Search for More Articles: Go Print This Page Email to Friend

IRA Distributions to SNTs: Avoiding the 'Five-Year Rule'

LAST UPDATED: 3/2/2008

For many parents, the majority of their savings is held in some kind of a retirement account, often an Individual Retirement Account (IRA). At age 70 ½, an IRA account holder faces the Required Beginning Date, when he or she must take mandatory distributions from the IRA. These payments are determined by the government and are known as Required Minimum Distributions.

If the parents have a child with special needs, it is often important for the parents' estate plan to direct Required Minimum Distributions following the parents' death into a special needs trust (SNT) that has been set up for the child. For income tax purposes, it is usually best to stretch these distributions out over as long a period as possible, particularly if the IRA is a large one.

How long the distributions can be stretched out depends. Typically, if an IRA account holder names a "designated beneficiary," the designated beneficiary's age determines the amount of the distributions. If there is no designated beneficiary, a "five-year rule" for distribution applies – the account must be paid out in full within five years after the account owner passed away.

Unfortunately, a poorly drafted SNT may not qualify as a "designated beneficiary" under the IRS rules. As long as all of the SNT's remainder beneficiaries are individuals, required distributions are allowed to be made based on the age of the eldest remainder beneficiary. The problem is that sometimes SNTs are drafted so that entities that don't have life expectancies -- such as a charity -- are potential beneficiaries. In such cases, the five-year rule applies and IRAs can't avoid the income tax consequences of expedited withdrawal.

This is one of the potential IRA pitfalls for "third-party SNTs," trusts set up and funded by someone other than the child. But when the person with special needs has his or her own assets, a **"first-party" or "self-settled" SNT** may be more appropriate.

Through careful and complicated tax planning, it may be possible to avoid paying income tax on distributions from an IRA into a first-party SNT so long as those distributions are passed on to the beneficiary (which would be the case with smaller IRAs). For this to happen, the trust must be viewed by the IRS as a "grantor trust" -- a trust where all income and expenses from the trust count as the grantor's for income tax purposes.

If a first-party SNT does not meet the requirements for a grantor trust but the beneficiary meets the definition of being disabled under the Social Security rules, the trust may still be able to take advantage of the same income

tax exemptions by being treated for tax purposes as a "qualified disability trust." But a trust can lose this exemption if the beneficiary loses his or her benefits, for whatever reason.

As you can see, the rules governing IRA distributions to SNTs are exceedingly complicated. This is all the more reason to consult with an attorney whose practice focuses on planning for those with special needs. To find such an attorney near you, **click here**.

For more on IRAs and SNTs, **click here**.

<< Previous Article | **Next Article >>**