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

This issue of the Voice® is an update by Lisa Nachmias Davis, CELA, of her original article that appeared in 2014. Ms. Davis is a partner is the New Haven, Connecticut law firm of Davis O'Sullivan & Priest, LLC. She 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.

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If you're reading this article, and have a child or family member with special needs, you've probably already set up a third party 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 to read some other *Voice®* articles first, including Developing an Estate Plan for Parents of Children with Disabilities: A 15-Step Approach and Your Special Needs Trust ("SNT") Defined. 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 at your family member's death from claims against his or her estate, or in some cases during his or her 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 which 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. This article explains considerations when naming a special needs trust as the beneficiary of your IRAs and other retirement accounts.

The "Estate" as Beneficiary

The first thing to understand is that your will controls only assets which are in your name alone and do not have a 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 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 if you name a specific beneficiary to receive the accounts upon your

death. So, if your will leaves a share of your assets to a special needs trust intended for your child with special needs, but you have named your child with special needs 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.

When it comes to life insurance, you might choose to solve this problem by naming your living trust or a special needs trust as the beneficiary. Alternatively, you could name your estate as the beneficiary, particularly if you have several children or other beneficiaries. That way, the proceeds can be divided conveniently in as many portions as the document specifies, with the share for your child with special needs passing out to his or her special needs trust. The principal downside of naming your estate as a beneficiary on your life insurance policies is exposing the proceeds to your creditors and to the need to go through a court process to administer your will and access the proceeds (typically referred to as probate). In some states, however, life insurance proceeds are protected from creditors even if the estate is named as beneficiary.

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 the beneficiary, IRS regulations require that the IRA or account pay out quickly—perhaps over as short a time as five years if you are under 72 (up from 70 1/2 in 2020) (for IRAs) or still working (for an employer-sponsored retirement plan) when you die.

Why is this problematic? *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, the lifetime of your child with special needs—the tax bill each year will be much smaller, leaving more in the account to grow tax-deferred. If you name your estate as the beneficiary of your IRA or other retirement account, this stretch isn't possible, and total income taxes may be much higher.

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?

Retirement Account Distribution Rules

Once upon a time, Congress decreed that retirement funds accruing tax-deferred 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 was April 1st following the year the owner turned 70-1/2. This was changed to age 72 starting in 2020.

Second, there would be "Required Minimum Distributions," i.e., required amounts to be distributed each year beginning with that 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 RBD. If the owner dies before the RBD, the default rule is ten years. If the owner dies on or after the RBD, the default rule is the remainder of the owner's life expectancy (using a different "One-Life" table rather than the Uniform table) will determine minimum required distributions. 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 ten-year rule. (Someone 80 years old has a life expectancy of 10.2 years.)

In either case, death before or after RBD, there was an exception when the owner had a designated beneficiary. Prior to 2020, every time there was a designated beneficiary, the beneficiary could use what was called the "stretch." Whether death occurred before or after the RBD, the payout could be stretched over the life expectancy of a designated beneficiary, provided that payout started by December 31st of the year following the year of death. Starting in 2020, the so-called SECURE Act changed the stretch to a (usually much shorter) ten-year payout—with exceptions. One important exception is to allow the stretch when the beneficiary is a disabled person or a trust for the sole benefit of a disabled person, in other words, a special needs trust. For a general discussion of the SECURE Act, see this *Voice®* article – The Secure Act – How it Affects Special Needs Planning and Special Needs Trusts.

What is and what is not a "designated beneficiary"?

What is a "designated beneficiary" (DB)? Is that the same as a beneficiary? And if your beneficiary is an estate or a trust, what then? The IRS regulations determined that an estate, even if named on your beneficiary designation form, cannot be a DB 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 DB, 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 charity is not a DB and gets no stretched out payments. However, charities are not subject to income tax, so the charity will unlikely be concerned about the loss of a long stretch.

Trusts as Beneficiaries

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 determined 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 (whether that would mean the ten-year rule or, as with a person with a disability or a special needs trust, the person's life expectancy). 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 don't have life expectancies, so if a charity is named as a trust beneficiary it would always have the shortest life expectancy 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 distributions 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 therefore no longer a beneficiary 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.

This look-through rule applies to most 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.

Some Examples

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? Prior to 2020, the answer was a definite "no." The IRS would 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). When the law changed in 2020, however, this became less clear. The exception for special needs trusts under the SECURE Act at least implies that any trust where the person with a disability is the sole beneficiary during that person's lifetime would qualify to use that person's life expectancy. Everyone is waiting for regulations or possibly further change to the law to clarify this issue.

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 whether before or after 2020! 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 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 carefully consider these issues:

- 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 distributions over your child's lifetime? Would the trustee reasonably decide to spend the money in five years anyway?
- 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? (Stay tuned for regulations to clarify that issue.)

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, and if the pre-SECURE DB regulations aren't changed, 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 trust. 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 must 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).

How long does the stretch last?

There's one more "gotcha" trap that you ought to know about. The stretch is only available to the beneficiary with a disability named on the owner's or plan participant's death (or other eligible designated beneficiaries under the SECURE Act). 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.

When this article was first written, I added this comment: "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!" And in 2020 Congress acted—shortening the stretch to ten years for most non-spouse beneficiaries. Thanks in part to lobbying by the Special Needs Alliance, however, the stretch was retained for individuals with disabilities and special needs trusts for their benefit. That said, we await clarity on how these trusts needs to be drafted to ensure the stretch is available. Please refer to this *Voice®* article for a discussion of this issue and the Special Needs Alliance advocacy related to it.

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 or public benefits eligibility disaster. 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 should seek review from a competent special needs attorney.

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