By Bruce D. Steiner

# Before Setting Up A Trusteed IRA

Consider these potential pitfalls

Internal Revenue Code Section 408(a) defines an IRA as "a trust. . . for the exclusive benefit of an individual or his beneficiaries." But Section 408(h) permits a custodial IRA to be treated as an IRA for purposes of Section 408[1] and the Treasury Regulations contain similar provisions.[2]

Indeed, in the early years of IRAs, financial institutions generally referred to themselves as "trustees" rather than "custodians," even if the IRA owner made the investment decisions. I remember opening several IRAs with various banks and a mutual fund company back in the 1970s and 1980s, and every time the financial institution referred to itself as "trustee." More recently, financial institutions have taken to referring to themselves as "custodians" and the term "trusteed IRA" has taken on a new meaning.[3]

In recent years, as an alternative to naming a trust or trusts as the beneficiaries of IRA benefits, several financial institutions have added the dispositive terms of a trust following the IRA owner's death to the IRA agreement itself. In this scenario, the financial institution serves as trustee of the IRA for the benefit of the beneficiaries, in accordance with the dispositive provisions set forth in the IRA agreement itself. This is sometimes referred to as a "trusteed IRA."[4]

The trusteed IRA can save the IRA owner the cost of having a trust individually prepared. But the IRA owner can achieve greater flexibility by creating a trust or trusts, either in his will or in a separate trust instrument, to be the beneficiaries of his IRA benefits.[5]

Indeed, before IRA owners choose to go the trusteed IRA route, they should consider these potential problems:

• **Co-trustees**—A testator who names a corporate trustee often names one or more individuals to serve as trustees together with the corporate trustee. Often, the beneficiary of the trust is a trustee. This arrangement is not possible with a trusteed IRA. IRC Section 408(a)(2) requires that the trustee of an IRA be a bank, a credit union "or such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust will be consistent with the requirements of this section." The regulations permit institutions other than banks to serve as trustees. As a practical matter, however, the regulations limit the trustees to financial institutions.[6] An individual cannot be a trustee.[7]

• **Power to Change Corporate Trustees**—A testator who names a corporate trustee often gives the beneficiary (or someone else) the power to remove the corporate

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trustee and replace it with another corporate trustee, or some other independent trustee. This arrangement is permitted under Revenue Ruling 95-58,[8] *Estate of Vak v. Commissioner*[9] and *Estate of Helen S. Wall*.[10] Indeed, according to one private letter ruling, if the person holding that power is not the grantor, it may not be necessary for the replacement trustee to be independent.[11] But, because a PLR is not binding on the Service except with respect to the taxpayer to whom it is issued,[12] prudence suggests requiring that the replacement trustee be independent.

There is, of course, no reason that a trusteed IRA could not permit the beneficiary (or someone else) to have the power to remove and replace the corporate trustee. One of the trusteed IRAs that I've reviewed suggested that the financial institution might permit the beneficiary to remove and replace the corporate trustee, but offered no assurance that it would do so. The relevant provision stated: "The trustee, in its sole discretion, may refuse to transfer any inherited IRA for any beneficiary who is subject to [trust terms] unless the successor custodian or trustee agrees in writing to administer the inherited IRA in accordance with the [trust terms]." Another trusteed IRA that I examined did not contain such a provision.

• **Flexibility of Dispositive Provisions**—There are no restrictions on the dispositive terms that a trusteed IRA could contain. But the only way to customize the dispositive terms is to individually draft them, in which case there is no need for a trusteed IRA.

The trusteed IRAs that I've reviewed offer a limited menu of choices from which the IRA owner can select. While there is nothing to limit the choices offered, the trusteed IRAs I've seen did not permit maximum flexibility.

• **Discretion Over Income and Principal**—In the trusteed IRAs I've reviewed, the trustee did not have complete discretion to distribute the income and principal to or for the benefit of the beneficiary and his or her issue, or to accumulate the income.[13] The trustee could not retain any of the required distributions from the IRA in the trust. Instead, the trustee was required to distribute these amounts to the beneficiary. To the extent of these mandatory distributions, the opportunity to protect the IRA benefits from the beneficiary's potential creditors (including spouses) is destroyed. Moreover, if the beneficiary lives to life expectancy, which by definition will happen 50 percent of the time, all of the IRA benefits, which could have been kept out of the beneficiary's estate, will be thrown into the beneficiary's estate for estate-tax purposes.

> The IRA owner already will have paid to have a trust prepared. So, cost saving shouldn't be key in deciding on a trusteed IRA.

While inconsistent with a provision mandating a certain level of distributions, one of the trusteed IRAs I've reviewed limited distributions in excess of those mandated to specified purposes. What if it is desirable to make a discretionary distribution for a purpose other than those enumerated? The other one contained a blank space where the IRA owner could "augment [the] beneficiaries' rights to distributions by inserting additional provisions below (for example, grant the trustee the power to pay more at its discretion or for XYZ reason)."[14]

In the trusteed IRAs I've reviewed, each trust had only one current beneficiary to whom the trustee can make distributions. What if it would be desirable to make a distribution to a child or grandchild of the beneficiary?

• **Powers of Appointment**—Testators often give beneficiaries powers of appointment over trusts for their benefit. This provides additional flexibility, and enables the beneficiary to transfer assets to others without incurring estate or gift tax. But in the trusteed IRAs I've reviewed, the beneficiary did not have a special power of appointment exercisable during lifetime. In one of the trusteed IRAs, if the beneficiary had a power of appointment exercisable at death, it was a general power rather than a special power, thus throwing the entire value of the trust into the beneficiary's estate for estate-tax purposes. In the other, the IRA owner could give the beneficiary either a general or a special power of appointment exercisable at death, could make the power of appointment conditional, and in the case of a special power, could specify the class of permissible appointees.[15]

• **Cost Savings Should Not be a Major Factor—**An IRA owner who wants to leave his IRA in trust rather than outright will probably leave his other assets in trust as well. Thus, the IRA owner already will have incurred the cost of having a trust or trusts prepared. The only modification needed to create a trust or trusts to receive IRA benefits is to provide that no accumulated IRA benefits can be distributed or appointed to anyone born in a year prior to the year of birth of the desired designated beneficiary.

## We'll See

Clearly I'm not a big fan of the trusteed IRA—at least not yet. But if you are, I hope I've given you some issues to consider.

### Endnotes

1. Internal Revenue Code Section 408(h) states: "For purposes of this section, a custodial account shall be treated as a trust if the assets of such account are held by a bank (as defined in subsection (n)) or another person who demonstrates, to the satisfaction of the Secretary, that the manner in which he will administer the account will be consistent with the requirements of this section, and if the custodial account would, except for the fact that it is not a trust, constitute an individual retirement account described in subsection (a). For purposes of this title, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof."
2. Treasury Regulations Section 1.408-2(d).
3. While Section 408(a) sets forth certain requirements for the governing instrument creating the IRA, it doesn't prevent the inclusion of additional provisions and the Internal Revenue Service forms for IRAs actually provide space to do so. Article VIII at the end of the two forms the IRS has issued for traditional IRAs (Form 5305, "Traditional Individual Retirement Trust Account" and Form 5305-A, "Traditional Individual Retirement Account Custodial Account) states that it: "may be used for any additional provisions. If no other provisions will be added, draw a line through this space. If provisions are added, they must comply with applicable requirements of state law and the Internal Revenue Code."
4. I've reviewed two forms of trusteed IRAs, one from a national brokerage firm and the other from a regional bank.
5. For a more detailed analysis of trusts as beneficiaries of retirement benefits, *see* Bruce D. Steiner, "Trusts as Beneficiaries of Retirement Benefits," 29 *BNA Tax Management Estates, Gifts & Trusts J. No. 2*, 108 (March-April 2004).
6. Treas. Regs. Section 1.408-2(e),
7. Treas. Regs. Section 1.408-2(e)(2)(i)(A).
8. 1995-2 Cum. Bull. 191.
9. *Estate of Vak v. Commissioner*, 973 F.2d 1409 (8th Cir. 1992), rev'g T.C. Memo 1991-503.
10. *Estate of Helen S. Wall*, 101 T.C. 300 (1993).
11. Private Letter Ruling 199909016.
12. Section 6110(j)(3); Treas. Regs. Section 301.6110-7(b).
13. If the trust is intended to qualify for the estate tax marital deduction as a qualified terminable interest trust under IRC Section 2056(b)(7), the spouse must be entitled to all of the income of the trust, and no principal of the trust can be distributed to anyone other than the spouse during the spouse's lifetime. It's not common to leave an IRA to a qualified terminable interest property trust, because generally the IRA must be paid out over the spouse's life expectancy, thus sacrificing substantial income tax deferral.
14. This provision may be inconsistent. Granting the trustee discretion does not necessarily give the beneficiary any rights. It can be argued that limiting the trustees' discretion to distribute to specified purposes might give the beneficiary a right to receive distributions for the specified purposes. A discussion of this issue is beyond the scope of this article.
15. To obtain the desired stretch out, no accumulated IRA distributions can be distributed to or appointed to or in trust for any individual born in a calendar year earlier than that of the desired designated beneficiary, or to or in trust for anyone other than an individual. PLRs 200228025 and 200235038. In the case of a special power of appointment, the class of permissible appointees must be limited accordingly. For the beneficiary to have a general power of appointment exercisable at death, either the power cannot extend to any accumulated IRA distributions (which may add some drafting complexity), or the trust must mandate that the trustee distribute each year's required distributions from the IRA to a beneficiary (which limits the flexibility of the trust).