SPECIAL NEEDS TRUSTS:
RECENT DEVELOPMENTS IN PLANNING FOR SPECIAL NEEDS CHILDREN

Presented by:

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I. INTRODUCTION

The laws and rules regarding special needs planning change over time, and most of these changes are not written in any one book that you can read to be up to speed. As I attend conferences, read postings on list-serves, and draft special needs trusts for families, I learn something new every week. Today we'll discuss some of the most recent law changes, and the issues the families may face in special needs planning.

The number of families with a child or other family member with a disability continues to grow. With advances in medical care, parents should no longer assume they will outlive their child. In fact, their son or daughter could very likely outlive his or her parents for decades. Planning for the future care of the child is vital to their well-being.

The cost for lifetime care for children with special needs can be daunting. Although government programs may help, they will not cover the entire cost, leaving the families to bear the expense. With the current political climate, we have no idea what the government programs for individuals with disabilities will look like next year, much less in 20 years. Therefore, future planning is urgent and essential for these families.

In many cases, families will create a life plan or person-centered plan for their child, using the services of a professional care manager or other expert. The parents may also draft a Letter of Intent to guide the future care of their child. The families can use these plans, and with the assistance of their financial advisor, determine an estimated dollar amount needed to provide for the lifetime care of their child. Financial advisors can recommend life insurance, investments and other vehicles to maximize the funds available for the child's care. Financial advisors, care managers, and attorneys work together to create a comprehensive plan with the best chance of success.

Today we'll also discuss several advanced planning strategies, including minimizing taxes and maximizing the resources available to the child with special needs, for the more sophisticated estate plans.

Keep in mind that in this paper I am greatly simplifying many issues. Government benefits, eligibility and special needs trusts can be complex and this article is not meant to substitute proper research or counsel.

II. GOVERNMENT BENEFITS

The government programs that are affected by Special Needs Trusts are “needs-based” or “means-tested.” They are only available to a person who is sufficiently disabled and financially needy. It is important to differentiate these programs from Social Security Disability or Medicare, because those programs are not based on financial need. It is vital to review the client’s benefits award letter to determine which benefits they are receiving rather than relying on the client’s memory.

A. GOVERNING LAW

Supplemental Security Income (‘SSI”) and Medicaid are federal programs administered by the states. Although federal laws and regulations apply, the Social Security caseworkers mostly rely on the Program Operations Manual System (“POMS”) when determining whether an applicant is eligible for benefits. The POMS contains the Social Security Administration’s (“SSA”) interpretations of the rules and law and their internal procedures. We must also consider how the Texas agencies and the Dallas Regional Office interpret the rules. SSA rules and interpretations can change at any time, and vary by state.

- SSI source of law: Social Security Act § 1611 *et seq.*; 42 U.S.C. § 1382 *et seq.*
- Federal regulations: 20 C.F.R. Part 416
- Program Operations Manual System (“POMS”): https://secure.ssa.gov/poms.nsf/Home?readform; https://secure.ssa.gov/apps10/poms.nsf/partlist
- Texas Medicaid for Elderly and Disabled Persons Manual (“MEPD”) https://hhs.texas.gov/laws-regulations/handbooks/medicaid-elderly-people-disabilities-handbook

B. PROGRAMS

SSI is Supplemental Security Income, which in 2022 is a check for up to $841 per month that is meant to be used for food and shelter. This amount may be less, as we explore below. Each year the SSA sets out how much the maximum SSI payment will be for that year.

Medicaid is basic medical care and other services. Many Medicaid services are now delivered by Managed Care Organizations.

Medicaid Waiver Programs provide in-home or community services to a person with a disability so that they do not have to live in a nursing home to get services. The wait list in Texas for some of these programs is 12-15 years. Medicaid waiver programs include CLASS, MDCP, HCS, DBMD, HCBS and STAR+PLUS Waiver.

Other government programs include the Health Insurance Premium Payment Program (HIPP), which may pay the child’s premium for private health insurance. Medicare Savings Program (QMB, SLMB) may help pay for co-pays or prescriptions.

These programs may provide in-home nursing or attendant care, supplies and equipment, home modifications, diapers, housing, job training and coaching, day programs, therapies and other services. There are 40 different Medicaid programs in Texas, and all of them have different eligibility requirements. It is important to stress that clients should place their child on the waiver wait list as soon as a diagnosis is received.

C. ELIGIBILITY REQUIREMENTS

1. Sufficiently Disabled

In order to receive these government benefits, the individual must be sufficiently disabled. An adult is disabled if he or she is unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment that can be expected to result in death or that has lasted or can be expected to last for a continuous period of at least 12 months.[1]

If a person makes more than $1,350 per month in 2022, they are considered to be able to perform substantial gainful activity and therefore are not considered disabled.

A child is disabled if he or she has "a physical or mental condition(s) that very seriously limits his or her activities; and the condition(s) must have lasted, or be expected to last, at least 1 year or result in death."[2]

2. Countable Income

In order to qualify for these benefits, the person must have less than $2,000 per month in countable monthly income for Medicaid, and if the individual is on SSI their countable income must not reduce their SSI by $841 per month.

"Countable income" for the purposes of government benefits is not the same as income as defined by the IRS. Income is defined as cash, food and shelter, and anything that can be converted into food and shelter.[3] The first $20 is not counted.

The government has set forth what it calls in-kind support and maintenance ("ISM"). Since SSI is to be used for food and shelter, if food and shelter is provided by someone else, it reduces the benefits dollar for dollar.[4] Shelter includes room, rent, mortgage payments, property taxes, and utilities.[5]

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[1] 42 USC §1382c(a)(3)(A); 20 C.F.R. § 516.905
[2] POMS DI 11055.001; See also 42 USC §1382c(a)(3)(C)
[3] 20 C.F.R. § 416.1120
[4] 20 C.F.R. § 416.1130-416.1148
[5] 20 C.F.R. § 416.1120

However, there is a One-Third Reduction Rule: if the beneficiary is living in the household of someone who is providing both food and shelter, the SSI benefit can be reduced by 1/3 instead of dollar for dollar.[6] Under the Presumed Maximum Value Rule, if the 1/3 reduction rule doesn't apply and someone provides any food or shelter, the presumed value of what is provided is 1/3 of the SSI check plus $20. The client can show that actual value is less, if appropriate.[7] The current SSI benefit is $841 per month, and 1/3 of that is $280, which would be deducted from the SSI check, so the beneficiary will receive $561.

There are exceptions to 1/3 Reduction Rule which may be helpful to your client. Under the Business Arrangement Rule, there is no reduction in benefits if beneficiary pays their pro rata share of the actual cost of food and shelter[8] as long as actual cost does not exceed the SSI rate plus $20. In addition, under the Rent Subsidy Rule, if the beneficiary pays rent that exceeds presumed maximum value (1/3 of maximum SSI rate plus $20), SSI is not reduced. This only applies if beneficiary lives with the parent/landlord.[9] To avoid a reduction based on ISM, the beneficiary must pay for their own food and other shelter expenses that are not rent, such as utilities.

If a Special Needs Trust ("SNT') owns a house, the shelter is not income to the beneficiary; but if the SNT pays for utilities, that is considered income if not reimbursed by the beneficiary.[10] It may be best in some circumstances for the trustee of the SNT to provide all food and shelter, resulting in a 1/3 reduction of SSI.

Under the concept of Deeming, the income of parent living in same household is deemed to be the income of a child under 18.[11] Deeming rules are quite complex and must be studied closely. Most of our clients' children are not eligible for SSI until they are 18 because of the deeming rule. There is no deeming, however, for most waiver programs, so the clients' children may be eligible for waiver programs regardless of parents' income.

Earned income (wages) reduces the SSI check 50¢ per dollar. Don't count the first $65.[12] Unearned income (such as investment income) nreduces SSI dollar for dollar.[13]

3. Countable Resources

[6] 20 C.F.R. § 416.1131; POMS SI 00835.210
[7] 20 C.F.R. § 416.1140; POMS SI 00835.300
[8] 20 C.F.R. § 416.1130(b), 416.1133
[9] 20 C.F.R. § 416.1130(b); POMS SI DAL00835.380
[10] See POMS SI 01120.200F1
[11] See 20 C.F.R. § § 416.1160-416.1169
[12] 20 C.F.R. § 416.1110
[13] 42 U.S.C. §1382a(a)(2); 20 C.F.R. § 416-1120-416.1211

In order to be eligible for SSI and Medicaid, the individual must have less than $2,000 in countable resources.[14] What is not countable is a home, one vehicle, household goods and personal effects. Everything else is countable.

Countable resources reduce SSI payment dollar for dollar. If countable resources exceed $2,000, the beneficiary is not eligible for SSI/Medicaid.

529 education savings accounts are not considered a resource, since the custodian can change the beneficiary, and the child has no power to direct the use of the funds for maintenance and support. In addition, an employment-related annuity owned by the beneficiary is not a countable resource. Be aware, however, that distributions are counted as income.

A Uniform Transfer to Minor Account is considered to be a resource at the time the child is eligible to receive funds at age 21 (in Texas), even if child doesn't withdraw the money at that time.

4. Special Rules

In Texas, if a person receives at least $1 of SSI, they automatically receive Medicaid. Receipt of an asset is considered income in the month received. If the beneficiary retains it past midnight of first day of next calendar month, it becomes a resource. The client may want to spend or transfer assets to an ABLE account in month received in order to avoid it becoming a resource.

There may be a transfer penalty imposed. If the beneficiary transfers an asset for less than fair market value within a look-back period of applying for benefits, they may be subject to period of ineligibility.

D. CHILD SUPPORT

Child support can disqualify a child from government benefits. 2/3 of child support received is considered income to a child under the age of 18 or under 21 and attending school.[15] 100% of child support is considered unearned income to the adult child not fitting the previous definition.[16] It is considered income for SSI/Medicaid purposes to child regardless of whose name is on the check or how it is spent.

One strategy is to use the Presumed Maximum Value, in which the parent pays support in the form of food and shelter, resulting in a 1/3 reduction of SSI. The parent can also pay for services directly to provider.

[14] 20 C.F.R. Part 416, Subpart L

[15] 42 U.S.C. §§ 1382a(a)(2)(E), (b)(1), (b)(9)
[16] POMS SI 00830.420C

The strategy we use most often is a Special Needs Trust. The obligor pays support to a Self-Settled SNT. The court order must irrevocably require the payment be made to the SNT. This results in no reduction of the SSI payment.[17] This is often the preferred strategy. The Texas Family Code was amended recently so that if a child support payment is paid to an SNT, it cannot be paid through the Attorney General's office. However, we have had success with the check being paid in the trustee's name, and deposited into the SNT checking account.

We often work with family law attorneys to draft the SNT, draft language to include in the child support decree, and educate the trustee (usually the parent the child resides with) on how to make distributions from the trust without affecting the child's government benefits.

E. CHANGE IN BENEFITS

When a parent starts receiving Social Security Retirement or Social Security Disability, or dies, the Disabled Adult Child ("DAC") may receive Social Security based on a percentage of the parent's social security benefit. To qualify for DAC, the child's disability must have begun prior to age 22 (be ready to supply proof to the SSA if the child is not already receiving SSI). If the Social Security DAC check is less than $841, the beneficiary's benefits may come from two different sources (Social Security and SSI).

After receiving Social Security DAC for 2 years, child will be eligible for Medicare. The child could be dual-eligible, receiving both Medicare and Medicaid. Disabled adult child benefits are not based on financial need, but on the fact that the parent contributed to the social security system. The client can go to ssa.gov to determine the amount the disabled adult child could receive.

The beneficiary may still need other government programs based on financial need, so you may want to retain eligibility by using a special needs trust.

III. SPECIAL NEEDS TRUSTS

Special Needs Trusts ("SNTs") are the most flexible tool to take countable assets that would disqualify a person from benefits and reclassify them so they are not countable resources. SNTs are a device used to legally maximize ownership of countable resources in order to qualify for the program benefits, while supplementing those benefits. The SNT supplements but does not supplant government benefits.

[17] POMS SI 01120.203B.f

Distributions from an SNT are not considered income to beneficiary for SSI/Medicaid purposes if they are properly distributed. The corpus is not a countable resource if the trust is properly drafted.

Who needs an SNT? Any person with disability who may need to qualify for benefits at some time, including long-term nursing care. We want to identify which program the beneficiary is receiving, and determine the eligibility requirements for that program. If the beneficiary is not yet receiving benefits, we base our planning on the basic SSI/Medicaid eligibility rules.

The client must report to SSA when the SNT is funded and go through the trust review process.

A. SELF-SETTLED TRUSTS

A Self-settled SNT is also called a first party trust, (d)(4)(a) trust, or Medicaid payback trust. The trust allows individual to put their own money in a trust and still qualify for public benefits. The biggest drawback is the Medicaid payback provision.

A self-settled SNT is created with assets of the beneficiary, such as a bank account, outright inheritance, personal injury settlement or child support.

The general rule is that a person cannot put their own money into a trust to qualify for public benefits. The SNT exception was established by a statute commonly called OBRA 1993.[18] If the beneficiary's assets are placed in a trust for his or her benefit, the trust is an available resource that can disqualify from SSI/Medicaid *unless* it complies with 42 USC § 1396p(d)(4)(a) (self-settled trust) or (d)(4)(c) (pooled trust).

In order to qualify as a d(4)(a) trust, the individual must be sufficiently disabled[19], and the beneficiary must be under the age of 65 when trust created and initially funded (funding after age 65 is treated differently). The trust must be for the sole benefit of only one beneficiary.[20] It can be established by the beneficiary's parent, grandparent, guardian or court. Under the new SNT Fairness Act, an individual with a disability can establish their own trust if they are mentally competent. This was signed into law December 3, 2016 as an amendment to 42 USC § 1396p(d)(4)(a). The trust must be irrevocable. The grantor can nominally fund with a $10 bill.

The biggest issue to remember with self-settled SNTs is the Medicaid payback. Assets in the trust when the beneficiary dies are used first to repay the state for what it has expended on behalf of the beneficiary for the beneficiary's lifetime in Medicaid medical care.

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[18] 42 USC § 1396p(d)(4)(a), as amended by the Omnibus Budget Reconciliation Act of 1993 ("OBRA 93")
[19] Defined in 42 USC § 1382c(a)(3) and § 1614(a)(3) of the Social Security Act
[20] See POMS SI 01120.201F.2

The advantages of a self-settled SNT include the fact that a transfer of the beneficiary's assets to the trust does not create a transfer penalty if made prior to age 65 (transfers after age 65 are subject to a transfer penalty). Assets in the trust are not considered an available resource to beneficiary for SSI/Medicaid eligibility. Trust assets can be used to pay for the special needs of the beneficiary.

Beware of the Sole Benefit Rule. The Social Security Administration ("SSA") interprets the law to require that the trust be used for the sole benefit of the individual.[21] If the trust benefits others during the individual's lifetime, the trust may be disqualified from the SNT exception.[22]

An early termination clause is not recommended, but if the trust has this provision, it should provide that upon early termination the remaining trust funds must first go to the state and then to the beneficiary (the beneficiary cannot hold power to terminate the trust early). If the trust allows for termination of the trust prior to the individual's death and payment of the corpus to another individual or entity (other than the State or another creditor for payment of goods and services provided to the induvial), it will result in disqualification for the SNT exception."[23]

One question we are asked is can the grantor name a trust protector with power to amend trust in the event the SNT rules change in order to maintain eligibility? Some attorneys believe that will disqualify a trust, but there is no definitive authority.

B. THIRD PARTY TRUSTS

1. Requirements

A third party SNT is created with assets that do not belong to the beneficiary. Parents or grandparents, for example, can fund this trust by gift, will, or beneficiary designation for life insurance or retirement benefits. The biggest distinction from a first-party trust is that a third party SNT has no Medicaid payback provision.

A third party SNT does not have to comply with OBRA 93, so it is more flexible. If the beneficiary does not have power to revoke the trust or direct the use of the trust assets for his or her benefit, the trust principal is not a resource for SSI purposes.[24] The sole benefit rule does not apply.

A third party SNT won't disqualify a beneficiary from Medicaid/SSI if the proper distribution standard used. (1) A strict special needs standard means that the trust is only

[21] POMS SI 01120.201F.2
[22] POMS SI 01120.203B.1e
[23] POMS SI 01120.203B.1e
[24] POMS SI 01120.200D.2

used for things the government does not pay for. (2) A pure discretionary standard gives the trustee discretion as to whether to make a distribution or not. (3) A third distribution standard is special needs or discretionary: the trust can be used to pay for things government benefits provide, if the trustee determines that it is in the best interest of the beneficiary to do so, even if it affects government benefits. Texas allows this third distribution standard. The support standard is acceptable in Texas only if trust has spendthrift and facility of payment clauses. Be aware that other states have different distribution standards. If the child moves to a different state, the trust may disqualify the child.

2. Provisions

The drafting attorney can add provisions to a regular third-party trust to make it an SNT. The trust is used to supplement but not supplant benefits. The following provisions can be added:

1) The settlor’s intent should demonstrate that the settlor intends that trust not disqualify the beneficiary from government benefits.
2) Special needs distribution standard: add language that the trust supplements, but does not supplant, government benefits. Remember that Texas allows a discretionary distribution standard.
3) Authorize in-kind distributions if it is in beneficiary’s best interest.
4) Facility of payment clause provides that the trustee can distribute to third parties for the benefit of the beneficiary.
5) Spendthrift clause—it is best to label it so that the SSA trust reviewer can locate it.
6) Broad trustee discretion can be added so that the SSI/Medicaid caseworker is less likely question a distribution as abuse of discretion.
7) Broad trustee investment powers allow the trustee to invest in non-income producing assets such as housing.
8) Early termination: be careful with an early termination clause that results in an outright distribution to the beneficiary, as it could cause trust to be considered a resource to the beneficiary unless upon early termination trust proceeds go to remainder beneficiary. Early termination clauses allow termination if the corpus is small, if the beneficiary is no longer disabled, or if the trust is deemed available resource.
9) Prohibit the beneficiary from serving as the trustee, revoking the trust, demanding or directing trust distributions, and removing or replacing trustee. These are essential provisions[25].

Keep in mind that an SSA employee will be determining whether this is an exempt trust, so use special needs language they will recognize.

You can also consider adding the following to a third-party trust:

[25] MEPD F-6100

1) Power to amend trust so that it remains an exempt trust if SNT rules change or the beneficiary moves to another state. The grantor may give amendment power to the trustee, trust advisor, or trust advisory committee.
2) Trust advisor or trust protector to oversee the trustee.
3) Trust advisory committee to assist with distribution advice. Sometimes we give this committee the power to remove or appoint a trustee, especially if a corporate trustee is serving.
4) Decanting power, so that the trust can be decanted if conditions change.
5) Power to convert the trust to a pooled trust. This is helpful if a trust becomes so small the corporate trustee will no longer manage the trust
6) Power to merge this trust with another one.

3. Testamentary vs. Living Trust

The Grantors may want to establish the SNT in their will or as a stand-alone trust. To determine which is appropriate for your client, questions include:

- Does the client want to use the probate process to establish the SNT? Then a testamentary trust may be used.
- Does the client expect others to contribute to SNT? Then a stand-alone trust may be used.
- Is trust the beneficiary of life insurance or retirement accounts? A testamentary or stand-alone trust could be appropriate.

4. Standalone SNT v. SNT Provisions in a Revocable Trust

Another decision the attorney must make is whether to draft a stand-alone SNT, or add SNT provisions to the parents' revocable living trust ("RLT").

If you add SNT provisions to a revocable trust, the entire trust will have to be submitted to the SSI or Medicaid benefits caseworker for approval. Some clients wish to keep the terms of their RLT confidential. However, in some cases it is appropriate to add SNT provisions to an RLT instead of a stand-alone trust if the distribution to beneficiary with disabilities is contingent upon other people not outliving the grantor.

A standalone SNT has several advantages. For example, others (such as grandparents) can contribute to the trust now. The parents, grandparents or others can set aside assets for the beneficiary during their lifetime, or leave assets to the SNT upon their death. Further, it may be easier to get approval of a stand-alone trust from the state as an exempt trust, since the caseworker is not reviewing provisions that don't apply to the special needs beneficiary. Lastly, the provisions in longer RLT may disqualify the beneficiary.

Standalone SNTs allow you to add more robust language concerning the care of a child who cannot advocate for themself or who has significant needs. The trust may contain more explicit instructions for a corporate trustee, and may create a support team for the beneficiary.

5. Revocable v. Irrevocable

The attorney must decide whether to draft the trust as revocable or irrevocable. With a revocable SNT, the client can change the provisions as the abilities of child change or as the SNT rules change. The client can change trustees or the remainder beneficiaries over time. A revocable SNT is usually drafted as a grantor trust for tax purposes, which means that the client does not use their gift tax exemption to fund it, income of the trust is taxed to the grantor, and the assets receive basis adjustment when grantor dies. It does not remove the assets from grantor's estate for estate tax purposes. If the parents fund the trust during their lifetime, the trust assets are available to grantor's creditors.

With some irrevocable SNTs, trust assets are not part of grantor's estate, and are not subject to the grantor's creditors. The trust income is not taxed to grantor (unless it is designed as an intentionally defective grantor trust). Income of the trust is taxed at the higher trust tax rate. Distributions from trust can pass income tax liability to the beneficiary. The grantor cannot amend the trust but may give a limited power to amend to a trust protector or trustee. Transfers to trust may be taxable gifts. It is not a present gift eligible for the annual gift tax exclusion unless Crummey withdrawal powers are given to the beneficiary. Be aware, however, that Crummey withdrawal powers are considered income or a resource of the beneficiary for SSI/Medicaid purposes, even if the beneficiary makes no withdrawal. When drafting, you may be able grant withdrawal powers to other beneficiaries of the trust[26] but proceed with extreme caution.

C. POOLED TRUSTS

A third option is a pooled trust: an individual can put their assets into a pooled SNT so that it does not count against them for public benefits eligibility purposes.

1. Statutory Authority

The federal statute setting out the requirements for a pooled trust are found at 42 U.S.C. §1396p(d)(4)(c). A pooled trust is established by a non-profit organization, and funds are pooled for investment and management purposes, with a separate account maintained for each beneficiary. The non-profit organization serves as the trustee. Upon the death of the beneficiary, the non-profit trustee can keep remaining assets for use of others, instead of paying back Medicaid, in some situations.

2. Texas Pooled Trust

[26] see Estate of Cristofani v. Commissioner, 97 T.C. 74 (29 July 1991)

The Arc of Texas Master Pooled Trust[27] is available to Texas residents who are disabled. The Arc invests the assets and serves as the distribution trustee for each individual trust. The client signs a joinder agreement, so no separate SNT document is required. The sub-account established by the individual, a parent, agent, guardian or court. It may be a self-settled or third party SNT, and is not counted as resource to beneficiary.

3. Termination Options

The grantor chooses who the trust is distributed to upon the termination of the trust. If it's a first-party trust, the grantor can chose to reimburse Medicaid, with excess going to family members; or the remainder can be retained by the pooled trust, and none goes to Medicaid or to family members. If the account is established by order of a guardianship court, the pooled trust cannot be the remainder beneficiary.

4. Advantages of Pooled Trusts

The pooled trust can provide professional management of trust assets at a lower cost than professional trustees. It can accept smaller trusts that are not economically feasible for corporate trustees. The pooled trust can provide professional administration at a generally lower fee. Pooled trusts can also accept trusts for individuals over 65 (subject to a transfer penalty).

D. WILL THE CHILD NEED GOVERNMENT BENEFITS AND AN SNT?

When we are preparing estate planning for a family with a special needs child, the parents may ask whether the child will need government benefits, and thus need an SNT.

If the parents have substantial assets, will the child need government benefits? Often times yes. Some services are only provided through Medicaid and are not available on the open market. Some services provided by Medicaid would be extremely expensive to pay for privately, and paying out of pocket may deplete the inheritance too early. Most often, the child will not be fully employed and will not have enough money to pay for long-term nursing care, and may need Medicaid.

We don't know what programs and services will be available in the future, so most clients will want to allow their child to maintain eligibility. Remember that the employer-provided health insurance of the parents goes away when the parents die, and then the child must purchase a private policy (which can be expensive and may not cover much) or private pay for medical care. Medicaid may be a good back-up.

Questions to consider when working with a family include: Could government benefits be a tool to assist the child? Could the beneficiary manage assets without assistance? It may

[27] https://www.thearcoftexas.org/trust/

be best to draft the trust with flexibility so that the child can qualify for benefits if he or she needs them. It may be a good idea to keep options open, and leverage assets so that the parents' money lasts for the child's lifetime.

The purpose of an SNT is not just to qualify the child for benefits. SNTs can provide for advocacy and create a support team for child who cannot advocate for himself or herself. SNTs can manage assets for a child who cannot manage it themselves, and provides asset protection. The trust can provide more detailed instructions to the trustee if the child is not able to communicate their needs.

E. QUALIFIED INCOME TRUSTS

If the individual with a disability's monthly income exceeds the income limits, the income may be able to be transferred to the trustee of a Qualified Income Trust, also called a Miller Trust. The trustee must pay the income out of the trust accordance with the statute.[28]

F. SPOUSAL SNTs

If a spouse is disabled or may become disabled and may need Medicaid for long-term nursing care, the client should not leave assets outright to the spouse but should use an SNT. It is important to note that a spousal SNT must be in a will, and not in a living trust. If the clients have a revocable living trust, upon the death of first spouse the trust must pour assets back into the will that has SNT language for the spouse.

G. COURT-CREATED TRUSTS

1. § 142 Management Trusts

Section 142 Management Trusts require a lawsuit, usually a personal injury suit[29]. It is established for an incapacitated person, and a corporate trustee is required. It must be for the sole benefit of the beneficiary. You will draft it as a self-settled SNT with Medicaid payback provisions.[30]

2. § 1301 Management Trusts

Section 1301 Management Trusts are created by a court for an incapacitated person[31]. It can be with or without a guardianship. 1301 trusts can be drafted as special needs trusts. Like 142 trusts, it is a self-settled with trust with Medicaid payback. The trust must name financial institution to serve as trustee except in certain situations.

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[28] 42 U.S.C. § 1396p(d)(4)(B)
[29] Tex. Prop. Code § 142
[30] Tex. Prop. Code § 142.005(g)
[31] Tex. Est. Code § 1301

With the recent changes in Texas guardianship laws, persons applying for guardianship must establish that less restrictive alternatives are not sufficient to care for the proposed ward. One alternative to guardianship of the estate is 1301 management trusts. In a large number of cases where a guardianship of the estate may have been appropriate, management trusts are now used.

H. STRATEGIES FOR SNT DISTRIBUTIONS

Improper distributions could disqualify the beneficiary, even if the trust is properly drafted and not considered a resource. The trustee must be aware of the rules when deciding which distributions to make and how to make them.

1. Trust Distribution Standards

There are two main types of distribution standards for SNTs. The Strict Special Needs Standard states that the trust cannot pay for anything that will affect the beneficiary's government benefits. Many old trusts contain this standard. The trust funds cannot be used for food and shelter, even if it would be in beneficiary's best interest.

The Discretionary Standard provides that the trustee can make distributions for things the government benefits provide if the trustee deems it in the best interest of the beneficiary, even if it reduces or disqualifies from benefits. For example, if the trustee decides that it is best if the trust pays for the beneficiary's food and shelter, even though it will reduce the SSI check by 1/3, the trustee may do so.

In Texas it is acceptable to use the Discretionary Standard. What if the beneficiary moves to another state? The trust may require a different distribution standard and may need to be modified.

2. Improper Distributions

The trustee cannot distribute cash to the beneficiary or caretaker. We also recommend that the trustee not use a debit card, since it could be considered the same as cash. If the trustee distributes cash, it is considered income to the beneficiary and can result in a reduction or loss of benefits.

3. Proper Distributions

The trustee can distribute trust funds for the beneficiary's needs, including dental/medical, equipment and supplies, therapies and rehab, education, recreation, attendant or companion care, and personal items. Typically, the trustee can use funds for everything the government benefits do not pay for, as long as it is for the beneficiary.

4. How to Make Distributions

The Trustee can pay vendors directly, or a credit card can be used for the beneficiary and the trustee pays off the credit card monthly with trust funds. A new and popular option is to use a True Link Card, which is a pre-loaded card. For example, if the trustee wants the beneficiary to have $500 a month for miscellaneous expenses, such as entertainment, clothing, or personal care, the trustee can transfer $500 from the trust bank account to the True Link Card. The trustee can set limits on where and on what the card can be used for. The beneficiary or their caregiver can then use the card like a debit card.

5. Home

A third-party SNT can own the home the child lives in. Maintenance and improvements can be made by trust, and are not considered In-Kind Support and Maintenance ("ISM"). Paying for utilities, taxes, etc. is ISM and will result in a 1/3 reduction of the SSI payment.

When a self-settled trust owns the home, be careful because of Medicaid payback. If other family members are living in the home, they may lose the home if the beneficiary dies.

6. Car

The trustee of an SNT can purchase a car for the beneficiary. Title can be put in the name of the driver. The trustee can place a lien on the title so the driver cannot sell or borrow against it. You will also want to name the SNT as a named insured on the auto insurance policy.

7. Travel

A self-settled trust cannot provide payment for travel expenses for family and friends to visit the beneficiary, as this provides a financial benefit to someone other than the beneficiary.[32] This interpretation was published in 2012, so it's important to review trusts drafted prior to that date. If the trust has language allowing payment for family travel, it's not an exempt SNT. A third-party can provide for expenses for family to travel to visit the beneficiary.

I. TRUSTEES

The grantor must choose a trustee who is knowledgeable about investments, accounting, taxes, government benefits, special needs law, the beneficiary's needs and how to meet them, and distribution rules. If an individual is chosen as the trustee, he or she must be willing to obtain counsel to learn how to properly administer the SNT without the loss of benefits. If the beneficiary is receiving HUD housing subsidies, the trustee cannot be a member of the same household.

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[32] POMS 01120.201

Corporate trustees that specialize in administering SNTs are often the best choice. They charge a fee, but they provide professional management and eliminate burdening family members or friends.

J. MILITARY SURVIVOR BENEFIT PLANS

In the past, members of the military faced a dilemma: they could name their child with disabilities as a beneficiary of their survivor benefit plan and risk losing SSI/Medicaid, or not name their child as a beneficiary and hope their child can survive on SSI/Medicaid. They were not allowed to name an SNT as a beneficiary. There is a new remedy.

1. Services Available for a Child with Disabilities

Service member can designate a disabled child over 18 as an Incapacitated Dependent (DD Form 137-5) so that the child has lifetime eligibility for TriCare health benefits and military post privileges. Medicaid and SSI may provide many services that TriCare does not (such as in-home caregivers, day programs, job coaching, supported housing).

2. Survivor Benefit Plan

The military's Survivor Benefit Plan ("SBP") allows members to select coverage for a spouse or a spouse and a child, and pays up to 55% of the member's retirement pay when the retiree dies. If the service member names a child with disabilities as a beneficiary of their SBP, those payments will count as income and may disqualify the child from much needed benefits. Previously they could not name an SNT as a beneficiary.

3. The Disabled Military Child Protection Act

Enacted in December, 2014, the Disabled Military Child Protection Act allows the service member to direct the payment of their SBP to an SNT for their child[33]. It must be a self-settled SNT with a Medicaid payback provision. The member makes an irrevocable substitute election, and needs to send a letter of assignment or complete DD Form 2656 Section X. You will also obtain a tax ID number for the SNT to provide so that there is no delay in annuity payments.

The attorney must send a verification letter (Attorney SNT Certification Form) certifying that the SNT is for the sole benefit of the child with a disability and is in compliance with federal and state laws. Mail the package to:

Defense Finance and Accounting Service
U.S. Military Retired Pay

[33] 10 U.S.C. 1448(b)(6); 10 U.S.C. 1450(a)(4); 10 U.S.C. 1455(d)(1)(C)

P.O. Box 7130
London, KY 40742-7130

Please note that this is not the third party SNT that the parents may have created to hold proceeds from their will or life insurance. These families may need a third party SNT to serve as a beneficiary of their estate plan, and a first party SNT to name as a beneficiary of the SBP.

K. COORDINATING THE PLAN

It is important to coordinate the SNT with the client's overall estate plan. One issue to discuss with the family is how much of the parents' estate goes to the SNT and how much goes the other children. We also provide our clients with the appropriate language to the grandparents so that they can name the SNT as a beneficiary of their estate planning. It is also imperative to ensure that the beneficiary designations for life insurance and retirement accounts are changed to properly name the SNT. Lastly, the client should designate a guardian for the child to serve if both parents pass away.

IV. INHERITED IRAS IN SPECIAL NEEDS TRUSTS

A. THE SECURE ACT

The Setting Every Community Up for Retirement Enhancement (SECURE) Act became effective January 1, 2020. The new distribution rules apply only to beneficiaries of participants who die after December 31, 2019.

When we prepare estate plans for parents of a child with special needs, we consider the tax ramifications of leaving retirement assets such as 401(k)s and Individual Retirement Accounts (IRAs) to a special needs trust. For simplicity's sake, I'll call these type of retirement assets "IRAs."

Under the new SECURE Act, most children who inherit a parent's IRA must cash out the IRA within 10 years of the parent's death (by the end of the calendar year in which the 10^{th} anniversary of the death occurs).

There is a major exception to this 10-year payout that is of most importance to us. An "Eligible Designated Beneficiary" (EDB) is not subject to the 10-year rule, but is entitled to distributions from the inherited IRA over their lifetime. The amount of the annual distribution is based on the IRS single life chart. This allows the account to grow tax deferred for the beneficiary's lifetime, usually resulting in a larger payout over time. We call this a "stretch IRA."

B. DISABLED OR CHRONICALLY ILL PERSONS

A person named as an IRA beneficiary who is disabled or who is chronically ill meets the definition of EDB and is entitled to the stretch of the inherited IRA.

A person is considered to be disabled by the IRS if he or she "is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual shall not be considered to be disabled unless he (sic) furnishes proof of the existence thereof in such form and manner as the Secretary may require."[34]

The IRS does not require that the beneficiary be determined to be disabled by the Social Security Administration, even though the definition of "disabled" is very similar. It may be possible for someone not receiving SSI or SSDI to be entitled to the lifetime stretch, but they must prove to the IRS that they are disabled.

A personal is considered to be chronically ill by the IRS if he or she unable to perform at least two daily activities of daily living for at least 90 days, or they must require "substantial supervision to protect such individual from threats to health and safety due to cognitive impairment."[35] A medical professional must certify that the inability is indefinite and "reasonably expected to be lengthy in nature."[36]

A chronically ill person certainly doesn't have to be receiving SSI or SSDI. A disabled person who is not receiving government benefits might more easily meet the definition of chronically ill.

C. SEE-THROUGH TRUSTS

If the trust that is named as a beneficiary of an IRA qualifies as a "See-Through Trust," the IRS looks though the trust and treats the trust beneficiary as the Designated Beneficiary.

In order to qualify as a See-Through Trust, the trust must meet these requirements:

1. The trust is valid under state law[37] at the date of death of the participant. It may be an inter-vivos or testamentary trust.
2. The trust must be irrevocable or will become irrevocable upon the death of the participant.[38]

[34] I.R.C. Sec. 72(m)(7)
[35] I.R.C. Sec. 7702B(c)(2)
[36] Sec. 401(a)(9)(E)(ii)(IV)
[37] Reg. Sec. 1.401(a)(9)-4, A-5(b)(1); see also Reg. Sec. 1.401(a)(9)-5, A-7(c)(30, Examples 1 and 2
[38] Reg. Sec. 1.401(a)(9)-4, A-5(b)(2)

3. The beneficiaries of the trust must be identifiable from the trust instrument.[39]
4. The trustee must supply certain documents to the plan administrator by October 31 of the year following the year of the death of the participant,[40] including a final list of beneficiaries and a copy of the trust instrument.[41]
5. All beneficiaries must be "Designated Beneficiaries," or human individuals. If a beneficiary is the estate or a charity, the trust does not qualify as a See-Through Trust.

A **conduit trust** provides that distributions from the trust must be paid immediately to the beneficiary. Distributions, which include the required as well as discretionary distributions, cannot be retained or accumulated in the trust. Required distributions for a conduit trust are calculated based on the life expectancy of the primary beneficiary.[42] The remainder beneficiaries of the trust are not considered, even if they are an older person, a charity or an estate. A conduit trust will qualify as a See-Through Trust.

An **accumulation trust** allows the trustee to accumulate distributions in the trust—they do not have to be paid out immediately to the beneficiary. Under the pre-SECURE law the remainder beneficiaries are not ignored. The IRS will use the life expectancy of the oldest of the primary beneficiary *and* the remainder beneficiaries in determining the distribution payout.[43]

An accumulation trust may or may not qualify as a See-Through Trust. The IRS looks at who, under the terms of the trust, is entitled to the trust property immediately and outright when the primary beneficiary dies. If these are individuals, the trust is a See-Through Trust. If the remainder beneficiaries are a charity or estate, it is not a See-Through Trust. This determination is made at the time of the participant's death, and who actually ultimately inherits the IRA is irrelevant.

Since the IRS looks at the primary and the remainder beneficiaries in determining who is the oldest beneficiary for the accumulation trust, it was important to draft the trust so that the remainder beneficiary is younger than or near to the age of the primary beneficiary. Similarly, if an estate or charity is named as the remainder beneficiary, the trust does not qualify as a See-Through Trust.

The best practice may be to name specific people as the contingent beneficiaries. It is important to look closely at a power of appointment, as it may result in the beneficiary not being identifiable or may result in an older person being the designated beneficiary.

[39] Reg. Sec. 1.401(a)(9)-4, A-5(b)(3)
[40] Reg. Sec. 1.401(a)(9)-4, A-6(b
[41] Reg. Sec. 1.401(a)(9)-4, A-5(b)(4)
[42] I.R.C. Sec. 409(a)(9)-5, A-7((c)(3), example 2
[43] Reg. Sec. 1.401(a)(9)-5, A-7(c)(1)

Naming the beneficiary's estate as a remainder beneficiary could also cause the trust to fail as a See-Through Trust.

The advantages of an accumulation trust are that it allows for tax-deferred growth and lifetime payout, while providing the protections of a trust (creditor/spouse/bloodline protection). If the beneficiary does not need the distribution in a given year, it can be retained in the trust to grow. The disadvantage is that it is more complex and could result in higher income taxes.

D. THIRD-PARTY SPECIAL NEEDS TRUSTS

If the trust beneficiary is a person with disabilities who may rely on government benefits based on financial need, the trust should be drafted as a third-party Special Needs Trust. If done properly, the trust will not be considered a resource to the beneficiary. If the trust is drafted as a conduit trust, all distributions must be paid to or on behalf of the beneficiary, which could be considered income for SSI/Medicaid eligibility purposes. Conduit trusts are generally not used for special needs beneficiaries.

An accumulation trust may be the best option for a beneficiary with disabilities who needs to qualify for public benefits. You may draft the trust as a discretionary supplemental needs trust. Under the SECURE Act, an accumulation trust for a disabled beneficiary counts as an EDB as a sole beneficiary, regardless of who the remainder beneficiary is. The disabled beneficiary just has to be the life beneficiary. [44]

It is not clear under the SECURE Act whether we still need to draft the SNT with remainder beneficiaries who are younger or near the same age as the primary beneficiary. It appears that the primary beneficiary's life expectancy is used, regardless of who is named as the contingent beneficiary. It may still be best practices to name only individuals (and not a charity) as remainder beneficiaries, who are near in age to the disabled beneficiary. We hope the IRS will clarify this issue.

E. INCOME TAXATION OF AN INHERITED IRA TRUST

A trust that is the beneficiary of inherited IRAs is taxed as a complex non-grantor trust, and so all of Section V of this paper applies. These trusts may qualify as a Qualified Disability Trust and receive a larger exemption.

After the participant's death, distributions from the retirement account are considered gross income to the trust. The general rule is that if income is accumulated in the trust, the income is taxed to the trust. If income is distributed, the trust receives an income tax deduction and the beneficiary reports it as income. The beneficiary is taxed at a usually much lower marginal rate, and it may result in no taxation.

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[44] Sec. 401(a)(9)(H)(iv)(II), (v)

Further, distributions from the inherited IRA generate Income in Respect of a Decedent, so IRD rules should be consulted if the estate is subject to estate tax. The rules regarding taxation of trusts are complex, and the practitioner or client may want to consult with a tax expert regarding the trust taxation.

F. TRUSTS FOR ROTH IRAS

Roth IRAs may be better for accumulation trusts and SNTs, because the growth and distributions are not taxed to the beneficiary (the income tax was already paid by the plan participant). Then the higher trust rate does not cause as much of a problem. Roths are also beneficial because the participant does not have to take out required distributions over their lifetime, so the account can grow tax-free for his or her lifetime. Thus, the taxation of an inherited Roth in an accumulation trust can be significantly lower than that of a traditional IRA.

G. SEPARATE SHARE RULE

If the participant names a single trust for multiple beneficiaries as a beneficiary of their IRA (and does not name the separate sub-trusts on the beneficiary form), after the participant's death the beneficiaries cannot create separate shares with separate life expectancies as they may have been able to do prior to SECURE. Distributions will be based on the life of the oldest beneficiary. The one exception is that a separate share can be created for a person who is disabled or chronically ill.[45]

H. PLANNING CONSIDERATIONS

The client may want to leave their IRA to special needs beneficiary (in trust) since the beneficiary may be in a lower income tax bracket than the other children, and leave tax-free assets such as life insurance to the other children. Also, a surviving spouse could disclaim a portion of an IRA so that it goes to the SNT. If the child is employed and earns his or her own IRA, it cannot be put into an SNT.

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[45] I.R.C. Sec. 401(a)(9)(H)(IV)

V. ESTATE TAX PLANNING AND POTENTIAL PITFALLS

Many parents with children with disabilities want to provide for their child while retaining eligibility for government assistance. If your clients are wealthy enough to be concerned about gift or estate tax, then their child won't need government benefits, right? Not necessarily. Some families with taxable estates do create special needs trusts for their children. Some grandparents require tax planning and want to provide for their disabled grandchild. However, many tax planning techniques could be detrimental to beneficiaries receiving government benefits. Crummey withdrawal rights and disclaimers, for example, could disqualify them from SSI or Medicaid. Estate tax planning for a family with a child with disabilities must be done carefully.

A. DISCLAIMERS

A disclaimer is a refusal "to accept an interest in or power over property" the person in entitled to under a will or trust.[46] The disclaimer must be in writing and signed.[47] If the beneficiary makes a "qualified disclaimer" under federal law, the property will be treated as if it was never transferred to the beneficiary.[48]

However, if the beneficiary is or will be receiving needs-based government benefits, the disclaimer will be considered a transfer for less than fair market value. The disclaimer will result in a transfer penalty or a reduction or loss of benefits.[49]

B. LIFETIME GIFT TO SNTS

If the client, while they are living, uses their own assets to fund a trust for someone else, it may be considered a gift. If the grantor funds a trust and the grantor retains control of the trust assets, it is not a gift. If the grantor funds an irrevocable trust and retains no control, it may be a gift. Typically funding a revocable trust or grantor trust is not gifting.

Some clients want to gift their Annual Exclusion Amount to an SNT for their loved one. If a gift is made to a revocable third-party SNT and the distributions are subject to the discretion of the trustee, the beneficiary does not have a present right to possess and enjoy the property. It is a future interest and so it does not qualify for the annual exclusion.

If the grantor does not have a taxable estate, they may not be interested in the gift qualifying for the annual exclusion. If the client wants the gift to qualify for the exclusion, however, the trust must include certain withdrawal powers.

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[46] Texas Property Code Sec. 240.002(2)
[47] Texas Property Code Sec. 240.009(a)
[48] IRC Sec. 2518
[49] See 1 T.A.C. Sec. 358.401; MEPD E-3372

C. PROBLEMS WITH CRUMMEY POWERS AND POSSIBLE SOLUTIONS

A gift to an irrevocable SNT is a present interest only if beneficiary has withdrawal powers.[50] The problem for a beneficiary with disabilities, of course, is that withdrawal power means the beneficiary has a right to the demand or possess the property for that period of time. The amount subject to the withdrawal right may be considered income or a resource to the beneficiary during the withdrawal period for SSI/Medicaid purposes, which could affect their eligibility for government benefits. Failure to exercise the withdrawal right does not prevent it from counting against the beneficiary for SSI/Medicaid purposes; in fact, it may be considered an uncompensated transfer.

Another potential problem is that the failure to exercise the right of withdrawal may be considered to convert a third-party SNT into a self-settled SNT, which would require the inclusion of a Medicaid payback provision. The portion of the trust subject to the withdrawal right may be considered to be the beneficiary's own funds, even if the beneficiary does not exercise the right. If the beneficiary's own funds are co-mingled with third-party funds, the SSA may consider the entire trust to be a first-party SNT, requiring a Medicaid payback.

Some attorneys believe that by limiting the amount of the withdrawal to the greater of $5,000 or 5% of the trust assets ("5 or 5 Powers"), the trust is not converted into a self-settled trust.[51] While this may be true from an IRS standpoint, the author could not find caselaw in which the SSA or Medicaid took this position.

To avoid benefits disqualification, one option is to give the withdrawal power to someone other than the person with disabilities. An SNT is usually drafted for the sole benefit of the disabled beneficiary, so there are usually no other primary beneficiaries to which to give the withdrawal right. However, the trust usually will name remainder beneficiaries, and the withdrawal right can be given to them.

In Estate of Cristofani v. Commissioner,[52] the tax court held that Ms. Cristofani could grant the withdrawal power to the vested remainder beneficiaries, and not just to the primary beneficiary. The court stated that the lifetime gifts were complete, and that no gift tax was incurred. We call these 'Cristofani Powers." You may want to add language to your trust specifically prohibiting the disabled beneficiary from having withdrawal powers. When the remainder beneficiaries fail to exercise the withdrawal right, the contribution will be held in the trust for the benefit of the disabled beneficiary.

Some attorneys have offered another option of establishing the withdrawal period for less than 28 days. They believe this will create a present interest, but since the withdrawal right terminates before the end of the calendar month, it is not considered income or a resource

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[50] *Crummey v. CIR*, 397 F.2d 82 (9th Cir. 1968)
[51] See IRC Sec. 2041(b)(2)
[52] 97 T.C. 74 (1991)

for SSI/Medicaid purposes. The author could find no reported cases in which this strategy was approved by the SSA or the Medicaid authorities as a way to avoid loss of benefits.

Lastly, your client could simply use up part of their gift/estate tax exemption when funding an SNT, and not bother with trying to qualify for the Annual Exclusion. Then no withdrawal rights need to be given. The client can then use the exclusion gifts to fund their other children's trusts. The client may file a 709 return for the taxable gift to the SNT. If the client does not and likely will not have a taxable estate, they probably won't need to include withdrawal powers anyway.

Be aware that the lapsing of the withdrawal right may cause all or part of the trust to be included in the beneficiary's estate for estate tax purposes.[53] If the client wants to make the trust GST exempt, so that the remainder beneficiaries don't pay tax, the trust may be drafted with Hanging Crummey Withdrawal Rights using the 5 or 5 formula.[54] Hanging withdrawal powers provide for a gradual lapse of the powers. This would be problematic for a person receiving government benefits. Typically clients are not as concerned about estate tax after the disabled beneficiary dies, since their main goal is to provide for the loved one with special needs. These types of trusts are highly complex and a tax attorney may need to be consulted.

D. IRREVOCABLE LIFE INSURANCE TRUSTS

The client may remove life insurance proceeds from their taxable estate by creating an Irrevocable Life Insurance Trust ("ILIT"). The trust owns the insurance policy on the grantor's life. The grantor cannot serve as the trustee or have any other rights. In addition to reducing estate taxes, ILITs are useful to provide liquidity upon death in case the other estate assets are illiquid, replace charitable gifts so that the children receive an inheritance, or provide for children from a prior marriage. They can also be used to fund an SNT for a disabled beneficiary.

The annual premium payments typically are contributed to the ILIT by the client, and the trustee then pays the premium. The contributions can qualify for the gift tax exclusion if the beneficiaries have a Crummey withdrawal power and receive proper notice. Again, it is important to be careful giving withdrawal rights to a person receiving needs-based government benefits. The client may want to use Cristofani rights and give the withdrawal powers to the remainder beneficiaries of the trust.

If the ILIT provides for grandchildren, the grantor will also file a gift tax return to allocate the GST exemption.

ILITs can be useful for special needs planning. Married clients can purchase a second-to-die policy in an ILIT, and the ILIT can pour into an *irrevocable* third-party SNT after both

[53] See IRC Sec. 2041; 2514, 2036, 2038
[54] IRC Sec. 2514(e)

spouses pass away. You may want to draft and execute the ILIT and the SNT at the same time.

E. GRANTOR RETAINED ANNUITY TRUSTS

A Grantor Retained Annuity Trust ("GRAT") is another way to remove an asset from the client's taxable estate. It is an irrevocable trust that holds an asset for a period of time, during which the grantor can receive annuity payments. At the end of the period, the trust property is transferred to the beneficiaries with no gift or estate tax.

GRATs are useful for a rapidly appreciating asset such as a closely held business that may soon be sold. GRATs work best in a low interest rate environment. Upon funding the GRAT, the grantor has made a taxable gift to the beneficiaries, and since it is a gift of a future interest the annual exclusion cannot be used. A gift tax return must be filed, and the gift tax is calculated based on the value of the trust property minus the present value of the annuity payments.[55]

GRATs can be used by parents to fund an irrevocable third-party SNT that is intended to be non-GST. Since the grantor is not trying to create a present gift, the trust does not have to provide Crummey withdrawal powers.

F. QUALIFIED PERSONAL RESIDENCE TRUST

A Qualified Personal Residence Trust ("QPRT") is an irrevocable trust created to own and hold a residence (primary or secondary).[56] It can remove the residence from the taxable estate of the grantor. The grantor transfers the real estate to the trust, and has a right to live there for a period of years. The grantor uses up part of their gift tax exemption, and reports the gift on the gift tax return. The value of the property may be discounted, which reduces the exemption used.

When the trust period ends, the ownership of the residence can be transferred to a beneficiary or to a trust for the beneficiary. The grantor can still live in the home, and pay rent to the new property owner. The new owners will not receive a step-up in basis, but will retain the donor's original basis.

A QPRT may be an option to transfer a home to a child with disabilities. If the parents own a second home that they intend for their special needs child to live in, they may use a QPRT to transfer ownership of the home to an irrevocable third-party SNT at the end of the period.

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[55] IRC Sec. 2702; Treas. Reg. Section 25.2702-1, -2
[56] IRC Sec. 2702(a)(3)(A)(ii)

G. CHARITABLE REMAINDER TRUST

A Charitable Remainder Trust ("CRT") provides a distribution of a specified amount or percentage to the grantor or some other designated person for a term of years or the life of the recipient. At the end of the trust term, the remaining trust assets go to a charity.

If the grantor names someone other than him/herself as the recipient, the grantor makes a taxable gift upon funding the trust. The grantor's charitable deduction is based on the actuarial value of the remainder interest that will pass to charity.

Such a trust may be appropriate for a client:

- seeking an income tax deduction
- seeking to reduce estate tax,
- does not need the assets for the client's owns needs
- wants to use it for their disabled child's care
- wants the remaining trust assets to go to charity.

The trust perhaps could be drafted as an SNT, naming the child with disabilities as the current recipient.

H. CHARITABLE LEAD TRUST

A Charitable Lead Annuity Trusts ("CLAT") is another method for transferring assets to the client's heirs without estate tax. This irrevocable trust provides for annual payments to a charity for a fixed term, such as 20 years, and at the end of the term the remaining trust assets are transferred to the heirs. This allows a charitably minded client to achieve their philanthropic goals yet still provide for their children or grandchildren at a later date. It provides the client with an income tax charitable deduction (calculated per IRS rules), and may be ideal for an appreciating asset. The client can use their gift tax exclusion to initial fund the trust, so no Crummey withdrawal powers are needed.

A CLAT can pour into an irrevocable SNT upon the end of the term. This trust may be useful if the client does not need the funds for the beneficiary's care for several years. For example, if the parents have sufficient income to care for their child for the next 20 years, but want to make sure the child is cared for after they retire or die, they may consider a CLAT.

I. HEALTH AND EDUCATION EXCLUSION TRUST

The client can make unlimited "qualified transfers" for a beneficiary's tuition and medical expenses without using their gift and GST exclusion if the payments go directly to the school or medical care provider.[57] Eligible medical expenses include amounts paid for medical insurance or medical treatment, but does not include those that are reimbursed by insurance. Making these qualified transfers removes the asset from the client's estate, free of gift/estate and GST taxes.

The client can establish a Health and Education Exclusion Trust ("HEET") and gift assets to the trust to pay for those expenses as they arise. This trust is useful for clients who wish to pay for their grandchildren's school and medical needs, since it is not subject to GST tax and does not use up the GST exclusion. The gift to the HEET may be subject to gift tax unless it is drafted to qualify as a present interest gift. HEETs are most often used as a way to provide for grandchildren without paying GST tax.

Drafting a HEET to qualify as an SNT could be tricky. Payments from the trust are made directly to the educational institution or medical care provider. Distributions for education are allowed for tuition only—not for room or board.[58] If the trust is drafted with the "supplement but not supplant" language of an SNT, it can be argued that the distribution is not income to the SNT beneficiary for SSI/Medicaid purposes. If the client is funding the trust with their gift tax exclusion, Crummey/Cristofani withdrawal powers must be addressed.

VI. ABLE ACCOUNTS

A. OVERVIEW

Individuals with disabilities face a dilemma when they try to save money. If a single person has more than $2,000, they could lose their valuable Supplemental Security Income (SSI) or Medicaid services, which for some folks mean losing housing and medical care. The Achieving a Better Life Experience (ABLE) Act was enacted in December, 2014, to enable those with special needs to save money in an ABLE account without jeopardizing their eligibility for needs-based benefits. This new tool adds options for individuals with special needs, but does not replace other tools such as special needs trusts.

B. STATUTORY AUTHORITY AND STATE PROGRAMS

Achieving a Better Life Experience Act of 2014[59] allows states to establish saving programs. In 2015 the Texas legislature passed a law to allow Texans to use ABLE

[57] IRC Sec. 2503(e), 2611(b)(1), Treas. Reg. Sec. 25.2503-6(a)
[58] Treas. Reg. Sec. 25.2503-6(a), -6(b)(2)
[59] Internal Revenue Code 26 U.S.C. § 529A

accounts.[60] Some Treasury Regulations to guide the states have been issued and some are still in progress.

The Texas ABLE program is now established and has a very helpful website.[61] Other states allow non-residents to open accounts. Many of our clients have used the Ohio program[62], as it is well established and has a debit card available to connect with the account. This helps keep track of expenditures. The account is created easily online.

C. FEATURES

An ABLE account may be established for any individual who became disabled or blind prior to the age of 26. If an individual is receiving SSI or Medicaid, they are considered disabled. If the person has not received a disability determination by the Social Security Administration, they must submit a disability certification with supporting documentation to the ABLE program.

An individual is allowed to have only one ABLE account, but anyone may contribute to the account. If the beneficiary is not able to open their own account, an agent, parent or legal guardian may establish the account. The beneficiary is considered to be the owner of the account, regardless of who has signatory authority.

The individual or contributor may fund the account with an annual contribution not to exceed the annual gift-tax exclusion amount ($16,000 in 2022). The accounts may accumulate up to the state's limit for 529 education plans (currently $500,000 in Texas).
SSI, however, only exempts the first $100,000. If someone receiving SSI saves over $100,000, they would lose eligibility for SSI, but would remain eligible for Medicaid. Further, distributions for certain housing expenses are not disregarded for SSI purposes.

ABLE accounts are funded with after-tax dollars, and interest earned is not taxed if the funds are used for Qualified Disability-Related Expenses (QDE). Allowable expenses include education, housing, transportation, employment support, health and wellness, legal fees, assistive technology and personal support, funeral and burial, and other personal expenses. Qualified distributions are not taxable to the contributor or the beneficiary. A distribution for a non-qualified expense is subjects the beneficiary to income tax and a 10% penalty. The ABLE account owner should keep records to prove the funds were used for disability related expenses.

D. ABLE ACCOUNTS AND SSI

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61 www.texasable.org

62 www.stableaccount.com

The corpus of the ABLE account is not a resource to beneficiary for SSI/Medicaid eligibility. Interest is not income to beneficiary, and distributions are not income to the beneficiary if they are made for QDE. Distributions for food and shelter are not considered income. The client may have to provide records to the SSA to prove that the distributions were for QDE. The SSA has issued a POMS update on their policy for the treatment of ABLE accounts[63]. You will want to read it when using ABLE accounts as part of your client's plan.

The SSA may want an accounting of how the client uses the ABLE account. We advise clients to scan the receipts of everything the account is used for, so that they can document the distributions to prove they were used for QDE.

E. MAJOR DRAWBACK

The major drawback of ABLE accounts is the Medicaid payback provision. When the beneficiary dies, the remaining funds must first be used to reimburse Medicaid for payments made on behalf of the beneficiary subsequent to the establishment of the account. If the account beneficiary is receiving Medicaid, one must carefully consider how much should be placed in the ABLE account.

F. COMPARE ABLE ACCOUNTS WITH SNTS

If the clients are funding the account with someone else's money, note that a third party SNT has no Medicaid payback provision, but an ABLE account does. Also note this difference: a self-settled SNT has a Medicaid payback for expenditures for entire lifetime, whereas an ABLE account must pay Medicaid back for expenditures on behalf of the beneficiary after ABLE account is created.

G. EFFECTIVE USE OF ABLE ACCOUNTS

There are several situations where an ABLE account is an effective planning technique. Relatives and trustees can provide food and shelter up to $16,000 per year without creating income by running the funds through the ABLE account. The family can pay for some food and shelter without reducing SSI check by 1/3. It can also be used for overpayment of government benefits (past payments paid in lump sum), or to allow an individual to save their own earnings or gifts. We've also used of to hold small inheritances.

The IRS allows the rollover from a 529 education account to an ABLE account. If the parents or grandparents established a 529 account and then the child does not go to college, the parents or grandparents can name another child as a beneficiary of the 529, or roll it over into an ABLE account for the disabled child.

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[63] POMS SI 01130.740 https://secure.ssa.gov/apps10/poms.nsf/lnx/0501130740

H. HOUSING AND WAGES CAVEATS

If the purpose of the distribution is for housing, if the distribution is retained the next calendar month following month of receipt, it is considered a resource.[64] It is important to not put rent into ABLE account until the month it will be paid out.

We have been asked if a beneficiary can have their wages deposited directly into the ABLE account and avoid the income counting against them. The SSA has said that no, the wages are still considered income to the beneficiary (see footnote 63).

I. CONCLUSION

The ABLE Act brings attention to the special needs community and allows people with disabilities to become more independent. While ABLE accounts provide an additional option for individuals with special needs, it is not appropriate in every circumstance and may not subvert the need for other tools in planning for those with special needs, such as the Special Needs Trust.

VII. NEW FIXES AND POST-DEATH REMEDIES

Imagine the case where a person with a disability receiving needs-based benefits is the beneficiary of a decedent's will or trust, and that will or trust does not include a special needs trust. The inheritance will count as a resource and disqualify the beneficiary from SSI/Medicaid. The distributee may be able to create an SNT for the funds, but it must be a self-settled SNT, with a Medicaid payback provision. Fortunately, new statutes allow for the modification or reformation of the will or trust to create a third-party special needs trust without Medicaid payback.

A. WILL MODIFICATION OR REFORMATION

The probate court can modify or reform a will in cases where a distributee receives SSI or Medicaid, in order to protect those benefits. Texas law provides that the court may order that the terms of the will be modified or reformed in order to qualify a distributee for government benefits as long as it is not contrary to the testator's intent[65]. The modification changes the will to create a testamentary third-party SNT. Some attorneys are using this method to pourover into a standalone SNT.

The personal representative is the applicant. The statute applies to cases pending or filed after September 1, 2015. The action must be filed within four years of admission of will to

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[64] POMS SI 01130.740D.2
[65] Tex. Est. Code § 255.451(a)(2)

probate.[66] The order may state that it is retroactive to the date of the decedent's death.[67] This hopefully will prevent the agency from determining that it overpaid the recipient for that time period prior to the court order. The SNT should name beneficiary's estate as the remainder beneficiary, according to respected Texas SNT attorneys. This modification avoids need for first-party Medicaid payback SNT because this is a third-party SNT.

B. TRUST MODIFICATION OR REFORMATION

Likewise, a trust may be modified or reformed to create an SNT for a beneficiary receiving needs-based benefits. In past years trusts could be court-modified to allow a beneficiary to qualify for benefits "because of circumstances not known to or anticipated by the settlor," if the order furthers the purposes of the trust.[68] The applicant had to prove that the settlor did not anticipate that a beneficiary would be eligible for or receiving public benefits.

New: the new statute specifically allows modification in order "to qualify a distributee for government benefits" if it is not contrary to the settlor's intent.[69] The new statute also allows reformation of a trust in order to qualify a distributee for governmental benefits.[70] The applicant is not required to prove that the settlor did not anticipate a disabled beneficiary. The trust is modified or reformed to create an SNT. The trustee or beneficiary is the applicant. The order may be retroactive.[71] It's possible that self-settled SNTs may be modified or reformed using this technique in the event of a change in POMS or other SNT rule changes.

C. TESTAMENTARY TRUST MODIFICATION

Should you use Estates Code §255 for wills or Trust Code §112.054 for trusts to reform or modify a testamentary trust? Glenn Karish takes the position that the Trust Code is preferable.[72] The Estates Code provides that the personal representative can bring the action, whereas the Trust Code allows a trustee or beneficiary to seek reformation. The Estates Code action must be filed within four years of the court order admitting the will to probate, but trust modification does not have a deadline.

D. BENEFICIARY DESIGNATION MODIFICATION

Unfortunately, if a person receiving public benefits is named as the beneficiary of life insurance or retirement accounts and no SNT is established, there is no statutory remedy to modify the beneficiary designation.

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[66] Tex. Est. Code § 255.451(a-1)
[67] Tex. Est. Code § 255.453
[68] Tex. Prop Code §112.054(a)(2)
[69] Tex. Prop Code § 112.054(a)(4)
[70] Tex. Prop. Code § 112.054(b-1)
[71] Tex. Prop. Code § 112.054(c)
[72] See page 13 of Glenn Karish's 2017 Texas Legislative Update

The inheritance is considered income in the month received and a resource if retained the next month, and could disqualify the beneficiary from SSI/Medicaid. If the beneficiary disclaims his or her interest, that disclaimer is considered a resource because the beneficiary had a legal right to the funds.

The beneficiary may be able to create a self-settled SNT with a Medicaid payback provision. The beneficiary may also spend down the money in month of receipt to purchase non-countable resources or to pre-pay for services. The individual could also put up to $16,000 per year, with a maximum of $100,000 total, into an ABLE account.

The SSA has no formal rule on how they treat inherited IRAs. The local SSA office more often than not holds that if the IRA is not in required distribution stage, it does not count as a resource. When the IRA is in required distribution state, the principal is not counted as a resource but the distributions are counted as income. An inherited IRA is in required distribution stage, and so the income will count against the beneficiary.

When the disabled person is named outright as a beneficiary of an IRA, we have had success with creating a first party SNT as an accumulation trust, so that the trust qualifies for the stretch of the IRA, and distributions are made based on the life expectancy of the beneficiary.

E. DECANTING

It may be possible to decant a trust, where the trustee transfers the property from a trust that does not include special needs trust provisions into one that does. It is not conclusive as to how the SSA will interpret such a transfer. If the original trust is a third-party trust, will the SSA consider the new trust to be a self-settled trust and require Medicaid payback? It can be argued that it will still be a third-party trust with no Medicaid payback. Does the state agency consider this a transfer to be subject to the transfer penalty? Maybe not if trust has a spendthrift provision.

A trust may be decanted per the terms of the trust. Statutory decanting[73] is possible but may be a challenge since the original trust is usually a limited discretionary trust, and so the new trust must have the same beneficiaries. Counsel may consider adding provisions to current trusts to allow an independent trustee to decant.

Even though decanting may be allowed by the trust or by statute, the question is how will the SSA or the HHSC treat the decanting. Since there are no clear guidelines from the government, it may be risky to decant. Since we have judicial modification available, that may be the best option.

[73] Tex. Prop. Code §112.071-112.087

F. OTHER OPTIONS

Will or trust modification or reformation may not be appropriate in some situations. In such cases, the individual can consider other options:

- "Spending down" by:
    - Purchasing non-countable resources (home, car, household goods/personal effects)
    - Pay off debt
    - Prepay for therapies, education, attendant care (have contract or receipt)
    - Pre-need funeral plan (irrevocable)
- Transferring up to $16,000 per year to an ABLE Account
- Joining the Arc of Texas Pooled Trust

VIII. <u>TAXATION OF SNTS</u>

When looking at SNT tax issues, we look at who is taxed on the trust income, whether the grantor made a completed gift, and whether it is part of the grantor's estate for federal estate tax purposes.

A. SELF-SETTLED SNTs

A self-settled or first party SNT is taxed as a grantor trust as to the beneficiary. Income generated by the trust is taxed at the beneficiary's marginal tax rate. An EIN is optional—usually the social security number of the beneficiary is used as the tax ID number.

B. QUALIFIED DISABILITY TRUST

A third-party SNT may be entitled to special tax benefits if it meets the requirements of a Qualified Disability Trust ("QDT").

A Qualified Disability Trust is entitled to claim a larger deduction from federal income taxes. In 2022, that deduction is $4,450. Trust income up to that amount is not taxed. Contrast this with a simple trust that has a deduction of $300, or a complex trust with a deduction of $100.

A trust is a Qualified Disability 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.[74]

The 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."[75]

In order to be a QDT, a trust must meet the statutory requirements of 42 U.S.C. 1396p(c)(2)(B)(iv):

(i) It must be irrevocable;

(ii) It must be for the sole benefit of the disabled beneficiary;

(iii) The beneficiary must be under the age of 65; and

(iv) The beneficiary must be disabled as defined for purposes of the Supplemental Security Income (SSI) and Social Security Disability Income (SSDI) programs.[76]

Most first-party SNTs would be a Qualified Disability Trust. A third party SNT, however, could qualify for QDT status if the beneficiary is receiving SSI or SSDI, the trust is irrevocable, the disabled beneficiary is the sole beneficiary, and the trust was funded before the beneficiary reached the age of 65.

Case Study

Parents create a revocable third-party SNT for their child, and fund it with their own funds while they are living. This is taxed as a grantor trust as to the parents. This trust does not qualify as a QDT because the trust is not a separate tax payer, and the trust is revocable.

Case Study

Parents create a third-party SNT for their child, and it is not funded until both parents pass away. When the parents die, the trust becomes irrevocable, so it could qualify as a QDT if the child is under 65 at that time.

Case Study

Grandparents establish an irrevocable SNT for their disabled grandchild, naming someone other than the grantors as the trustee. The grandparents fund the trust with their annual gift tax exclusions each year ($16,000 each in 2022). The grandchild is a minor and has not applied for SSI/Medicaid because the income and resources of the parents are deemed to be that of the child, and disqualify the child. Since the grandchild has not received a

[74] I.R.C. Sec. 642(b)(2)(C)
[75] I.R.C. Sec. 642(b)(2)(c)(ii)
[76] 42 U.S.C. 1396p(c)(2)(B)(iv)

disability determination from the Social Security Administration, the trust is not a QDT. When the child turns 18 and receives SSI/Medicaid, the trust will qualify as a QDT for that year.

Case Study
Parents create a pot trust for their children but only one is disabled. The pot trust is not a QDT, since all of the beneficiaries are not disabled.

C. GRANTOR TRUSTS

Third-party SNTs can be taxed as grantor trusts. A revocable trust in which the grantor is also the trustee and has full control over the trust is usually a grantor trust. A revocable SNT created and funded by the child's parents while they are alive may be taxed as a grantor trust during their lifetime.

A grantor trust allows the grantor to retain enough control that the grantor is treated as the owner of the principal and income for tax purposes.[77] Under certain circumstances the trust will be considered a grantor trust, such as:

1. The grantor retains a reversionary interest of at least 5%;[78]
2. The grantor retains beneficiary enjoyment of the corpus or income;[79]
3. The grantor retains certain administrative powers;[80]
4. The grantor has the power to revoke;[81]
5. Income can be used for the benefit of the grantor;[82]

Income on a Grantor trust is taxed to the grantors as if they owned the assets outright. The trust is not treated as a separate taxpayer, and the trust is essentially ignored for federal income tax purposes. The trust's income, tax deductions and credits are taxed to the grantor, even if distributions are made to the beneficiary. The grantors must include the trust income, deductions and credits on their personal income tax return. The grantors will be taxed at the rate that is applicable to their tax bracket. The beneficiary is not taxed for any distributions made on his or her behalf.

A separate tax ID number is not required for a grantor trust.[83] Typically, the clients use the social security number of one of the grantors as the tax ID. The trustee must prepare a statement for the grantor showing the trust's income, deductions, and credits so that the

[77] I.R.C. Sec. 671-677
[78] I.R.C. Sec. 673
[79] I.R.C. Sec. 674
[80] I.R.C. Sec. 675
[81] I.R.C. Sec. 676
[82] I.R.C. Sec. 677
[83] 26 C.F.R. Sec. 301.6109-1(a)(2)(i)(B)

grantor can report it on his or her tax return.[84] The trustee may also file a separate Form 1041 tax return for the trust if there are multiple grantors.[85]

<u>Case Study</u>
Parents create a revocable SNT for their child, the parents are the trustees and they fund it with their own money while they are living. Income on the trust assets is added to the parents' other income to determine their income tax rate. The income is paid by the parents and not the trust.

<u>Case Study</u>
Parents create a revocable SNT for their child, the parents are the trustees, and they fund it with their own money while they are living. When both parents pass away, the trust is no longer a grantor trust.

D. NON-GRANTOR TRUSTS

Third-party SNTs can be taxed as non-grantor trusts. A grantor trust created by the child's parents becomes a non-grantor trust when the grantors die. Also, if third-parties, such as grandparents, contribute to the SNT created by the parents during the parents' lifetime, the trust is taxed as a non-grantor trust as to the contributions of the third-parties. Testamentary trusts are always non-grantor trusts.

A non-grantor trust is taxed as a separate tax paying entity, and has its own tax ID number. The income tax rates for non-grantor trusts are "compressed," and the trust reaches the highest tax rate at a much lower income than the personal tax rate. In 2022, the top tax rate of 37% is reached when the non-grantor trust income is over $13,450. Contrast this with a single individual, who reaches that top rate with income over $539,900, or a married couple with income of $647,850.

A non-grantor trust can be taxed as a simple trust or a complex trust, and the classification is made on a year-by-year basis.

1. Simple Trust

A trust is taxed as a simple trust if:

1. The terms of the trust require all income to be distributed currently;[86]
2. The terms of the trust do not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes;[87] and

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[84] 26 C.F.R. Sec. Sec. 1.671-4(b)
[85] 26 C.F.R. Sec. 1.671-4(a)
[86] I.R.C. Sec. 651(a)(1)
[87] I.R.C. Sec. 651(a)(2)

3. The trust must not actually distribute anything other than the income required to be distributed.[88]

A simple trust has a deduction of $300, so the first $300 in income is not taxed.[89] Since the simple trust is required to distribute out all income, the income passes through to the beneficiary who pays the income tax.[90] Of course, the trustee will want to consult with a tax professional to determine appropriate deductions and taxes.

It is unlikely that a third-party SNT would be taxed as a simple trust since under its terms it does not require income to be distributed, principal can be distributed, and the trustee has discretion to make distributions or not. Read the terms of the trust to determine if it is a simple trust.

2. Complex Trust

Most, if not all, third-party SNTs that are non-grantor trusts are taxed as complex trusts, since they are discretionary trusts and the income is not required to be distributed. The trustee can accumulate income and distribute principal. A complex trust reports its income and deductions on its own tax return, Form 1041. The beneficiary is taxed for his or her proportionate share of the Distributable Net Income and the trust receives a deduction for the distribution.

A complex trust is one that does not qualify as a simple trust.[91] In any year is which the following occurs, the trust is taxed as a complex trust:

1. Income is required to be accumulated;[92]
2. The trustee has the discretion to accumulate or distribute income, even if the trustee actually distributes all of its income for that year;[93]
3. Principal is distributed;[94] or
4. A charitable contribution is made.[95]

A complex trust receives a deduction of $100, so the first $100 in income is not taxed.[96]

3. Carry-out of Income to Beneficiary

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[88] I.R.C. Sec. 651(a)
[89] I.R.C. Sec. 642(b)(2)(B)
[90] I.R.C. Sec. 652
[91] I.R.C. Sec. 661(a); Reg. § 1.661(a)-1
[92] Treasury Regulations (Reg.) § 1.661(a)-2(a)
[93] Treas. Reg. § 1.651(a)-2(c)
[94]Treas. Reg. § 1.651(a)-3
[95] Treas. Reg. § 1.651(a)-4
[96] I.R.C. Sec. 642(b)(2)(A)

A distribution from a complex trust for the benefit of the beneficiary "carries out" income to the beneficiary. The trustee must prepare and send a Schedule K-1 to the beneficiary to show the income the beneficiary must report on his or her tax return. The K-1 should categorize the type of income earned by the trust, such as interest, tax-exempt interest, and dividends. The beneficiary reports this income on their personal income tax return and pays the appropriate tax, if any.

The beneficiary pays tax on their proportionate share of the Distributable Net Income ("DNI"). DNI is the maximum amount of taxable income that is taxed to the beneficiary as a result of distributions for the beneficiary.[97] The computation of DNI is fairly complicated and is calculated under I.R.C. Sec. 643(a). If the distributions are less than the DNI, the trust pays income tax on the difference.

Can the trust pay the beneficiary's income tax? In most cases, tax professionals will tell you yes. If the trust is pushing out income to the beneficiary, paying his or her taxes does not violate the sole benefit rule for the special needs trust.

4. 65 Day Rule Election

A special 65-day rule, called a Section 663(b) election, allows the trustee of a complex trust to determine at the end of the taxable year to make a distribution within the first 65 days of the following year, but the distribution is treated as having been made in the preceding year. This gives trustees more flexibility to time distributions for income tax reasons. The trustee may want to distribute the DNI but can't determine the trust income until after the books are closed for the year. If the trustee makes this election, the trustee has 65 calendar days from the end of the tax year to make a distribution for the benefit of the beneficiary.[98] The election must be made before the return due date.[99] The distribution is then taxed to the beneficiary.

5. Distribution Deduction

The complex trust will receive a deduction against income for distributions made for the benefit of the beneficiary.[100] The deduction cannot exceed the DNI. Distributions from tax-exempt income is not deductible,[101] for example.

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[97] I.R.C. Sec. 643(a)

[98] I.R.C. Sec. 663(b)
[99] Reg. Sec. 1.663(b)-2(a)(1)
[100] I.R.C. Sec. 661(a)
[101] I.R.C. Sec. 661(c); Reg. Sec. 1.661-(c)(1)

The trust can deduct "amounts properly paid or credited or required to be distributed."[102] This includes discretionary payments made by the trustee,[103] annuity payments paid from principal,[104] and payments in kind.[105] The distribution deduction is pro rata; that is, in the same proportion of the class of income used to compute DNI.

If the trust has multiple beneficiaries, the DNI is allocated under a complicated tier system, depending upon whether the distributions to that beneficiary are mandatory or discretionary.[106] A separate share rule allocates the DNI when the beneficiaries receive disproportionate distributions.[107]

6. Expense Deductions

In addition to DNI, certain expenses are deductible and can reduce the complex trust income tax of a complex trust. The rules are detailed, and a CPA should be consulted to determine appropriate deductions. Some common expense deductions include:

1. Ordinary and necessary expenses paid or incurred for tax advice and representation, with respect to the determination, collection, or refund or any tax;[108]
2. Personal, casualty, or theft losses, subject to the $100 deductible and the 10% adjusted gross income limitation;[109]
3. Taxes set forth under the Internal Revenue Code Section 164, including real and personal property taxes and state income taxes;[110] and
4. If the trust is a Qualified Disability Trust, a deduction of $4,450; or if not a QDT, a deduction for $100 for complex trusts.[111]

Expenses must be allocated between taxable and tax-exempt income.[112] Depreciation and depletion deductions will be allocated between the trust and the beneficiaries based on the proportion of net accounting income less distributions of net accounting income. The trust provisions or state law, however, may allow the entire depreciation deduction to be taken by the trust.

7. What is Trust Income?

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[102] I.R.C. Sec. 661(a)(2)
[103] Reg. Sec. 1.661(a)-2(c)
[104] *Ibid*
[105] Reg. Sec. 1.661(a)2(f)
[106] I.R.C. Sec. 662(a)
[107] I.R.C. Sec. 663(c)
[108] I.R.C. Sec. 212(3)
[109] I.R.C. Sec. 165(h)
[110] I.R.C. Sec. 164
[111] I.R.C. Sec. 164
[112] I.R.C. Sec. 265

Usually, the mere funding of a trust is not a taxable event. When the grantor establishes the trust and the grantor or someone else funds the trust, no income tax is due.

Trust Accounting Income of a complex trust is determined under the terms of the trust instrument and state law.[113] The trustee determines whether disbursements and receipts are allocated to income or principal. To determine what is income, the trustee must read the trust and examine the Texas Principal and Income Act. There is no standard method for determining what is trust income.

The general rule is capital gains are not included in DNI, and are taxed at the trust level.[114] There are some exceptions to this rule that can cause capital gains to allocated to trust accounting income or to principal, or distributed to the beneficiary. The trust instrument and state law are also instructive.

Generally, trusts report income based on a calendar year.

E. TRUST TAX RATES FOR 2022

The applicable rates for ordinary income earned by complex trusts for 2022 are:

Income is Over	But not over	The tax is	Of the amount over
$0	$2,750	$0 + 10%	$0
$2,750	$9,850	$275 + 24%	$2,750
$9,850	$13,450	$1,979 + 35%	$9,850
$13,450	--	$3,239 + 37%	$13,450

Be aware of the "Kiddie Tax" imposed for investment income for individuals under the age of 18 (or a full-time student aged 19-24).[115] Parents can elect to report the child's interest, ordinary dividends, and capital gains distributed on their return in some situations.[116]

Case Study
The non-grantor trust investments earn income of $15,000, but the trustee distributes $30,000 for the beneficiary's care. The $15,000 in income is carried out to the beneficiary.

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[113] I.R.C. Sec. 643(b)
[114] I.R.C. Sec. 643(a); Reg. Sec. 1.643(a)(3)

[115] See I.R.S. Form 8615
[116] See I.R.S. Form 8814

The trustee issues a K-1 and the beneficiary reports the $15,000 as income on his/her income tax return. The beneficiary is in the lowest income tax bracket of 10% so their tax would be $1,500, but the standard deduction for a single taxpayer is $12,950, so the beneficiary pays no income tax. The $15,000 is a deduction to the trust, so the trust is not subject to income tax.

Case Study
A QDT earns income of $15,000 but does not make a distribution to the beneficiary that year. The trust is entitled to the QDT $4,450 deduction, so $10,500 is subject to income tax at the trust tax rate, which is calculated to be $2,206.50.

Case Study
A QDT earns income of $35,000 and distributes $15,000 for the beneficiary. $15,000 is carried out to the beneficiary, and $20,000 is retained by the trust. The trust is entitled to the QDT $4,450 deduction, so $15,500 is subject to income tax, which is calculated to be $3,997.50 at the trust tax rate.

1. Net Investment Income Tax/Medicare Surtax

Net Investment Income Tax (NII), or Medicare Surtax, is an additional tax of 3.8% imposed on some complex trusts' unearned income.[117] It is calculated on the lesser of the trust's undistributed net investment income or excess of the trust's adjusted gross income over the dollar amount at which the highest tax bracket begins, which is $13,450 in 2022. Because of this low threshold, a trust could be subject to the NII tax way before an individual would. However, the trust income is subject to this tax only to the extent that the net investment income is not distributed to the beneficiary.

2. Capital Gains Tax

Long-term capital gains of complex trusts are also taxed as compressed tax rates. Long-term capital gains of less than $2,800 are not taxed, gains between $2,800-$13,700 are taxed at 15%, and trust LTCG of over $13,700 are taxed at 20%. Contrast this with a single person, who reaches the top 20% bracket at an income of over $445,850.

F. TRUSTEE DUTIES REGARDING TAXES

A trustee owes a fiduciary duty to the beneficiary, and that includes making sure a tax return is filed on behalf of the trust. The Trustee must also consider taxation in making investment and distribution decisions. Distributions can be part of the tax planning.

[117] I.R.C. Sec. 1411

Throughout the year the trustee should review the investment statements. Consider the effect any gains or losses, and especially unrealized gains or losses. Perhaps the loss could be realized in the same year in order to offset the gain.

The trustee should hire a tax professional to prepare the trust tax return form 1041. The trustee will review the form before it is filed. Review the types of income the trust received (such as interest, dividends, capital gains, IRA distributions), as well as the deductions. Review the various tax rates to determine whether you should make investment or distribution changes the following year.

At tax time a K-1 will be prepared by the CPA and issued to the beneficiary. It shows the DNI—the income that was distributed. This amount is deducted from the 1041, and the beneficiary declares that amount as income on their personal form 1040.

The trustee may want to consult with the financial advisor and tax professional throughout the year to determine whether it is best for the trust to pay income tax or to push it out to the beneficiary. In some situations, the trustee may make distribution determinations based on this calculation. The trustee must determine what type of income it is. It may be tax-exempt income, capital gains, or ordinary income. Ordinary dividends are taxed as ordinary income, but qualified dividends that meet certain requirements are taxed at lower capital gain rates.

The trustee should also consult with the financial professionals to determine what types of investments to use. For example, if the trustee plans to accumulate the trust income that year because the beneficiary's needs are met by other sources, the trustee may want to invest the assets in such a way as to reduce the income tax, since it won't be distributed out to the beneficiary and would be taxed at the higher trust tax rate.

Case Study
The beneficiary's current needs are being provided for by his/her parents and the trustee has determined that it would be in the best interest of the beneficiary to make no distributions until the parents pass away, at which time the beneficiary's needs will not be met by other sources. The trustee can work with the financial advisor to determine what investments can grow the trust fund without producing high ordinary income.

Case Study
The trust has produced income, and the trustee, after consulting with the financial professionals and the beneficiary, determines that it would be best to distribute that income for the beneficiary's needs and carry out the income to the beneficiary rather than pay the higher trust tax rate. The trustee can make a Section 663(b) election, and make the distribution within the first 65 days of the following year, but the distribution deduction will be taken in the prior year.

IX. FINAL REMARKS

A document alone is not sufficient protection for a child or loved one with disabilities. A team approach is the best indicator of success. Attorneys, advisors, care managers and trust officers can work with the clients to create a plan for the best life of the child.

Please remember that this paper provides a broad survey of special needs law, and its scope is limited. Many of the issues regarding SSI/Medicaid eligibility and special needs trusts are complex and contain exceptions and further details which are not within the scope of this paper. Readers are recommended to do their own research when assisting clients with a loved one with special needs, or work with an experienced special needs trust attorney.