

Special Needs Trust as Distributee of an IRA or Retirement Plan

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If an owner of an IRA or other qualified plan dies, it is important to review all options available. Delay or avoidance of electing payment options can be a very costly mistake. IT IS HIGHLY RECOMMENDED THAT YOU SEEK PROFESSIONAL GUIDANCE BEFORE YOU MAKE ELECTIONS.

For many families, the IRA is one of the biggest if not the biggest asset of a person's estate. It is often necessary to use all or part of such a deferred benefit plan to fund a special needs trust for a child with a disability.

Due to the nature of deferred benefit plans, a parent must be very careful when naming a SNT as beneficiary of the plan. If the beneficiary is deemed to be receiving income, it is likely that the 'receipt' will render the beneficiary ineligible for needs based government benefits. The important thing is to remember that "income" for tax purposes is different than "income" received by a recipient of needs based government benefits.

To effectively designate a SNT as beneficiary, it is important to understand the new rules governing minimum required distribution (MRD). When Distributions begin from the deferred plan, all amounts in excess of what was contributed by the employee/parent are taxable ordinary income to the recipient. As long as the employee is living, MRD is calculated by reference to a uniform table based on the life expectancy of the employee. The required beginning distribution age is still 70 ½. If the employee dies before 70 ½ the benefits must be paid out within five (5) years unless there was a "designated beneficiary" named. The regulations provide, for example, that a charity cannot be a "designated beneficiary". Benefits may be paid out over the life of the designated beneficiary as long as distributions begin within one year. If the spouse is the named beneficiary, payments can be deferred until the employee would have reached age 70 ½. It may be possible for the spouse to roll over the IRA into his or her own name and extend the benefits further.

Unlike prior law, a trust can be the designated beneficiary if it meets the requirements. These are:

- 1) The trust must be a valid trust under state law;
- 2) The trust must be irrevocable or become so at the death of the employee;
- 3) The individual beneficiaries must be identifiable from the trust instrument; and
- 4) The employee must provide documentation pertaining to the trust to the IRA trustee.

Item #3 is the difficult requirement. If the IRA names the owner's living trust and that trust names a SNT as a beneficiary, the trust has failed as a "designated beneficiary". The IRS will not look "through" a trust to another trust. You could leave ½ of the IRA to a SNT as long as the SNT meets the criteria. If a SNT is named, it cannot have a charity as a remainder beneficiary because a charity is not considered a "life in being".

Assuming the above 4 conditions are met, a SNT can be the beneficiary. All of the trust beneficiaries are viewed as "designated beneficiaries" for payment calculation. Thus, for tax benefits, a SNT can be named as a beneficiary for an IRA.

However, payments from a SNT must be solely in the discretion of the trustee in order for the trust not to be considered a resource for SSI or needs based benefits. Such a discretionary trust will be a complex trust which will be required to pay tax at the trust level on all income that is not distributed to or for the beneficiary. If the needs of the disabled beneficiary will be less than the income required to be distributed from the IRA, the SNT may not be the appropriate beneficiary for the IRA or deferred benefit plan. One option may be for the trustee to have discretion to spray the income among several beneficiaries. The required distribution would be based on the oldest beneficiary.

One advantage of naming the SNT as beneficiary is that distributions for the benefit of the disabled beneficiary will be taxed at the beneficiary's tax rate which is likely to be lower than the rate of a non-disabled sibling who may be gainfully employed and taxed on other income. If payments are made for the beneficiary for medical, tax preparation, etc. (which are deductible on Schedule A of the 1040), the beneficiary gets the use of these deductions on his or her 1040 to reduce the taxable income 'received' from the trust on the K-1 form.

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