA except that the account assets are held in a trust rather than a "custodial account."

---

## OTHER FACTORS TO CONSIDER

A trustee IRA is not the right solution for everyone. Two concerns in particular are cited as reasons why a particular individual would not use a trustee IRA: cost and the fact that required distributions must be paid to the beneficiary.

### Cost

Because the trustee of a trustee IRA has greater responsibilities than the custodian of a custodial IRA, the annual fee of the IRA provider will normally be higher for a trustee IRA than for a custodial IRA. Here are three points to consider regarding this factor:

- The IRA owner needs to evaluate whether the advantages of the trustee IRA are worth the investment.
- If the IRA owner is already paying the financial institution for investment management with respect to a custodial IRA, the cost increase may be minimal or nonexistent to convert the account to a trustee IRA.
- Normally a trustee IRA format is not suitable for smaller accounts.

### Required distributions must be paid to the beneficiary

As noted, the trustee IRA allows the IRA owner to prevent the beneficiary from simply cashing out the inherited account immediately upon the owner's death. However, even with a trustee IRA, the beneficiary will be receiving some distributions from the account that are outside the IRA owner's or trustee's ability to prevent. Specifically, the tax law requires that the beneficiary receive the RMD each year after the owner's death. This required distribution must be distributed each year.

The RMD issue is not a problem if all the IRA owner wants to do is be sure that the beneficiary takes advantage of the stretch or life-expectancy payout. However, if the owner wants the trustee to be able to hold back the RMDs (not pass them out automatically to the beneficiary), then the trustee IRA, by itself, can not accomplish the owner's goal.

- **Certain disabled beneficiaries:** A common situation in which this presents a problem is the disabled beneficiary for whom the IRA owner wants to leave the IRA in a "supplemental needs trust." Under a supplemental needs trust, the trustee

has full control of the funds and uses them to supplement benefits the disabled beneficiary is receiving under means-tested government programs. If IRA payments are paid outright to the beneficiary, the payments will count as "income" or "assets" of the beneficiary and he or she may lose his or her qualification for the government benefits. Thus, a supplemental needs trust must give the trustee the power to hold back RMDs from the beneficiary.

Because trustee IRA RMDs must be distributed annually (the trustee cannot hold them back), a trustee IRA cannot be a supplemental needs trust. To leave IRA assets in a supplemental needs trust, the IRA owner would need to have his or her attorney prepare a separate supplemental needs trust and name it as beneficiary of the IRA.

- **Beneficiary who cannot suitably manage any funds:** The same would be true in any situation where the IRA owner does not want the chosen beneficiary to have outright control of any of the IRA funds—for example, because the beneficiary does not have the capacity to handle money responsibly. If the IRA owner does not want the beneficiary to receive even the required annual minimum distribution, the IRA owner must use a separate trust and name it as beneficiary of the IRA.

A trustee IRA can offer greater protection for the IRA during the owner's life (for example in case of the owner's disability) and an increased ability to control disposition of the IRA after the owner's death.

---

## EXAMPLES

Here are situations in which an individual IRA owner might consider using a trustee IRA.

### **Spendthrift Protection**

Arthur wants to leave his IRA to his grandson Billy, age 21. Since Billy's support and education have been provided for by his parents (Arthur's daughter and son-in-law), Arthur feels this inherited IRA should be preserved as a tax-deferred retirement plan for Billy, with the funds professionally invested for Billy's benefit. Arthur wants Billy to receive the annual RMD each year, and not to take out any additional funds from the account unless the trustee agrees that such additional distribution is advisable. Arthur places his IRA funds in a trustee IRA for Billy's benefit. Billy will not be able to unwisely cash out the account when Arthur dies; he will receive control gradually, through annual RMDs and (if appropriate) additional distributions in the trustee's discretion.

### **Possible Future Disability**

Grace recently retired and is structuring her assets and her estate plan for a hopefully long and happy retirement. With the help of her estate planning attorney she has adopted a will, living trust, and durable power of attorney. Turning her attention to her substantial IRA, she is concerned about how funds in this account will be handled if she becomes unable to manage her affairs. The will she signed has no effect on anything until after her death. Her living trust is set up to manage her assets, but IRA assets cannot be placed in a living trust during the owner's life. That leaves the durable power of attorney as the only instrument that could be used to manage IRA assets and make withdrawals to pay her bills in case of incapacity. But durable powers of attorney can be problematic—for example, the rights and duties of the holder of a power or attorney are not well settled in the law. Since her IRA is very substantial, and the financial institution where she keeps the IRA is also where her financial advisor is (who is very familiar with her family and finances), she adopts a trustee IRA. Now the trustee of the trustee IRA can respond directly to her needs in case of disability, instead of having to rely on the holder of a power of attorney.

### **Providing for a Spouse and Children from a Prior Marriage**

George is married to Gina. He has two children from a prior marriage. George wants to leave his IRA primarily for Gina's lifetime use; he wants her to receive the annual RMD, plus additional amounts (if any) needed (in the trustee's judgment) for her health and support. He is concerned, however, that upon Gina's later death, if there is still money in this IRA, it should pass to his children, rather than to Gina's relatives. George adopts a trustee IRA that so provides. If George used a custodial IRA with Gina as beneficiary, and Gina later died while there was still money in the account, that money would pass to Gina's chosen beneficiaries or heirs, not to George's children.

### **Creditor Protection**

Janet wants to leave her IRA to her son Louis. Louis is in the construction business, and she feels he has a risk of exposure to lawsuits. Janet wants Louis to have this money, but at the same time she wants to give it some protection from potential future lawsuits. For total protection of the asset from any creditor of Louis, she would have to tie up the asset permanently in a spendthrift trust. She doesn't want to go that route, because Louis so far has avoided business problems and she really wants him to get the benefit of the money. But if she simply names him as outright beneficiary and he gets sued shortly after her death, the whole account might be lost. To compromise her conflicting goals, she uses a trustee IRA. Louis will get the RMD every year, so he will have funds from the account. But the rest of the account will remain safe from his creditors in the trustee IRA until it has all been paid out gradually over his life expectancy.

---

## THE BENEFITS OF A TRUSTEED IRA

Although any financial institution that offers IRAs could offer trustee IRAs, relatively few do in fact offer the trustee IRA. Merrill Lynch is among the leading national IRA providers that offer the trustee IRA, through U.S. Trust.<sup>3</sup>

The Trustee IRA offered to Merrill Lynch clients through U.S. Trust has the following features that may be to your advantage if you are considering a trustee IRA:

You can specify that your accountant, attorney, or other financial advisor will receive information regarding the account directly from U.S. Trust.

You can specify how you want your beneficiary(ies) to receive payments from the account after your death. You can choose among some pre-set popular options, such as unlimited payout option; estate tax marital deduction-qualifying payout to your spouse; beneficiary receives only the RMD; or beneficiary receives RMD plus amounts needed for health, education and support. Or you can specify some other distribution format if agreed upon between you and the trustee.

You can provide that your beneficiary will choose his or her own successor beneficiaries for amounts remaining in the account at his or her death, or you can choose the successor beneficiary yourself.

If you are incapacitated, the trustee may make payments directly for your health and support if you have chosen that option.

This article has provided an introduction to the benefits and limitations of the trustee IRA. Your Private Wealth Advisor can answer any additional questions you may have about the trustee IRA.

<sup>1</sup> Although all IRA custodians must calculate your RMD, some offer a service that allows the IRA owner to direct the custodian to automatically distribute the RMD each year.

<sup>2</sup> Unless automated distribution service is in place.

<sup>3</sup> U.S. Trust is a division of Bank of America, N.A. and affiliate of Merrill Lynch.

Natalie B. Choate is of counsel to the law firm of Nutter McClennen & Fish LLP in Boston, Massachusetts and a nationally known speaker on issues related to estate planning and retirement benefits. She may be reached at [www.ataxplan.com](http://www.ataxplan.com).

Neither the author of this paper, nor any law firm with which the author may be associated, is providing legal or tax advice as to the matters discussed herein. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness. Individuals should consult their own legal and tax counsel as to matters discussed herein and before entering into any estate planning, trust, investment, or retirement arrangement.

Natalie Choate is unaffiliated with Merrill Lynch. She is compensated by Merrill Lynch for services performed as a consultant. The opinions reflected are solely her own and Merrill Lynch expresses no opinion with regard to them.

Copyright Natalie B. Choate 2015. Reprinted by permission. All rights reserved.



PRIVATE BANKING &  
INVESTMENT GROUP

---

The Private Banking and Investment Group is a division of MLPF&S that offers a broad array of personalized wealth management products and services. Both brokerage and investment advisory services (including financial planning) are offered by the Group's Private Wealth Advisors through MLPF&S, a registered broker-dealer and registered investment adviser. The nature and degree of advice and assistance provided, the fees charged, and client rights and Merrill Lynch's obligations will differ among these services. Investments involve risk, including the possible loss of principal investment.

The banking, credit and trust services sold by the Group's Private Wealth Advisors are offered by licensed banks and trust companies, including Bank of America, N.A., member FDIC, and other affiliated banks.

Trust and fiduciary services are provided by U.S. Trust, a division of Bank of America, N.A., member FDIC, and wholly owned subsidiary of BofA Corp.

MLPF&S and Bank of America, N.A. make available investment products sponsored, managed, distributed or provided by companies that are affiliates of BofA Corp. .

*Merrill Lynch* is a registered trademark of BofA Corp.