

NALTA Quarterly



THE JOURNAL OF THE
NATIONAL ■ ACADEMY ■ OF ■ ELDER ■ LAW ■ ATTORNEYS

VOLUME 14 ■ NUMBER 3 ■ SUMMER 2001

Guest Editor's Message

BY IAN S. OPPENHEIM, CELA

2

The Progeny of Link-Cricchio

BY CLIFTON B. KRUSE, JR., ESQ.

4

The Dark Side of Pooled Trusts

BY RENÉE LOVELACE, CELA

6

Distribution Standard for the Special and Supplemental Needs Trust

BY CYNTHIA L. BARRETT, ESQ.

10

Special Needs Trusts: Administration and Compliance*

BY ROGER M. BERNSTEIN, ESQ., LL.M.

13

Taxation of Special Needs Trusts

BY ROBERT FLEMING, CELA AND STUART MORRIS, CELA

18

Taxation of Special Needs Trusts

BY ROBERT FLEMING, CELA AND
STUART MORRIS, CELA

With the reduction of available services to disabled individuals and the increasing costs associated with these services, Special Needs Trusts (SNTs) have become more common in order to preserve the assets and benefits of disabled individuals. Although there is a considerable body of information about SNTs, less help is available when it comes to the taxation issues involved in their design and administration.

SNTs include concerns about income taxes, gift taxes, estate taxes and even (though rarely) generation-skipping taxes. While most of the more difficult problems center on income taxation, each of the other types of tax issues may be involved in a given trust.

Two broad categories of SNTs exist. Some SNTs are established by (and with the assets of) a third person for the benefit of the disabled public benefits recipient. Others are established with funds which would otherwise be directly available to the beneficiary, whether by the beneficiary or by another person (or a court) acting in the beneficiary's stead. As with SNT construction, the distinction is of paramount importance for tax considerations. Some practitioners use the terms "Supplemental Needs" or "Supplemental Benefits" to describe one or the other of the basic types of Special Needs Trusts, but there is no consistent distinction in practice or the literature.

Third Party Created Trust for a Public Benefits Recipient

A SNT may be created by a donor who chooses to set aside for a disabled individual without jeopardizing that beneficiary's eligibility for public benefits. The donor's goal in such a case will usually not be to establish public benefits eligibility for the donor, but to continue existing benefits eligibility. This occurs most frequently when a parent would like to establish a trust for a disabled child. This may also arise when the spouse of a Medicaid recipient, or potential Medicaid recipient, wishes to leave some or all of their estate in trust for the benefit of a disabled spouse.

When providing estate planning services the attorney should determine whether there are any beneficiaries who receive benefits from government programs and how this affects the client's estate planning goals. If the beneficiary is a disabled child or grandchild who receives government benefits, the goal should be to implement a plan which preserves the assets being distributed to the disabled beneficiary without jeopardizing the recipient's government benefits. Sometimes a disabled beneficiary is not already receiving public benefits but might qualify for future

benefits. In either case protection of the public benefits eligibility can be accomplished through the use of a SNT.

Generally, government programs for disabled beneficiaries only provide the disabled beneficiary with a subsistence level of benefits. A SNT affords clients the opportunity to supplement the state and federal benefits by providing for collateral needs not covered under the government programs such as travel, entertainment, and (of particular importance in many cases) uncovered therapy and/or medication.

During the estate planning process, the fact that assets which are available to the disabled beneficiary may cause the beneficiary to become ineligible for government assistance is frequently overlooked. For example, the transfer of property to a fiduciary (such as a Trustee or Custodian) who later relinquishes control to a disabled minor beneficiary when he or she reaches majority may result in the loss of government benefits upon the later transfer. This may force the disabled beneficiary to become responsible for medical care costs originally covered by the government and will likely deplete the beneficiary's inheritance rapidly. A SNT circumvents this avoidable trap.

Even if the disabled beneficiary possesses the mental faculties to manage the trust assets at majority, a SNT ensures both the proper management of assets and the continuous receipt of government benefits. Thus, if the goal is to supplement and not replace government benefit programs, a SNT is a practical solution.

Where a trust is created by a third party for the beneficiary, the trust will almost always be a separate taxpayer. The trust will have its own EIN (employer identification number) and the trustee will file annual state and federal fiduciary income tax returns.

Most third-party SNTs will be "complex" trusts within the meaning of Treas. Reg. §1.661(a)-1. This treatment is obtained when (a) the trust is not a grantor trust and (b) the trust instrument itself does not require distribution of all income, which will be the case in most third-party SNTs. "Complex" trust status is to be distinguished from treatment as a "simple" trust, which is obtained regardless of actual distributions when the trust's governing instrument requires distribution of all income to the beneficiary. The practical result of the distinction between "complex" and "simple" trusts is that the former will treat income as taxable to the beneficiary only to the extent it was actually distributed to the beneficiary, while the latter will treat all income as taxable to the beneficiary whether distributed or not.

To the extent that distributions have been made to the beneficiary in a given year, the trust return will show distributions of income to the beneficiary and a K-1 will be sent to the beneficiary. The K-1 will report that income has been paid to the beneficiary and will include the beneficiary's Social Security number.

Self-Settled Trust for Public Benefits Recipient

A SNT may also be established for a disabled individual with the individual's own funds. This occurs most

(continued on page 19)

Taxation of Special Needs Trusts

(continued from page 18)

frequently when there is lawsuit recovery or settlement or if the disabled individual is a beneficiary of an estate or insurance policy. Creating and administering this type of trust are extremely challenging due to the heavy correlation between trust requirements and the often inconsistent and unclear rules of the public benefits programs with regard to such trusts. It is only by scrutinizing the rules of each program for which a client may wish to qualify that it is possible to draft a trust that will not jeopardize the public benefits eligibility of the beneficiary.

The central difficulty in understanding income taxation of self-settled SNTs arises from the compressed nature of the income tax rates on trusts. While an individual pays taxes at the highest marginal tax only on income in excess of \$250,000,¹ trusts ordinarily reach the same highest marginal rate at income of only \$7,500.²

Fortunately, self settled special needs trusts (that is, trusts created by the beneficiaries or by another with the beneficiary's own assets) are almost always "Grantor Trusts" for income tax purposes pursuant to the provisions of IRC. §§671-678. The income generated by a grantor trust is taxed to the grantor. Thus, in most cases, all of the income generated by the self-settled SNT, whether distributed to the grantor or not, will be reported on the income tax return of the grantor.

Although this may seem problematic, the result is normally positive. There is one small potential benefit when income is taxed in the SNT itself, since trust administration expenses can be deducted from income without having to reach the two percent floor imposed on individual taxpayers.³ In most circumstances, however, this benefit to direct trust taxation is far outstripped by the income tax benefit to having income "passed through" to the beneficiary by treatment as a grantor trust.

For planning purposes, one goal of most self-settled SNT drafting may be to ensure treatment as a grantor trust.

Three popular methods to accomplish this result are (1) to give the beneficiary a special power of appointment,⁴ (2) to allow the beneficiary to substitute property of equal value,⁵ or (3) to permit the beneficiary to borrow from the trust without giving adequate security.⁶ Although the last power may be somewhat more problematic, none of these powers should interfere with public benefits eligibility or sound administration of the trust, while preserving favorable income tax treatment.

Note that a power of appointment results in grantor trust treatment even though the beneficiary is in fact incapable of exercising the power. If the beneficiary is capable, or may later recover capacity, a power of appointment helps maximize the beneficiary's autonomy and self-determination. For these reasons the inclusion of a power of appointment is the most frequently used method of preserving grantor trust status.

When the SNT primarily (or solely) includes personal needs settlement proceeds, special rules may apply. Generally, a personal injury settlement or verdict is not subject to income tax whether the recovery is paid in a lump sum or in periodic payments.⁷ The tax-exempt nature of the income will be available to the beneficiary of a grantor trust as well, since the trust's income and deductions are reported directly on the beneficiary's personal income tax return. The punitive and interest portion of damages, and any recovery for nonphysical injury or sickness, however, is likely to be subject to income tax. Any income (interest, dividends, etc.) generated by the funds, including income arising from structured payments after they are paid to the trust, will of course also be subject to income tax regardless of grantor trust status.

The IRS maintains that I.R.C. §2036 covers a trust containing a litigation settlement. A litigation-funded SNT is also likely to be considered a grantor trust for federal income tax purposes. A grantor trust's income, deductions,

(continued on page 20)

The central difficulty in understanding income taxation of self-settled SNTs arises from the compressed nature of the income tax rates on trusts. While an individual pays taxes at the highest marginal tax only on income in excess of \$250,000,¹ trusts ordinarily reach the same highest marginal rate at income of only \$7,500.²

1. IRC §1 (a) - (c).

2. IRC §1(d).

3. IRC §67.

4. IRC §674

5. IRC §675(4)

6. IRC §675(2)

7. IRC §104(a)(2)

Taxation of Special Needs Trusts

(continued from page 19)

credits, etc. are includible by or allowable to the grantor in calculating his/her individual income tax.

Many personal injury cases, medical malpractice cases and workers' compensation cases are settled using a structured settlement annuity issued by a licensed insurance company providing a stream of payments to the plaintiff. The payments are usually made monthly and continue for the life of the plaintiff. Payments can be guaranteed for an alternate beneficiary if the plaintiff dies prematurely. These annuities must be bought and paid for directly by the defendant, in order to retain their income tax-free character. Actual receipts of the funds and subsequent purchase of an annuity by the plaintiff, or constructive receipt of funds, will cause the annuity to be treated as having been purchased by the beneficiary directly, resulting in taxation of that portion of the annuity payouts representing income on the initial purchase.⁸

Effect of Reporting Individual Income

Regardless of the tax status of a given SNT, any taxable income actually paid to or for the benefit of the disabled beneficiary will be distributed to the beneficiary for tax purposes. This will either be evidenced by preparation and delivery of a K-1 (in the case of a non-grantor trust) or by inclusion of all taxable income on the beneficiary's own return (in the case of a grantor trust). In either case the beneficiary, trustee and family members may be concerned about the reporting of any income on the beneficiary's return.

Although careful documentation is essential, inclusion of income on the beneficiary's return will not automatically result in suspension, loss or reduction in public benefits. "Income" for income tax rules is not the same as "in kind distributions" for public benefits programs such as Supplemental Security Income and Medicaid. Although public benefits eligibility workers may have failed to grasp that distinction in the first years after creation of SNTs, the concept has become rather more widely understood and accepted in subsequent years. Inclusion of income in the beneficiary's tax return may require careful explanation in subsequent years, but should not cause anything more than administrative difficulty.

One approach to this distinction might be to report the income tax treatment to the public benefits program immediately. Especially when the SNT trustee is also the representative payee for public benefits, it might be strategically sound to simply submit a copy of both the trust and individual income taxes to the Social Security Administration (for instance), along with an explanation distinguishing between income tax and public benefits treatment of income.

Estate Tax Treatment of Special Needs Trusts

The commuted value of any guaranteed payments remaining in a structure on the death of the annuitant is an item subject to estate tax. To calculate the estate tax, the IRS suggests including the present value of the future guaranteed payments. The present value is calculated by discounting the face value of the payments by an interest rate that is 120 percent of the federal mid-term interest rate then in effect. The trustee must make sure that the estate has sufficient liquidity at all times to cover the estate tax due on the commuted value of the annuity. Certain life insurance companies offer structures that have a no-cost rider which allows the commutation of the future value at the time of death, in order to pay estate taxes.

Otherwise the remaining balance in a self-settled SNT will almost always be taxed as part of the beneficiary's estate, even if the SNT was not subject to grantor trust treatment for income tax purposes. The beneficiary's estate will include any assets transferred out of the beneficiary's name (as when

the trust was established and funded) if the beneficiary retained any beneficial interest, even though the income benefit was necessarily limited by the special needs language.⁹

A third-party Special Needs Trust will not usually be treated as part of the beneficiary's estate for estate tax purposes, and such treatment will not usually be desirable. One exception: if the SNT is expected to hold substantial appreciable assets (such as growth stock, real estate or other investments expected to increase in value over the life of the trust) and yet remain below the taxable level, it might be beneficial to pass the assets through the

(continued on page 21)

Many personal injury cases, medical malpractice cases and workers' compensation cases are settled using a structured settlement annuity issued by a licensed insurance company providing a stream of payments to the plaintiff. The payments are usually made monthly and continue for the life of the plaintiff.

8. IRC §61(a)(9).

9. IRC §2036(a)

Taxation of Special Needs Trusts

(continued from page 20)

beneficiary's estate in order to obtain a stepped-up basis. If that result is desirable, the trust can include a general power of appointment exercisable by the beneficiary, though this may expose the trust assets to possible claims by the beneficiary's creditors, possibly including the Medicaid program itself (depending on state law and future developments in benefits programs).

Gift Tax Treatment

I.R.C. § 2501(a) imposes a tax for each calendar year on the transfer of property by gift during such calendar year. It is at best doubtful whether a completed gift is made by the disabled individual when assets to which he or she is otherwise entitled (as in a self-settled SNT) are paid into a trust set up for the disabled individual's benefit. The transfer of property constitutes a completed gift to the extent that the donor has parted with dominion and control of the property; i.e., the donor has no power to change the disposition of the property.¹⁰ Generally, if the funding of the Trust is considered part of a negotiated settlement, it should arguably not be considered a transfer by the disabled individual. Moreover, it could be argued that the disabled individual did not intend to make a gift of the settlement proceeds because the trust is created for the primary benefit of the disabled individual and no one other than the disabled individual can benefit from the trust. Hence, there are no gift taxes.

Generally, transfers made contemporaneously with a structured settlement being implemented are not gifts to an irrevocable trust by the plaintiff, and should be construed as a release of a claim for consideration. Since consideration is involved, presumably there are no adverse gift tax ramifications to such a transfer. Alternatively, if the disabled individual retains a power over the disposition of trust assets, such as a testamentary general power of appointment over the remainder interest upon death, then there will be no completed gift (and, hence, no gift tax liability).¹¹ One caveat: there may be gift tax ramifications if the plaintiff's attorney deposits settlement money into his escrow account and then distributes it as payable to the injured party who then conveys the property to the trust. Generally, the attorney should receive the check from a defendant or its insurance company made directly payable to the attorney *as attorney for the trust*.

If the disabled individual has retained no interest in or control over the trust property, the funding of the trust could be considered a completed gift subject to gift tax and

not part of the estate for estate tax. If the disabled individual has retained powers over the transferred property under Code Sections 2033-2041,¹² such property will be included in the disabled individual's estate at death. Section 2033 requires including in the estate the value of all property in which the decedent has an interest at death. Code Section 2031 provides that the value of the gross estate is based on the value at the time of death of all property owned by the decedent, whether real or personal, tangible or intangible. Under IRC §2039, if the decedent individually has the right to receive annuity payments during the individual's life and someone has the right to receive those payments following his or her death, the present value of the annuity payments to be received by the remainder beneficiaries is included in the decedent's estate.

Summary and Conclusions

Tax treatment of SNTs varies between self-settled and third-party SNTs. In most cases, a third-party SNT's income will be taxed to the beneficiary only to the extent of actual distributions for the benefit of the beneficiary (with any undistributed income taxed to the trust itself). Third-party SNTs will ordinarily not result in either gift or estate tax liability for the beneficiary, although it may be desirable in the case of a SNT holding appreciated assets to incur estate tax liability.

Self-settled SNTs, on the other hand, will ordinarily be included in the beneficiary's estate for estate tax purposes. Few self-settled SNTs will result in any gift tax liability.

Although it might be argued that there may be a benefit to designing the self-settled SNT to prevent treatment as a grantor trust, most self-settled SNTs will (and should) be grantor trusts within the rules of I.R.C. §§671-678.

Generally, if the funding of the Trust is considered part of a negotiated settlement, it should arguably not be considered a transfer by the disabled individual.

Robert B. Fleming, CELA is a partner in the Tucson, AZ law firm of Fleming & Curti, P.L.C., with a practice limited to guardianship, conservatorship, estate planning and probate. Mr. Fleming has been selected as a fellow of both the American College of Trust and Estate Counsel and the National Academy of Elder Law Attorneys. He is currently the chair of the mental health and elder law section of the State Bar of Arizona.

Stuart R. Morris, CELA is the principal in the Law Office of Stuart R. Morris, P.A., with offices in Boca Raton, Fort Lauderdale and Aventura, FL. In addition to being a practicing attorney, Mr. Morris is a licensed certified public accountant in Florida. Mr. Morris is board certified in wills, trusts and estates by the Florida Bar and is a Certified Elder Law Attorney through the Florida Bar and the National Elder Law Foundation.

10. Treas. Regs. §25.2511-2(b)

11. Treas. Regs. §25.2511-2(c)

12. IRC §§2033 through 2041 provide inclusion in the decedent's gross estate for property over which the decedent had or retained any of various kinds of control. Most important for these purposes are §2036, which includes property over which the decedent retained a life estate, and §2037, which includes property as to which the transfer takes effect at death.