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Special needs require special attorneys.

Taxes and Special Needs Trusts

"The lawyer says that the personal injury settlement isn't subject to income tax. I'm putting it in a special needs trust. So what's this about income taxes?"

"You told us the special needs trust would not affect my son's benefits. But now the accountant is telling us my son will have to file an income tax return. Won't that affect his benefits?"

The idea of a special needs trust is pretty straightforward, but the income tax rules that apply may be anything but. Whether someone will have to pay income taxes -- and who will have to pay them -- depends on what the trust says, what comes out of the trust, but most importantly, what goes into the trust.

First-Party and Third-Party Trusts

There are basically two kinds of special needs trusts: a "self-settled" or "first-party" trust and a "third-party" trust. A "first-party" trust is funded with the beneficiary's own funds, usually out of proceeds of a personal injury settlement or an inheritance. The first-party trust typically requires a "payback" provision, which provides repayment to the state on the beneficiary's death for Medicaid benefits received during the beneficiary's lifetime. Such a trust can only be funded when the disabled beneficiary is under 65. A third-party trust (used in estate planning for a person with a disability) is funded with the funds of someone other than the beneficiary of the trust, usually by a family member and usually, but not necessarily, at the family member's death. The third-party trust won't generally include a payback to Medicaid at the beneficiary's death.

First-Party Trusts - Grantor Trusts

Transferring assets into a self-settled or first-party special needs trust allows the person funding the trust to qualify for government benefits (at least Medicaid and SSI). Because the trust assets may be used to satisfy the beneficiary's own debts (or used for the beneficiary's benefit), for federal tax purposes the trust is taxed as if there were no trust at all. That is, if the trust has investment income, it's taxed as if the beneficiary had received the income directly, even if the income is not distributed to the beneficiary but instead remains in the trust. For tax purposes this type of trust is known as a "grantor trust." Grantor trust status is important if not all trust income will be distributed to the beneficiary, because trust tax rates (on income held in the trust) are generally higher than individual income tax rates and a regular trust must pay tax on any income not distributed to the beneficiary.

"But," you say, "the trust was funded with a personal injury settlement, and that isn't subject to

income tax. Why is there any income tax to pay at all?" Usually funds received in a personal injury settlement are not taxable. However, if the money is then invested, the investment income (interest and dividends) generated will be subject to income tax. The special needs trust lawyer may put into the trust provisions that will cause the trust to be treated as a grantor trust in order to gain favorable income tax treatment.

Third-Party Trusts -- General Rule: Distributions Carry Out Income

The typical third-party trust is established for the benefit of a disabled person when a relative dies and leaves money in trust. This type of trust generally won't qualify as a grantor trust, so the trust will have to pay income tax directly. Trust income tax brackets are notoriously steep, with a tax rate for 2010 of 35% starting when income reaches only \$11,200. The good news is that the trust gets to deduct what it pays out to the beneficiary. The bad news is that the income is reported as paid out to the beneficiary and the beneficiary is issued a "K-1" showing taxable income, which is reported to the IRS, and on which the beneficiary must pay income tax.

Here things get technical. Interest and dividends are treated as income for this purpose; capital gains, including the capital gains distribution generated by mutual funds, may not be treated as income, and may be trapped inside the trust, which then pays the tax. To the extent that the trust does have to pay income tax, it can get a bigger exemption if it meets the requirements for a "qualified disability trust," which include having a beneficiary under age 65.

If a family member is setting up a third-party trust and transferring assets to the trust during the person's own lifetime, rather than at death, it may be possible to include language in the trust instrument that will cause the trust income to be taxable to the donor rather than to the trust or the beneficiary. This is sometimes called an "intentionally defective grantor trust." This can be very advantageous, depending upon the particular situation - for example, if the donor of the funds has a lower tax bracket than the trust or the beneficiary.

The Problem of Income Tax Reporting

"But we don't want our son to report income to the IRS! Can't the trust distribute something else, not income, so he won't have to report the income on a tax return?"

Alas, no -- "all trust distributions carry out income" to the extent that the trust has income. If the trustee of a third-party trust buys Junior a new sofa, a new computer, and a new handicap-equipped vehicle, with a total tab of \$50,000, then if the trust has \$50,000 of investment income the same year, all \$50,000 will be reported to the IRS as if Junior had received it in cash, and Junior will have to file an income tax return, report the income, and pay the tax. If the trust pays Junior's \$10,000 income tax liability the following year, but nothing else, and in that year the trust has at least \$10,000 of investment income, the \$10,000 tax payment will be a distribution taxed to Junior, and so on and so on.

Just to make things a little more complicated: If the trust were a first-party grantor trust, the investment income might be reported directly as being taxable income to Junior; if the trust were

an "intentionally defective grantor trust" set up by Junior's dad, Junior's dad would owe and pay the tax. If the trust had \$50,000 of investment income, but had only distributed \$10,000 to pay Junior's tax liability -- nothing else -- the remaining \$40,000 of investment income would be subject to tax at the trust's higher tax rates, and the trust would have to pay that tax.

It is important to remember that taxable income is not necessarily "countable" income for purposes of Medicaid or other government benefits. Hang on to that fact, because government agencies often get a "tracer" report from the IRS about beneficiary income, and may issue preliminary notices that benefits will be terminated unless they receive proof that the beneficiary did not have countable income. The trustee should be prepared to explain that although the income was reportable to the IRS as the beneficiary's income for tax purposes, the beneficiary only received distributions "in kind" (not in cash) which in general (with certain exceptions) are **not** counted as income for purposes of SSI, Medicaid, or other programs.

[Thanks to Lisa Nachmias Davis and Shawn L. O'Sullivan of New Haven, CT for this article. Lisa is a fellow member of the Special Needs Alliance, a national organization of attorneys committed to helping individuals with disabilities, their families, and the professionals who represent them. Learn more at www.specialneedsalliance.com.]

For assistance with the creation or administration of any type of special needs trust, contact Richard A. Courtney at 866-ELDERLAW(353-3752).