Protecting Your Asset and Your Autistic Family Member

Naming a Special Needs Trust as Beneficiary of your IRA or Retirement Plan

If you're reading this article, and have a child or family member with special needs, you've probably already set up a special needs trust (sometimes called a "supplemental needs trust") and named it as a beneficiary of your will or living trust. If not, you might want read some other Voice articles first, including "Developing an Estate Plan for Parents of Children with Disabilities: A 15-Step Approach," May 2013, and "Your Special Needs Trust ("SNT") Defined," January 2013. Your goal will typically be to leave assets that can benefit your family member with a disability without causing his or her loss of needs-based government benefits. Further, you will likely want to protect those assets against later claims on your family member's death, or in some cases during lifetime, for Medicaid or other public benefits received.

Setting up the special needs trust and then preparing a will or trust that names the special needs trust as a beneficiary are the most important first steps. But then you have to decide what assets are to go into the special needs trust. What about your retirement plan or IRA? IRAs and retirement accounts may represent a significant portion of your total assets and may appear to be a natural source of funding for your special needs trust. However, this article explains the perils and pitfalls of naming your special needs trust as the beneficiary of your IRAs and other retirement accounts.

The first thing to understand is that your will controls only assets for which you have made no "beneficiary designation." For example, if you've named a beneficiary of your life insurance, the proceeds of your life insurance will pass to the beneficiary you have named, and won't be controlled by the terms of your will. The same is true of joint tenancy accounts where the named joint tenant fully owns the account after your death under a "right of survivorship." And the same is generally true of your IRAs and other retirement accounts. IRAs and other retirement accounts almost always name a specific beneficiary to receive the account upon the death of the owner. As a result, if your will leaves a share of your assets to a special needs trust intended for your special needs child, but you have named your special needs child as beneficiary on your IRA beneficiary form (perhaps by naming all your children as equal beneficiaries), the IRA will pass *directly* to the child when you die, not to the special needs trust. Accordingly, your beneficiary designations, will, and trusts all need to be coordinated so that they don't work at cross purposes.

When it comes to life insurance, you might choose to solve this problem by naming your living trust or special needs trust as the beneficiary. Alternatively, you could name your "estate" as the beneficiary, particularly if you have a number of children or other beneficiaries. That way, the proceeds can be divided conveniently in as many portions as the document specifies, with your special needs child's share passing out to his or her special needs trust. The only downside of naming your "estate" as a life insurance beneficiary would be exposing the proceeds to your creditors and to the need to go through a court process to administer your will (typically referred to as probate).

However, unlike life insurance, when it comes to IRAs and other retirement accounts, there are big problems if you name your "estate" as beneficiary, and there may be similar problems if you name a trust as beneficiary, depending on how the trust is written.

First, let's look at what happens if you name your "estate". If the "estate" is beneficiary, IRS regulations require that the IRA or account pay out fairly quickly — perhaps over as short a time period as five years if you are under 70-1/2 (for IRAs) or still working (for an employer-sponsored retirement plan) when you die. Why should you care? *Income tax*. Except for Roth accounts, IRAs and retirement accounts are made up of pre-tax dollars, and the recipient of distributions from these

accounts must pay income tax on every dollar received. If the account is large, and distributed over five years, the yearly distribution will be large, and the tax bill correspondingly large. By contrast, if payment can be stretched out over many years — for instance, your special needs child's lifetime — the tax bill each year will be much smaller, leaving more in the account to grow tax-free. If you name your "estate" as the beneficiary of your IRA or other retirement account, this "stretch" isn't possible, and total income taxes will be much higher. Note: if you've already retired, the account would have to be distributed over your remaining life expectancy, which is probably longer than five years, but still a much shorter time period than your child's lifetime.

So why can't the payout be "stretched" when you name your "estate" as beneficiary–and will the same problem occur if you name the special needs trust? Here is the long answer. (Get a cup of coffee, and don't read this right after lunch or at the end of a long day!)

Once upon a time, Congress decreed that retirement funds accruing tax-free should have "minimum distribution" requirements so that the IRS could collect its deferred taxes within a reasonable time after retirement (and not let the taxpayer defer payment of taxes forever).

First, there would have to be a "Required Beginning Date" (RBD) for taking distributions. For employer plans, this was set as the later of when the person retired, or April 1st after turning 70-1/2. For IRAs, the RBD is April 1st following the year the owner turned 70-1/2. (Why 70-1/2? Why not? What were they thinking? No one seems to know the answer to this. The mind boggles.)

Second, there would be "Required Minimum Distributions" (RMDs), i.e., required amounts to be distributed each year beginning with that "Required Beginning Date" (RBD). The IRS in 2001 set up a simple "Uniform Lifetime Table" for account owners. (Those with younger spouses have slightly more complex rules).

What is the tax treatment when the account owner/ participant dies? Here again, the IRS stepped in with detailed regulations and tables. Payout after death would depend upon whether the death was before or after the Required Beginning Date. If the owner dies before the RBD, the default rule is five years. If the owner dies after the RBD, the default rule is the remainder of the owner's own life expectancy (using a different "One-Life" table rather than the "Uniform" table). According to the One-Life Table, someone age 75 has a life expectancy of 13.4 years, so this is not as short a payout period as the five-year rule. (Someone 90 years old has a life expectancy of 5.5 years.)

In either case, death before or after RBD, there was an exception: the stretch. Whether death occurred before or after the required beginning date, the payout could be "stretched" over the life expectancy of a "designated beneficiary" (DB), provided that payout started by December 31st of the year following the year of death. Especially if the owner is still working and the account is large, it can be very important to "stretch" the payout over the beneficiary's lifetime. Forcing a $500,000 IRA to be paid out over five years would take a terrible tax bite out of funds you intended to take care of your child after your death.

So what is a "designated beneficiary"? Is that the same as a beneficiary? And if your beneficiary is an estate or a trust, what then? The IRS regulations decided that an "estate," even if named on your beneficiary designation form, cannot be a "designated beneficiary" because it doesn't have a life expectancy. An estate is essentially a collection of assets and a group of obligations (to pay taxes, administration expenses, creditors, and only eventually beneficiaries). Although the estate might eventually have human beneficiaries with life expectancies, the IRS said that such beneficiaries are

too remote and uncertain to qualify as “designated beneficiaries.” No designated beneficiary, no stretch. That’s why naming your “estate” as the beneficiary of your IRA or other retirement account can create a tax disaster. Especially if you are still working, you probably shouldn’t do it, unless it’s a very small account and likely to stay that way.

Similarly, the IRS determined that charities (nonprofit organizations) would be treated like estates, because they don’t have life expectancies either. As a result, a gift to a charity is not a gift to a “designated beneficiary” and gets no stretched out payments.

However, the IRS was a little less strict when it came to IRA distributions to trusts. Trusts are entities like estates, and so also don’t have life expectancies. Nevertheless, the IRS grudgingly agreed that certain trusts could be “looked through,” and certain trust beneficiaries would then be counted and considered the “designated beneficiaries” for purposes of stretching the payout. That’s the good news. The bad news is that when the IRS looked at multiple beneficiaries of a trust, it said that the shortest life expectancy would be used to measure the payout. Naming Great-Aunt Sadie as one of the potential beneficiaries would therefore create obvious problems.

Less obviously, the IRS also decided that charities would be counted as trust beneficiaries, and that because they don’t have life expectancies, a charity’s “life expectancy” would be considered to be zero. As a result, a charity would also always have the shortest life expectancies of multiple beneficiaries. In other words, the IRS will only allow us to “look through” the trust to find a DB if there is no charitable beneficiary. However you describe it, even if there are twenty trust beneficiaries, and only one is a charity, looking through and finding a life expectancy over which to “stretch” distribution won’t work. You are then back to the default rules of five years (before RBD) or owner’s remaining lifetime (after RBD). The IRS does allow a grace period to patch up this problem. If a beneficiary has been paid off and is out of the trust distribution scheme by September 30th of the year following the year of death, everyone can pretend that the beneficiary (in this case the charity) was never a beneficiary, and the retirement distributions can then be stretched out over the life of the oldest human beneficiary.

This look-through rule applies to trusts that are considered “accumulation” trusts. With an “accumulation trust”, the trustee has the choice either to pay out or to retain in trust any IRA distributions the trustee receives. A different type of look-through trust, called a “conduit” trust, is a trust requiring that all distributions from retirement accounts be paid out immediately to the beneficiary. For a conduit trust, only the conduit payee, who is the beneficiary receiving those distributions, is counted, and the payout can always be stretched over that beneficiary’s lifetime, even if a charity is the “remainder” beneficiary for whatever is left of the IRA at the conduit payee’s death. Most special needs trusts are subject to accumulation trusts rules because they are typically, and often must be, discretionary trusts where the trustee has the choice either to pay or to withhold income and/or principal.

Let’s go back to your child’s special needs trust for some illustrations of these rules. Assume that you name your child’s special needs trust as beneficiary of your retirement account or IRA. Suppose your trust names your child as beneficiary during lifetime, but on your child’s death, the trustee is to distribute the remaining trust property to the National Alliance on Mental Illness (NAMI). Will the rules let you “look through” the trust to your child as DB and allow the trustee to “stretch” the required minimum distributions over your child’s life expectancy? Unfortunately, no. The IRS will look through and see not only your child but NAMI, with a net life expectancy of zero, and will require payout to the trust over five years (if you die before your RBD) or your remaining life expectancy (if

you die after your RBD). If your IRA or retirement account is big, this accelerated payout is not tax-efficient.

Of course, there are situations where it is less cut and dried. Your trust might name your child as primary beneficiary; specify that if your child dies, everything goes to the child's siblings, your other children; and if they also die, everything goes to their children, and only if everybody dies does the remaining property go to NAMI. This works! Even for accumulation trusts, the IRS looks at probabilities, and ignores a "mere potential successor" beneficiary. Provided that there is at least one alternative human beneficiary living at your death (which is when the payout is being determined) who would receive the account outright if your child had died, the beneficiaries following after can be disregarded, even if they are charities.

This is a simplification, and there are many fine points and individual issues that your attorney should take into account when drafting your trust and helping with the beneficiary forms. In general, though, if you need to name your child's special needs trust as beneficiary of a retirement account, you must consider carefully these issues:

1. The likely amount that will be in the account at your death. In other words — how important is it for this particular account to "stretch" distribution over your child's lifetime? Would the trustee reasonably decide to spend the money in five years anyway?
2. Whether you have or haven't reached your RBD. (Are you avoiding the 5-year rule or that 13.4 year life expectancy figure that applies if you are 75 and retired?)
3. The trust document itself. Assuming that it isn't a conduit trust, are there any problematic life expectancies that would be counted by the IRS to prevent a stretch? Or, if all the alternate or successor beneficiaries are human beings of your child's age or younger, is there no need to worry?

If it's important to you to have an elderly person or charity as the successor trust beneficiary after your child's death, or as an alternate payee while your child is living, you may have to decide not to name your special needs trust as the beneficiary of the retirement account at all but instead to name other individuals as beneficiaries and leave a larger portion of your non-IRA assets to the special needs trusts. Another option may be to include language in your trust that handles retirement distributions differently from other property — so that the retirement distributions the trustee receives will be held separately and never pass to a charitable or elderly beneficiary.

There are also procedural requirements that have to be met. For the IRS to "look through" a trust, it must be irrevocable as of the date of your death. In addition, the IRA custodian or retirement plan administrator must receive from the trustee either a copy of the trust document or a final list of all beneficiaries determined as of September 30 of the year following the year of death (certified by the trustee as correct and complete).

There's one more "gotcha" trap that you ought to know about. The "stretch" is only available to the beneficiary named on the owner's or plan participant's death. It is not available to successor beneficiaries who receive the retirement account after the initial beneficiary's death. This can be a trap for the unwary widow or widower. Suppose that John's IRA names his wife Helen as primary beneficiary and their child's special needs trust as contingent beneficiary. John then dies. Under IRS rules, Helen could "roll over" John's IRA funds into her own IRA and name her own beneficiaries. However, instead of "rolling over" John's IRA to create her own IRA Helen just continues distributions from John's IRA. Then on her death, John's contingent beneficiary — the trust — won't have the option to stretch the IRA over their child's lifetime, but will be stuck with Helen's remaining

life expectancy (which is likely to be a lot shorter than the child's). In other words, the typical married couple, who leaves everything to each other and only on death to the trust, should make sure that the survivor remembers to "roll over" retirement accounts to the survivor's own IRA and to name the trust as the new primary beneficiary. If there are concerns about the survivor's ability to carry out these steps, it's wise to include in the survivor's durable power of attorney document a power authorizing the agent to take these actions to roll over the account and designate the special needs trust as the new primary beneficiary.

If you think this is too stingy, it could get worse: every year the presidential budget proposals have included elimination of the stretch and a return to the 5-year rule for everyone other than the retirees themselves. There is a lot of deferred income tax piling up in IRAs and retirement plans and the IRS wants it. Stay tuned!

As is often the case, what seems like a simple process that anyone can do without legal advice is not at all simple. Indeed, the naïve belief that you can "just go online and fill out a form" to designate your trust as beneficiary of your retirement accounts can easily result in an income tax disaster. Particularly if your estate plan makes your trust a beneficiary of your retirement plans, and your trust includes multiple beneficiaries of varying ages or charitable beneficiaries, you need to get competent legal advice.

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This issue of the Voice was written by Special Needs Alliance member Lisa Nachmias Davis, a partner in the New Haven, Connecticut law firm of Davis O'Sullivan & Priest, LLC. Ms. Davis helps clients with estate planning, setting up or administering special needs trusts, qualifying for public benefits, and probate and estate settlement; she also represents charities and other nonprofit organizations. Her website is www.sharinglaw.net.

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