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KeyBank Institutional Advisors

IRA distributions to special needs trusts

This article will focus on the changes to the SECURE Act (Setting Every Community Up for Retirement Act) and the impact on individuals and, more importantly, on the biggest provision that affects estate planning — the elimination of the "Stretch IRA".

Elimination of the "Stretch IRA"

The "Stretch IRA" was a way to maximize the tax deferral nature of traditional IRAs as long as possible, thus increasing wealth to future generations. Under past law, if a child or grandchild was named as beneficiary either individually or through a trust that qualified as a see-through trust, there was a way to structure it so that the IRA assets could be distributed based upon the life expectancy of the child or grandchild. Under prior law, the worst-case scenario would be immediate distribution, fully taxed, or if an IRA was payable to a non-qualified beneficiary, it had to be distributed under a five-year rule.

Under the SECURE Act, all IRAs and Qualified Plans will need to be withdrawn over 10 years, rather than over a lifetime. There will be some exceptions for certain beneficiaries. These exceptions include the surviving spouse of the employee (or IRA owner), children of the employee (or IRA owner) who have not reached the age of majority (not grandchildren or any other children), disabled or chronically ill individuals, or individuals not more than 10 years younger than the employee (or IRA owner). Remember that this rule applies to beneficiaries of someone who dies after the end of 2019.

What does this mean for those who have named a special needs trust as their IRA or plan beneficiary? There are basically two types of IRA trusts: a conduit trust and an accumulation trust.

With a conduit trust, the Required Minimum Distributions (RMDs) are paid from the inherited IRA to the trust and then paid out to the trust beneficiaries each year. No RMDs remain in the trust. The beneficiaries pay tax on the distributions at their own personal tax rates.

With an accumulation trust, the trustee has the discretion on whether to pay out the RMDs to the trust beneficiaries or to retain the funds. If the funds are retained, they are taxed at potentially higher trust tax rates. If they are paid out to the beneficiary, they are taxed to the beneficiary at their own personal tax rate.

> If a parent has a child with special needs, it is often important for the parent's estate plan to direct Required Minimum Distributions following the parent's death into a special needs trust (SNT) that has been set up for the child. For income tax purposes, it is usually best to stretch these distributions out over as long a period as possible, particularly if the IRA is a large one.

The elimination of the stretch IRA is more of a problem for conduit trusts. At the end of the 10-year term, the entire balance would need to be paid out to the beneficiaries, leaving no funds protected inside of the trust and potentially getting money into the hands of a beneficiary who is not yet capable of handling the funds responsibly yet, not to mention the huge tax bill to the beneficiary (and potentially kiddie tax that could apply). With an accumulation trust, although the inherited IRA funds would have to be paid out of the IRA by the end of the 10-year term, the funds could still remain in the trust and continue to be protected.

Unfortunately, a poorly drafted SNT may not qualify as a designated beneficiary under the IRS rules. As long as all of the SNT's remainder beneficiaries are individuals, required distributions are allowed to be made based on the age of the eldest potential beneficiary of the trust. The problem is that sometimes SNTs are drafted so that entities that don't have life expectancies — such as a charity — are potential beneficiaries. In such cases, either the five-year rule or the life expectancy rule applies and the SNT will have to face the income tax consequences of an expedited payout of the IRA.

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This is one of the potential IRA pitfalls for third-party SNTs, trusts set up and funded by someone other than the child. But when the person with special needs has his or her own assets, a first-party or self-settled SNT may be more appropriate.

Through careful and complicated tax planning, it may be possible to minimize the income taxes that would otherwise be paid by the SNT on distributions from an IRA into a first-party SNT so long as the trust qualifies as a grantor trust — a trust where all income and expenses from the trust count as the grantor's for income tax purposes. In a first-party SNT, the grantor for income tax purposes is the beneficiary. In such a case, the beneficiary will generally pay the income taxes at a lower tax rate than if the income was taxed to the SNT directly.

If a first-party SNT does not meet the requirements for a grantor trust, but the beneficiary meets the definition of being disabled under the Social Security rules, the trust may still be able to take advantage of an additional income tax exemption if the SNT qualifies as a qualified disability trust. But a trust can lose this exemption if the beneficiary loses his or her benefits, for whatever reason.

For more information about Special Needs Trusts or nonprofit donations, please contact National Director of Philanthropic Advice, Cynthia J. McDonald at 518-257-8745.

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