DESIGNATING A SPECIAL NEEDS TRUST AS A BENEFICIARY OF A TRADITIONAL IRA

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Many parents who have a child with special needs know the importance of establishing a third-party special needs trust to protect assets that can provide for their child's special needs without jeopardizing his or her entitlement to means-tested government benefits such as SSI and Medicaid. Drafting and funding a third-party special needs trust with a traditional IRA, however, requires expert adherence to Internal Revenue Service (IRS) codes and regulations.

Importantly, a last will and testament governs only those assets that are not held jointly with right of survivorship or that do not have a beneficiary designation. Therefore, if the IRA names the person with special needs as a beneficiary, that IRA will pass to that person, even if the will directs the IRA assets to be paid to a special needs trust.

FROM THE EXPERTS

Tax-deferred IRAs are subject to "minimum distribution" requirements designed to prevent taxation to be deferred indefinitely. There is a Required Beginning Date (RBD) for taking distributions that is April 1 of the year after the year the owner reaches age 70½, as well as "Required Minimum Distributions" (RMDs) that must be distributed each year beginning with the RBD.

Ideally, people like to defer income taxes on IRAs and allow the IRA to continue to grow tax-free. This is accomplished by "stretching" RMDs over the life expectancy of a "designated beneficiary." When an IRA account holder dies, RMD is calculated based on a number of factors such as whether or not the designated beneficiary is a spouse. If the designated beneficiary is an individual who is not a spouse, RMD depends on whether the account owner died before or after the RBD. If the account owner died before the RBD, RMD is calculated based on the life expectancy of the designated beneficiary unless the five-year rule is elected. If the owner dies after the RBD, RMD is based on the longer of the life expectancy of the designated beneficiary or the deceased owner's life expectancy.

If the beneficiary is not an individual, such as an estate or charity, it cannot qualify as a designated beneficiary and 100% of the IRA must be distributed (and taxed) by December 31 of the year of the fifth anniversary of the owner's death.

A trust may qualify as a designated beneficiary if four requirements are met. The trust must (i) be valid under state law; (ii) be irrevocable or become irrevocable when the IRA owner dies; (iii) have beneficiaries that are all identifiable as individuals; (iv) be provided to the custodian of the IRA by October 31 of the year following the year that the IRA owner died. If a trust, such as a third-party special needs trust, meets the four requirements, the trust beneficiaries are considered the beneficiaries and the RMD may be stretched over the single life expectancy divisor of the oldest trust beneficiary.

A trust that qualifies as a designated beneficiary may be a conduit trust or an accumulation trust. A conduit trust requires the trustee to make RMD payments to the beneficiary annually. Such payments, however, could cause the beneficiary of a third-party special needs trust receiving SSI and/or Medicaid to lose these benefits. An accumulation trust, on the other hand, gives the trustee the discretion to pay the RMDs annually to the beneficiary or to make payments for the benefit of the beneficiary. In this way, the beneficiary's access to means-tested government benefits can be preserved.

An IRA inherited by a person with disabilities might be allowed to transfer to first party special needs trusts without first having to liquidate the account and pay income tax on the entire amount based on private letter rulings by IRS; however, private letter rulings cannot be relied upon as precedent and are expensive to obtain.

In contrast, an IRA owned (not inherited) by a person with disabilities cannot be transferred to a first party special needs trust without having to pay income tax on the entire amount based on another private letter ruling.

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