



This is the first half of a two part article on the Taxation of Special Needs Trusts. Please look for the rest of the article in the next issue of the NAELA News.

Taxation of Special Needs Trusts

By Dennis Sandoval, CELA

I. Overview

A. Characterization and Taxation of Income.

The characterization of income for trusts is the same as the characterization of income for individual taxpayers. Thus, income from interest, rents, and royalties is taxed as ordinary income. Although trusts are taxed on this income in the same manner as individuals, trusts have an accelerated rate schedule, which means that a trust reaches its maximum marginal tax rate at a much lower net income than does an individual. For 2008, a trust reaches its maximum marginal tax rate of 35% at only \$10,700 of taxable income, while a single individual taxpayer would have to earn over \$347,700 to be taxed at the same marginal tax rate. The tax rate schedules for individuals and trusts for 2008 are as follows:

2008 Tax Rate Schedule for Individuals

If Taxable Income is over –	But not over –	The tax is –
\$0	\$8,005	10% of the amount over \$0
\$8,025	\$32,550	\$802.50, plus 15% of the amount over \$8,025
\$32,550	\$78,850	\$4,481.25, plus 25% of the amount over \$32,550
\$78,850	\$164,550	\$16,056.25, plus 28% of the amount over \$78,850
\$164,550	\$357,700	\$40,052.25, plus 33% of the amount over \$164,550
\$357,700	No Limit	\$103,791.75, plus 35% of the amount over \$357,700

2008 Tax Rate Schedule for Trusts

If Taxable Income is over –	But not over –	The tax is –
\$0	\$2,200	15% of the amount over \$0
\$2,200	\$5,150	\$330, plus 25% of the amount over \$2,200
\$5,150	\$7,850	\$1,067.50, plus 28% of the amount over \$5,150
\$7,850	\$10,700	\$1,823.50, plus 33% of the amount over \$7,850
\$10,700	No Limit	\$2,764.00, plus 35% of the amount over \$10,700

Under current law, income in the form of qualified dividends paid to individual taxpayers is taxed at capital gain rates. As with individual taxpayers, trusts pay capital gain rates on qualified dividends. A qualified dividend is a dividend from an American company or qualifying foreign company that is not listed by the IRS as a dividend that does not qualify and for which the required holding period is met.

When an individual or trust sells or exchanges a capital asset, the sale is taxed at capital gain rates. For individual taxpayers as well as trusts, the maximum long term capital gain rate is 15%. In order to qualify for long term capital gain treatment, the asset must have been held for more than twelve months. Internal Revenue Code § 1223.

For 2007, an individual taxpayer was entitled to a standard deduction of \$5,350. An individual taxpayer that is not claimed as a dependent on another person's tax return is also entitled to a personal exemption of \$3,400 for 2007. An individual taxpayer with income of less than \$8,750 (\$5,350 plus \$3,400) would generally owe no income tax and not be required to file an income tax return. This is not true if the individual taxpayer is being claimed as a dependant on another taxpayer's tax return.

Furthermore, if the taxpayer is under eighteen years of age, any unearned income received by the minor is subject to the "kiddie tax". Under the Tax Increase Prevention and Reconciliation Act of 2005, the kiddie tax is applicable to all unearned income over \$1,800.00. The first \$850 of the child's unearned income is not subject to tax. The next \$850 of unearned income is taxed at the child's tax rate (usually 15%). Any tax on unearned income of the child over \$1,800.00 is taxed at the parent's marginal tax rate (as high as 35%). Any earned income earned by the child would be entirely taxed at the child's marginal tax rate.

A trust is not entitled to a standard deduction. The exemption amount for a simple trust is \$300. The exemption amount for a complex trust is \$100. A trust with over \$600 of income is required to file a fiduciary income tax return.

However, if the trust is categorized as a Qualified Disability Trust, the trust is entitled to an exemption equal to the personal exemption for an individual (\$3,400 in 2007). To be characterized as a qualified disability trust, the trust must be an irrevocable trust established for the sole benefit of a person under the age of 65 who is also disabled, as defined by the SSI and Social Security Disability Income programs.

B. Difference Between Income for Tax Purposes and Income for Purposes of Determining Eligibility for Government Assistance

Internal Revenue Code § 61(a), defines "gross income" as:

all income from whatever source derived, including (but not limited to) the following items: (1) compensation for services, including fees, commissions, fringe benefits, and similar items; (2) gross income derived from business; (3) gains derived from dealings in property; (4) interest; (5) rents; (6) royalties; (7) dividends; (8) alimony and separate maintenance agreements; (9) annuities; (10) income from life insurance and endowment contracts; (11) pensions; (12) income from discharge of indebtedness; (13) distributive share of partnership gross income; (14) distributive share of partnership gross income; (14) income in respect of a decedent; and (15) income from an interest in an estate or trust.

This contrasts with the definition of income for purposes of SSI purposes. 42 U.S.C. § 1382(a) provides:

- (a) For purposes of this subchapter, income means both earned income and unearned income; and—
- (1) earned income means only—(A) wages...; (B) net earnings from self-employment...; (C) remuneration received for services performed in a sheltered workshop or work activities center; and (D) any royalty earned by an individual in connection with any publication of the work of the individual, and that portion of any honorarium which is received for services rendered; and
- (2) unearned income means all other income, including—(A) support and maintenance furnished in cash or kind...; (B) any payments received as an annuity, pension, retirement, or disability benefit, including veterans' compensation and pensions, workmen's compensation payments, old-age, survivors, and disability insurance benefits, railroad retirement annuities and pensions, and unemployment insurance benefits; (C) prizes and awards; (D) payments to the individual occasioned by the death of another person, to the extent that the total of such payments exceeds the amount expended

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by such individual for purposes of the deceased person's last illness and burial; (E) support and alimony payments...; (F) rents, dividends, interest, and royalties...; and (G) any earnings of, and additions to, the corpus of a trust established by an individual..., of which the individual is a beneficiary, to which section 1382b(e) of this title applies, and, in the case of an irrevocable trust, with respect to which circumstances exist under which a payment from the earnings or additions could be made to or for the benefit of the individual.

Practitioners must be fully aware of the disconnect between the definition of income for income tax purposes and the definition of income as provided under Social Security Act. Certain items that are reported as income on the tax return of the disabled individual are not characterized as income for SSI qualification purposes, and vice versa. For instance, payment by the trustee of a SNT of rent payments for a disabled beneficiary from the principal of a SNT would not be considered income for income tax purposes, but would be considered income for purposes of determining initial and continuing SSI eligibility. If, instead of the using the principal distribution to pay rent for the disabled beneficiary, the trustee of the SNT used such distribution to pay for education costs for the disabled beneficiary, the distribution would not be considered income for either income tax purposes or purposes of initial or continuing SSI eligibility.

The distinction between income for purposes of SSI eligibility and income for income tax purposes is often not appreciated by Social Security Administration caseworkers. The caseworker will often incorrectly send out notices of reduction or termination of SSI benefits because of the worker's belief that income for SSI eligibility purposes was not previously reported. In these instances, the practitioner must be fully prepared to advocate for the disabled beneficiary by explaining to the caseworker and his or her supervisor why income for income tax purposes is not income for public benefits purposes.

II. Taxation of Trusts

A. Grantor Trusts vs. Non-Grantor Trusts

A Non-Grantor Trust is a separate taxpayer from its creator. In the first half of the twentieth century, marginal tax rates for trusts were much lower than the marginal tax rates for individuals, which were between 70% and 95% following World War I, World War II, and the Korean War. Creative tax planners would use various trust schemes during this era in order to bring down the overall taxes of a family. In reaction to these creative schemes, Congress and the Internal Revenue Service brought about the grantor trust rules. A violation of these rules by the grantor or other designated individuals caused the trust to be disregarded for income tax purposes, and the income taxed to the grantor at his or her individual income tax rate. These rules were quite effective in eliminating many of the strategies that the IRS viewed as abusive.

Many years later, creative estate planners began to take advantage of the grantor trust rules by purposefully violating them in the creation of an "Intentionally Defective Grantor Trust" or IDGT. The IDGT is an irrevocable trust that is established during the lifetime of the grantor and is used to remove assets from the estate of the grantor. If the proper rules are violated, the trust assets will not be included in the grantor's estate at death, but the income from the trust will be taxed to the grantor. Given that the same amount of income will be taxed at a lower marginal income tax rate when reported on a Form 1040 as opposed to a Form 1041 (at least until the trust income reaches \$357,700), this strategy will usually result in lower overall income taxes. In addition, because the grantor is legally liable to pay the income tax for the trust from his or her personal funds, the income and principal of the trust are preserved to compound on a tax-free basis. This is very desirable since it reduces the size of the grantor's taxable estate while allowing assets outside the taxable estate to grow at a faster rate.

In more recent years, a select group of California elder law attorneys have begun using the Medi-Cal Intentionally Defective Grantor Trust, or MIDGT, especially as a vehicle to hold title to a residence for Medi-Cal purposes. The MIDGT is an excellent planning vehicle because it removes the residence or other asset from the estate of the Medi-Cal recipient for purposes of recovery by the Department of Health Services while maintaining important income tax advantages such as the Section 121 exclusion and step-up in basis at death, at least until 2010.

B. Income Taxation of First Party Versus Third Party SNTs

A Special Needs Trust may be taxed as either a grantor trust or a non-grantor trust, depending upon the circumstances surrounding its creation.

A First Party SNT is a Special Needs Trust that is created by the disabled beneficiary. It typically holds the proceeds from the settlement of the lawsuit resulting from the actions that created the beneficiary's disability or an outright inheritance from a third party. This type of trust is authorized under 42 U.S.C. § 1396p(d)(4)(A). It is commonly referred to as a Litigation SNT or a (d)(4)(A) Trust.

A (d)(4)(A) Trust is characterized as a First Party or Self Created SNT because the funds used to establish the trust belong to the disabled beneficiary. This is true even if the disabled beneficiary never directly received the litigation or inheritance proceeds and such proceeds were instead paid directly to the (d)(4)(A) Trust.

First Party SNTs are generally characterized as grantor trusts for income tax purposes because the grantor is the source of the trust assets and the grantor retains a beneficial interest in the trust income and principal, even if that beneficial interest is restricted by the fact that distributions are at the full discretion of the trustee and can generally be made only for purposes that are supplemental to any benefits that the disabled beneficiary would receive from whatever government assistance programs for which he or she has qualified for. As a grantor trust, the income from a First Party Trust will be taxed to the disabled beneficiary. While this can on occasion generate negative results, it is generally beneficial. This is because the disabled beneficiary will usually be in a very low income tax bracket and the beneficiary may also have large medical expenses that will qualify as deductions on the beneficiary's income tax return.

On occasion, the trustee of a large (d)(4)(A) SNT may find it hard to distribute all of the SNT's income. The trustee of a smaller (d)(4)(A) SNTs may have the opposite experience. Depending on the deductions available to the trust, it may be more desirable on these occasions to attempt to qualify a smaller (d)(4)(A) SNTs as non-grantor trust. This may allow the SNT to take tax deductions that would otherwise be subject to the two percent floor for miscellaneous itemized deductions if taken as a deduction by the disabled beneficiary and it may also allow the

(d)(4)(A) SNT to qualify as a Qualified Disability Trust.

A Third Party SNT is a Special Needs Trust created by someone other than the disabled beneficiary. Third Party SNTs are often created by the parents or grandparents of a special needs person. The Third Party SNT can be created during the lifetime of the grantor. In the case the trust is generally drafted as a stand-alone document. The trust is usually irrevocable, but is sometimes drafted as a revocable trust.

If created during lifetime, the Third Party SNT can be drafted as either a grantor trust or a non-grantor trust. If drafted as a grantor trust, the income from the SNT would be taxable to the third party creator. This is usually advantageous because this allows the SNT assets to grow at a faster rate (since they are not being depleted by taxes) and because the creator is usually being taxed at a lower tax rate than would be applicable if the Third Party SNT was being taxed as a non-grantor trust. If drafted as a grantor trust, the grantor trust status would terminate upon the death of the creator(s) and the trust would thereafter be taxed as a non-grantor trust.

If drafted as a non-grantor trust, the lifetime Third Party SNT would report its income on its own income tax return and pay the taxes on its income from trust income or principal. The non-grantor Third Party SNT would be subject to the compressed tax rates for trusts, so it would generally pay a greater tax on accumulated income than a Third Party SNT drafted as a grantor trust. However, if the non-grantor Third Party SNT's accumulated income is anticipated to always remain relatively modest, there may be an advantage in drafting the SNT as a non-grantor trust so that it could qualify for Qualified Disability Trust status.

A Third Party SNT can also come into existence as the result of the death of a third party who provides for the creation of a SNT for the benefit of a disabled beneficiary under the terms of his or her Will or Revocable Living Trust. In this case, the Third Party SNT will be taxed as a non-grantor trust.

Dennis Sandoval, CELA, practices Elder Law in Riverside, CA. He is a Certified Elder Law Attorney and is certified by the California Bar Board of Legal Specialization as a Certified Estate Planning, Trust and Probate Law Specialist, as well as a Certified Taxation Law Specialist. He serves on the Board of Directors of the National Academy of Elder Law Attorneys and the National Elder Law Foundation, and is the Director of Education for the American Academy of Estate Planning Attorneys.

This article will be concluded in the next issue of the *NAELA News*.