



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

This edition of The Voice® is a reprint of an article originally published back in April of 2017. As we head into tax season with so many different things on our minds, we thought it a good idea to reprint this article to remind special needs trust trustees of their obligations at tax time.

The primary focus of this article is to provide an introduction to the tax form that typically must be filed for special needs trusts that are generating income.

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Does the trustee of a special needs trust have to file an income tax return?

Trusts generally are considered separate taxable entities for income tax purposes and the trustee must file an income tax return for the trust.

First party special needs trusts

First party special needs trusts are funded with the assets of an individual with a disability who is typically participating in a means-tested government benefit program such as Supplemental Security Income or Medicaid. First Party Special Needs Trusts generally always receive the tax classification of a “grantor trust.” This tax classification means that all of the items of income, deduction, and credit generated by the trust should be reflected on the personal income tax return of the individual with the disability, who is the trust beneficiary. In first party special needs trusts, the grantor is actually the beneficiary because the law requires the trust be funded with the beneficiary’s own assets; however, the trust can be established by the beneficiary if he or she is competent to do so, the beneficiary’s parent, grandparent, legal guardian, or a court.

Practice varies regarding how to report this income. Some trustees obtain a separate taxpayer identification number for the first party special needs trust when it is established. As a result, when the time comes for financial institutions to report how much income the

trust has earned, a Form 1099 will be issued to the trust reflecting the trust's separate taxpayer identification number.

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

Alternatively, in situations where the trustee of a first party special needs trust does not obtain a separate taxpayer identification number for the trust, the beneficiary's social security number is reflected as the taxpayer identification number for the trust. Since the beneficiary's social security number is reflected on the Form 1099s issued by the financial institutions reporting the income earned by the trust, a separate informational Form 1041 is not generally filed.

Third party special needs trusts

Third party special needs trusts are generally either considered "complex trusts" or "qualified disability trusts" for income tax purposes and the trust 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 a qualified disability trust than that of 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 the form on which most trustees and other fiduciaries (i.e., executors, personal representatives and administrators of estates) 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 or not 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 and/or accountant who has familiarity with trust income taxation.

When must a Form 1041 be filed?

In the case of a first party special needs trust, which is a grantor trust for tax purposes and where a separate taxpayer identification number is obtained for the Trust, 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 trusts, a Form 1041 generally must be filed if any one of the following three circumstances is applicable: (1) The trust had any taxable income for the tax year; (2) The trust had gross income of \$600 or more (regardless of taxable income); or (3) The trust has a beneficiary who is a non-resident alien.

Since special needs trusts, 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, 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 extension granted to individuals, only five-month extensions are granted to trusts.

How does the trustee of a special needs trust 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 very helpful in navigating the completion of the Form 1041. These forms and instructions can be found on www.irs.gov.

First party special needs trusts

As referenced above, if the trustee of the first party special needs trust has obtained a separate taxpayer identification for the trust, this trust is likely classified as a “grantor trust” for income tax purposes. In these circumstances, the Form 1041 is very simple to complete.

The trustee will check the box on Form 1041 indicating that the trust is a grantor trust and provide some general information about the trust (name, address, tax identification number, and the date the trust was established). No income is reported on these returns. Typically, a statement will be added to the first page of the return indicating that the trust is a grantor trust and the income is taxable to the grantor under sections 671-678 of the Internal Revenue Code.

The income reporting is completed on an attachment to the Form 1041 that is often referred to as a “Grantor Trust Information Letter.” The attachment itself needs to reflect the following: (1) the name, social security number, and address of the person to whom the income is taxable (generally the beneficiary with a disability in the context of first party special needs trusts); (2) a detailed description of the taxable income; and (3) a detailed description of any deductions or credits that are applicable. Each of these items is then carried through and added to the personal income tax return of the grantor/beneficiary.

Third party special needs trusts

Sometimes, third party special needs trusts are grantor-type trusts. This occurs when the person creating (and funding) the trust reserves certain rights, powers and authorities that cause grantor trust status. In the case of third party special needs trusts, if the trust is considered a grantor trust, all items of income, deduction and credit are generally taxed to the individual(s) who created and funded the trust (typically parents or other relatives of the individual with a disability). Whether the “grantor” for income tax purposes is the trust beneficiary with a disability in the case of first party special needs trusts or a relative of the beneficiary as is the case with third party special needs trusts, the reporting method described above is the same.

For third party special needs trusts that are non-grantor trusts with a filing requirement, Form 1041 must be thoroughly completed. The trustee will first need to determine the tax classification of the trust; typically, this will be either a “complex trust” or a “qualified disability trust.” Trusts that are classified as qualified disability trusts receive an exemption equivalent to a personal exemption, for 2020 income tax filing purposes \$4,300, whereas trusts classified as “complex” only receive a \$100 exemption.

All items of income, deduction and credit are reported on Form 1041 consistent with the form’s instructions. Given the complexity of the Form 1041 and the rules that relate to the reporting of trust income in general, it is strongly recommended that trustees consult an attorney or tax preparer who specializes in fiduciary income taxation and special needs trusts.

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

A Schedule K-1 is a tax form that is issued by a non-grantor trust to a beneficiary, when the trust makes distributions to that beneficiary that carry out income. By way of a generalized example, if a non-grantor trust had \$5,000 of interest income in 2020 and made \$6,000 worth of distributions for the benefit of the trust beneficiary, for income tax reporting purposes the trust is deemed to have distributed all of the trust income to the beneficiary. As a result when the trust’s income tax return is prepared for 2020, a Schedule K-1 will be issued to the trust beneficiary advising him or her that \$5,000 of interest income must be reported on his or her personal income tax return. In that case, \$5,000 was the only income earned by the trust, the trust will not report any taxable income but rather will show that income as having been “carried out” to the trust beneficiary by issuing a Schedule K-1.

If instead of making \$6,000 worth of distributions on behalf of the trust beneficiary, the trustee only made distributions of \$3,000, the trust would still issue a Schedule K-1 to the trust beneficiary showing that \$3,000 of interest income should be reported on the trust

beneficiary's personal income tax return, but the trust would also report \$2,000 of interest income taxable to the trust. In this case, both the trust and the trust beneficiary may have tax liability.

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

Typically, if the income must be reported by the trust beneficiary on his or her own personal return, the trust itself will have provisions that allow the trust to pay any income tax due. While in these circumstances the actual responsibility for paying the income tax belongs to the beneficiary (the person by whom the income is reportable) often the trust beneficiaries don't have their own assets to pay income tax liability and the trustee will use trust assets to pay any such liability.

When the income tax is reportable by the trust and taxed at the trust level, the trustee is responsible for paying any income tax due out of the trust assets.

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

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

While there are similarities between personal and fiduciary income tax returns, the forms and the deductions available differ significantly. A firm with experience in preparing the tax returns can typically prepare them in a cost-efficient manner.

Since the filing of income tax returns will likely be required for the duration of the trust term, it is important that returns are prepared and filed correctly from the onset.

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