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Income Tax Reporting for the Special Needs Trust

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Introduction:

The special needs trust (SNT) is established to benefit a disabled person who may, but not always, be eligible for government assistance programs. The disabled person's government benefit package may, but need not, limit the beneficiary's income and resources. The trust beneficiary's public benefit package may be a combination of HUD (Section 8) subsidized housing, long term care Medicaid, state-defined waiver programs such as the Oregon Health Plan, mental health services, Veterans Aid and Attendance, Medicare, Social Security Disability, and Supplemental Security Income (SSI).

Compliance with federal and state income tax reporting requirements is not difficult, but the tax preparer may be unfamiliar with special needs trusts. The trustee needs to know what to expect from the hired tax preparer. Also, the trustee should be aware that IRS rules on "income" confuse public program administrators. Knowing that the trust income tax returns will be reviewed by both the IRS and the public benefit agencies, the trustee's goals are to:

1. Comply with applicable income tax reporting requirements;
2. Understand the income tax return information;
3. Be able to explain the income tax return to a public benefit agency employee.

The focus here is solely on the federal income tax reporting requirements for special needs trusts, and not on eligibility for particular public programs.

A. Who, other than government benefit agencies, will review the income tax returns?

The SNT income tax return may be scrutinized not only by the tax preparer and the trustee who signs the return, but also by interested parties and public benefit agencies.

The trust accounting language may require the trustee to give a copy of the tax return each year to the beneficiary, his or her guardian, the successor trustees, and other interested persons (usually relatives or informal advocates).¹

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Review the trust administration articles of the trust to find its accounting requirements. The typical SNT may require:

ACCOUNT. Once each year the Trustee shall account to the Beneficiary (and to the Beneficiary's legal representative or guardian, if any) in an account filed with the court overseeing the beneficiary's conservatorship. In the account, the Trustee shall report any change in the Beneficiary's eligibility for public benefit programs. The statement of account shall include a description of the operations in the reporting period, showing all receipts, disbursements, investment transactions, distributions of both principal and income since the last statement of account, and an inventory of current trust assets. The statement of account shall be deemed to have been furnished to the person entitled thereto when it has been placed in the United States Mail addressed to that person at the

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Interested parties have access to the SNT tax return, and may ask their lawyer or certified public accountant to review the return. If the trustee is operating a court-permitted jointly operated conservator/special needs trust (common in Oregon), the local probate court clerk and judge also review the annual trust account with its attached tax return.

The trustee should have some minimal understanding of SNT tax reporting, to aid the trustee in explaining the return to the interested parties. However, the SNT trustee is most concerned with possible government agency review of the tax return.

B. What Government Agencies Will Review the SNT Tax Return?

The SNT tax return will be reviewed by

1. The IRS
2. Needs-based public benefit agencies

B.1 IRS Scrutiny:

The IRS, of course, wants someone (trust or beneficiary) to report taxable income, and to pay taxes due. The IRS may audit the trust or beneficiary income tax return, and an incomplete or unusual tax return might trigger IRS attention. Very few trust tax returns are actually audited at this time, but perhaps the IRS might turn its attention to trusts in the future.

B.2 Public Benefit Agency Scrutiny:

The SNT trustee should be more concerned about inevitable public benefit agency scrutiny, than about possible IRS review of trust operations. Public benefit agency employees do not have training in trust income taxation. The agency reviewer simply wants to screen out trust beneficiaries who might not meet the strict income and resource requirements of most needs-based programs. The trustee who can clearly explain the difference between program income and taxable income to an agency employee will reduce the likelihood of a denial of benefits for the trust beneficiary.

At three distinct points in time, the needs-based government benefit agency will concern itself with trust existence or operation:

1. Application for needs-based public benefits
2. Periodic review of the beneficiary 's eligibility for public benefits
3. Cross-checking the IRS records with the public benefit rolls.

During the time the SNT beneficiary is not eligible for needs-based programs, no public agency cares to

*person's last known address even if that person is under a legal disability. Copies of documents evidencing ownership of assets in the name of the trust, and a copy of the most recently filed **trust tax return** shall be attached to the accounting. The court may require the trustee to submit to a physical inspection of the trust property in the control of the trustee which inspection may occur at any time and in any manner the court may specify.*

scrutinize trust operations. However, even if the disabled SNT beneficiary does not then need public benefits, the trustee should anticipate future public benefit agency scrutiny. The disabled beneficiary's condition may decline over time, and he might later seek needs-based program help.

2.1 Application :

Upon application for needs-based benefits, the beneficiary should report the existence of the special needs trust to the program caseworker. If the trustee knows of a benefit application, the trustee can encourage the beneficiary to report trust existence. The trust income tax return may or may not be part of the application review, but an agency may scrutinize the tax return to help the agency determine past distributions to the public benefit applicant.

2.2 Periodic Review of Eligibility:

All needs based public benefits recipients are obliged to periodically report newly received income and resources.² The report's contents and timing vary by program.

The existence of a special needs trust should be routinely disclosed in the periodic reports. The trustee or hired case manager might be advised to meet with the program caseworker to review how trust distributions can (in the opinion of that one caseworker!) least harm a desired benefit package. Agency employees are not sure how to deal with a trust and proposed distributions, and may be abrupt in manner or very arbitrary. Agency employees treat beneficiaries with the same apparent fact situation differently, and their responses may vary both within a state and from state to state. The trustee should be advised about this varying treatment, and the lack of predictability. Good SNT trustees try to work within the apparent guidelines the workers understand where possible.

The Social Security Administration, in its periodic review of SSI cases, will ask the beneficiary to provide information about trust expenditures. Practitioners report to the author that some state benefit agencies also ask for periodic reports directly from the trustee of the special needs trust, not just from the beneficiary. So far, Oregon public benefit agencies do not ask the SNT trustee to make reports. The SNT trustee responding to a state or federal agency request for a trust report should expect that agency to have a copy of the beneficiary's income tax return, if any, the K-1, the 1099s from the trust investments, and the trust income tax return.

2.3 Cross Checking IRS Records :

All needs-based public benefit agencies have access to federal and state income tax records under the tax identification number of the benefit recipients, and will be able to cross-match to search for unreported income and assets. An agency employee may believe that the trust income "counts" against the individual beneficiary. When the beneficiary has not "reported" to the program an item of income shown on the tax reports, an agency employee will send out an inquiry.

When the beneficiary tax id number is tied to reported income and assets, even though the subject

² "The Deficit Reduction Act of 1984 (Public Law 98-369) requires the Internal Revenue Service to furnish SSA with certain nonwage information about SSI recipients. . All match information is sent to Social Security offices for verification of the information. For fiscal years 1994 and 1995 there were 297,000 and 181,000 matches respectively." 1998 GREEN BOOK, Committee on Ways and Means US House of Representatives, p.270

property is held in a trust, the SSA sends a letter asking the recipient to report details of trust administration or lose benefits.

How does the SNT trustee find out about the inquiry?

Where the same individual serves as trustee and as the representative payee for a disabled beneficiary's SSI monthly check, or as an appointed representative under the program rules for the beneficiary, the trustee will receive the inquiry.

Where the trustee has no standing to deal with the Social Security Administration (not serving as representative payee and not being an appointed representative), the trustee can ask the beneficiary, case manager (if one is privately engaged), the representative payee (if there is one), or the beneficiary's appointed representative to send the trustee any SSA inquiries regarding trust distributions or assets.

If the recipient of the SSA or other public program inquiry does not notify the trustee, the disabled person may be issued a denial notice before the proper information is exchanged between trustee and agency.

While this article focuses on the trust income tax return, the SNT trustee always has to keep in mind eventual public benefit agency scrutiny.

Comment: getting mental health-services Medicaid with existing claim against resources and in-life payback rules

C. Tax Reporting for Grantor and Third Party Special Needs Trusts

Who is taxed on the income of a special needs trust, and what kind of tax forms should be filed? The IRS wants an appropriate report of income, and payment of any tax owed.

The basic rules for trust tax reporting are:

Grantor Trust If the trust is a grantor trust, then the trust creator or grantor reports the income on his or her own personal tax return, the Form 1040, which shows the trust taxable income as personal income of the trust beneficiary.

Non-Grantor Trust If the trust is a non-grantor trust, then the trustee reports all income and deductions on a fiduciary income tax return, the Form 1041, which files a K-1 reporting the distributable net income to the trust beneficiary. The trust beneficiary's own Form 1040 picks up the K-1 income.

The SNT trustee determines whether his or her trust is a grantor or non grantor trust, then knows what kind of tax report is needed. In the SNT world, these two categories of trusts are easily distinguished:

Grantor trust is created by the disabled public benefit recipient (or his representative with his actual or implied consent) with the beneficiary's funds, and may also have one or more of the IRC §671-678 grantor trust provisions.

Third party trust is created by another person, not the beneficiary, and funded with an inter vivos gift or testamentary transfer to a trust for a disabled beneficiary

C.1 Disabled Beneficiary is SNT Grantor - 42 U.S.C. § 1396p(d)(4)(A) :

Some SNTs are established with funds of the disabled person (i.e. outright inheritance recharacterized by family settlement agreement as a special needs trust, or personal injury settlement or retroactive SS lump sum placed into a special needs trust). These trusts are grantor trusts, because the public beneficiary (or his representative) is establishing the trust with his own funds for his sole benefit. Some elder law practitioners are including grantor trust powers (IRC §671-678) to clarify the tax nature of the trust (most commonly, that the trustee can distribute income without requiring the approval of the remainder beneficiaries of the trust).³

Elder law attorneys frequently recommend special needs trusts to protect long term care Medicaid or SSI benefits as permitted by the Foster Care Independence Act of 1999, 42 U.S.C. 1982b(e)(5), and 42 U.S.C. 1396(p)(d)(4)(A). The trustee can determine whether the trust is a (d)(4)(A) trust by looking at the opening paragraphs of the trust and at the termination clause. Most SNT drafters refer to the federal statute, 42 U.S.C. 1396(p)(d)(4)(A), in the opening paragraph, and in the termination clause the (d)(4)(A) trust always, on death of the beneficiary, permits payback of a State Medicaid estate recovery claim.

Comment: Cite to IRS sections, for way to get grantor trust treatment

A threshold question for many grantor SNTs is whether the trustee should obtain a tax identification number.⁴ The trustee usually prefers to have banks and brokerage companies issue 1099s to the trust, rather than to the individual grantor/beneficiary, so that the trustee can keep assets for which the trustee is responsible quite distinct from other income or resources of the disabled beneficiary.

Tax reporting for a grantor trust is straightforward. The SNT trustee files a Form 1041 for the tax identification number of the trust, reciting that the return is an “information only” return, a phrase similar to:

GRANTOR TRUST. ALL INCOME AND DEDUCTIONS FLOW THROUGH NAME OF GRANTOR, SS# _____, INFORMATION RETURN ONLY.

The trustee attaches the statement of income and deductions required by Reg. §1.671-4(b)(2) to the information-only Form 1041, and sends the statement to the beneficiary for inclusion of its items on the beneficiary's Form 1040. Because in special needs trust situations the beneficiary is both poor and disabled, SNT trustees often pay any tax related to trust income, and pay for preparation of the beneficiary's personal return.

Grantor trust treatment may be particularly important if the source of the trust corpus was a personal injury claim. Recovery for tort-type damages on account of a physical injury or sickness is not

³ Robert B. Fleming, ELDER LAW ANSWER BOOK, Q. 16.29, p. 16-20, (Aspen Publishing 2000; IRC § 677(a). At the 2000 NAELA Institute, presenter Robert Fleming opined that most self-settled SNTs are grantor trusts, and there was some debate on that subject (in audio tape, not written materials/ Robert Fleming/Stuart Morris presentation) .

⁴This issue was debated in the Robert Fleming/Stuart Morris presentation at the NAELA 2000 Institute in Colorado Springs, and the arguments in favor of obtaining the tax ID number seemed persuasive. The audio tapes of the NAELA Institute presentation report the discussion.

included in the grantor's gross income for tax purposes. 26 U.S.C. 104(a)(2).⁵

When the grantor trust is terminated (typically, when it is drained by lifetime distributions, or when the lifetime beneficiary dies), the trustee files a final Form 1041 showing termination and makes final distribution to the remainder beneficiaries. If the beneficiary has died, then the grantor trust final Form 1041 is a complete return, not a flow through return, and includes the final remainder distribution and costs. The trustee terminates the trust with a Form K-1 to remainder beneficiaries, a final Form 1040 for beneficiary, and a Form 56 to IRS reporting the end of the fiduciary relationship.

C. 2 Third Party Trusts (Disabled Beneficiary Is Not the Grantor):

Most special needs trusts are NOT grantor trusts. Trusts established for a disabled son by a mother in her will, or funded with life insurance on the mother's life at her death, are independent trust entities for income tax purposes, and such trusts report income, credits, and deductions on a Form 1041.

When the beneficiary is NOT the grantor, then the trustee always obtains a tax identification number, always files a Form 1041 income tax return, and always reports distributable income on a Form K-1 to the beneficiary.

Inter vivos third party special needs trusts are not usually grantor trusts. A donor creates the third party trust inter vivos, by making a completed gift of the assets to a SNT, and by not retaining the grantor trust powers set out in I.R.C. § 671-678.

These non-grantor trusts typically name family members or a non-profit entity as remainder beneficiaries. Non-grantor trusts are NEVER 42 U.S.C. 1396 p(d)(4)(A) trusts, and need not provide for payback of a State Medicaid claim.

For this non-grantor third party trust, the trustee files a Form 1041, showing trust taxable income, credits, and deductions, and issues a K-1 to the trust beneficiary showing taxable income. The trustee should hire a professional familiar with fiduciary income, taxable income, and distributable net income concepts to prepare the trust tax return.

2.1 Simple testamentary SNT:

How does income tax reporting work with a standard testamentary special needs trust?

The testamentary trust is a third party trust, created after the death of the testator with the testator's funds. The trustee will hire a tax preparer to determine the trust taxable income and prepare Form 1041 and a K-1 for the beneficiary. The beneficiary should file a personal Form 1040, showing the K-1 income. Some SNT trustees pay for preparation of the beneficiary's personal return, and pay any income tax related to K-1 income.

The trustee has to follow fiduciary accounting rules, and the trustee's tax preparer has to follow income tax rules. The K-1 distributable net income (DNI) may NEVER be the same as the accounting

⁵ If the trust corpus is annuitized (a structured settlement), payout to a non-grantor trust raises the issue of adverse income or transfer tax consequences. The author has seen no discussion of this issue in the literature on special needs trusts.

income and trust taxable income. The trustee should not worry about the different sorts of “income.” Just remember that there is a pro rata carryout rule, which requires that the distributable net income carried out to the beneficiary be allocated between the different kinds of income generated in the trust (less capital gain income, which is allocated to corpus and does not become part of DNI!).

Not all of trust income items will flush out to the beneficiary- some income is usually trapped in the trust. The professional will prepare the return, and the trustee should understand enough to be able to explain the return to interested parties and to a public agency employee.

C.3. Hybrid Third Party Grantor Special Needs Trusts:

In some cases a hybrid sort of SNT (both third party funded and a grantor trust) may be created. The wealthy donor gifting assets inter vivos to a special needs trust may want to intentionally keep the income tax obligation, perhaps to increase the gift by assuming all tax obligations⁶; perhaps to avoid public agency cross-matching. The wealthy donor will then create a third party SNT which is also a grantor trust, that is, the donor will be the grantor for income tax reasons.

For gift and estate tax planning purposes, the grantor may wish to have the gifted property out of his estate to reduce transfer tax at death, yet keep the gifted asset in his estate during his life for income tax purposes. To achieve these goals, the donor makes a completed gift for estate tax purposes, yet retains I.R.C. §671-678 grantor trust powers to keep the asset in his lifetime estate for income tax purposes. In this unlikely planning circumstance, the grantor will be the donor, and report the income and expenses on the donor’s return, and the beneficiary will NOT report the income and deductions of the grantor trust on the beneficiary’s personal return.

It is conceivable, then, to have a parent make an inter vivos gift to a special needs trust for the benefit of a disabled child, retaining the grantor trust powers so that the parent reports the income items as in other grantor trusts. This income tax result does not remove all public agency scrutiny of the trust, but might ease the parent’s concern about IRS and agency cross-matching.

II Could a third party trust, funded with a third party’s assets, be made a grantor trust for the disabled beneficiary? Conceivably a donor could gift to a special needs trust that gives the disabled beneficiary grantor trust powers. That is, a trust established by someone other than the disabled individual, with the other’s own funds, and intentionally be made the beneficiary’s grantor trust. The beneficiary would then be reporting the income and deductions of a third party trust on the beneficiary’s own tax return. Would a public agency begin to look for Medicaid payback at termination, as in some other grantor trusts, and raise eligibility questions? A hybrid third party trust (beneficiary as grantor) may confuse public agencies, and trigger payback claim.

Comment: It is conceivable that for estate tax planning purposes the donor of funds wants to create a completed gift,

Comment: These trusts will be less likely, in my judgment, to eventually be considered available for spend down before eligibility. The current federal law for long term care Medicaid and SSI only regulate trusts

Comment: ?

Comment: other than by will

Comment: ?

Comment: , and the implication for me is that the government as public policy encourages the rest of us to privately plan to benefit our disabled brethren, but is wary of all attempts to set up living trusts for their benefit.

D. Trust Income and Public Program Income

“Income” for the purpose of taxation is NOT the same as “income” for the purpose of a particular public benefit program.

⁶“Making such “free” gifts of the annual income tax imposed on the trust is clearly attractive to wealthy grantors who wish to make additional gifts without incurring any gift or GST tax.” John R. Price, PRICE ON CONTEMPORARY ESTATE PLANNING, 2nd Ed., §10.32/1, p. 1126

In the income tax world, gross taxable income for an individual is not the same as “taxable income” after deductions from gross income, itemized or standard deductions, and exemptions are applied. Similarly, in the public benefit world, not all receipts by a program beneficiary are considered countable income - there are uncounted items and exemptions applied to receipts by a beneficiary before the item is “countable” to reduce the public assistance.

For example, under the Supplemental Security Income (SSI) program a “person with too much income is not eligible for SSI benefits. However, not everything a person gets is income and not all income counts.”⁷ What is not countable income? According to the 1997 Social Security Handbook, p. 400:

“2131. CERTAIN THINGS A PERSON RECEIVES ARE NOT INCOME even though they may have value. Among them are:

A. Medical care and services, including room and board provided by anyone during a medical confinement in a treatment facility such as a hospital or nursing home.

EXCEPTION: Cash provided by an individual -- or cash provided by a nongovernmental medical services program or by health insurance if it is not reimbursement for, or restricted to the future purchase of, program-approved services -- is income.

B. Social Services.

EXCEPTION: Cash provided by an individual -- or cash provided by a nongovernmental social services program if it is not reimbursement for, or restricted to the future purchase of, program-approved services -- is income.

C. Receipts from the sale, exchange or replacement of a resource. These receipts are simply resources that have changed their form. This includes any cash or in-kind item provided to replace or repair a resource that has been lost, damaged or stolen (see §2137).

D. Income tax refunds.

E. Payments by credit life or credit disability insurance.

F. Proceeds of a loan. This includes money an individual borrows or receives as repayment of a loan.

G. Money paid by someone else directly to a supplier on behalf of an individual. However, goods or services the individual receives as a result of the payments may be income even though the third-party payments themselves are not.

H. Replacement of income already received; e.g., replacement of a stolen paycheck.

I. Weatherization assistance such as insulation or storm doors.

⁷ P. 400 §2129 Social Security Handbook, 13th Edition 1997

J. Any item (other than an item of food, clothing or shelter) which, if retained, would be an excluded nonliquid resource (see §2157).”

Both SSI and the Medicaid programs are needs-based, and too much of the wrong kind of income can disqualify the trust beneficiary from the program. There are a myriad of other needs-based programs, some national and some local, and each program has its own income rules.

Do supplemental needs distributions escape being disqualifying income for each needs-based program? Does the trust income reported on the beneficiary’s personal tax return (whether flow through from the grantor trust or by K-1 from the third party trust return) escape being disqualifying income for each needs-based program?

The trustee must understand how each of the beneficiary’s needs-based public benefit program’s define “income” before the trustee can answer either question.

Because public program administrators and case workers do not clearly understand the difference between the tax world income and program world income, the trustee faces much uncertainty when the two worlds intersect.

To help poor disabled beneficiaries, family members, advocates, and SNT trustees are slowly developing law in this area. The impact of particular distributions on a particular needs-based benefit is beyond the scope of this article.

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