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# Elder Law Attorney

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## Message from the Chair

It is with great sadness that I report to you that **Ken Grabie**, an active member of our Section and Co-Vice Chair of the Legislative Committee of our Section, passed away. Anyone who knew Ken knew that he was a great lawyer and a great man. He will be sorely missed by his family, his friends and the Elder Law Section.

As I write this message, I am returning from the fantastic 2007 Fall Elder Law Section Meeting at the Turning Stone Casino and Resort in Verona, New York. The Fall Meeting was co-chaired by **Sharon Gruer** and **Joe Greenman**. The Advanced Institute, which was held on October 20, 2007, was co-chaired by **Anthony Enea** and **Bob Kurre**. The turnout was great, the programming was stupendous and the receptions, lunch and dinner provided great fun and great networking for all involved. It was also nice to see so many new faces, and the consensus, from upstaters as well as downstaters, was that the location was not only scenic but was easy to get to and inexpensive as well (assuming no gambling was going on).

The programming covered the usual legislative updates, pearls and gems, and discussion of the state of the law as it relates to personal care contracts, promissory notes and annuities. The programming also covered the administration of special needs trusts, New York-Florida issues, tax implications of life estates, Surrogate's Court litigation and some topics not often covered in our meetings such as public benefits other than Medicaid, planning for individuals with psychiatric illnesses, setting up group homes, insurance claims and the real world of advanced care planning from the perspective of a physician. The Advanced Institute on Saturday was also well received and was an open, guided exchange of questions and issues relating to Medicaid eligibility and Medicaid lien and recovery issues.

The presenters all did an excellent job and on behalf of the Section I wish to thank them: **Michael Amoruso, Cora Alsante, Tim Casserly, Ellen Makofsky, Joan Robert, Gayle Eagan, Howard Krooks, Stephen Silverberg, Richard Weinblatt, Lou Pierro, Gary Freidman, Valerie Bogart, Carolyn Reinach Wolf, Saundra Gumerove, Hermes Fernandez, Bruce Reinoso, Dr. Warren Greenspan, Michael Cathers, David Goldfarb,** and **Rene Reixach**. All of the speakers were well received; and the co-chairs did an excellent job of putting together a great program, and I thank all of them for that. A special thanks also goes

## Inside this Issue

# IRAs and SNTs—Between a Rock and a Hard Place

By Salvatore M. Di Costanzo

With increasing frequency, individual retirement arrangements (IRAs) constitute a significant portion of a client's estate. Advances in medicine and technology are extending longevity. Couple these facts with the fact that a greater number of children are being classified as disabled, and you will conclude that there is a growing number of adults who should incorporate testamentary planning that provides for their disabled children typically through the use of testamentary supplemental needs trusts (SNTs).[1] Where the assets used to fund an SNT consist of IRAs, it is imperative to ensure that the trust qualifies as a designated beneficiary to maximize the deferral of income tax payable on IRA benefits. Moreover, a basic understanding of the often diametrically opposed income tax consequences of leaving IRA benefits to an SNT is necessary to properly advise your client.

The goal when planning for any client with an IRA is to "stretch" the payout of the retirement benefits to the beneficiaries of the IRA after the client's death. For this to occur, the beneficiary must be a "designated beneficiary."[2] In order for a trust to be considered a designated beneficiary, it must meet the requirements of a "see-through trust" under the Internal Revenue Code ("Code").

Once a trust qualifies as a designated beneficiary, the retirement benefits can be distributed over the life expectancy of the oldest trust beneficiary.[3] If the trust does not qualify as a designated beneficiary, however, the IRA must be distributed to the trust over (i) a five-year period or (ii) the remaining life expectancy of the owner of the IRA, known as the "participant," depending on whether the participant died before reaching the date on which he or she would be required to start taking required minimum distributions.[4]

A trust will be considered a see-through trust, and thus a designated beneficiary if it meets certain requirements.[5] One of those requirements is that all trust beneficiaries must be individuals.[6]

In the case of an SNT, the aforementioned requirement requires careful planning. Consider the following facts. A parent establishes a testamentary SNT for the benefit of a disabled child where the disabled child is the only issue of the parent. The parent wishes to benefit a group home that has cared for the disabled child. Thus, the trust provides that upon the death of the disabled child, the trust property passes to the group home which is a qualified charitable organization under the Code.

Although the charity is only a contingent remainder beneficiary, it may still be considered a beneficiary by the IRS. And since the beneficiary is not an individual, this hypothetical SNT will not satisfy the requirement that all beneficiaries be individuals unless the SNT is drafted as a conduit trust which is more fully discussed below.

Even if the trust qualifies as a designated beneficiary, the income of the trust (that being the IRA distribution) will likely be taxed at the trust level, and as a result, will likely be taxed at the highest tax rates since the tax brackets for a trust are compressed. Net income of only $10,050 will result in the trust being taxed at the highest tax rate of 35%, whereas a single individual with the same amount of income is taxed at only 15%.

Taxation at the trust level can be avoided if the trust is a conduit trust. A conduit trust would be a trust that requires the trustee to distribute to the trust beneficiaries any distribution it receives from a retirement plan causing the income to be taxed at the beneficiary's tax rates. However, making the trust a conduit trust can destroy the primary purposes of an SNT, i.e., discretionary distribution of income and principal, and the retention of government assistance. If the payments from a conduit trust are too high, the disabled child may be disqualified from government assistance in its entirety.[7]

However, as stated above, the unintended consequence of a conduit trust may be to enrich a disabled beneficiary to the point where he or she no longer qualifies for government benefits.

Therefore, the difficult planning choice is whether it is more important to "stretch out" the income tax consequences resulting from IRA distributions or to pay the tax and keep the disabled child's government assistance intact.

One of the ways to ensure that the income of a testamentary SNT is taxed at the individual level is to make the SNT a grantor trust to the beneficiary. If the trust is a grantor trust the beneficiary is treated as the owner of the trust and consequently, all items of income, deduction, credit, etc. are taxable at the individual level.[8] However, drafting the SNT as a grantor trust would require giving certain powers to the beneficiary which would likewise disrupt the ~~inherit~~ inherent purpose of the SNT.

Where IRA distributions are relatively small, the trustee may be more willing to distribute the retirement benefits to the trust beneficiary since it will likely have no effect on the beneficiary's government benefits. However, where the retirement benefits are substantial, the client may again be forced to accept paying taxes out of the trust property so as to preserve the inherit benefits of an SNT for the disabled child.

Coupling an SNT with retirement benefits is an opportune plan to preserve such benefits for a disabled individual; however, one must be aware that there most likely will be unavoidable income tax consequences. Most of the time, it is prudent to protect the funds and take the tax hit.

*The author would like to thank William Maker Jr., Esq. for his insight into the writing of this column.*

### Endnotes

1. In 2007, the Centers for Disease Control reported that 1 out of every 150 children is diagnosed with autism. For decades prior, this statistic was closer to 1 out of every 2,000 children.
2. The minimum distribution rules pertaining to individuals are outside the scope of this column. For a comprehensive review of such rules, *See Life and Death Planning for Retirement Benefits*, Natalie Choate, 6th edition 2006.
3. Treas. Reg. § 1.401(a)(9)-5,A-7(a)(1).
4. With certain exceptions, an individual is required to begin taking required minimum distributions by April 1 of the year following the year in which the participant attains 70½ years of age. *See* Treas. Reg. § 1.401(a)(9)-5,A-1(c).
5. *See* Treas. Reg. § 1.401(a)(9)-4,A-5(b)(1)-(5).
6. Treas. Reg. § 1.401(a)(9)-4,A-5(b)(5).
7. There may be other strategies that can be explored to continue designated beneficiary status, such as naming a charitable remainder trust as the beneficiary.
8. *See* I.R.C. § 678(a)(1).