The SECURE Act – How It Affects Special Needs Planning and Special Needs Trusts

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August 2021 - Vol. 15, Issue 8

The purpose of this article is to address special needs planning, with a focus on special needs trusts and planning with retirement assets, after the passage of the SECURE Act. If you have a child or family member who is a person with a disability, you are probably already familiar with (and may have set up already) a third-party special needs trust (or supplemental needs trust) that will receive assets from you or another person for the person with a disability. A third-party supplemental needs trust is to be funded with assets of persons other than the person with a disability.

Another type of special needs trust is a first-party special needs trust (sometimes called a "payback" special needs trust), which is a trust created to hold the assets of the person with a disability. For more information on the types of special needs trusts and why nomenclature is important, see *What Is a Special Needs Trust Anyways*? published in the Voice in October, 2020 – Vol. 14, Issue 12.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act, which has an effective date of January 1, 2020, affects special needs planning related to both third-party supplemental needs trusts and first-party special needs trusts.

How SECURE Affects Special Needs Planning with Third Party Special Needs Trusts.

A bit of history is called for here before discussing how SECURE affects retirement accounts. Prior to SECURE, if a traditional retirement account or IRA was paid to a properly drafted third-party special needs trust, that qualified as a "designated beneficiary," then the payments from the traditional retirement account or IRA could be paid into the trust over the lifetime of the trust beneficiary (and as the payments are made to the trust and not to the disabled person directly, the payout would not cause loss of needs-based benefits). This allowed for a stretch of the traditional retirement account or IRA payments over the lifetime of the beneficiary and a further deferral of the income tax that was due on the payments of the traditional retirement account or IRA after the death of the IRA owner. In

summary, the goal in planning with traditional retirement benefits for a person with a disability was to designate a properly drafted third-party special needs trust, which qualified as a "designated beneficiary" (typically an accumulation trust) as the beneficiary of the retirement account. For a definition of an accumulation trust and more of a history lesson and details on third party special needs trusts as beneficiaries of retirement accounts, see the *Naming a Special Needs Trust as Beneficiary of Your IRA or Retirement Plan* published August 2014 – Vol. 8, Issue 5. (An update to this Article will be published in the next issue of the Voice).

Here is the good news about the SECURE Act – it does not change the goal, or the general method of planning related to children or persons with a disability and planning with retirement assets. A properly drafted third-party special needs trust, which qualifies as a "designated beneficiary" (particularly an accumulation trust), is still the preferred planning method for a person with a disability in order to provide asset management, to maintain public benefits, and to provide for a lifetime stretch of the traditional retirement account or IRA over the lifetime of the trust beneficiary.

The bad news about the SECURE Act is the new 10-year payout of retirement assets after the death of the account owner – there is no longer a lifetime stretch for all beneficiaries of retirement assets. The result of the 10-year payout is that it accelerates income taxation on the retirement assets that must be withdrawn over 10 years. As described below, only persons who qualify as an "eligible designated beneficiary" (EDB) can take advantage of a longer payout than the new default 10-year rule.

Now, under SECURE, unless an exception applies, traditional retirement accounts or IRAs must be paid out within 10 years if there is a "designated beneficiary" or within 5 years if there is not a designated beneficiary (technically, if there is not a designated beneficiary, the assets must be paid out within 5 years if the owner died prior to age 72 or must be paid out over the deceased owner's life expectancy if the owner died on or after age 72).

SECURE creates a new class of beneficiary of an IRA, called an "eligible designated beneficiary" (EDB). An EDB is an exception category for individuals that can still use a lifetime stretch payout of the traditional IRA. The EDBs under SECURE, for which a lifetime payout is possible, are (1) a surviving spouse, (2) a minor child of the participant, (3) a disabled beneficiary, (4) a chronically ill individual, and (5) a beneficiary less than 10 years younger than the participant.

For purposes of planning for persons with a disability, it is important to note that a disabled beneficiary qualifies as an EDB and a property drafted third party special needs trust for the benefit of a disabled beneficiary, typically an accumulation trust, can receive payments

from a traditional retirement account or IRA over the lifetime of the disabled beneficiary. The lifetime payout will result in less income tax realized by the distributions of the retirement assets, provided the beneficiary's life expectancy is longer than the default 10-year rule under SECURE.

There are still unanswered questions under the SECURE Act, however, which will have to be addressed by the Internal Revenue Service/Treasury in the form of regulations. Some of the existing questions that need to be answered are:

1. Can remainder beneficiaries of a properly drafted third-party special needs trust be disregarded when determining the applicable distribution period for an EDB during the EDB's lifetime? Prior to SECURE, the life expectancy of the oldest individual trust beneficiary had to be used when calculating the applicable distribution period, and a beneficiary that was a non-individual or charity often caused the trust to not be eligible for a life expectancy payout at all. It is hoped that the Internal Revenue Service/Treasury will issue guidance which completely disregards the remainder beneficiaries of the third-party SNT when determining whether an EDB is entitled to a lifetime payout.

2. If the EDB is a minor, can proof of another category of EDB (i.e., proof of "disability" or proof of "chronic illness") be provided prior to the expiration of the rules related to minors, so that the EDB status can continue past the rules relating to minority? Is there any way to name a trust for minors as a beneficiary without losing EDB status and requiring a 10-year payout?

3. Can disability be certified by: (a) eligibility for Supplemental Security Income (SSI), Social Security Disability Benefits (SSDI), or long-term care Medicaid, or (b) a separate disability certification process like what exists for ABLE accounts?

So, stay tuned for (hopefully) good news on guidance to be issued by the Internal Revenue Service/Treasury related to the unanswered questions listed above.

How SECURE Affects Taxation of First-Party Trusts – Return of the Kiddie Tax.

SECURE provides potential positive income tax benefits for minor trust beneficiaries of first-party special needs trusts. A little history of taxation related to minors is in order here. Decades ago, children paid income tax at their own tax rates and many affluent families transferred income-producing assets to or for the benefit of their minor children so those assets could then be taxed at the minor child's lower income tax rate. In response to the income tax avoidance being undertaken by the affluent, Congress passed a "Kiddie Tax" to close this tax loophole, whereby a minor child's income tax rate would be the same as their parents' rate. A first-party special needs trust is a Grantor Trust for income tax purposes,

meaning all income items are taxed to the trust beneficiary at their individual rate, rather than at the compressed rates for trusts. For a minor child (or a child aged 19-23 who is a full-time student) who was the beneficiary of a special needs trust, this meant that income was taxed to the child, which under the Kiddie Tax, meant the minor's tax rate was the same as the minor's parent. Then, Congress passed the Tax Cut and Jobs Act of 2017 (TCJA), which had the draconian effect of changing the tax rate to the higher rates applicable to trusts and estates. The highest income tax bracket for a trust and estate is reached at a much lower level of income than that that for an individual – the highest rate maxed out at 37% after only $12,500 of taxable income, whereas the highest rate maxed out at 37% for an individual at $500,000 of taxable income (using 2018 tax rates). The effect of the TCJA was to increase the income tax rate for a minor first-party SNT beneficiary for tax years 2018 and 2019. Thankfully, SECURE changed this draconian income tax treatment and reverted to the old Kiddie Tax rules, where the minor child is taxed at the parents' income tax rate and made it retroactive for tax years 2018 and 2019. Parents of minor children who are beneficiaries of first-party special needs trusts should consider filing amended income tax returns for 2018 and 2019 – there may be considerable income tax savings by doing so.

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