Income Tax and "Third Party" Special Needs Trusts

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So you have a "special needs trust" for your child with special needs. The lawyer who drafted the trust for you may, or may not, have applied for and given to you an FEIN (Federal Employer Identification Number) for the special needs trust. Subsequent to your signing the trust, you, as well as grandparents, may have gifted money or transferred property to the special needs trust. Now it is "tax time". Do you need to file trust income tax returns for both the IRS and your state? Can you just report any income earned by the special needs trust on your individual income tax return, your "1040"? Does it matter if the income earned by the trust has been spent for the beneficiary during the tax year? You have many questions, and so may your tax preparer. This article is an attempt to answer many of those questions.

To begin with, you must understand what "kind of" special needs trust you have. There are two kinds of special needs trusts, and you might have both of them. The first "kind" has many names. It is sometimes referred to as a "self-settled", "first party", "OBRA 93", "Pay-Back", or "d4A" special needs trust. A prior article addressed how this type of special needs trust is taxed. This article will discuss how the second "kind" of special needs trust, actually, the more common form of special needs trust, is taxed.

Parents of children and adults with special needs should all have as part of their estate plan prepared by a qualified and experienced special needs planning attorney, what is commonly referred to as a "third-party" special needs trust, in order for their child with special needs to receive inheritances and gifts from their parents, as well as from others, without in any way jeopardizing, reducing, or interfering with that child's receipt of government benefits. A third-party special needs trust, hereinafter referred to as a "SNT", is the original type of special needs trust. In most states it dates back to the early 1980s. However, too often the drafting attorney fails to explain to the family how and when the trust's income is taxed.

For federal income tax purposes, all trusts are classified as either a "Simple" Trust, "Grantor" Trust or "Complex" Trust. There also is a classification known as a "Qualified Disability Trust", but it really is a Complex Trust that meets certain rules or requirements that we will discuss further in this article.

A SNT, depending on how the attorney drafted the trust, that is, the language in the trust, could be either a "Complex" Trust, a "Grantor" Trust or a Qualified Disability Trust. A SNT can never be a "Simple" Trust, because a "Simple" Trust requires distributions of all earned income to the beneficiary, and therefore could never qualify as a SNT.

GRANTOR TRUST

A typical SNT established by a parent, or jointly by married parents, qualifies as a Grantor Trust of the parents(s) and is **NOT** required to use a Federal Employer Identification Number for the SNT, but **MAY** use a grantor's (either parent's) Social Security Number, as provided by the following IRS Regulations. In accordance with IRS Regulation Sec. 1.671-4 a Grantor Trust must either file a 1041 (Trust Income Tax Return) under a trust Federal Employer Identification Number, and on that form furnish the name and social security number of the grantor, or not file a Trust Form 1041, not use a trust Federal Employer Identification Number, but rather just report all income on the Grantor(s)' Form 1040 (Individual Income Tax Return). Further, the IRS regulations provides that a husband and wife who file a Joint 1040, can use either of their social security numbers, and report all income on their Joint Form 1040. A Grantor Trust occurs when the person creating or establishing the SNT reserves certain rights, powers and authorities that cause, under specific IRS rules, the trust to have "Grantor" trust status. IRS Regulation Sec. 1.671-1 defines what powers over the SNT the parents may have that qualify the trust as a Grantor Trust. Some of these powers are that the parents are contingent beneficiaries if their child with special needs dies before them, if they are not the contingent beneficiaries but they control who are the contingent beneficiaries, if they have certain administrative powers over the trust, among other powers. When the Grantor(s) of a Grantor Trust die, the Grantor Trust becomes a Complex Trust (see below). Depending on certain language in the trust (see below) the Complex Trust may be a Qualified Disability Trust (see below).

COMPLEX TRUST &
COMPLEX/QUALIFIED DISABILITY TRUST

A Complex Trust, including a Complex/Qualified Disability Trust, is a trust that does not require the income from the trust to be distributed to the beneficiary. That is, it is in the total and absolute discretion of the trustees if income (or for that matter, principal) is ever distributed to or for the benefit of the beneficiary. A SNT that is drafted for parents of a child with special needs may be a Complex or Qualified Disability Trust from the start, from its inception, if not drafted as a "Grantor" Trust.

A Complex Trust is not allowed the deduction for personal or dependent exemption of $4,000 as an individual receives. Rather the Complex Trust is allowed an exemption of only $100. A Qualified Disability Trust, however, is allowed the same exemption as an individual, that is, $4,000. How does a Complex Trust qualify as a Qualified Disability Trust and get the $4,000 exemption? The trust must be established for the "**sole benefit**" of an

individual under 65 who is deemed “disabled under the Social Security definition, it must be an irrevocable trust, and cannot qualify as a Grantor Trust (however, a Grantor Trust **will become** a Complex, or Qualified Disability Trust when the parent(s) (or other grantors) pass on).

Complex Trusts and Complex/Qualified Disability Trusts are responsible for reporting their own items of income, deduction and credit. This filing is made on Form 1041, but as described below, there is significantly more that goes into completing an income tax return for a Complex Trust or Qualified Disability Trust than that of a Grantor Trust.

In states where trusts are also subject to a separate state income tax, there is typically a state form on which trust income needs to be reported. These forms differ from state to state, so if a trustee is unsure about whether a separate state return needs to be filed, and which form is to be used, the trustee should be sure to consult with a tax attorney or CPA who has familiarity with trust income taxation.

When must a Form 1041 be filed for a Complex or Complex/Qualified Disability Trust? A Form 1041 generally must be filed if any one of the following three circumstances is applicable: (1) The trust had any taxable income for the tax year; (2) The trust had gross income of $600 or more (regardless of taxable income); or (3) The trust has a beneficiary who is a non-resident alien. The Form 1041 return is due at the same time personal income tax returns are due, April 15th of the year following the year for which the income is being reported. It is possible to request an extension of time to file a Form 1041, but unlike the extension granted to individuals, only 5-month extensions are granted to trusts.

How does the trustee of a special needs trust complete Form 1041? Every year, the IRS updates the Form 1041 (as it does for Form 1040) and issues instructions. The instructions are very detailed and are very helpful in navigating the completion of the Form 1041. These forms and instructions can be found on www.irs.gov. All items of income, deduction and credit are reported on Form 1041 consistent with the form’s instructions. Given the complexity of the Form 1041 and the rules that relate to the reporting of trust income in general, it is strongly recommended that trustees consult a CPA or tax attorney who is knowledgeable about fiduciary income taxation and special needs trusts.

A Complex and a Qualified Disability Trust are able to deduct from gross income the portion of the trust’s income that has been distributed from the trust to or for the benefit of the beneficiary during the year. By way of example, if a Complex or a Qualified Disability Trust had $5,000 of interest income in 2015 and made $6,000 worth of distributions for the benefit of the trust beneficiary, for income tax reporting purposes the trust is deemed to have distributed all of the trust income to the beneficiary. The $6,000 is subtracted from the $5,000, and the trust has no income on which to pay tax, and the $5,000 in income is taxed on the beneficiary’s Form 1040. The beneficiary is likely going to be at the lowest bracket, and may have his or her own $4,000 exemption and, possibly, a $6,300 standard deduction to apply before there is any actual tax. Therefore, if the beneficiary is not being taken as an exemption on another’s tax return, they can shelter $10,300 of income, including trust distributions for his or her benefit.

If instead of making $6,000 worth of distributions on behalf of the trust beneficiary, the trustee only made distributions of $3,000, the trust would deduct the $3,000 on the Form 1041, the beneficiary would report the $3,000 on his or her Form 1040, and the trust would have only $2,000 income on which to pay tax $5,000 less $3,000), but if the trust was a Qualified Disability Trust with a $4,000 exemption, there would be no tax due to the $4,000 exemption.

When tax is due on income generated by a special needs trust, who is responsible for paying the tax? When the income must be reported by the trust beneficiary on his or her own personal return due to distributions made from a non-grantor trust that carry-out income to the beneficiary, the trust itself will usually have provisions that allow for the trust to pay any income tax due by the trust beneficiary on his or her own personal income tax return.

While in these circumstances the actual responsibility for paying the income tax belongs to the beneficiary (the person by whom the income is reportable), often the trust beneficiary does not have his or her own assets to pay income tax liability and the trustee will use trust assets to pay any such liability. When the income tax is reportable by the trust and taxed at the trust level, the trustee is responsible for paying any income tax due out of the trust assets. It is important to remember that “income” for IRS purposes is not the same as “income” for eligibility purposes. Trust distributions “for the benefit of” the beneficiary, while income for IRS purposes, is not “income” for eligibility purposes. However, note that if the beneficiary is receiving SSI, distribution for food and/or shelter could reduce the SSI amount by 1/3.

While there are similarities between personal and fiduciary income tax returns, the forms and the deductions available differ significantly. Since the filing of income tax returns will likely be required for the duration of the trust term, it is important that returns are prepared and filed correctly from the onset. Always seek individual advice from a “trust tax knowledgeable” tax attorney or CPA.