



Filing a Tax Return for a Special Needs Trust: What a Trustee Needs to Know at Tax Time

The Voice is the e-mail newsletter of The Special Needs Alliance. This installment of The Voice was written by Special Needs Alliance member [Tara Anne Pleat, Esq.](#) Tara is a founding partner of the law firm of [Wilcenski & Pleat PLLC](#) in Clifton Park, New York. She practices in the areas of Special Needs Planning, Elder Law, and Trust and Estate Planning and Administration. Tara writes and lectures frequently on issues affecting individuals with disabilities and their families.

April 2017 - Vol. 11, Issue 3

Taxation of trusts was the subject of two prior articles that were published in The Voice in 2012. The first article, [A Short Primer on Trusts and Trust Taxation](#) authored by SNA members Barb Hughes and Tara Pleat, focused on the taxation of trusts in general. The second article, [Is a Qualified Disability Trust Appropriate?](#) by SNA member Elizabeth L. Gray, focused on Qualified Disability Trusts, a tax classification that is unique to trusts where there is a sole beneficiary who has been determined to be disabled by the Social Security Administration.

The primary focus of this article is to introduce the tax form that typically must be filed for Special Needs Trusts (SNTs) which generate income.

Does the trustee of a SNT have to file an income tax return?

First-Party SNTs

First-party SNTs are funded with the assets of an individual with a disability who is typically receiving means-tested government benefits such as Supplemental Security Income (SSI) or Medicaid. A first-party SNT is generally classified as a “grantor trust.” This tax classification means that all of the items of income, deduction and credit generated by the SNT should be reflected on the personal income tax return of the beneficiary with the disability. In first-party SNTs, the grantor for tax purposes is actually the beneficiary because the law requires the SNT to be funded with the beneficiary’s own assets, even though the SNT is formally established by a parent, grandparent, legal guardian or a court (or, after December 13, 2016, the beneficiary himself).

Practice varies regarding how to report income generated by a first-party SNT. Some trustees obtain a separate taxpayer identification number (TIN) for the first-party SNT when

it is established. As a result, when financial institutions report how much income the SNT has earned, a Form 1099 will be issued to the trustee reflecting the SNT's separate TIN.

The question then becomes: how does this income, which is reported to the IRS under the SNT's separate TIN, make its way onto the personal income tax return of the SNT beneficiary? The answer is that the trustee of the first-party SNT files an informational Form 1041 with a "Grantor Trust Information Letter" attached. The mechanics of this informational filing are described in detail below.

Alternatively, in situations where the trustee of a first-party SNT does not obtain a separate TIN for the SNT, the beneficiary's social security number (SSN) is reflected as the TIN for the SNT. Since the beneficiary's SSN is reflected on the Form 1099s issued by the financial institutions reporting the income generated by the SNT, a separate informational Form 1041 is generally not filed.

Third-Party SNTs

Third-party SNTs are generally considered either "complex trusts" or "qualified disability trusts" for income tax purposes. The SNT itself is responsible for reporting its own items of income, deduction and credit. This filing is also made on Form 1041 but, as described below, there is significantly more that goes into completing an income tax return for a complex trust or qualified disability trust, than for a grantor trust.

What is a Form 1041?

Form 1041 is the U.S. Income Tax Return for Estates and Trusts. Similar to a Form 1040 on which individuals report their income annually to the federal government, Form 1041 is used by most trustees and other fiduciaries (i.e. executors, personal representatives and administrators of estates) to report income to the federal government.

In states where trusts are also subject to a separate state income tax, there is typically a state form on which estate and trust income needs to be reported. These forms differ from state to state, so if a trustee is unsure about whether a separate state return needs to be filed, and which form is to be used, the trustee should be sure to consult with an attorney or accountant who is familiar with fiduciary income taxation.

When must a Form 1041 be filed?

In the case of a first-party SNT which is a grantor trust for tax purposes and where a separate TIN is obtained for the SNT, the general rule is that if there is at least \$1.00 of income, an informational return must be filed in order to provide the IRS with information about the taxpayer to whom that income should be taxed.

In the case of all other SNTs, a Form 1041 generally must be filed if any one of the following three circumstances exists: (1) the SNT had any taxable income for the tax year; (2) the SNT had gross income of \$600 or more (regardless of taxable income) for the tax year; or (3) the SNT has a beneficiary who is a non-resident alien.

Since SNTs, regardless of type, must file on a calendar year basis, the Form 1041 return is due at the same time personal income tax returns are due, i.e. April 15th of the year following the year for which the income is being reported. It is possible to request an extension of time to file a Form 1041, but unlike the 6-month extension granted to individuals, only 5-month extensions are granted to SNTs.

How does the Trustee of a SNT complete Form 1041?

Every year, the Internal Revenue Service updates the Form 1041 (as it does for the Form 1040) and issues instructions. The instructions are very detailed and are helpful in navigating the completion of the Form 1041. These forms and instructions are found at www.irs.gov.

First-Party SNTs

As discussed above, even if the trustee of the first-party SNT has obtained a separate TIN for the SNT, this type of SNT is likely classified as a “grantor trust” for income tax purposes. In this circumstance, the Form 1041 is very simple to complete.

The trustee will check the box on Form 1041 indicating that the SNT is a grantor trust and provide some general information about the SNT, including the name and address of the trustee, the TIN of the SNT, and the date the SNT was established. No income is actually reported on this type of return. Typically, a statement will be added after the first page of the return indicating that the SNT is a grantor trust and that the income is taxable to the grantor beneficiary under sections 671-678 of the Internal Revenue Code.

The actual income reporting is completed on an attachment to the Form 1041 that is often referred to as a “Grantor Trust Information Letter.” The attachment must reflect the following: (1) the name, SSN and address of the person to whom the income is taxable (generally the beneficiary with a disability in the context of a first-party SNT); (2) a detailed description of the taxable income; and (3) a detailed description of any applicable deductions or credits. Each of these items is then reflected on the personal income tax return of the grantor beneficiary.

Third-Party SNTs

Under some circumstances, third-party SNTs are characterized as grantor trusts. This occurs when the person creating and [funding the SNT](#) reserves certain rights, powers and

authorities that trigger grantor trust status. If a third-party SNT is considered a grantor trust, all items of income, deduction and credit are generally taxed to the individual(s) who created and funded the SNT (typically parents or other relatives of the beneficiary with a disability). Whether the grantor for income tax purposes is the beneficiary with a disability (in the case of a first-party SNT), or a relative of the beneficiary (in the case of a third-party SNT), the reporting method described above is the same.

For a third-party SNT which is a non-grantor trust and has a filing requirement, Form 1041 must be thoroughly completed. The trustee will first need to determine the tax classification of the SNT. Typically, this will be either a “complex trust” or a “qualified disability trust.” SNTs classified as qualified disability trusts receive an exemption equivalent to an individual’s personal exemption (\$4,050 in 2017), whereas SNTs classified as complex trusts only receive a \$100 exemption.

All items of income, deduction and credit are reported on Form 1041. Given the complexity of Form 1041 and the rules that relate to the reporting of SNT income in general, it is strongly recommended that trustees consult a tax preparer or attorney who specializes in fiduciary income taxation and SNTs.

What is a Schedule K-1 and when is it issued?

A Schedule K-1 is a tax form issued by a non-grantor SNT to a beneficiary when the trustee of the SNT makes distributions for the benefit of that beneficiary which “carry out” the income generated by the SNT. By way of a simple example, suppose that a non-grantor SNT had \$5,000 of interest income in 2016 and made \$6,000 worth of distributions for the benefit of the beneficiary. For income tax purposes, the SNT is deemed to have distributed all of the SNT income to the beneficiary for tax reporting purposes. As a result, when the SNT’s income tax return is prepared for 2016, a Schedule K-1 will be issued to the beneficiary advising him that all \$5,000 of the SNT’s interest income must be reported on his personal income tax return. In that case, since \$5,000 was all of the income earned by the SNT, the SNT itself will not report any taxable income. Rather, the Schedule K-1 will show that all of the SNT’s income has been “carried out” to the beneficiary.

If the same SNT only made \$3,000 worth of distributions for the benefit of the beneficiary, the SNT would still issue a Schedule K-1 to the beneficiary showing that only \$3,000 of interest income should be reported on the beneficiary’s personal income tax return. However, \$2,000 of interest income would remain taxable to the SNT.

When income tax is due on income generated by a SNT, who is responsible for paying the tax?

If the SNT's income must be reported by the beneficiary on his own personal return, the SNT document should allow the SNT to pay the beneficiary's income tax liability from the assets in the SNT. While the actual responsibility for paying the income tax belongs to the beneficiary (i.e. the person by whom the income is reportable), SNT beneficiaries typically do not have their own separate assets to pay their income tax liability. When the SNT income is reportable by the SNT and taxed at the SNT level, the trustee is responsible for paying any income tax liability out of the SNT assets.

Should a Trustee hire an accountant or an attorney to assist with filing Form 1041?

Unless the trustee specializes in the income taxation of SNTs, it is prudent for the trustee to consult with or hire a tax preparer or attorney who specializes in fiduciary income taxation, regardless of whether the SNT is a grantor trust, complex trust, or qualified disability trust. Consulting with or hiring one of these professionals should help ensure that all SNT income is reported properly and that no available deductions are lost or overlooked.

While there are similarities between personal and fiduciary income tax returns, the forms and the available deductions differ significantly. Since the filing of annual fiduciary income tax returns will likely be required for the duration of the SNT term, it is critical that returns are prepared and filed correctly from the inception of the SNT [until its termination](#). A firm with significant experience in preparing fiduciary income tax returns can typically prepare them in a cost-efficient manner.

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