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__on Special Needs Planning and Special Needs Trusts__

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SECURE Act 2.0
IRA Administration

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I. Introduction

Pooled Special Needs Trusts (PSNTs) are unique trust vehicles. PSNT trustees provide vital services for what may perhaps be the most underserved, yet most deserving, population in our country. A PSNT allows a person with a disability the opportunity to protect funds for supplemental needs while still qualifying for crucial means-tested public benefits.

As the U.S. population continues to age, there is even more need for competent Special Needs Trust (SNT) administration. PSNT trustees are uniquely situated to assist. This presentation will outline the opportunities available to PSNT trustees and their counsel in managing Individual Retirement Accounts (IRAs) for trusts for people with disabilities. It will cover taxation of IRAs as well as exciting new planning opportunities afforded under the Setting Every Community Up for Retirement Enhancement (SECURE) Act 2.0.

II. Demographics

Retirement savings in the United States continue to grow. Additionally, approximately 76 million baby boomers are living in the U.S. today. The choices baby boomers will make in terms of retirement and how they pass on their retirement savings will have a significant impact on trustees of all types of trusts, but potentially most significantly on trustees of SNTs.

According to research from ICI, at the end of the second quarter of 2020, there was $10.8 trillion in IRAs, representing 34% of all U.S. total retirement assets. This means that the remaining 66% of retirement assets, or approximately $31.8 trillion, are in employer-sponsored retirement plans (401(k)s, 403(b)s, 457(b)s, profit-sharing plans, non-qualified deferred compensation plans, SEP plans, etc.). Additionally, the ICI research shows that about

82 million households (or 64% of the U.S.) had some type of tax-advantaged retirement savings. These figures suggest that there is a robust opportunity for SNT trustees who administer inherited IRAs for the benefit of SNTs.

It is important to note, however, that many people in the U.S. live much longer than the average of 78.7 years. According to the Social Security Administration, a healthy 65-year-old woman has a very good chance to live until age 86. This advanced life expectancy may translate into smaller inherited IRA assets. Additionally, more Americans are dipping into their retirement funds early. A recent TD Ameritrade survey showed that 44% of Americans ages 40 to 79 have taken money out of a retirement account. Accordingly, those counting on Social Security to fund post-retirement life may be in for a shock. The Social Security program is only guaranteed to be funded through 2035; according to *Business Insider*, after 2035, it may only be three quarters funded. This may mean that people already taking money from Social Security may see a drop in payments while new retirees may have trouble getting any money at all. Also, the number of people in the U.S. 65 and older is projected to increase from approximately 56 million today to more than 78 million by 2035. More people may, therefore, be eligible to receive benefits from Social Security while fewer people will be paying into the fund.

III. IRAs - General

An IRA is a tax-advantaged savings account that individuals can use to save for retirement. Any person who has earned income can fund an IRA. An IRA is very similar to an employer-sponsored retirement account (401(k), etc.), but it does not require the employer to be involved - thus the “individual” of “individual retirement account.” A person may have an IRA and an employer-sponsored retirement account such as a 401(k). The only limitation is on the combined total amount of assets that a person may contribute to retirement accounts annually ($22,500 for 2023).

There are several types of IRAs including traditional IRAs, Roth IRAs, Simplified Employee Pension (SEP) IRAs, and Savings Incentive Match Plan for Employees (SIMPLE) IRAs. Each type of IRA has different rules regarding taxation, eligibility, and withdrawals. For brevity's sake, this presentation will focus primarily on traditional IRAs, rollover IRAs, and inherited IRAs.

Early Withdrawals

Since IRAs are meant to be retirement savings vehicles, there is generally an early withdrawal penalty of 10% federal tax if a person takes funds out of the IRA before the age of 59½. There are notable exceptions to this penalty, however. Early withdrawals from an IRA without penalty are allowed in the following circumstances:

- Up to $10,000 for a "first-time" home purchase (i.e., a person hasn't owned a home in the last two years)
- Qualified education expenses (e.g., tuition, fees, room and board, textbooks, etc.)
- Permanent disability
- Unreimbursed/uncovered medical expenses exceeding 7.5% of adjusted gross income (AGI)
- Health insurance premiums while unemployed 12 weeks or longer
- Substantially Equal Periodic Payments (SEPP)

Of note, early withdrawals are taxed as income just as Required Minimum Distributions (RMDs) are (covered later in this presentation) even if not subject to early withdrawal penalties.

Contributions

In most cases, contributions to an IRA are tax deductible. Put simply, if a person contributes $2,000 to an IRA, their taxable income is reduced by that same amount. Funds in an IRA are usually invested, and IRA holders do not pay taxes on any growth. However, when a person withdraws funds from an IRA in retirement, the withdrawal amount is taxed at their ordinary income tax rate. This is why IRAs are sometimes referred to as "tax-deferred" vehicles. This is particularly advantageous for the growth of the IRA and the contributor's personal taxable income reduction, but also because most Americans will have a lower ordinary income tax rate in retirement than they have when they are working.

For 2023, the annual individual contributions to traditional IRAs cannot exceed $6,500 for people younger than 50. People older than 50 can contribute up to $7,500 annually (aka a "catch-up contribution"). Beginning in 2025, new provisions in the SECURE Act 2.0 allow for catch-up contributions for people ages 60-63 of the greater of $10,000 or 50% more than the regular catch-up amount to a workplace plan (which will be indexed annually for inflation). For an individual without an employer-sponsored retirement plan (e.g., 401(k)), traditional IRA contributions are fully tax deductible. For an individual (or their spouse) who does participate in an employer-sponsored retirement plan, the person's modified adjusted gross income (MAGI) determines how much of the traditional IRA contributions can be deducted.

Roth IRAs

Contributions to a Roth IRA are not tax deductible. Because contributions to a Roth IRA are made with after-tax dollars, investment gains are not taxable either. Qualified distributions and distributions after retirement from Roth IRAs do not incur income taxes. Additionally, Roth IRAs have no Required Minimum Distributions (RMDs), which are discussed in more detail later in this presentation.

Rollover IRAs

A rollover IRA is an account used to transfer money from an employer-sponsored retirement plan, such as a 401(k), into an IRA. When done correctly, the funds maintain their tax-deferred status and do not lead to income taxes or early withdrawal penalties. The transfer of an employer-sponsored retirement plan into an IRA is sometimes referred to as a “custodian to custodian” transfer - meaning the nature of the account is staying the same, but the investment provider and/or asset custodian is changing.

When an individual leaves an employer, they typically have three options for their retirement plan: 1) leave it in the current plan, 2) roll it over into an IRA or a new employer’s plan, or 3) cash out the funds (thus triggering taxes and potential penalties). According to the aforementioned ICI research, approximately 6 in 10 traditional IRA-owning households indicated that their IRAs contained rollovers from employer-sponsored retirement plans. Ease of use, lower fees, greater investment options, and account consolidation are some of the most common reasons for IRA rollovers. Rollovers can be done into traditional IRAs or Roth IRAs depending on the nature of the account’s contributions (i.e., pre- or after-tax). Note that rollovers do not count as contributions.

If a direct rollover, or custodian to custodian transfer, is completed correctly, there are no taxes to be considered. In an indirect rollover, the account owner (or trustee, personal representative, etc.) asks for a check to be made out to themselves from the employer-sponsored retirement plan. Generally, the person has 60 days from the date they receive that distribution to put the money into a rollover IRA. If that deadline is missed, the account holder owes ordinary income taxes on the amount of the check, plus the 10% early withdrawal penalty (if applicable). Often in an indirect rollover, the employer will withhold 20% of the individual's retirement account balance. To recoup these funds, the individual must deposit into their IRA the complete account balance. For example:

- An individual's employer-sponsored retirement account has a balance of $100,000.
- If they are withholding 20%, the employer would send a check to the individual in the amount of $80,000.
- The individual would need to deposit the $80,000 check plus an additional $20,000 into a rollover IRA to show the IRS that the complete account balance was deposited.
- If $100,000 is deposited into the rollover IRA, the IRS would refund the $20,000 withheld after the individual has filed their personal tax return.
- If only the $80,000 check is deposited into the IRA, ordinary income tax would be owed on $20,000, and the 10% early withdrawal penalty would apply.

Finally, most trustees will roll over assets in employer-sponsored retirement plans into IRAs once the IRA account holder has passed away.

Inherited IRAs

When a person or trust is named as the beneficiary of an IRA or employer-sponsored retirement plan, the heir or trustee will typically have to move assets out of the decedent's name to a newly opened inherited IRA in the heir's or trust's name. An inherited IRA is also sometimes referred to as a beneficiary IRA. Any type of IRA (and most employer-sponsored retirement plans) may be turned into an inherited IRA, and the taxation of the inherited IRA generally follows the same rules that applied when the original IRA owner was alive. In other words, accounts that were funded with pre-tax dollars (e.g., traditional IRAs) or after-tax dollars (e.g., Roth IRAs) maintain their same tax treatment.

Once the account is inherited, if the inheritor is a designated beneficiary (but not an eligible designated beneficiary as defined below in the following SECURE Act section below), they must transfer the assets into an inherited IRA in their name and take distributions over the next ten years. There is no Required Minimum Distribution (RMD) each year, but the inherited IRA must be fully depleted by December 31st of the tenth year following the decedent's year of death.

An inherited IRA is generally retitled as follows:

- John Doe, (Deceased) IRA fbo John Doe, Jr.
- John Doe, (Deceased) IRA fbo John Doe, Jr., Trustee of the Jane Doe Special Needs Trust, as created under the John Doe Living Trust Agreement, Dated May 1, 2015.
- John Doe, (Deceased) IRA fbo John Doe, Jr., Trustee of the Jane Doe Special Needs

Trust, as created under the Last Will and Testament of John Doe, Dated May 1, 2015.

The beneficiary must begin taking required minimum distributions (RMDs) from the inherited IRA as required by the Secure Act. For a beneficiary who inherits an IRA, RMDs must begin by December 31 of the year following the account owner's death. The 10% early withdrawal penalty does not apply to RMDs from an inherited IRA.

IV. SECURE Act

The Setting Every Community Up for Retirement Enhancement (SECURE) Act passed just before the end of 2019. Many planners in the community did not expect the Act to pass, and there was little warning before its passage. The SECURE Act ushered in some very important changes in how planners should evaluate the transfer of IRA assets to beneficiaries with disabilities. Now, the Secure Act 2.0 has made even further changes to the IRA landscape.

The most notable change brought about by the SECURE Act is the elimination of "stretching" RMDs for beneficiaries of an IRA in most cases. As noted above, earnings in a traditional IRA are generally not taxable to the beneficiary until they are distributed. Once funds are distributed for RMDs or otherwise, they are taxed as regular income at the beneficiary's applicable ordinary income rate. Before the passage of the SECURE Act, a beneficiary (other than a spouse) of an inherited IRA could choose to take distributions over their lifetime and pass any remaining funds onto future generations. This was colloquially known as the "stretch" option. The RMDs under the stretch option were calculated based on the beneficiary's life expectancy. As such, the younger the beneficiary, the smaller the annual distributions and the longer the inherited IRA funds could grow tax deferred. Should the IRA beneficiary need to take out funds exceeding the RMD, they may certainly do so.

The SECURE Act now requires that most beneficiaries of an IRA withdraw all the money, and pay the applicable income taxes, from the IRA within ten years of the death of the IRA funder (or "holder"/"owner"). This provision applies to everyone who inherits an IRA beginning January 1, 2020. Three types of beneficiaries may now inherit a retirement account:

Non-Designated Beneficiaries (NDBs)

A non-designated beneficiary (NDB) must take its distributions from a retirement account within five years of the death of the account owner if the account owner was younger than age 72 at death. If the account holder was age 72 or older at the date of death, the NDB may take its RMDs over the decedent's life expectancy. This latter option is sometimes referred to as the "ghost expectancy rule" or the "at least as rapidly rule." NDBs can be an estate, a charity (if the beneficiary is not an Eligible Designated Beneficiary as discussed later), or a nonqualified trust. A nonqualified trust is a trust that is not irrevocable as of the IRA account holder's death, is not valid under state law, and the beneficiaries are not specifically identified in the trust document.

Designated Beneficiaries (DBs)

Designated Beneficiaries (DBs) are now subject to a 10-year payout requirement. A DB may take funds out of the IRA whenever it is most convenient for them so long as the account is fully depleted by December 31st of the tenth year following the decedent's year of death. A DB can be an individual or a see-through trust (defined later herein). If the IRA account owner died before their required beginning date (RBD), then a DB is not required to take any distributions until the tenth year following the decedent's year of death. If the IRA account owner died after their RBD, then the designated beneficiary must take annual RMDs during the ten-year period.

Eligible Designated Beneficiaries (EDBs)

The SECURE Act makes exceptions for beneficiaries with disabilities by preserving the life-expectancy option for five classes of Eligible Designated Beneficiaries (EDBs):

- Spouse
- Disabled beneficiary (IRC § 401(a)(9)(E)(ii)(III))
- Chronically ill beneficiary (IRC § 401(a)(9)(E)(ii)(IV))
- Individuals not more than 10 years younger than the decedent
- Minor children of decedent (during minority only)

This presents a fantastic planning opportunity for beneficiaries with disabilities. When withdrawals are made over many years, funds within the IRA are allowed more time to grow tax-deferred. Additionally, withdrawals spread out over time are less likely to push beneficiaries into a higher personal income tax bracket. The definitions of these EDBs are as follows:

- Disabled beneficiary over the age of 18: An individual who is "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration."

- Disabled beneficiary under the age of 18: An individual with "a medically determinable physical or mental impairment that results in marked and severe functional limitations and that can be expected to result in death or to be of long-continued and indefinite duration."
- Chronically ill beneficiary: An individual who "if, without substantial assistance, (...) [is] unable to complete two or more of the activities of daily living (e.g., grooming, dressing, toileting, ambulating, eating, or transferring)" and the illness is "reasonably expected to be lengthy in nature."

Of note, to be considered an EDB by having a disability, the EDB must provide documentation to the plan administrator/IRA custodian by October 31st of the year following the original account holder's year of death. If the beneficiary has already been determined disabled by the Social Security Administration (42 U.S.C. § 1382(a)(3)(A) and (B)) as of the date of the original account holder's death, they will automatically qualify as disabled/EDB as defined by IRC § 72(m)(7). To be considered an EDB by being chronically ill, documentation must include a certification from a licensed healthcare practitioner verifying the inability of the inheritor to complete two or more activities of daily living for at least a lengthy period.

Additionally, the SECURE Act provides that the IRA holder may designate an SNT as the beneficiary of the IRA (IRC § 401(a)(9)(H)(iv)), and the SNT trustee may use the IRA to fund the SNT for the beneficiary's supplemental needs. When the SNT pays nothing to anyone other than the EDB, the life expectancy payout rules apply. This provision allows the SNT beneficiary to continue to qualify for means-tested public benefits by creating a see-through trust. As noted previously, there are generally two types of see-through trusts: a conduit trust and an accumulation trust. In a conduit trust, the IRA would make distributions to the trust, and the trust would subsequently pass out these funds to or for the benefit of the beneficiary. This is advantageous from a tax perspective as the IRA funds would flow out to the beneficiary and be taxed at their personal tax rate, which is most likely lower than the compressed trust tax rates. However, this income distribution to the beneficiary is generally mandatory in the trust language and would most likely disqualify the beneficiary from means-tested public benefits eligibility (as the beneficiary would be over income). Conversely, in an accumulation trust, the IRA would make distributions to the trust, and the trustee may retain those funds or use them for the benefit of the trust's beneficiary at the sole discretion of the trustee. This may result in trapped income vis-a-vis Distributable Net Income (discussed later in this presentation) and discretionary distributions to or for the benefit of the beneficiary. While such trapped income may potentially be taxed at the higher compressed trust tax rates, proceeding as such will protect the beneficiary's vital means-tested public benefits.

Distribution Requirements

<u>SECURE Act</u>

	Death Before RBD	**Death On/After RBD**
Non-Designated Beneficiary (NDB)	Five Year Rule	Ghost Expectancy Rule
Designated Beneficiary (DB)	Ten Year Rule	Ten Year Rule

Spouse DB	Life Expectancy Rule	Life Expectancy Rule
Conduit Eligible Designated Beneficiary (EDB) Trust	Life Expectancy Rule (adj. for minors)	Life Expectancy Rule (adj. for minors)
Accumulation EDB Trust (Spouse, Child, or Person > 10 years younger)	Ten Year Rule	Ten Year Rule
Accumulation EDB Trust (Disabled or Chronically Ill)	Life Expectancy Rule	Life Expectancy Rule

**RBD = Required Beginning Date (for RMDs)*

<u>See-Through Trusts</u>

When a trust is designated as a beneficiary of an IRA, a review of the trust to determine if it is a qualified trust is necessary to determine if the trust is a conduit or an accumulation trust. To qualify as a "qualified trust" or "see-through trust", the trust must comply with the guidelines set out in 26 CFR § 1.401(a)(9). Specifically, the following five requirements apply:

- The trust must be valid under state law.
- The trust must be irrevocable.
- A copy of the trust must be provided to the plan provider/asset custodian no later than October 31st of the year following the owner's death.
- All countable beneficiaries of the trust must be identifiable.

- All countable beneficiaries of the trust must be individuals (and may include charities thanks to SECURE Act 2.0 provisions).

If the trust qualifies as a see-through trust, the trustee must determine if the trust is a conduit trust or an accumulation trust in order to determine the RMD structure.

Conduit trusts must be specifically drafted to require the trustee to distribute all withdrawals from the IRA in the same calendar year in which they are received to the lifetime beneficiary (26 CFR § 1.401(a)(9)-4(f)(1)(ii)(A)).

An accumulation trust is any trust that is not a conduit trust. Accumulation trusts (wherein the 10 year rule applies unless the primary beneficiary is an EDB) must be specifically drafted to allow the trustee, in their discretion, to accumulate income within the trust and only distribute such income in their discretion (26 CFR § 1.401(a)(9)-4(f)(1)(ii)(B)). A third party SNT is always an accumulation trust. For example, the discretionary distribution language of a third party SNT may read as follows:

"Our Trustee shall be responsible for determining what discretionary distributions shall be made from this trust. Our Trustee may provide for the benefit of Mary, that amount of net income which will not cause Mary to be ineligible for governmental financial assistance benefits, in the event Mary is receiving such benefits. If Mary is not receiving governmental financial assistance benefits, or our Trustee determines it is not in her interest to receive such benefits, then our Trustee has complete discretion to distribute income and principal to or for her benefit. Any undistributed income shall be added to principal. Our Trustee may distribute discretionary amounts of principal to or for the benefit of Mary for those supplemental needs not otherwise provided by governmental financial assistance and benefits, or by the providers of services."

To reiterate for emphasis, in a conduit trust, the IRA would make distributions to the trust, and the trustee must subsequently distribute these funds to or for the benefit of the beneficiary in the same calendar year. The language of the trust must make these distributions mandatory. This is advantageous from a tax perspective as the IRA funds would flow out to the beneficiary and be taxed at their personal tax rate, which is most likely lower than the compressed trust tax rates of up to 37%. Conversely, in an accumulation trust, the IRA would make distributions to the trust, and the trustee may retain those funds or use them for the benefit of the trust's beneficiary at the sole discretion of the trustee. This may result in trapped income vis-a-vis Distributable Net Income and discretionary distributions to or for the benefit of the beneficiary.

Given the differences between these two types of trusts, settlors may prefer one over the other - particularly when family dynamics are involved. For example, in an accumulation trust, the trustee has full discretion as to how and when distributions are made. As such, under the new SECURE Act rules, a lifetime spendthrift trust for a designated beneficiary (e.g., a child or grandchild) may not work well since an IRA designated to the trust must be fully paid out within ten years of the account owner's death.

Countable Beneficiaries

As noted above, to qualify as a see-through trust, all beneficiaries must be identifiable and individuals. The "tier" test may be used to determine which beneficiaries count in order to meet this requirement. The tiers are defined as follows:

- The current beneficiary is the first tier to be reviewed. The current beneficiary is defined in 26 CFR § 1.401(a)(9)-4(f)(3)(i)(A) as "any beneficiary who could receive amounts in the trust representing the employee's interest in the plan that are neither contingent upon, nor delayed until, the death of another trust beneficiary…."
- The second tier of beneficiaries is defined as a beneficiary "that could receive amounts in the trust representing the employee's interest in the plan that were not distributed to the beneficiaries described in paragraph (f)(3)(i)(A) of this section" (i.e., the first-tier beneficiaries).
- The third and final tier of beneficiaries to be reviewed is any beneficiary "who could receive amounts from the trust that represent the employee's interest in the plan solely because of the death of another beneficiary described in paragraph (f)(3)(i)(B) of this section" (i.e., only after the death of the second tier beneficiary).

In other words, should the current beneficiary die, all remainder beneficiaries of the trust (current or contingent) until the very last one should be reviewed for eligibility. However, in a conduit trust, only the first-tier beneficiaries count for eligibility. In an accumulation trust, first- and second-tier beneficiaries count for eligibility. Prior to the passage of the SECURE Act 2.0, if any of those beneficiaries are a charity (or not an individual), the trust was then not considered a see-through accumulation trust and was most likely subject to a five-year or ghost expectancy payout schedule. Said differently, if the ultimate beneficiary of the IRA was a charitable organization (such as a Pooled Special Needs Trust's charitable remainder fund), the five-year or ghost expectancy payout schedule would have applied. Under the SECURE Act 2.0, if a charitable organization (as described in I.R.C. § 408(d)(8)(B)(i)) is named as beneficiary, the charity is now treated as a Designated Beneficiary (I.R.C. § 401(a)(9)(H)(iv)(II) and I.R.C. § 401(a)(9)(H)(v)). This means that the EDB Trust may now take advantage of the life expectancy "stretch" option for IRA depletion.

Flexibility

Post-death fixes to amend intended (or create better) outcomes still exist under the SECURE Act regulations. By and large, multiple beneficiaries of an IRA are analyzed as a whole group. If there is one NDB in the group (e.g., a charity), then all of the beneficiaries are ineligible for DB or EDB status. The "September 30th Rule" (IRS Publication 590-B, Distributions from Individual Retirement Accounts) allows the NDB to be eliminated from such a group of multiple beneficiaries before September 30th of the year following the account owner's death. If the NDB is eliminated before this date, the remaining beneficiaries can qualify for DB or EDB status.

The "Separate Accounts Rule" (IRS Publication 590-B, Distributions from Individual Retirement Accounts) allows individual beneficiaries in a multiple beneficiary group to set up separate accounts to receive their share of the retirement account. Such separate accounts must be set up by December 31st of the year following the account owner's death. If done correctly, each separate account may apply its own appropriate payout rule. However, the Separate Accounts Rule cannot be used in situations where a revocable trust is named as the primary beneficiary. The only exclusion to this is an SNT, which may separate itself and use the EDB rule if applicable.

This concept is particularly useful in an Applicable Multi-Beneficiary Trust (AMBT). An AMBT is a trust that has more than one beneficiary and at least one beneficiary is an EDB as defined by 26 CFR § 1.401(a)(9)-4(g)(1): "An applicable multi-beneficiary trust is a see-through trust with more than one beneficiary and with respect to which–(i) All of the trust beneficiaries are designated beneficiaries; and (ii) At least one of the trust beneficiaries is an eligible designated beneficiary who is disabled (as defined in paragraph (e)(1)(iii) of this section) or chronically ill (as defined in paragraph (e)(1)(iv) of this section)." Under the SECURE Act, separate sub-trusts are treated as separate accounts regardless of the beneficiary designation form. For an SNT created as a sub-trust under an AMBT, the life expectancy payout would then be applicable.

V. Required Minimum Distributions (RMDs)

Required Minimum Distributions (RMDs) are generally the minimum amounts that a retirement plan account owner must withdraw annually from their account the year they turn 72. The age 72 RMD requirement is new under the SECURE Act (previously age 70½), which became effective January 1, 2020. If an account owner turned 70½ before January 1, 2020, the RMDs must be taken when the account owner turns 70½. The SECURE Act 2.0 increases the RMD start age to 73 on January 1, 2022, and 75 on January 1, 2033. Full information and instructions on beneficiary start dates for RMDs may be found in IRS Publication 590-B, Distributions from Individual Retirement Accounts.

The RMD rules apply to all employer-sponsored retirement plans as well as traditional IRAs and IRA-based plans such as SEPs and SIMPLE IRAs. As noted previously, however, Roth IRAs do not have RMD requirements. An account owner must take their first RMD by December 31st of the year in which they turn age 73. If an account owner has more than one retirement plan, they may take their full RMD from one account if they choose and not proportionately out of multiple accounts. All that matters is that the full amount of the RMD is properly calculated and distributed by December 31st.

Typically, an RMD is calculated by dividing the prior year's December 31st value by the life expectancy factor that the IRS publishes in its IRS Publication 590-B, Distributions from Individual Retirement Accounts. There are three main tables to use for these calculations:

- **Joint and Last Survivor Table II:** For use if the sole beneficiary is the account owner's spouse and the spouse is more than 10 years younger than the account owner
- **Uniform Lifetime Table:** For use if the sole beneficiary is not the account owner's spouse or the account owner's spouse is not more than 10 years younger than the account owner
- **Single Life Expectancy Table I:** For use if the account owner is a beneficiary of an account (e.g., inherited IRA)

Example: Beneficiary A inherits an IRA via their properly drafted see-through Third Party SNT, making them EDB. Beneficiary A is 38 years old. The 12/31 fair market value of the IRA was $450,000, and the decedent had been taking RMDs.

2021 Publication 590-B (sample)

TABLE I

(Single Life Expectancy)

(For Use By Beneficiaries)

Age	**Life Expectancy**	**Age**	**Life Expectancy**
5	79.8	35	50.5
6	78.8	36	49.6
7	77.9	37	48.6
8	76.9	38	47.7
9	75.9	39	46.7

Calculation:

$450,000 / 47.7 = RMD of $9,433.96

At the beginning of the year after an RMD is taken, the plan administrator/asset custodian will typically issue an IRS Form 1099-R for inclusion on the beneficiary's or the beneficiary's trust's tax return. This form will include the amount withdrawn, how much is taxable (if applicable), any taxes withheld, and a code indicating distribution type.

An IRS Form 5498 reports total annual contributions to an IRA account and identifies the type of retirement account the account owner has (e.g., traditional IRA, Roth IRA, SIMPLE IRA, etc.). Form 5498 will also report any amounts that the account owner rolled over or transferred from other types of retirement accounts into this IRA. This form can be especially helpful to trustees trying to figure out what kind of IRAs they are dealing with, annual contributions, and the like.

That said, it may be difficult to determine if the original IRA owner had taken their RMD in the year of their death. If the original owner had not taken their RMD, the beneficiary or trust must make sure that the minimum amount gets withdrawn. Failing to do so used to result in a penalty of 50%. Under the provisions of the SECURE Act 2.0, this penalty is now reduced to 25% and may even be reduced to 10% if the missed RMD is taken by the second year following the year it was due. Taking the appropriate RMD may be particularly difficult if the original IRA holder dies late in the year. December 31st is the deadline for taking all RMDs. If the decedent was not yet required to take RMDs, then no year-of-death distribution is required.

RMDs +

When reviewing the tax implications of RMDs, the PSNT trustee may be wary of withdrawing anything over and above the RMD annually. However, there may be times when it is prudent to withdraw more than the RMD annually. Consider the following examples:

- Taking only the RMD may subject children to higher income tax rates when they inherit depending on how their personal tax return is filed.
    - Potential solution: take the highest dollar amount possible without triggering the next higher tax bracket.

- Personal income tax rates and trust income tax rates are unlikely to decrease in the future.
    - Potential solution: maximize IRA withdrawals when prudent.
- It may be appropriate to accelerate IRA distributions in years in which the beneficiary has higher deductions, thus potentially reducing the income tax due.
    - Example: a beneficiary of an SNT wherein all income passes out to them (e.g., First Party SNT (Grantor Trust), Third Party SNT (Complex Trust) wherein distributions exceed income (DNI), etc.) may need a $5,000/month payment to an assisted living facility. This could allow the trustee to take $60,000/year more in withdrawals to be offset by this beneficiary's personal deduction.

VI. Private Letter Rulings (PLRs)

A private letter ruling (PLR) is a written statement from the IRS to a taxpayer that interprets and applies tax laws to the taxpayer's represented set of facts. A taxpayer must independently request the IRS to review their situation and issue and PLR. A PLR is generally issued by the Chief Counsel of the IRS and is used when a taxpayer wishes to confirm that a transaction will not likely result in a tax violation. Qualified retirement plan rules require the owner of the account to be an individual. A trust can be a beneficiary, but a trust cannot be the owner of the account. A beneficiary may lose their means-tested Medicaid benefits if they are named as a direct beneficiary of an IRA. The following PLRs are important to review in terms of IRA planning when a beneficiary receiving means-tested Medicaid benefits inherits an IRA.

<u>Private Letter Ruling 200620025</u>

This Private Letter Ruling (PLR) was brought about when Taxpayer A died while owning an IRA. This IRA named his four sons as beneficiaries through a beneficiary designation. One of his sons was a minor and receiving Medicaid benefits. If he received the money from the IRA distribution, he would lose his SSI and Medicaid eligibility.

The facts of PLR 200620025 are as follows:

1) The IRA shares for three of the sons were set aside in sub-IRA accounts for their benefit.
2) The disabled son's share was not distributed from the IRA. However, the RMDs were made to his guardian on his behalf.
3) The disabled son's mother was his legal guardian. She sought and obtained an order from the state court authorizing the creation of an SNT for her son's benefit.
    i) The trust authorized by the court was a First Party SNT with a proper Medicaid payback provision.
    ii) The disabled son was the sole beneficiary of the trust during his lifetime, and the trustee (his mother and guardian) could distribute as much principal and income as she determined.
    iii) However, upon the son's death, Medicaid would receive reimbursement from the trust assets up to the amount of medical assistance they paid on the son's behalf during his lifetime.
    iv) Any remaining trust assets would then be distributed to the son's heirs at law. The son's mother executed a disclaimer as to her contingent remainder interest in the trust.

To keep the son on Medicaid and fund the SNT with the IRA assets, the mother/guardian sought to transfer her son's share, as 1/4 beneficiary of his father's IRA, to an IRA benefitting the SNT authorized by the state court. As part of this process the mother sought a PLR from the IRS to establish two things: 1) that the transfer of the father's IRA to the SNT would not be considered a transfer under I.R.C. § 691(a)(2) and would therefore be disregarded for federal income purposes, and 2) that the mother as trustee could use her son's life expectancy to calculate the annual RMDs required under I.R.C. § 401(a)(9).

Private Letter Ruling 1: Transfer of IRA to Trust

The IRS begins the analysis of this question with an examination of whether or not the transfer from the IRA to an IRA for the benefit of the SNT qualifies as a taxable transfer. I.R.C. § 691(a)(1) provides that "all items of gross income that are not properly includible in a prior period shall be included in the gross income, for the taxable year when received, of: (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent; (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or (C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right." I.R.C. § 691(a)(2) continues stating that if a right described in § 691(a)(1) is received under the circumstances described in that section then "the fair market value of that right shall be included in the gross income of the estate or person receiving it. For the purposes of this section, a 'transfer' does not include the transmission at death to the estate of the decedent or a transfer to a person who has a right to receive it through bequest, devise, or inheritance."

Generally, the distribution to a beneficiary of a decedent's IRA that equals the amount of the balance in the IRA at the decedent's death, less any nondeductible contributions, is gross income in respect of the decedent under I.R.C. § 691(a)(1) and is includable in the gross income of the beneficiary for the taxable year the distribution is received (Rev. Rul. 92-47, 1992-1 C.B. 198). However, the rules are different when dealing with a grantor trust.

I.R.C. § 677(a) specifies that a "grantor shall be treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be (1) distributed to the grantor or the grantor's spouse; (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse…." Furthermore, if a grantor is treated as the owner of a trust, the grantor is considered to be the owner of the trust assets for federal income tax purposes (Rev. Rul. 85-13, 1985-1 C.B. 184). As such, a transfer of the grantor's assets to the trust is not recognized as a sale or disposition for federal income tax purposes (Rev. Rul. 85-13, 1985-1 C.B. 184).

Based on this analysis, the IRS determined that the SNT was a grantor trust and would be treated as owned by the son under I.R.C. §§ 671 and 677(a). Therefore, it was determined that the transfer of the son's share of his father's IRA to the SNT was not a sale or disposition for the purposes of I.R.C. § 691(a)(2) and was not includible for federal income tax purposes.

Private Letter Ruling 2: Life Expectancy for Annual Distributions

The PLR in this case then moves on to analyze whose life expectancy should be used in calculating annual distributions from the IRA. Generally, a trust will not be considered a "qualified plan" unless the plan provides that the entire interest of each employee (i) will be distributed to such employee not later than the required beginning date, or (ii) will be distributed, beginning not later than the required beginning date, over the life of such employee or over the lives of such employee and a designated beneficiary or over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and a designated beneficiary (I.R.C. § 401(a)(9)(A)). If a portion of the interest of a deceased IRA holder is payable to, or for the benefit of, a designated beneficiary, such portion will be distributed beginning not later than one year after the date of the deceased's death and distributed over the life of the beneficiary (or a period not extending beyond the life expectancy of the beneficiary pursuant to I.R.C. § 401(a)(9)(B)(iii)). Finally, pursuant to I.R.C. § 401(a)(9)(E), the designated beneficiary is defined as any individual designated as a beneficiary by the employee.

The PLR next examines the rules that apply if the IRA of a deceased IRA holder is divided into separate accounts for the purposes of I.R.C. § 401(a)(9) (2004-26 I.R.B. 1082, 1098 (June 28, 2004)). These rules establish that if separate accounts are established under an IRA and the beneficiaries of one account differ from the beneficiaries of another account then the accounts are not aggregated with other accounts to determine whether they satisfy I.R.C. § 401(a)(9). This applies only as long as the separate accounts are established no later than the last day of the year following the calendar year of the IRA holder's death. These separate accounts must have a separate accounting maintained for each that includes all post-death investments, gains and losses, contributions, and forfeitures for the period prior to the establishment of the separate accounts (Final Regulations § 1.401(a)(9)-8, Q&A-3).

After analyzing these requirements, the IRS determined that the "separate account" requirements of section 1.401(a)(9)-8 of the "Final" regulations, Q&As 2 had been met for the years after the father's death. Additionally, the IRS determined that under the facts the trust was intended to qualify as a special needs trust and that it was appropriate to calculate the annual RMDs required under I.R.C. § 401(a)(9) by using the son's life expectancy.

Key Facts

There are two sets of facts in this case that facilitated a favorable ruling by the IRS. The first is that the RMDs were timely made from the IRA to the son's guardian on his behalf. Had the beneficiary failed to take the first RMD by the required date, the rules automatically default to the five-year rule.

The second important set of facts in this case is that the mother, as the son's guardian and the trustee of the SNT, disclaimed her contingent remainder interest in the SNT. As one of the son's heirs at law she would otherwise have a contingent remainder interest under the SNT, which would be problematic as she was also the trustee of that trust. Under the grantor trust rules, this situation may have prevented the trust from qualifying as a grantor trust because she would have been an adverse party. Without this qualification as a grantor trust, the trustee-to-trustee transfer from the IRA to the trust would not have been possible. The only solution then would have been to liquidate the IRA, pay all the income tax, and place the remaining proceeds into the SNT.

Takeaways

Of note, PLRs cannot be cited as precedent but only as an indication of the IRS's position on the particular question. In this PLR, it behooved the planners and counsel to pay very close attention to deadlines for making distributions and filing any disclaimers. Additionally, cooperation between the IRA asset custodian and trustee was key.

<u>Private Letter Ruling 201116005</u>

The facts of PLR 201116005 are as follows:

1) The terms of the trust provide that *X* is the sole beneficiary of the trust during *X*'s lifetime.
2) The trustee shall apply so much of the net income of the trust as the trustee deems beneficial for the use of *X* taking into consideration the best interest and welfare of *X*.
3) If the income from the trust, together with any other income and resources possessed by *X*, including all governmental benefits, is insufficient to provide for *X*'s benefit, the trustee is authorized to invade principal.
4) In general, however, the trustee may not invade the principal if such act will serve to deny, discontinue, reduce, or eliminate any government entitlement or payment which *X* would otherwise receive.
5) Upon *X*'s death, any remaining principal and undistributed income of the trust shall be distributed to the State as reimbursement for assistance provided during *X*'s lifetime. After reimbursement to the State, all remaining principal and undistributed income will be distributed to *X*'s issue or, if there are no issue, to *X*'s siblings, then to their issue by representation.

The facts of the PLR do not disclose who was serving as trustee of the trust, and the ruling does not include any discussion as to what makes the trust a grantor trust for income tax purposes.

Takeaway

The IRS begins its analysis with a discussion of I.R.C. § 691(a)(1). Although the ruling does not mention whether this is an inherited IRA or the beneficiary's own IRA, the reference to Section 691(a)(1), income in respect of a decedent (IRD), indicates that the ruling is addressing an inherited IRA. As in Private Letter Ruling 200620025, the IRS cites Rev. Rul. 85-13, 1985-1 C.B. 184 and concludes that if a grantor is treated as the owner of a trust, the grantor is considered to be the owner of the trust assets for federal income tax purposes. Therefore, the trust, as represented in the PLR, will be treated as owned by *X,* and the transfer of *X*'s share of the IRA to the trust is not a gift by *X* and will not be treated as a sale or disposition for federal income tax purposes.

Private Letter Ruling 201117042

Although the IRS has issued favorable rulings on the transfer of an inherited IRA into a First Party SNT, the same cannot be said for a transfer of the SNT beneficiary's own IRA. In Private Letter Ruling 201117042 (Apr. 29, 2011), the IRS stated that "an individual retirement account cannot be set up and maintained in the name of a trust." Any transfer of an IRA to a trust should be treated as a taxable distribution by the financial institution making the transfer. The facts of PLR 201117042 are as follows:

1) The taxpayer, a person with muscular dystrophy, filed a petition to the state court to create a First Party SNT for his own benefit.
2) The taxpayer's only asset to be funded into the First Party SNT was his own IRA.
3) The taxpayer signed documents that he thought transferred his IRA into his SNT. Instead, the financial institution transferred the taxpayer's IRA into a non-IRA account and issued a Form 1099-R reporting a fully taxable distribution.
4) The 60-day rollover period lapsed, and the taxpayer requested a PLR for additional time to transfer the funds from a non-IRA account to an IRA account and for the IRA to be titled in the name of the First Party SNT.

Takeaways

Although the taxpayer prevailed on the waiver of the 60-day rollover requirement, the IRS refused to favorably rule on the taxpayer's request to transfer his own IRA to a First Party SNT. The ruling does not discuss or mention whether the SNT established by the taxpayer was a grantor trust. The IRS concluded that the financial institution correctly issued a Form 1099-R treating the transfer of the IRA as a fully taxable distribution.

VII. Decedent Proceedings

Many state Medicaid regulations specifically designate the state as a remainder beneficiary of a First Party SNT. When the State Medicaid department classifies itself as a remainder beneficiary of the First Party SNT, the trustee is faced with the issue of whether a distribution from the SNT for payment of the state's Medicaid claim is a payment of a debt due to a creditor or a distribution to a beneficiary. The overall objective in determining as such is to lessen the potential tax burden of an IRA distribution to the trust and/or remainder beneficiaries in the final year of administration.

The amount due to satisfy a payback obligation to the state Medicaid office is determined based upon the "medical assistance" paid on behalf of the beneficiary. In effect, Medicaid is paying the beneficiary's cost of care in exchange for a promise to repay the state with the trust assets upon the death of the beneficiary. The amount ultimately paid to the state is based upon the total medical assistance provided to the beneficiary. If the trust assets are insufficient to pay back the state, then the state receives only what is remaining in the trust. The residuary beneficiaries of the trust do not have personal liability for any unpaid amount due to Medicaid. Since the residuary beneficiary does not have personal liability for the payment of the state Medicaid claim the distribution is not a payment on behalf of a residuary beneficiary that will carry out DNI (I.R.C. §1.661(a)-2(d)).

The amount due to the state is based upon the cumulative medical assistance "advanced" to the beneficiary by Medicaid. In other words, the amount due to the state is not based upon a specific dollar amount or a percentage of the remaining trust assets, meaning the state is not entitled to any more from the trust than the amount owed for past medical assistance provided. For an insolvent trust, it is clear the phrase "beneficiaries" means those entities and individuals to whom the trust would have been distributed if it had not been insolvent. For an insolvent trust, the state will not be classified as a beneficiary.

As such, can the payment by the SNT of the state's Medicaid claim create a corresponding deduction (as medical expenses) to the trust for its final tax filing? As a general rule, the medical and dental expenses of a decedent that are paid by the estate or trust are not deductible in computing the estate's or trust's taxable income pursuant to IRS Pub. No. 559 (2005), p.19. Medical expenses are deductible only by the taxpayer who paid them (and only in the tax year in which they were paid). In addition, expenses incurred by a taxpayer for their medical care but paid after his death out of their estate aren't among the allowable income tax deductions in respect of a decedent. However, medical expenses are treated as paid by the taxpayer at the time they were *incurred* if they are paid out of the deceased taxpayer's estate during the one-year period beginning with the day after the date of the taxpayer's death, as per IRS Reg. Sec. 1.213-1(d)(1).

As such, medical expenses are "incurred" for the purpose of deductibility in the year the medical services are rendered. If the services were rendered in a year for which a return has already been filed, an amended return must be filed for that earlier year. However, no credit or refund of tax will be allowed for any tax year for which the normal statutory period for filing a claim has expired.

> **Example:** A, who filed his return on a calendar year basis, died on June 1, Year 2, after having incurred $8,000 in medical expenses. $5,000 of that amount was incurred during Year 1 and the balance of $3,000 was incurred in Year 2. The decedent had filed his Year 1 personal income tax return on April 15, Year 2. His executor paid off the entire $8,000 liability in August Year 2. The decedent's executor may then file an amended return for Year 1 claiming the $5,000 medical expenses as a deduction thus securing a refund resulting from the increase in the decedent's Year 1 deductions. The $3,000 of expenses incurred in Year 2 may be deducted on the decedent's final return.

If the conditions discussed above are not satisfied, the medical expenses cannot be deducted on the deceased taxpayer's income tax return.

Unfortunately, there is no clear answer when the trust has significant income in the year of termination due to an IRA distribution plus a large payback amount due the state Medicaid department. Most importantly, planners and trustees must proactively recognize when there will be this issue and devise a plan before the trustee pays the Medicaid claim. Once payment has been made to satisfy the Medicaid payback amount, it is likely too late to completely protect the trustee from liability. In most situations, the problem will occur when the First Party SNT's primary asset is an IRA.

The recommended course of action is for the trustee to withhold sufficient taxes on the IRA distribution. The Trustee should plan on a tax rate of 37% plus taxes due to the state. The trustee is usually authorized to pay federal and state income taxes prior to satisfying the state Medicaid claim. Taxes can be withheld even if the withholding causes the payback claim to not be paid back in full.

Alternatively, the trustee could treat the payment of the state Medicaid claim as a distribution to a beneficiary of the trust. The Trustee will be required to send a K-1 to the state Medicaid office that reflects the amount of the income allocated to the state as a beneficiary of the trust. A state agency or department does not pay federal or state income tax. As a result, there are no income tax consequences to the state for being treated as a beneficiary of the trust. The risk to the trustee here is twofold. First, the trustee risks being audited by the IRS and the distribution deduction claimed for the distribution to the state Medicaid office is disallowed. The trustee may be personally liable for any unpaid taxes and interest due to the disallowance of the distribution deduction. Second, classifying the state Medicaid office as a beneficiary of the trust may open the trustee to more liability as the state has been elevated from creditor status to beneficiary status.

VIII. SECURE Act 2.0 Updates

The SECURE Act 2.0 brought approximately 90 new separate provisions to IRA administration, each with its own effective date. Some of the other salient provisions contained in the Act are as follows:

- **Student Loans** (2024): employers may match contributions to retirement plans based on employees' student loan payment amounts.
- **Qualified Tuition Program (QTP) - aka College Savings/529 Plan)** (2024): a College Savings account may be rolled over to a Roth IRA under limited circumstances.
    - QTP must be maintained for 15 years
    - Annual limits for rollover must be within annual contribution limits
    - Lifetime limit of $35,000
- **Qualified Charitable Donation (QCD)** (2024): $100,000 charitable donation limit from an IRA is now adjusted for inflation beginning in 2024.
- **401(k) Lost & Found Database:** an online searchable database will be constructed for employees to find lost retirement plans (similar to a state escheatment office).
- **Saver's Credit → Saver's Match**(2027): a matching contribution to a retirement account will be provided for retirement account holders instead of a. tax credit.
    - Limited to 50% of IRA or retirement plan contributions up to $2,000 and is subject to income limits.

- **Roth 401(k)** (2024): are no longer subject to RMD rules before the account holder's death (but post death RMD rules still apply).
- **Surviving Spouse** (2024): may be treated as the deceased retirement account holder for RMD purposes. This may delay RMD beginning dates.
    - Election is irrevocable.
    - Surviving spouse must notify the account administrator of election.

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