When to Stretch and When Not to Stretch an Inherited IRA: The Special Case of the Special Needs Trust

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ABSTRACT
Use of the stretch strategy for an inherited IRA offers many attractive features for estate planning. In the area of special needs trusts (SNTs), many advisors also favor the stretch strategy to fund or help fund the SNT. Nevertheless, this article suggests there are at least three scenarios facing SNT planning where the stretch strategy may not be prudent: (1) where the IRA is the sole source of funding for the SNT and required minimum distributions are insufficient to meet the present needs of the beneficiary; (2) where the life expectancy of the beneficiary is projected to be short and other end-of-life issues and expense favor greater funding of present needs over future needs; and (3) where a contingent beneficiary becomes disabled after the creation of the SNT, the trustee is empowered to create a new third-party trust to support the newly disabled beneficiary, and the IRA is the sole source of funding for the new trust. This article reviews these issues in the context of a growing market for special needs planning, a review of the conventional planning wisdom on the stretch strategy, why special needs planning requires special care, and why scenarios where the stretch is not prudent create special implications for financial planners.

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Why It Matters: The Growing Market for Special Needs Planning

An important aspect of the scope of and need for the special needs planning market is that it is large and it is growing. The exact figure concerning the raw numbers or the percentage of the population that qualifies as special needs is difficult to precisely ascertain for at least two reasons. First, the definition and measurement of what constitutes special needs have evolved over time; such estimates may be revised upward as metrics change.[1] For example, Benedict et al.[2] estimate that 20.5 percent of children in North Carolina qualify as special needs children based upon five classifications, with 3.4 percent in the most disabled chronic condition (which includes such conditions as autism, cerebral palsy, cystic fibrosis, Down syndrome, hydrocephalus, learning disability, mental retardation, muscular dystrophy, and spina bifida) and the next most severe category of functional limitiations (which includes difficulties in seeing, hearing, communicating, attending, understanding, difficulties with activities of daily living, and problems with behavior) estimated at an additional 11.9 percent of children. Estimates for rates of special needs children (under 17) are similar to rates across the South (18.9 percent) and the United States (19.1 percent) in general. More recently, using slightly different definitions for disability, the U.S. Census estimates that at least 12.6 percent of the civilian noninstitutionalized population, or some 39 million people, are disabled.[3] Elsewhere, broader defini-

tions of disability estimate the total affected population at up to 54 million.

Second, it is also the case that people not previously disabled may become so as the result of accident, injury, or aging. As such, it is not just the the percentage of children who qualify for special needs planning support, but the changing percentage of the general population as well. For example, Silverman[4] reports that by 2007 the U.S. Census identified 41 million Americans, or nearly 15 percent of the population, as disabled, with at least 6.2 percent of children (2.8 million) ages 5 to 15 disabled. The differences in estimates for the percentage of children identified as disabled may be due to operational differences in defining disability, the degree of disability considered, or both. This also pertains to estimates of older Americans suffering from disabilities—up to 36 percent for those 65 years of age and older.[5]

In addition to these two main factors, there are other trends affecting the size and growth of the special needs planning market. For example, advances in neonatal intensive care units (NICUs) have greatly increased the survival rates of premature infants, who in turn may have increased risks for affliction with one or more special needs conditions.

In short, the market for special needs planning is a large, growing, moving target that is potentially underserved. While not all disabled persons may require a special needs trust (SNT), it is certainly the case that a great many people will need such planning protections going forward to help them ensure the highest quality of life possible within the limits of their conditions and the resources available to them. Among these, the stretch strategy for inherited IRAs is a valuable planning tool. Before addressing when it may not be prudent to take advantage of the stretch, it is useful to recap conventional planning wisdom on the stretch strategy.

A Review of the Stretch Strategy

For many persons, retirement savings may form a large portion of the possible funding for providing for those with special needs, though some advisors caution that retirement plans are an "inefficient" means of funding SNTs and should be supplemented where possible with other funding sources, such as a second-to-die life insurance strategy.[6] As for traditional estate planning purposes, the use of a stretch strategy to increase the lifetime value of an inherited IRA because it allows required minimum distributions (RMDs) to be spread out over the lifetime of a younger beneficiary, is documented in the literature and well known to planners. For example, Geiger[7] illustrates the traditional stretch strategy which provides benefits to a spouse. John, who is 60, has $500,000 in an IRA yet has enough funds to retire so he decides to name his spouse, Jenny, who is 50, as the beneficiary. If John dies Jenny will not take out any funds, unless necessary, to leave the IRA to their grandchildren. John dies at age 70 and his IRA appreciated at 6 percent per year, leaving Jenny $895,424. Jenny rolls it over and doesn't take any distributions. By age 70.5 the IRA has grown to $1,603,568.

In another example, Jacobs[8] notes the lifetime distribution advantages of using a stretch to an heir receiving even a modest inheritance from an IRA. In her hypothetical example, a 21-year-old grandson receiving a $100,000 inherited IRA must begin taking an RMD of $1,636.66 based upon his life expectancy of 61.1 years (adjusted yearly). Meanwhile, the principal of the IRA continues to appreciate at 6 percent yearly such that by the time he has reached 65, he will have $345,854 remaining, plus use of the RMDs over the years as ordinary income. Likewise, Appleby[9] illustrates a slightly different stretch scenario, whereby a father designates his son, 40, as the beneficiary and upon inheritance uses his own life expectancy of 42.7 years as the basis for computing the RMDs. Upon his death, the grandson receives the inherited IRA. While the grandson is not eligible to recalculate the RMD based upon his own life expectancy, he can still use the remaining life expectancy of his father, rather than his grandfather, and continue to take lower RMDs, thus allowing the principal to grow tax deferred.

These are just a few examples from the literature underscoring the use of a stretch strategy to increase the lifetime value of an inherited IRA. There are many more.[10, 11, 12]

Additionally, most vendors of financial products have compliance-approved documents summarizing stretch strategies and/or their link to estate planning needs, SNTs, or other products such as life insurance. For clients, planners, and the general public alike, most of these documents are available online from the providers and can be sources of information. For example, Merrill Lynch[13] uses a hypothetical stretch of $400,000 to pay RMDs to the owner from 70.5 years of age, through his death at 85, then continuing to support his wife, then son over a 67-year stretch, eventually resulting in over $4.3M in distributions before exhausting the principal. Similarly, Putnam[14] shows a hypothetical stretch of an initial $200,000 IRA yielding over $3 million in income over a 30-year stretch from owner, to spouse beneficiary, to adult child beneficiary when properly structured. Meanwhile, Prudential[15] combines a stretch IRA with a life insurance policy to help pay estate taxes on the owner's estate and free up more of the stretch principal for growth over the lifetime of subsequent beneficiaries. Of course, vendor publications are designed to support the sale of the vendor's products and help build relationships with clients. But to the extent that they are accessible and easy to understand, they can be quite helpful in educating those interested in learning about stretch strategies.

The discussion will turn now to special needs planning issues and the funding of SNTs, especially when the source is likely to be wholly an inherited IRA.

Why Special Needs Planning Is Special: Special Needs Trusts

Before determining whether or not a stretch strategy is desirable for an SNT, it is critical that clients and advisors carefully consider the differences between SNT planning and planning for other kinds of trusts. While the SNT is a variation on third-party or supplemental trusts, its unique characteristics for keeping beneficiaries qualified for governmental assistance require careful preparation on the part of the financial advisor and/or the planning team.[16]

Hanson and Jensen[17] provide a 15-step checklist for preparing for estate planning for parents of children with disabilities, including meeting with an attorney with SNT expertise. Not the least of these considerations is the need to ensure that the beneficiary of the SNT remains eligible for other sources of assistance, most notably Medicaid. This is because the lifetime health cost of providing medical care to special needs patients is high. For example, Honeycutt et al.[18] report that the additional medical costs of raising a special needs child over those of other children are more than $1,014,000 for persons with mental retardation and $921,000 for persons with cerebral palsy. Moreover, it is often the case that many services designed to support special needs persons are not available outside of governmental programs.[19] As such, it is crucial that the SNT be designed to work with these other sources of assistance.

Barr et al.[20] offer their own 15 tips for planners when setting up SNTs. They also note the importance of trustee selection, including the use of a corporate cotrustee. Additionally, they recommend SNT language that allows the SNT to create another third-party SNT in the event that a future beneficiary becomes disabled after the trust is already in effect.

Some advisors[21, 22] caution that naming another trust or charity as a contingent beneficiary to a child's SNT will void the use of stretch provisions allowing RMDs over the child's lifetime and require payout of all RMDs over 5 years. This is because such entities do not have a lifetime upon which to base a stretch provision. To avoid this situation, the grantor must name at least one other beneficiary (such as another child, the special needs child's children or other living person) alive at the time of the grantor's death so the trust can "see through" to a real person whose lifetime becomes the basis for the stretch. That done, when all such named persons die, the remainder of the trust can then pass to one or more named charities. However, not all advisors agree on the precise language needed to ensure qualifying for the stretch provision, and so it is crucial that a client consult with an attorney experienced in drafting SNT language.[23]

This in turn requires additional care in setting up the SNT because there are two types of see-through

trusts: conduit trusts and accumulation trusts. As Nickerson notes:

> … the "conduit" trust and the "accumulation" trust. In the conduit trust, we only look at the life expectancy of the current beneficiary. The trustee must immediately distribute the required annual minimum distributions to the current beneficiary. Individuals who have special needs wouldn't benefit from a "conduit" trust because it would disqualify them from SSI and Medicaid…. In an accumulation trust, when the required minimum distributions are received from the retirement account by the trustee, they are not required to be immediately paid out to or for the benefit of the trust beneficiary. Thus, the see-through accumulation retirement stretch trust with special needs provisions is best when naming a beneficiary of a significant retirement account for the benefit of a disabled child.[24]

Some advisors might well suggest that conversion of a traditional IRA to a Roth IRA can solve many of the pitfalls associated with stretching as it relates to the funding of an SNT. To be sure, since a Roth IRA does not face the long-awaited tax event of a traditional IRA, it is a more flexible funding source for an SNT than a traditional IRA. But a Roth conversion decision, even if the client can afford to pay the tax now, may not make the most sense for increasing the assets available to fund the SNT. For example, Kitces[25] notes that high-income clients may already be paying taxes at higher marginal rates than they would pay later in retirement when they withdraw from their traditional IRAs and pay taxes at long-term capital gain rates. Under such conditions, the more complicated planning for using the traditional inherited IRA to fund the SNT may provide more assets to fund the trust than would first appear to be the case.

It is within this context that the matter of funding the SNT intersects with the stretch strategy for an inherited IRA. As noted above, many planners and vendors advocate a mix of sources for funding any estate planning vehicle, including SNTs. But sometimes, perhaps often, an inherited IRA may be the sole source of funding for an SNT. Barr et al., though cautioning that use of retirement plans is an "inefficient" means of funding an SNT, specifically recommend use of stretch provisions inside of SNTs and caution that it requires very careful planning to avoid a default to the 5-year payout rule.[26] Given the very real advantages of using a stretch strategy to increase lifetime distributions to beneficiaries, planners and their clients would do well to employ the stretch strategy whenever possible. Nevertheless, the authors suggest there are situations where this otherwise prudent advice is not necessarily in the best interests of the beneficiary of the inherited IRA.

When Not to Stretch an Inherited IRA

Because the benefits of stretching an IRA over the lifetime of a relatively younger beneficiary are so pronounced, it is easy for this to be considered a default position for the vast majority of cases where the income from the RMD is either not the main source of income for the recipient or wholly sufficient to meet their financial needs. Additionally, a trustee can choose to withdraw an amount greater than the RMD as needs arise, while still allowing the benefits of lower RMDs going forward to accumulate under the stretch. However, in the case of the SNT, there may be situations where it would be unwise to stretch the IRA. Following is one such scenario.

Scenario 1

- The IRA is the sole means of funding the SNT, and
- The projected RMDs from the IRA are insufficient to meet the yearly needs of the SNT beneficiary

If the annual income expected to accrue from the RMDs is less than what is known or anticipated to be needed to provide for the care and well-being of the beneficiary, then it may be prudent to pay taxes sooner rather than later, even immediately, so that the full principal of the trust is available upon demand. In such a case, the long-term prospects for the SNT may be in doubt though there are some situations where this may not be an issue. It is also possible that use of a stretch

might be coupled with a larger withdrawal above the RMD, such that something of a hybrid strategy might be in order. For the planner, it makes sense to consider these possibilities to help advise clients in need of SNTs when designing the SNT terms with an attorney and incorporating a very clear letter of intent on the strategy or strategies to be considered when the IRA becomes eligible to be placed in the trust.

This leads to a second scenario.

Scenario 2

- The expected life span of the beneficiary is not long, and
- There are no contingent beneficiaries named and/or in need of residual funds

Under such conditions, it may be that a shorter duration for the SNT is both practical and desirable. For example, if the beneficiary is a disabled senior who is expected to die relatively soon (e.g., in less than 5 years), it may be that there will be end-of-life issues and expenses that would improve the quality of life for the beneficiary if there were a greater balance of funds for present needs rather than a much larger total net return over a much longer life span that is not to be expected. The same might be true for a disabled minor or adult child whose medical condition is tenuous and whose quality of life might be enhanced by a greater expenditure in the short term. In such a situation, it is not that the IRA does not qualify for the stretch strategy, but that some aspects of the stretch are not operationalized—present need outweighs possible future growth in total distributions.

Both of these conditions warrant an important caveat: scenarios where the present need of the SNT's beneficiary makes using the stretch imprudent may have long-term consequences that are necessarily very difficult to talk about with those involved. Certainly Scenario 2 may involve end-of-life decisions that can be very stressful to the grantor, beneficiary, and the family. Perhaps more complicated is Scenario 1, where present need necessitates access to more than RMDs but this will deplete the SNT principal sooner. With the inherited IRA as the only source of funding for the SNT, this scenario may eventually lead to very dire prospects for the beneficiary. Nevertheless, such contingencies must be recognized in order for planners to provide the best possible advice under whatever circumstances evolve. Accordingly, the special case of the SNT, when deciding on how to utilize an inherited IRA, has several implications for planners to consider.

Barr et al., point out that an SNT trust "… should deal with the possibility of a future beneficiary having special needs or a disability that is unknown when the document is prepared. The will or trust should include a provision that permits the fiduciary to establish a third-party SNT and to fund it…."[27] This suggests a possible third scenario.

Scenario 3

- A contingency beneficiary becomes disabled after the establishment of the SNT for the primary beneficiary, and
- The trustee/fiduciary is empowered under the terms of the trust to establish a third-party SNT and fund it, and
- The IRA is the sole source of funding for both the existing SNT and any additional third-party SNTs to be created to support another disabled beneficiary.

Here the original SNT may have sufficient assets such that the RMD covers the support and maintenance of the primary beneficiary but the needs for funding an additional SNT may make following the stretch strategy impractical.

In each of these scenarios, the practical impact is that the stretch strategy is not followed in terms of maximizing lifetime distribution versus the 5-year payout. It may be that the beneficiary could face hardship if the account is exhausted before death. However, the assets in the IRA may still be sufficient to provide a higher quality of life over the life expectancy of the beneficiary but perhaps not past that to benefit contingent beneficiaries later. Here again, a letter of intent can provide guidance to the trustee in the face of evolving conditions.

Implications for Planners

The potential for an SNT to be in a situation where a stretch strategy is not optimal suggests that planners take special care in advising clients of their options. This includes: careful analysis of likely present versus future needs; a need for currency, letters of intent, and advance planning to try and supplement funding sources for the SNT so as to eliminate scenarios that threaten use of the stretch strategy; and the need to exercise caution and review previous planning.

Doing the Math: Present versus Future Needs

While always prudent, where SNTs are concerned it is critical that the planner "run the numbers" on the short- and long-term needs of the SNT beneficiary, especially contingencies where possible unknown expenses must be estimated. Even more so than with other long-term planning situations, the variability of the SNT case requires exacting consideration of what will be needed and when. As suggested above, even conventional wisdom such as utilizing the stretch strategy cannot be taken at face value and so the costing-out of alternatives for the beneficiary must be as thorough and detailed as possible.

Staying Current

The planner needs to remain up to date on a number of issues if the SNT planning is to be executed as intended. Things can and do change over time, and sometimes those changes have important implications for the SNT strategy.

Planners should remain current on changes in the special needs beneficiary's prognosis. Some chronic conditions change relatively little over time, while others present differently and may require different levels of long-term care. Medical conditions that deteriorate may call for different levels of financial support for present needs over future needs. Moreover, privacy issues may come into play as a special needs child ages; the client and the planner should be proactive in advance of such changes, including compliance with HIPAA regulations.

Planners should also remain current on changes in family status—siblings, children, even close friends. Certainly, the planning process should be ongoing and the planner should be prepared to respond to changes. Often, changes are negative and constitute threats, but they may be positive as well. Siblings grow up, marry, and have careers of their own; any of these may create changes in how the SNT is structured, or as importantly, how the support system for trustees, personal representatives, and/or corporate trustees (or cotrustees) can evolve. Much of such planning takes place outside the SNT itself, which leads to the next area of interest: letters of intent.

Letters of Intent

While not a part of the trust document, the letter of intent provision can go a long way towards guiding future trustees on how to respond to changing conditions in the law, availability of benefits, and the medical condition of the beneficiary. For example, while the SNT contains language authorizing the creation of another SNT to protect a future beneficiary,[28] a letter of intent can articulate how the grantor would want things to work in concert, providing perhaps heuristics for making decisions in a changing fiscal environment.

Supplementing Funding with Advance Planning

While the premise of this article is that there exist scenarios in which it is not in the client's best interest to stretch an inherited IRA, the very possibility of such an occurrence should encourage planners to be proactive and for special needs families especially, attempt to enter the long-range planning process as early as possible. In many cases, the greatest possible threat to utilizing the stretch strategy emerges from the condition of the inherited IRA being the sole source for funding the SNT. As such, this should be avoided whenever possible. For example, Barr et al. note the desirability of supplementing an SNT with income from a second-to-die life insurance policy.[29] Such a provision might mean the difference between being able to take advan-

tage of the stretch provision and the necessity of taking the entire body of the IRA within the 5-year rule.

Similarly, other possible sources of funding might be explored. For example, family members or others might be willing to make contributions to the SNT as well.[30] If so, the planner must be prudent in coordinating such welcome gifts. For example, in the case of a testamentary trust, it may be necessary to set up a holding account to keep the money out of the trust while the grantor is alive to avoid activating an irrevocability clause. In such cases, the grantor and planner together should meet with an experienced SNT attorney and a certified public accountant to draft provisions to ensure that well-meaning benefactors do not inadvertently negate one or more aspects of a carefully designed SNT strategy.

Exercising Caution and Reviewing Previous Plans, Including Existing SNTs

It is understood that while the conditions in Scenarios 1 and 2 may be independent, it is possible that all conditions occur together, which may further advise against the use of a stretch. Be that as it may, it is very unlikely that an SNT drawn up by an attorney will not have one or more named beneficiaries. As discussed earlier, this can negate the possibility of employing a stretch strategy if care is not taken in how or if charities are designated as possible terminal beneficiaries. However, it is possible that the SNT was drawn up by the client, using one or more self-service options,[31] in which case the planner should be especially diligent, as a well-meaning contingency beneficiary may negate the use of the stretch when it is clearly warranted and desired. In any event, the planning professional must use an extensive checklist to ensure that both the client's intentions and the documentation necessary to implement those intentions are in order to deal with such contingencies. ■

Note: Special Needs Trusts planning may also have been affected by the Achieving a Better Life Experience (ABLE) Act, which was passed on December 16th 2014, allowing special needs individuals and their families to create tax-exempt savings accounts. The main benefit of this new legislation is that it allows special needs individuals to establish savings accounts that will not affect their eligibility for Social Security Insurance (SSI) and Medicaid. However, this is not a replacement for special needs trusts. The total annual contribution cap, which is not tax deductible, is $14,000. Additionally, the first $100,000 in an ABLE account is exempt from the SSI $2,000 limit and when the ABLE account exceeds $100,000 the beneficiary can no longer receive SSI monthly income. Furthermore, the total lifetime contribution limit is set by state law which can place restrictions on special needs clients.

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