Magical Mystery Tour: 
Naming a Special Needs Trust
as Beneficiary of a
Retirement Plan

Presenter:
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Distributions from a Retirement Plan at Death

Determination of Beneficiary

The determination of the identity of the beneficiary of a retirement plan is often critical as to what distribution options are available, as will be discussed further below. The beneficiary of an IRA or retirement plan must be determined by no later than September 30 of the calendar year after the participant’s death. This means that the participant can change beneficiaries during his lifetime and his or her required minimum distribution ("RMD") will not change. During lifetime, the participant will use the Uniform Table in almost all events (see Appendix “A”). The only exception would be if the participant changes the beneficiary designation to a spouse who is more than ten years younger than the participant and the participant chooses to use the Joint Table. (see Appendix “B”)

The period between date of death of the participant and September 30 of the following calendar year is sometimes referred to as the “shake-out period.” This name arose because during that period the beneficiary can be changed (such as by disclaimer or trust reformation) or an undesirable beneficiary

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can be removed in order to maximize “stretch” distributions. For example, the devise to an undesirable beneficiary, such as a charity (which has no life expectancy) can be removed from consideration by satisfying the devise prior to September 30. This time period can also be used to create separate accounts where there are multiple beneficiaries designated under the IRA or retirement plan. In some circumstance, the creation of separate accounts allows for the age of each beneficiary to be used in determining RMDs from his or her share. The concepts of stretch distributions and separate shares are discussed further below.

Inherited IRA – Death Before Required Beginning Date (“RBD”)

The Required Beginning Date, or RBD, is usually no later than April 1 of the year after the participant turns age 70½. There are exceptions for less than 5% business owners who continue to work beyond age 70 ½.

Option 1 – Distributions Over Beneficiary’s Life Expectancy

When the participant dies before the RBD and the beneficiary is other than the surviving spouse, RMDs are based on the beneficiary’s life expectancy using the Single Life Table (see Appendix “C”). To use the table, the beneficiary will find the factor associated with his or her age at the date of the participant’s death, and then simply subtract one from the factor every year thereafter. For instance, if the beneficiary is age 55 when the participant dies, the factor for determining the first RMD would be 29.6. The following year the beneficiary would subtract one and the beneficiary’s new factor for determining RMD for that year would be 28.6 (29.6 – 1). The Inherited IRA would be fully distributed in year 30.

Distributions must begin no later than December 31 of the calendar year after the year in which the

2. Removal of a beneficiary is usually accomplished by satisfying the beneficiary’s interest in the retirement account, estate or trust of the decedent, as applicable, before September 30 of the year after the decedent’s death. This can be done using retirement assets or other assets of the decedent.
participant died. Failure to take distributions by that date would, in effect, be an election by the beneficiary to use option 2 – the five year rule. If the five year rule was not adopted the failure to take a distribution would subject the beneficiary to a penalty.³

Option 2 – Five-Year Rule

Under the five-year rule there is no set schedule of distributions, but the retirement assets must be fully distributed to the beneficiary no later than December 31 of the calendar year five years from the death of the beneficiary. For instance, under the five-year rule the beneficiary could withdraw 20% of the retirement assets in year one, 25% in year two, 30% in year three, nothing in year four and the remainder in year five. Alternatively, the beneficiary could decide to take no distributions for the first four years and instead withdraw the entire balance on at the end of year five.

Inherited IRA –Death After RBD

Option 1 – Distributions Over Greater of Beneficiary’s or Participant’s Life Expectancy

When the participant dies after the RBD and the beneficiary is other than the surviving spouse, RMDs can be based on the greater of the beneficiary’s life expectancy or the participant’s life expectancy using the Single Life Table. To use the table, the beneficiary will find the factor associated with his or her age at the date of the participant’s death (or the age of the participant, if younger), and then simply subtract

³. The penalty for failing to take a RMD is 50% of the amount of the RMD.³ The IRS, in limited cases, may waive the penalty where “reasonable cause” is shown.

There is also a 10% premature withdrawal penalty for taking distributions from an IRA or qualified plan prior to age 59½ (premature withdrawal penalty). There are several exceptions to the application of this penalty, including: (a) payment of the distribution to an estate or a beneficiary; (b) disability of the participant; (c) substantially equal periodic payments; (d) medical care, but not in excess of the amount of medical expense deductions claimed for the year; (e) higher education expenses (IRA only); (f) qualified acquisition costs for a principal residence for the participant or a participant’s family member – max. $10,000 (IRA only); and (g) separation from service after age 55 (qualified plans only).
one from the factor every year thereafter. For instance, if the beneficiary is age 75 when the participant
dies, the factor for determining the first RMD would be 13.4. The following year the beneficiary would
subtract one and the beneficiary’s new factor for determining RMD for that year would be 12.4
(subtracting 1 from 13.4). The Inherited IRA would be fully distributed in year 14.

Distributions must begin no later than December 31 of the calendar year after the year in which the
participant died. Failure to take distributions by that would, in effect, be an election by the beneficiary
to use option 2 – the five-year rule. In the alternative, if the participant was age 71 at date of death, a 75
year old beneficiary could choose to take RMDs based on the participant’s life expectancy (given that
she was younger than the beneficiary). The factor under the Single Life Table for a 71 year old is 16.3.

Option 2 – Five-Year Rule

See explanation of five-year rule above.

No Designated Beneficiary

In some circumstances, the IRS considers that there is no designated beneficiary named for purposes of
being able to determine RMDs. The first circumstance when this occurs is when the participant fails to
name a beneficiary for his or her retirement plan and the plan has no default beneficiary (for those plans
that do have default beneficiaries, it is usually the spouse of the participant, or if there is no spouse, to
all children equally (outright and free of trust). Four less obvious events where the IRS considers there to
be no designated beneficiary are when the participant names a beneficiary, but the beneficiary is one of
the following:

- Estate
- Charity
- Non-Qualified Trust (see below for definition of a Qualified Designated Beneficiary Trust)
- Other Entity (such as corporation or partnership)
Distribution Options Where There Is No Qualified Beneficiary

The IRS considers there to be no designated beneficiary in these events because it is not possible to determine the life expectancy of an estate, charity, non-qualified trust or other entity.

What are the distribution requirements when no designated beneficiary is named? Here again, there are two scenarios.

**Participant Dies Before RBD**

If the participant dies before his RBD without having designated a beneficiary, then the retirement asset must be withdrawn under the five-year rule.

**Participant Dies After RBD**

If the participant dies after having reached his or her RBD without having designated a beneficiary, then the recipient of the retirement assets has two withdrawal options:

**Take RMDs over Participant’s Life Expectancy**

The recipient of the retirement assets could take RMDs based on the remaining life expectancy of the participant using the IRS’s single life expectancy table. For example, if the participant dies at age 73, his factor for that age under the Single Life Expectancy Table is 14.8. The recipient of the retirement assets would need to take an initial RMD by December 31 of the calendar year after the participant’s death equal to the value of the retirement asset divided by 14.8. The following year, the recipient would take a second RMD using a factor of 13.8 (14.8 -1), so that the retirement asset would be fully distributed over fifteen years, or

**Five-Year Rule**

The recipient of the retirement assets could take distributions from the retirement asset under the five-year rule.
Proper Titling of an Inherited Retirement Asset

Many attorneys and financial professionals erroneously believe that title to an inherited retirement asset should be taken in the name of the beneficiary. Unless the beneficiary is a spouse electing a spousal roll-over, this is not correct. Distributing the assets from a retirement plan (or liquidating the assets and then distributing them) to the beneficiary or an IRA in the name of the beneficiary would be considered a taxable distribution by the IRS, requiring that income taxes be paid on the full amount in the year of distribution. **Caution: the only beneficiary who can rollover a retirement asset is a surviving spouse who is named as beneficiary of the retirement account.**

An inherited IRA should be titled in the name of the deceased participant, but for the benefit of the beneficiary. Following are some examples:

- John Doe (Deceased) IRA fbo Mary Doe
- John Doe (Deceased) IRA fbo Mary Doe, Trustee under the John Doe Special Needs Trust created under the John Doe Revocable Living Trust dated January 1, 1985

Requirements for a Qualified Designated Beneficiary Trust

A Qualified Designated Beneficiary Trust allows the trust to be disregarded, and allows a look-through to the beneficiaries of the trust for purposes of determining life expectancy for RMDs. A qualified designated beneficiary trust must have the following four attributes:\(^4\): (a) trust is valid under state law; (b) trust is irrevocable or becomes irrevocable by the participant’s date of death; (c) **there are beneficiaries that are identifiable under the terms of the trust;**\(^5\) and (d) a copy of the trust document is provided to the plan administration or retirement plan custodian by no later than October 31 of the

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\(^4\) Treas. Reg. § 1.401(a)(9)-4 Q & A-5(b).

\(^5\) This requirement is the one that usually causes difficulty.
calendar year after the death of the participant.⁶

**Conduit Trusts versus Accumulation Trusts**

The general rule is that contingent beneficiaries of a trust must be considered in determining the oldest beneficiary under the terms of the trust.⁷ For instance, in PLR 200228025, a trust was named beneficiary of an IRA. The trust provided upon the death of the trustor, the trust shall be divided into three equal shares for the nephews of the trustor. At the time the trust was drafted the nephews were all minors. The terms of the trust provided that each share for a nephew would not be distributed to him until the nephew attained age thirty-five. Upon attaining age thirty-five, the nephew’s share was to be distributed out to him, free of trust. In the event the nephews died prior to reaching age thirty-five, the trust would be distributed to several contingent beneficiaries, the oldest of which was age sixty-seven at the time of the trustor’s death. At the time of the death of the trustor, the nephews were all under age twenty.

The IRS held that because it was possible a nephew could die between now and the time he attained age thirty-five, the contingent beneficiaries of the trust must be considered. The oldest contingent beneficiary was age sixty-seven. Therefore, should the trustee of the trust desire to stretch IRA payments to the maximum extent possible, the RMDs from the IRA to the trustee of each trust for nephews would be based on the life expectancy of a sixty-seven year old beneficiary and not the age of each nephew beneficiary.

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⁶ A copy of the trust document would need to be provided during the life of the participant only if lifetime RMDs from the trust are being calculated using the joint life expectancy table. If RMDs are being calculated using the Uniform Table, a copy need only be provided after death.

⁷ Treas. Reg. § 1.401(a)(9)-5; Q & A-7(b); Q&A-7(c)(3)
The Regulations contain an exception to the general rule that contingent beneficiaries must be considered in determining the identity of the oldest beneficiary of a trust.

A person will not be considered a beneficiary for purposes of determining who is the with the shortest life expectancy under paragraph (a) of this A-7, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the employee’s beneficiaries after the beneficiary’s death.8

Although A-7 suggests that it is possible to ignore all contingent beneficiaries who could receive trust distributions only in the event of another trust beneficiary, the regulation and its Questions and Answers make clear it is also necessary that no retirement plan distributions can be accumulated in the trust during the lifetime(s) of the person or persons who are the primary beneficiaries. In short, a contingent beneficiary will only be ignored if that beneficiaries interest if that beneficiary’s interest is contingent on the death of other beneficiaries and the trust immediately distributes all retirement plan distributions until the last of those deaths occurs. A trust drafted in this manner is commonly referred to as a “conduit trust.” This term is not an IRA term, but the IRA has used it on many occasions. A trust that is not drafted as a conduit trust is common referred to as an “accumulation trust.”

A third party special needs trust should never be drafted as a conduit trust. Drafting the special needs trust as a conduit trust would make the assets of the special need trust available for purposes of determining eligibility for SSI and Medicaid benefits.

8. Treas. Reg. § 1.401(a)(9)-5 Q & A-7(c)(1)
Drafting A Special Needs Accumulation Trust.

A Special Needs Accumulation Trust should be drafted to assure that there are no contingent beneficiaries who are older than the primary special needs beneficiary. This can usually be achieved by limiting remainder beneficiaries to the descendants of the special needs beneficiary, or where it is unlikely that the special needs beneficiary will have any descendants, to named beneficiaries or beneficiaries classes younger than the special needs beneficiary.

One or more of the siblings of the special needs beneficiary are often named as the remainder beneficiary of the special needs trust. If all siblings are younger than the special needs beneficiary, this creates no problems. If one or more siblings are older than the special needs beneficiary, then the oldest sibling would be designated as the oldest beneficiary under the terms of the trust and RMDs to the special needs beneficiary will be determined using the age of his or her sibling. If the age difference between the siblings is not great, there may not be a problem. If the sibling is ten to twenty years older than the special needs beneficiary, the amount of the RMDs required to be paid to the special needs trust will be substantially greater. For instance, the RMD from a $250,000 IRA to a special needs trust with a forty year old beneficiary is $5,734 (single life expectancy factor is 43.6). If the oldest beneficiary is sixty years old, the RMD would be $9,921 (single life expectancy factor is 25.2).

Traps to Avoid in Drafting a Special Needs Accumulation Trust

Powers of Appointment

Watch out for powers of appointment granted under the special needs trust which could allow a special needs beneficiary with capacity to appoint trust retirement assets to an appointee, such as a spouse, who is older than the special needs beneficiary. As it may not be able to determine the age of a potential appointee, RMDs from a special needs trust that contains a power of appointment may have to be made using the longer of the life expectancy of the trustor (as of the trustor’s date of death) or the
five year rule (see 1.5 above). If the special needs trust is to be drafted with a power of appointment, limit the power of appointment to appointees who are you younger than the special needs beneficiary (see Appendix “D” for sample language).

**Payment of Debt and Estate Administration Expenses**

The IRS has taken the position that the payment of the trustor’s debt or estate administration expenses is equivalent to distributing the trust assets to the estate of the trustor. This would limit RMDs from any retirement accounts payable to the trust to the longer of the trustor’s life expectancy at death or the five year rule. To avoid this problem, the trust should provide that any retirement assets paid to the trust which will be used to pay the debt or expenses of the trustor need to be paid prior to September 30th of the year after the trustor’s death. (see Appendix “E” for sample language).

**Payment of Trustor’s Estate Taxes**

The IRS has taken the position that the payment of the estate taxes of attributable to the death of the trustor is equivalent to distributing the trust assets to the estate of the trustor. This would limit RMDs of any retirement assets payable to the trust to the longer of the trustor’s life expectancy at death or the five year rule. To avoid this problem, the trust should provide that any retirement assets paid to the trust which will be used to pay the debt or expenses of the trustor need to be paid prior to September 30th of the year after the trustor’s death. (see Appendix “E” for sample language).

**Ultimate Beneficiaries**

Whether you call them ultimate beneficiaries, atom bomb beneficiaries, or exploding turkey beneficiaries, the contingent beneficiaries named in case all other distributive provisions of the trust lapse, these designations are often problematic. If the default beneficiary is an heir at law, the problem is that the actual beneficiary cannot be identified and he or she could be older then the special needs beneficiary. As such, distributions would be based on the longer of the trustor’s life expectancy on the
date of death. If the default beneficiary is a charity, there is a problem as charities don’t have life expectancies. These problems can be addressed by limiting heirs at law who can receive distributions from a retirement plan to those heirs at law who are younger than the special needs beneficiary or by prohibiting a distribution to a charitable beneficiary from retirement assets. (see Appendix “G” for sample language).

**No Application of Separate Share Rule.**

Because the beneficiary of the IRA was the trust, all potential beneficiaries under the terms of the trust are considered when determining the oldest beneficiary of the trust.\(^9\) This includes a beneficiary under the ultimate beneficiary provisions of the trust (no matter how remote) or potential beneficiaries under a power of appointment granted to any beneficiary of the trust.

If the drafting attorney intends to limit the potential beneficiaries to be considered in determining the oldest beneficiary of the trust, the drafting attorney should instruct the trustor to name the sub-trust as the beneficiary of the trust, or the trust for the beneficiary that will receive retirement plan assets should be drafted as a separate trust. An example is as follows:

*Primary Beneficiary:* My Spouse, Sally Jones

*Contingent Beneficiary:* One-third to the sub-trust created for Billy Jones under the Jeff Jones Revocable Trust dated September 15, 2012; one-third to the sub-trust created for Bobby Jones under the Jeff Jones Revocable Trust dated September 15, 2012; and one-third to the special needs sub-trust created for Betty Jones under the Jeff Jones Revocable Trust dated September 15, 2012, or

\(^9\) Treas. Reg. § 1.401(a)(9)-4 Q & A-5(c) provides that the separate account rules of § 1.401(a)(9)-8 are not available to beneficiaries of a trust with respect to the trust’s interest in the employee’s benefit.
Primary Beneficiary: My Spouse, Sally Jones

Contingent Beneficiary:

(a) One-third to the Billy Jones Retirement Trust dated September 10, 2012
(b) One-third to the Bobby Jones Retirement Trust dated September 10, 2012, and
(c) One-third to the Stand-Alone Betty Jones Special Needs Trust dated April 10, 2012.

Planning Alternatives for Retirement Assets Paid to a Third Party SNT

If the intent of the trustor cannot be met with a special needs trust drafted as an accumulation trust, another alternative would be to make the trustor’s retirement accounts payable to a Charitable Remainder Annuity Trust (CRAT) or a Charitable Remainder Uni-Trust (CRUT). Distribution of a retirement plan to a CRAT or CRUT will not lead to adverse income tax consequences. The special needs trust can then be drafted in any manner desired, and it can be named as the annuity / uni-trust beneficiary of the charitable remainder trust. The CRT will make payments to the special needs trust for as long as twenty years.\(^\text{10}\) If a special needs person dies prior to the expiration of the CRT term, the remainder of the CRT payments will be made to the remainder beneficiaries under the SNT. At the expiration of the CRT term, any funds remaining in the CRT would be payable to the designated charitable beneficiary(ies).

Retirement Assets Paid to a First SNT

The IRS has ruled that the life expectancy of the special needs beneficiary can be used for determining RMDs paid from an inherited IRA to a first party special needs trust ((d)(4)(A) trust\(^*\)). The IRS’ reasoning

\(^{10}\) Most entities, such as a trust or corporation, that are named as the beneficiary of a CRT will not qualify as a person with a life expectancy. As such, the CRT must terminate after a term of years. The maximum number of years CRT may exist is twenty years. If the payments are based on the life expectancy of a person, the CRT could last for a longer period of time.
for this is that the trust is a self created trust in which the special needs person retains a beneficial interest and thus the trust is a grantor trust for income tax purposes. While some commentators have warned that the IRS’ analysis is suspect, the IRS has affirmed its decision on multiple occasions and seems comfortable with its position.

The IRS was not so generous on the one opportunity it had to rule on the ownership of the special needs beneficiary’s IRA by a first party trust. In PLR 201117042, the IRS ruled an IRA can only be an individual. Apparently the IRS believes its analysis relating to grantor trusts is limited to inherited IRAs. This ruling has been subject to criticism and will hopefully be revisited by the IRS in the future.

11. A grantor trust is ignored for income tax purposes and is considered the alter-ego of the grantor.

12. PLRs 200620025, 2008260008, 201116005

### IRS Uniform Table for Calculating RMDs

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Appendix “B”

Excerpt from IRS Joint Life Expectancy Table

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The boxes shaded light grey demonstrate how the IRS Uniform Table is constructed using the joint life expectancies of the IRA owner and a person who is ten years younger than the IRA owner.
Appendix “C”

IRS Single Life Expectancy Table

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Appendix “D”

Limiting Powers of Appointment Granted to Special Needs Beneficiary

The Trustee shall distribute the Trust Estate among the descendants of Jane Doe or to such other persons who are younger than Jane Doe, and upon any trust terms and conditions, as Jane Doe appoints by any written instrument filed with the Trustee during her lifetime. Such writing shall specifically refer to and exercise this limited power of appointment over the Trust Estate. This power of appointment shall be exercisable only by Jane Doe. The Trustee may rely upon any written instrument that the Trustee, in good faith, believes to comply with the provisions above in carrying out the terms of these powers of appointment and shall not be liable for any good faith act in reliance upon such written instrument even if for any reason it is later determined to be invalid with respect to its purported exercise of these powers of appointment. If the Trustee receives no written instrument pursuant to the terms above, the Trustee may distribute the Trust Estate as though these powers of appointment had not been exercised and shall be conclusively presumed to have acted in good faith even if a valid written instrument exercising this power is thereafter discovered.
Appendix “E”

Fail Safe Language Relating to Payment of Trustor’s Debts and Expenses Using Trust Retirement Assets

Use of Retirement Assets payable to the Trustee for the payment of debts and expenses directly attributable and proportionate to the estate tax value of such Retirement Assets is limited to those payments that can actually be made prior to September 30 of the year after the death of insert name of trustor or would otherwise not cause the Trust to fail to be a qualified designated beneficiary.

Notwithstanding the rules otherwise applicable to apportionment, abatement and the payment of debts and expenses, Retirement Assets payable to the Trustee shall not be used to pay any of the debts or expenses of insert name of trustor still outstanding as of September 30 of the year after the death insert name of trustor or would otherwise cause the Trust not to be a qualified designated beneficiary.
Appendix “F”

Fail Safe Language Relating to Payment of Trustor’s Estate Tax Using Trust Retirement Assets

Use of Retirement Assets payable to the Trustee for the payment of Death Taxes directly attributable and proportionate to the estate tax value of such Retirement Assets is limited to those payments that can actually be made prior to September 30 of the year after the death of insert name of trustor or would otherwise not cause the Trust to fail to be a qualified designated beneficiary. Notwithstanding the rules otherwise applicable to apportionment, abatement and the payment of Death Taxes, Retirement Assets payable to the Trustee shall not be used to pay any Death Taxes still outstanding as of September 30 of the year after the death of insert name of trustor or thereafter. However, in that case, the Death Taxes attributable and proportionate to such Retirement Assets, to the extent otherwise apportionable under the Trust, shall, in the Trustee's discretion, be paid from funds provided by such beneficiary or charged against other property or trust distribution receivable by such beneficiary as a result of the death of insert name of trustor (provided that such other property is not otherwise eligible for the Marital Deduction).
Appendix “G”

Fail Safe Language Relating to Ultimate Beneficiaries

If, at any time before full distribution of the Trust Estate, all distribution provisions under the previous Article have lapsed and no other disposition of the property is directed under this Trust, the Trust Estate shall thereupon be distributed, outright and free of trust, to the Heirs at Law of John Doe. Notwithstanding the preceding sentence, any Retirement Assets payable to the Trustee and distributable under this Article shall only be payable to Heirs at Law who are younger than insert name of special needs beneficiary.

If, at any time before full distribution of the Trust Estate, all distribution provisions under the previous Article have lapsed and no other disposition of the property is directed under this Trust, the Trust Estate shall thereupon be distributed, outright and free of trust, one-half to the Heirs at Law of John Doe and one-half to ABC Charity. Notwithstanding the preceding sentence, any Retirement Assets payable to the Trustee and distributable under this Article shall only be payable to Heirs at Law who are younger than insert name of special needs beneficiary. Further, the distribution to ABC Charity shall not be made be made from any Retirement Assets payable to the Trustee unless such distribution can be made prior to September 30 of the year after the death of insert name of trustor. In the event such distribution cannot be made by September 30 of the year after the death of insert name of trustor and the Trust Estate is insufficient, excluding Retirement Assets, to fulfill the distribution to ABC Charity, such distribution shall be reduced to the amount of the Trust Estate, excluding Retirement Assets, available to distribute to ABC Charity.