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Integrating IRAs with SNTs

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By Thomas E. Simmons, Esq.

What happens when a client's IRA (or qualified retirement plan)[1] names a third party supplemental needs trust (SNT)[2] as a beneficiary? From a tax perspective, the result might not be pretty. The difficulty in integrating an SNT with an IRA lies in the "see through trust" rules which must be observed in order to qualify for beneficial income tax treatment.

Generally, the best use of an IRA lies in minimizing the distributions from the plan to defer taxes. The "Required Minimum Distributions" (RMDs) of an IRA are entitled to "stretch out" treatment when an IRA is left to a younger person. "Stretch out" is a good thing. It occurs when RMDs are recalculated based on a younger person's longer life expectancy, reducing the RMDs and stretching out the tax benefits of an IRA.

The rationale behind "stretch outs" is based on the idea that preferential tax benefits are granted in exchange for the funds in an IRA being used for retirement. An estate, a charity — or a trust — the IRS theorizes, cannot retire and do not have life expectancies. Therefore, a trust cannot qualify for stretch out treatment when named as an IRA beneficiary.

However, trusts which meet specific requirements in the Treasury Regulations and qualify as "See-Through Trusts" can escape this general rule. A "See-Through Trust" is one where the IRS can "see through" the trust to its beneficiaries and then apply stretch out treatment based on the beneficiaries' life expectancies, just as if they were the actual named beneficiaries of the IRA itself.

A "See-Through Trust" must:

1. Be valid under state law;
2. Be irrevocable when the plan participant dies; and
3. Have identifiable beneficiaries (none of whom are non-individuals).[3]

In addition, documentation must be provided to the IRA's plan administrator by September 30 of the year after the participant's death.[4]

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1 There are significant differences between IRAs and qualified retirement plans such as 401(k) accounts — primarily that IRAs are not subject to ERISA — but for simplicity's sake, the terms "IRAs" and "retirement plans" are used interchangeable in this article. Roth IRAs are also beyond the scope of this article, although they may provide additional planning options on account of their "tax-free distribution" treatment.

2 This article discusses third party supplemental needs trusts only. First party (d)(4) trusts may offer more flexible income tax planning options with IRAs, but are not attractive on account of the mandatory Medicaid "payback" clauses that are not required in third party trusts. Wilcenski (see note iv, infra) suggests creating a third party conduit SNT with a first party payback trust (drafted as an accumulation trust) as the beneficiary for all retirement plan distributions. Wilcenski at 21, citing PLR 2006 20025. This would result in the accumulated distributions held in the first party trust being subjected to payback requirements, but not the remaining assets of the third party trust itself.

3 Treasury Regulations section 1.401(a)(9)-4, A 5.

4 Because there appears to be no remedial procedure if documentation is not submitted by the prescribed date, the trust instrument itself should require or remind the trustee of this obligation. Steven E. Trytten, Got Stretch Out?, Trusts and Estates 41, 43 (July 2009). Another excellent discussion of SNTs and retirement benefits is provided by Edward V. Wilcenski & Tara Anne Pleat, Dealing with Special Needs Trusts and Retirement Benefits, Estate Planning 15 (February 2009). Your author is especially indebted to

If these four relatively easy requirements are met, a trust qualifies as a See-Through Trust and RMDs are calculated from the life expectancies of the "identifiable beneficiaries."[5] RMDs will be calculated by reference to the life expectancy of the oldest identifiable beneficiary.

But query who are the identifiable beneficiaries under these Treasury Regulations of a trust such as this one: "Make discretionary distributions to my daughter Susan until her death, then distribute to her children, if any, otherwise to her brother Sam (in trust if he is then under 35) or his children, but if none then to my heirs at law."

Susan is an identifiable beneficiary. Are there additional identifiable beneficiaries? Do the identifiable beneficiaries include Susan's children if she has any when the testator dies? Is Sam also an identifiable beneficiary? What about Sam's children or Sam's unborn (or unadopted) children? If state law allows adoption without regards to age, it is possible to calculate RMDs when it's impossible to even say that any additional contingent beneficiaries would at least be younger than their parents? If state law provides for an escheat under any circumstances, is the state a "non-individual" since it has no life expectancy?

If your head isn't spinning, it should be. More questions arise when a trust beneficiary holds a limited or general power of appointment. If a contingent charitable remainder beneficiary is included, then the rule prohibiting non-individual beneficiaries may be violated. And if the see-through rules are violated, stretch out is unavailable and the retirement plan must be distributed by the end of the fifth calendar year following the owner's death.[6]

Unfortunately, the Treasury Regulations don't offer clear guidance on all of the questions that can arise in determining who is an identifiable beneficiary, but there is a way to avoid these difficulties. If the See-Through Trust also qualifies as a "Conduit Trust," then all beneficiaries other than the primary beneficiary who will be receiving distributions are simply disregarded. Because of the great simplification this achieves, most practitioners strive to qualify a trust that will be named as a beneficiary of an IRA both as a See-Through Trust and also as a Conduit Trust. A Conduit Trust is such an easy solution to the identifiable beneficiary rules.

So what is a Conduit Trust? It is simply a See-Through Trust which requires all distributions from an IRA held in trust to be distributed to the beneficiary.[7] A Conduit Trust does not permit the trustee to accumulate distributions from an IRA in the trust.

If the trust instrument provides that IRA distributions must be distributed directly to the beneficiary, Conduit Trust treatment can be achieved and only the primary beneficiary's lifetime utilized in calculating RMDs. If a See-Through Trust fails to meet the requirements of a "Conduit Trust" because the trustee has discretion in making distributions, the trust would instead be categorized as an "accumulation trust." An Accumulation Trust requires going back to the drawing board to decipher who the "identifiable beneficiaries" are.

The problem with marrying an IRA to an SNT is that the Conduit Trust idea of mandating distributions to a beneficiary is contrary to the basic structure of an SNT, which allows the Trustee discretion in determining the timing, amount and forms that distributions will take.

If conduit provisions are incorporated in an SNT, the required trust distributions of IRA distributions will result in reduced or eliminated means-tested benefits for the beneficiary. An SNT which has as its primary goal the preservation of means-tested benefits can only be drafted as an "Accumulation Trust," which results in the head-spinning task of ascertaining the identifiable beneficiaries, as well as the risk that an identifiable beneficiary is a non-individual or is significantly older than the primary beneficiary.

Thus, to integrate an SNT with an IRA with optimum income tax advantages, an attorney cannot rely on the safe harbor of the Conduit Trust rules and instead must fall back into the morass of identifiable beneficiary questions inherent in accumulation trusts.[8]

Care must be taken to name remainder beneficiaries of similar age or younger than the primary beneficiary to avoid accelerated RMDs and to avoid the possibility of IRA assets in the trust ever being distributed to non-individuals.[9] Powers of appointment should be avoided in order to limit the potential number of identifiable beneficiaries.

Practitioners should not be intimidated by the challenges inherent in integrating a third party SNT with an IRA, but should be especially cautious and provide their clients with meaningful disclosure that the evolving nature of this area of the law, coupled with the incomplete and at time ambiguous guidance from existing Treasury Regulations and Private Letter Rulings, means that potential income tax inefficiencies cannot be entirely guarded against. On account of these difficulties, it may also be helpful to explore funding a third party SNT with non-IRA assets, if the client's net worth composition and objectives permit it. ■

these authors and their well organized and clearly articulated summaries of the law.

5 "Identifiable beneficiaries" are often referred to as "Designated beneficiaries."

6 See Treasury Regulations section 1.401(a)(9)-3, Q&A-2. This "five year rule" applies when the IRA owner dies before age 70? (or her applicable required beginning date); otherwise, RMDs would be required over the deceased owner's remaining life expectancy rather than that of the (generally younger) beneficiary. Treasury Regulations 1.401(a)(9)-5, Q&A-5(a)(2).

7 Treasury Regulations section 1.401(a)(9)-5, A 7(c)(3), Ex. 2.

8 Failing the See-Through Trust rules on account of the presence of a non-individual identifiable beneficiary would subject the IRA to mandatory distribution over just five years (see note vi, supra) as well as subject the trust to taxation of those distributions under trust compressed income tax brackets (assuming the SNT is not a grantor trust).

9 Sebastian V. Grassi Jr. & Nancy H. Welber, Estate Planning with Retirement Benefits for a Special Needs Child: Part 2 – Trusts as Beneficiaries of Retirement Plan Benefits, Probate & Property 60, 62 (September/October 2009).