

Taxation of Special Needs Trusts

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Introduction

A. “Income” and “Income”

One concept that permeates through the analysis of taxation of special needs trusts is that “income” may have different meanings. This concept is not unique to special needs trust planning or analysis. Recall that the notion of “income” for income tax purposes is different from “income” in trust accounting principles. It should be unremarkable that “income” could have yet another meaning when used in the public benefits arena.

For most (but not all) public benefits planning purposes, “income” more or less means the sum of (a) actual cash distributions to the benefits recipient, plus (b) distributions that could be converted to food and shelter, plus (c) “in-kind support and maintenance” (ISM). Distributions for the benefit of a trust beneficiary may be treated as income for tax purposes, but not for public benefits purposes, if they are not within those three categories. Furthermore, a given distribution (e.g.: for shelter) may be treated as income to the beneficiary for tax purposes while having a limited effect for public benefits purposes. This would be the result, for example, if a special needs trust were to pay \$800 for a month’s rent for a Supplemental Security Income (SSI) recipient. This payment might generate \$800 of taxable income to the beneficiary, while causing a

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reduction in SSI payments of less than one-third that amount.

Even were it true that income tax reporting had a negative effect on the receipt of benefits, it would not be permissible to simply ignore the tax effect and pretend that no distributions had occurred. Tax rules, like public benefits rules, are what they are; *Pigs is Pigs*² no matter the context.

This is not to say that no public benefits eligibility worker will ever misconstrue the meaning of income tax reporting, or even that correcting an erroneous ruling will always (even usually) be simple or straightforward. The correction of an administrative error may be difficult in individual cases; fortunately, the distinction seems to be better understood over time.

B. Types of “Special Needs” Trusts

While it is frequently observed that there are two entirely different types of “special needs” trusts, the reality is that there are at least five (arguably seven). The distinctions can be drawn based on the source of the funds and the legal authority underpinning a given trust. For our purposes, we will use the following terms and draw the distinctions indicated:

1. **d(4)(A) trusts** (sometimes “self-settled” trusts). These trusts draw their name from the federal statute conveying special treatment – 42 U.S.C. §1396p(d)(4)(A). The d(4)(A) trust must be “established” by a parent, grandparent, guardian or court, but the contents of the trust are the funds of the beneficiary. Thus the ironic result that the trust is often characterized as “self-settled” though it can not be created by the beneficiary himself or herself. It is of course possible to create a self-settled special needs trust without complying with §1396p(d)(4)(A), but the lack of benefit makes it unlikely that any settlor would be inclined to do so.

2. **Third-party trusts** are those trusts established by, and containing the assets of, someone other than the beneficiary. For our purposes they may be testamentary or *inter vivos*, and they may contain assets that once belonged to a single donor or more than one.

² The reference, of course, is to Ellis Parker Butler’s classic short story. Though steeped in cultural stereotypes that might seem offensive today, the story of a petty bureaucrat unable to distinguish between “domestic animals” (guinea pigs) and farm animals (pigs) while being overrun by the reproductive prowess of the former continues to evoke knowing chuckles at the expense of those who lack the power of discrimination.

3. **“Sole Benefit” trusts** is a term of art. Because 42 U.S.C. §1396p(c)(2)(B)(iv) exempts (for the purposes of Medicaid eligibility) from transfer penalties those amounts transferred to “or for the sole benefit of” a disabled recipient, much discussion has focused on the possibility of making the transferor eligible for benefits by establishing a trust – which in many but not all cases would be a “special needs” trust – for the benefit of a disabled child or other relative. No legislative guidance exists for determining what is meant by “sole benefit,” and the administrative pronouncements can be confusing. The central question boils down to this: must a “sole benefit” trust have a provision directing payment to the state Medicaid agency upon the death of the beneficiary?

a. Payback – the primary argument in favor of a payback requirement for “sole benefit” trusts comes from HCFA Transmittal 64³, which mandates (in §3257(B)(6)) that any transfer “for the sole benefit of” a disabled individual must provide no benefit to any other person “at the time the trust is established or any time in the future.” Transmittal 64 goes on to mandate that any trust (or other arrangement) must, in order to qualify, “provide for the spending of the funds involved for the benefit of the individual on a basis that is actuarially sound based on the life expectancy of the individual involved.” Oddly, that section then suggests an exception exists for trusts with a “payback” provision – citing §1396p(d)(4)(A).

b. No payback – on the other hand, the Social Security Administration seems to have opined that a “sole benefit” transfer (or trust) need only be “arranged so that no other person or entity can benefit from the transferred resources at the time of the transfer or for the remainder of that person’s life.”⁴ (emphasis added)

What does this mean? Are all (or at least nearly all) third-party special needs trusts “sole benefit” trusts by SSA/SSI standards, but by Medicaid

³ Transmittal 64, dated November, 1994, is actually §§3257-3259 of the State Medicaid Manual, and is available online at, among other locations, <http://www.sharinglaw.net/elder/Transmittal64.htm>

⁴ SSA POMS (Program Operations Manual System) SI 01140.120(B)(8), which by its terms is limited to determining the effect of a transfer (by an SSI applicant) for the sole benefit of a disabled individual. <https://s044a90.ssa.gov/apps10/poms.nsf/lrx/0501150121>

standards only if they include a payback provision?⁵

4. **“Miller” trusts** are established only to receive and distribute income for an individual who lives in a state imposing an “income cap” on Medicaid long-term care eligibility. The trusts are authorized by 42 U.S.C. §1396p(d)(4)(B). Because they handle only income and are unlikely to accumulate any significant principal, and because they clearly are taxable as grantor trusts, this category of special needs trusts will not be considered further.

5. **Pooled trusts** are interesting hybrids. The assets of a pooled trust may be pooled, but the individual beneficiary’s interest is separate for life. On death, the principal may be retained by the trust for the benefit of others, or may be repaid to the state Medicaid agency (to the extent that the beneficiary received benefits). Though practice has favored pooled trusts mostly for smaller contributions, there are a number of reasons that one might reasonably expect to see the utility of such trusts expanded over time, and a concomitant increase in tax issues. Pooled trusts are expressly authorized by 42 U.S.C. §1396p(d)(4)(C).

Income Taxation

A. Definitions

Before addressing income taxation issues for specific types of special needs trusts, some basic concepts and definitions need to be considered.

1. **Grantor Trust.** This concept is central to income taxation. Remember two things: (a) the “grantor” for income tax purposes is not necessarily the person who receives either the income or any benefit from the trust, and (b) the grantor trust rules were designed to prevent what were then seen as abuses, mostly by parents trying to shift income tax liability to their children’s lower tax rates while not losing control of the assets. Because of the imposition of the “Kiddie Tax,” the grantor trust rules are no longer needed for their original purpose, but they continue to bedevil and amuse tax practitioners.

The grantor trust rules are contained in Internal Revenue Code (IRC) §§671-679. The general structure of those rules is to require an individual who can be identified as a “grantor” to declare a trust’s income as if it

⁵ Do you hate unanswered questions? Here’s my answer, taken from that childhood oracle, the Magic 8-Ball: “Reply hazy, try again.”

were his or her own, ignoring the existence of the trust. Note that this may be true even though the trust is irrevocable, and even though the grantor receives no current or future benefit from the trust.

2. Adverse party (and nonadverse party). An adverse party is someone who has a “substantial beneficial interest” in a trust. Most commonly “adverse party” means a remainder beneficiary, but that is not the only type of adverse party. A nonadverse party is someone who is not an adverse party.⁶

3. Simple and complex trusts. If a trust is not a grantor trust, then it will be one of two types of trust: “simple” or “complex.” A simple trust is one which must distribute its income every year (or which actually does in a given year). A complex trust is one which (a) may and (b) actually does retain some of its income in a given year. This definition is not terribly important to most lawyers, but accountants love to consider and debate it. The trust’s Fiduciary Income Tax return must indicate whether it is a simple or complex trust.

4. Distributable Net Income (DNI). This is an income tax concept intended to approximate the actual benefit paid (or available, even if not paid, in the case of simple trusts) to beneficiaries. In general terms, income tax rules assume that all distributions actually made are first distributions of income and then, to the extent that income is insufficient, distributions of principal. This is true even though the distributions are clearly of items that would be considered principal for accounting purposes. Capital gains are generally not included in DNI, but in general terms all distributions are said to “carry out DNI.”

5. Qualified Disability Trusts. IRC §642(b)(2)(C)⁷ defines a new concept with considerable promise but, as it turns out, limited application. By way of background: most trusts are permitted a single \$300 deduction from income in lieu of a personal exemption (which, on 2007 tax returns, would mean a \$3400 deduction from adjusted gross income). Note, however, that a grantor trust is not entitled to any deduction or personal exemption; since the entity is ignored for tax purposes, the grantor simply includes trust income in his or her tax return (and receives his or her personal exemption, but no additional \$300 deduction under

⁶ See IRC §672(a) and (b)

⁷ This subsection was adopted as part of the Victims of Terrorism Tax Relief Act of 2001, and was effective beginning with tax years ending after September 11, 2001

§642(b)(2)(B)).

A “qualified disability trust,” however, receives more favorable tax treatment – apparently in an attempt to allow it to be taxed more like an individual taxpayer. IRC §642(b)(2)(C)(ii) defines a qualified disability trust:

(ii) Qualified disability trust

For purposes of clause (i), the term "qualified disability trust" means any trust if -
(I) such trust is a disability trust described in subsection (c)(2)(B)(iv) of section 1917 of the Social Security Act (42 U.S.C. 1396p), and

(II) all of the beneficiaries of the trust as of the close of the taxable year are determined by the Commissioner of Social Security to have been disabled (within the meaning of section 1614(a)(3) of the Social Security Act, 42 U.S.C. 1382c(a)(3)) for some portion of such year.

A trust shall not fail to meet the requirements of subclause (II) merely because the corpus of the trust may revert to a person who is not so disabled after the trust ceases to have any beneficiary who is so disabled.

Note that the IRC section specifically refers to 42 U.S.C.

§1396p(c)(2)(B)(iv), the “sole benefit” provision of the Social Security Act. That section, in turn, refers to §1396p(d)(4): “An individual shall not be ineligible for medical assistance by reason of paragraph (1) to the extent that -- ... (B) the assets -- ... (iv) were transferred to a trust (including a trust described in subsection (d)(4) of this section) established solely for the benefit of an individual under 65 years of age who is disabled (as defined in section 1382c(a)(3) of this title)....”

Before we travel further, we should determine whether we *want* to qualify as a disability trust. There are two good things flowing from that status, and one bad. First, the bad:

a. Compressed tax brackets. When trusts pay taxes (rather than passing through DNI to beneficiaries⁸) they will almost always pay at higher rates than individuals with the same income. This is true because of the dollar amounts of income required to trigger each step up to a higher tax bracket. In tax year 2007, for example, the highest marginal tax rate (35%) is imposed on trusts for income over \$10,450. Individual taxpayers do not enjoy the 35% bracket until their income reaches \$349,700 (for married couples or single filers).

⁸ Recall that the trust will not pay any income tax at all if it is a Grantor Trust, that it will pay almost no income tax if it is a simple trust, and that it will not pay income tax even if it is a complex trust unless it in fact does not make distributions for the benefit of its beneficiary – since trust distributions “carry out” DNI

That can translate into real money: a trust earning \$30,000 of net income in 2007 will pay \$4,769.50 more than a single individual would on the same income.⁹

On the other hand, there are some good things about treatment as a qualified disability trust that might outweigh the negatives to trust taxation:

b. Extra personal exemption. A qualified disability trust receives a full personal exemption, rather than being limited to the \$300 deduction.

c. AMT avoidance. In an increasing number of cases involving Kiddie Tax liability, the Alternative Minimum Tax may result in significant additional tax liability. In at least some such cases it might be preferable (if possible) to treat the trust as a qualified disability trust, secure its personal exemption and pay taxes at the more highly compressed rate.

Is it worth trying? Perhaps. Each case will differ. Note that if the only alternatives are grantor trust status or qualified disability trust treatment, the \$30,000 net income example above would see a narrowing of the tax disadvantage from trust treatment by \$1,085. In other words, the tax “penalty” for maintaining the income in the trust would be reduced to only \$3,664.50 (this assumes no AMT benefit). Of course, if we were able to pass most trust income out as DNI **and** get qualified disability trust treatment, the results might be more beneficial.

B. **d(4)(A)**. Let us now look at those rules as applied to some real trusts. We will start with the self-settled d(4)(A) trust. Of course, this trust will ordinarily be a grantor trust. Do we want to attempt to secure treatment as a non-grantor trust? Perhaps, if we see advantages to being a qualified disability trust. Assuming that we want our d(4)(A) trust to be taxed as a separate entity, are we able to accomplish that result? We need to consider a few of the grantor trust rules more closely:

1. §673. Reversionary interests. Section 673 causes grantor trust treatment of any trust in which the grantor “has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.” §673(c) adds: “...the value of the grantor’s

⁹ Trust income tax: \$2,701 plus 35% of the excess over \$10,450, or \$9,543.50 total. Individual income tax: \$782.50 plus 15% of the amount over \$7,825, or \$4,774

reversionary interest shall be determined by assuming the maximum exercise of discretion in favor of the grantor.”

In other words, the only way to avoid grantor trust treatment for our d(4)(A) trust will be to preclude the trustee from exercising discretion as to income or principal in excess of 5% of the value of the trust. But that limitation would be counterproductive in every case. Thus it is probably true to say that every d(4)(A) trust is a grantor trust, regardless of other provisions of the trust or the IRC.

2. §677. Income for benefit of grantor. If §673 doesn't get us to grantor trust status in every d(4)(A) case, §677(a) is going to do so. That section mandates grantor trust treatment any time

...income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be –
(1) distributed to the grantor or the grantor's spouse;
(2) held or accumulated for future distribution to the grantor or the grantor's spouse;...

Clearly, §677 is going to mandate grantor trust treatment *at least* for every d(4)(A) trust in which the trustee is a nonadverse party.

Let us assume, then, that grantor trust treatment is not only inevitable, but good. Is there anything we ought to do to assure such tax categorization?

3. §675(4)(C) - Power to substitute property. Perhaps the most popular way of assuring grantor trust treatment for d(4)(A) trusts is to invoke §675. It provides that inclusion of a “power of administration” will mandate grantor trust treatment. Included among those powers: “a power to reacquire the trust corpus by substituting other property of an equivalent value.” Knock yourself out.

4. EIN and 1041 requirements. Now that we know our d(4)(A) trust will be treated as a grantor trust, do we need to (a) secure a separate trust Employer Identification Number (EIN) and/or (b) file a Fiduciary Income Tax Return (Form 1041)? While it is permissible to secure an EIN for an irrevocable grantor trust, it is not required. Many practitioners (and trustees) report that the constant drumbeat from financial institutions, accountants and others insisting on an EIN makes it easier to simply apply for the number. It may also help protect against identity theft to have a trust EIN. For the practical and determined trustee, however, using the grantor/beneficiary's Social Security Number is fine.

Even if there is an EIN, the trust does not file a 1041 – except that it may (and probably should) file a simple return indicating that the trust's income is being taxed on the grantor's individual return. It is not an option

to file a 1041 and take deductions on that form. It is of no significance if the trustee files a 1041 with “informational” data showing income and expenses passed through to the beneficiary (since the “information” has no recipient). There is no point putting any information on a grantor trust’s 1041 other than the notice that no 1041 is being filed. It is an affirmative error to try to force any income tax effect onto the 1041.

5. Qualified Disability Trust? Can a d(4)(A) trust ever be a qualified disability trust? No. That is because it will always be a grantor trust, and the first requirement for a qualified disability trust is that it be a taxable entity.

C. **Third-party / Sole Benefit.** Let’s look at trusts created for the benefit of an individual with a disability but using assets of a third party grantor. For our purposes, the distinction here between most third-party special needs trusts and the “sole benefit” trust will be modest – except that it may make a difference when we analyze the availability of qualified disability trust treatment – so we will consider them together.

1. Grantor trust – to whom? The first consideration is whether these third-party trusts may be treated as grantor trusts, but with the grantor being someone other than the disabled beneficiary. In other words, even though the grantor may have made an irrevocable gift of assets to the trust, he or she may still be taxed on the trust’s income if the grantor trust rules apply. Does the grantor have a 5% reversionary interest? An “administrative power?”

It may be that the draftsman wanted to obtain grantor trust treatment. In the estate tax world, an “intentionally defective” grantor trust can be used to maximize the gift (by causing the original grantor to be responsible for income taxes on the trust, which effectively increases the value of gifts without incurring additional gift tax liability) and to minimize the income taxes (assuming that the grantor pays taxes at a lower marginal rate than the trust’s compressed rate bracket).

2. Complex vs. Simple. Assuming that the trust is not a grantor trust, then it will almost certainly be a “complex” trust – since it will not be required to distribute all of its income. Remember, though, that if in fact the trust does distribute all of its income for the benefit of the beneficiary in a given year, it will be treated as a “simple” trust and the DNI will flow out to the beneficiary.

3. Qualified disability trust. The most interesting question about taxation of third-party special needs trusts is whether they can be treated as qualified disability trusts. As noted above, IRC §642 limits its

applicability to trusts “for the sole benefit of” a disabled beneficiary. The primary question then becomes whether the third-party special needs trust must include a “payback” provision (for Medicaid services provided to the beneficiary during his or her life).

Assuming that qualified disability trust status is available in a given instance, when will it make sense to elect such treatment? If significant distributions are being made but some income remains undistributed, and grantor trust status is not available (including as against the non-beneficiary grantor), then qualified disability trust status will likely be advantageous.

- D. **Pooled.** The income taxation of the pooled trust share held for the benefit of a given beneficiary will likely follow one of two paths, both already discussed. Either the pooled trust contribution will have been made pursuant to 42 U.S.C. §1396p(d)(4)(C) or the pooled trust will have been set up through the third-party contribution of another. In the first instance, the income tax treatment (as with a d(4)(A) trust) will be as a grantor trust; in the second instance, the same grantor trust / taxable trust / qualified disability trust analysis should apply as in the case of a more traditional third-party special needs trust.

Gift Taxation

- A. **Generally.** Establishment of a d(4)(A) or d(4)(C) trust should not invoke any gift tax issues, since the trustee has the full discretion to use the entire trust for the benefit of the donor during his or her life. Transfer of funds into a third-party special needs trust (including a “sole benefit” trust), however, will involve some gift tax considerations for the donor.

B. **Important principles**

1. Mr. Crummey and Ms. Cristofani. A problem for gift tax purposes is that a gift into a trust, though it may remove the property from the donor’s estate, will not qualify for the annual gift tax exclusion (the \$12,000 per donee, per donor, per year figure for 2008). One long-practiced method of securing exclusion treatment for a gift to a trust has been to use the logic of *Crummey v. Commissioner*, 397 F.2d 82 (9th Circ. 1968). That venerable case held that where the beneficiary of the trust held a power to withdraw contributions in the year made, the gift was not precisely in trust; thus, the dual purposes (of (a) getting the property out of the donor’s estate and (b) avoiding gift tax liability for the gift) could both be met.

There are actually two problems with using *Crummey* powers in the third-

party special needs trust arena. First, the *Crummey* withdrawal right may itself be considered an available resource, and failure to exercise that right may be viewed as a transfer invoking an ineligibility penalty. Second, and perhaps even more insidious, is the possibility that the failure to exercise a withdrawal right may operate to convert the third-party trust into a self-settled trust – mandating inclusion of a payback provision (see below).

There are other options, however. It is possible to give the withdrawal right to someone (or more than one person) who is not the disabled beneficiary. In *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991) Ms. Cristofani had done just that. She gave the power to withdraw contributions to her two children and five grandchildren, but the trusts were to continue for her children's benefit upon lapse of the withdrawal powers. The Tax Court agreed that the lifetime gifts were complete, and that no gift tax liability had been created.

Applying this approach to a third-party special needs trust, it should be possible to give a remainder beneficiary (for instance) a withdrawal right as to annual contributions. Upon failure to exercise the right to withdraw, the remaining contributions could be held for the benefit of the disabled beneficiary.

Of course, this is not necessary if the grantor has no plans to make gifts totaling more than \$1,000,000 during life (and does not have a taxable estate). In much larger estates it may be problematic because giving the donor's non-disabled offspring withdrawal rights may reduce the available gift amount to those potential beneficiaries. Nonetheless, *Cristofani* powers can be an excellent tool for gift tax planning.

2. Lapse of withdrawal power. The notion that failure to exercise the withdrawal power can cause problems is not a new one. Commentators have long speculated about whether such failure might not convert a *Crummey* trust into a grantor trust under tax law, as well. Since tax law embraces a notion that exercise or non-exercise of such a right is of no significance so long as the right is limited to the greater of \$5,000 or 5% of the value of the trust, many *Crummey* draftspersons have limited the withdrawal right (and therefore, in a practical sense, the contribution amount) to that figure.

It is not clear whether the same approach would be taken by the Social Security Administration and/or a given state's Medicaid agency, but the concern is legitimate. If either agency did argue for that position, it is not clear whether the tax law exemption for so-called "5-by-5" powers would also be applied. Because of the long-term ramifications, even if there were a good reason to invoke the *Crummey* / transfer penalty principles, the

practical reality is that *Crummey* powers are of no use in the special needs trust arena.

Estate Taxation

- A. **Generally.** Finally, an easy tax discussion. A d(4)(A) trust will be fully included in the grantor's estate. A third-party (or sole benefit) trust will not – though either might be included in the donor's estate if the gift is not completed (if, for example, the donor retains reversionary interests in the trust). A pooled (d(4)(C)) trust may be included in the grantor's estate, but is unlikely to be a problem – since the only two remainder beneficiaries are likely to be either governmental entities or charities.
- B. **Important principles.** That does not mean there are no issues to consider. One important principle: when establishing a d(4)(A) trust from personal injury settlement proceeds and constructed to receive structured settlement payments (assuming that there is a guaranteed period for those payments), it is important the need for a commutation provision. Otherwise, the unpaid structure can create an estate tax liability with no liquidity to pay the resultant estate tax. With rising estate tax exclusion levels and lowering personal injury settlement amounts, this concern is perhaps less critical than in years past.