New York Times
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Your Money

How to Give an I.R.A. to Children Without Giving Up Control

Wealth Matters

By PAUL SULLIVAN NOV. 18, 2016

Most people spend whatever they have saved in their individual retirement accounts in the years after they stop working. If they're fortunate, they have enough to last.

But the few who have amassed such large retirement accounts that they will never exhaust them have a concern common to many wealthy parents: What happens to the money when they die and their children inherit it?

A trusteed I.R.A. is a relatively easy way for parents to control how, when and why their children receive the distributions from their retirement accounts.

It can accomplish many of the same things as a trust with less work and lower cost. It also makes it simple to extend the distributions to heirs based on their individual life expectancies.

"It's timely with this big generation of baby boomers who have all this wealth that they need to plan for," said Dana Vosburgh, director of family wealth management at Manning & Napier, which recently started offering trusteed I.R.A.s in conjunction with Exeter Trust Company.

"We do have a lot of clients who have large I.R.A.s, and it represents a meaningful portion of their estate," he added. "They're that much more interested in seeing this big asset distributed properly."

Duane Squires, who owned a mason subcontracting business outside of Buffalo, saved steadily and built up seven figures in retirement savings. "It worked out very well," he said. "I was surprised by how well it was managed and how the funds grew."

But that surprise meant that he and his wife, Nancy, now retired in Myrtle Beach, S.C., had more than they needed to live comfortably in retirement.

Now 85, Mr. Squires set up a trusteed I.R.A. last year to manage how the I.R.A. savings will be distributed to their four children when he and his wife die.

The savings will be put into separate accounts for the children, “with the knowledge that it was pretty secure and they couldn’t just take a lump sum amount,” he said. “As parents, you don’t want the money that comes to your children after your death to be squandered or ill-used. We felt this was a good way to help our children along.”

With a traditional I.R.A., the assets can be directed through beneficiary designation forms, which will split the funds among the heirs. But those forms don’t give the I.R.A.’s owner control over how someone uses the money.

A trusteed I.R.A. allows the assets to be divided into separate accounts — as opposed to going to separate individuals. And each account can have different guidelines on when and for what distributions are made.

“It’s that spot where retirement planning meets estate planning,” said Steven D. Brett, president of Marcum Financial Services. “You get to combine the tax advantages of an I.R.A. with the benefits of a trust.”

A trusteed I.R.A. also offers asset protection. Edwin Morrow, national wealth specialist at Key Private Bank, noted that the Supreme Court, in a 2014 decision, Clark v. Rameker, ruled unanimously that funds held in traditional I.R.A.s that are inherited do not have the same protection as retirement assets.

That ruling, Mr. Morrow said, increased interest in trusteed I.R.A.s as a way for people to protect their assets when their children inherit them, and to dictate how distributions above the minimum are made.

There is the option, of course, of establishing a trust and putting the I.R.A. into it. That certainly works, but it is generally more expensive and can be messy with an I.R.A.

“There are rules that could impact your ability to stretch distributions, how you calculate those distributions and when you can get access to the funds,” said Mark Newcomb, national fiduciary I.R.A. executive at U.S. Trust.

A trust can also be more than someone needs if the I.R.A. is the largest asset. A trusteed I.R.A. “does the same thing as a trust, but it does it a little more simply, a little more effectively,” Mr. Newcomb said.

The separate accounts that can be created with a trusteed I.R.A. allow the amount of the required minimum distribution to be calculated based on each individual’s age. When a traditional I.R.A. is inherited, the rate of distribution is set by the age of the oldest heir.

So, for example, if the heir was in her late 80s with a life expectancy of seven years, the distributions would be far larger — and incur income tax more quickly — than if the heir was 50 with a life expectancy of 35 years. If there were multiple heirs, they would all receive distributions based on the oldest among them.

The trusteed I.R.A.s allow the ages to be calculated in each separate account. If the people named to each account are, for example, 50, 60 and 70 when they inherit assets through a trusteed I.R.A., their required minimum distributions will be stretched out according to their life expectancies. In doing so, the younger beneficiaries could see the assets grow and pay the taxes on the I.R.A. more slowly.

A trusteed I.R.A. is also a way for someone to support a second spouse but ensure that whatever is left over gets directed to children from a first marriage. Otherwise, a spouse who inherits an I.R.A. could combine it with other I.R.A.s and leave it to whomever he or she wanted, Mr. Brett said.

There is also a benefit if the I.R.A. owner becomes incapacitated. The trusteed I.R.A. has a provision that allows the corporate trustee to request the required minimum distribution on someone’s behalf. Without that provision, if the owner had not requested that distribution, even though he was incapacitated, he could incur a substantial penalty — 50 percent of the distribution, Mr. Newcomb said.

One service offered by U.S. Trust, he said, pays the bills each month for the owners of trusteed I.R.A.s. That is a way to use the owners’ required minimum distribution.

Still, trusteed I.R.A.s have their limits.

For one, they are expensive compared with a traditional I.R.A. that owns passively managed investments. And someone with a smaller I.R.A. may not have enough assets to justify the management fees — if a provider would even agree to manage it.

Typically, the half dozen or so providers of trusteed I.R.A.s set up and manage the accounts for the same 1 to 2 percent fee they charge to manage the assets. But given that fee, advisers say trusteed I.R.A.s typically work best for retirement accounts of $500,000, if not $1 million.

Mr. Newcomb of U.S. Trust said the bank likes to see someone have at least $250,000 in an I.R.A. and no plans to spend it down.

Manning & Napier set its minimum at $1.5 million. Mr. Vosburgh said the minimum was partly to account for how that I.R.A. would probably be split into several separate accounts, which would each need to be managed.

Mr. Brett said given the amount of planning involved, people should look at this only if they have an I.R.A. that they won’t spend in their lifetime and can see their heirs using it for years.

Someone setting up a trusteed I.R.A. also probably needs to consult a lawyer to create and understand the document that will guide the distributions.

And a trustee of one of these I.R.A.s is not permitted to withhold payments, unlike a regular trust. Because of federal laws governing I.R.A.s, a trustee needs to pay out the minimum required distribution each year. That can be problematic if a beneficiary is a minor or is not capable of handling the money.

Still, apart from the required distributions, the bulk of the money does remain protected from creditors, including spouses seeking assets in a divorce.

People who are leaving their I.R.As to their spouses — or simply don't care how their money is spent after they're gone — probably have no use for a trusteed I.R.A. They could save themselves time and money by using simple beneficiary designation forms to determine who gets what.

But for a subset of affluent investors, a trusteed I.R.A. could accomplish many goals without the time and expense required to draft a trust.

A version of this article appears in print on November 19, 2016, on page B3 of the New York edition with the headline: When Retirement Savings Aren't Needed in Retirement.