IRA UPDATE: JULY 2011

Transferring Inherited IRA to Special Needs Trust

In a recent IRS Private Letter Ruling (PLR), a beneficiary of an inherited IRA was allowed to transfer his interest to a special needs trust created for his benefit by a parent without triggering taxation of the funds.

Fees for a PLR can be expensive as the IRS user fee just to request the PLR are $10,000. Fees to prepare the PLR could cost as least as much bringing the total over $20,000 and yet could have been avoided with proper planning. The beneficiary's father could have named the special needs trust as the beneficiary of the IRA (his share at least) which would have avoided the need to request the PLR in the first place.

In addition, if the beneficiary's father had named a special needs trust as the beneficiary of his IRA, then the trust would have been considered a "Third-Party Trust" which would have allowed any remainder in the trust after the death of the special needs beneficiary to pass to other beneficiaries. Since the trust in this case was funded by the inherited IRA that the beneficiary inherited directly, it was considered a "First-Party Trust" which means that any remaining assets would first be used to repay any benefits received from State programs and then any remaining assets would pass to other beneficiaries if there was anything remaining which often there are none. This mistake can cost a family much more than just the cost to request the PLR.

Is an inherited IRA an ideal asset for a special needs trust? Well one must consider that if the trust is discretionary, meaning that the trustee can determine how much if any amount is paid to the beneficiary, trust tax issues come into play. For example, any amounts of the required minimum distribution not paid to the beneficiary would be taxed at trust rates which hit the highest tax bracket at very low income levels. A potential solution is to use the IRA assets to purchase life insurance which is paid out income tax free so the taxation issue for RMDs at higher rates would be avoided. Also it removes special trust language requirements necessary to deal with RMDs from an IRA. Another option would be for the IRA owner to convert his IRA to a Roth IRA paying taxes at known rates which would be much lower than trust rates and the RMDs paid would be tax-free to the trust since they come from a Roth IRA. Lastly, the special needs trust could be funded with other non-IRA assets which would also greatly reduce complexity.

Special needs trusts are complex and can be further complicated when considering IRA assets. As always it is critical to consult with a qualified advisor and/or attorney in this area.

Sincerely,

Jeremy E. Portnoff

Jeremy E. Portnoff, CFP®, AIF®, CRPS®, CES™, CFS®, CTS™, CAS®
NAPFA Registered Advisor
Ed Slott Master Elite IRA Advisor
HS Dent Master Certified Advisor