



Tax Options for Third-Party Special Needs Trusts

This issue of The Voice® is by Sean R. Beck and Evan M.E. Barrett, who are colleagues of SNA member [Charlene K. Quade](#) of [C.K. Quade Law, PLLC](#). Located in Boise, Idaho, the firm is dedicated to serving clients in communities throughout the state in the areas of special needs planning, settlement planning, Medicaid and long-term care planning, estate planning and disability and elder law.

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The goal of this article is to serve as a reference for those who plan to draft, or have drafted, third-party special needs trusts (also called supplemental needs trusts, or 3pSNTs). This article aims to assist in determining the proper tax classifications and options available for these trusts.

By definition, 3pSNTs are funded with assets of third parties, i.e., not with assets belonging to the special needs beneficiary. The reader should keep in mind that this article deals strictly with 3pSNTs, and it does not address first-party special needs trusts or self-settled special needs trusts, which are classified as grantor trusts for tax purposes.

Income Tax Classification of Trusts

All trusts, including 3pSNTs, can be classified as either grantor, simple, or complex trusts. These classifications specifically refer to the status of the trust for taxation purposes, resulting in different tax treatment depending on the circumstances. In addition to the income tax classifications, a trust must also be either revocable or irrevocable. Grantor, simple, and complex trusts may all be irrevocable. However, only grantor trusts may be revocable. This means that all simple trusts and all complex trusts must be irrevocable. If either a simple or complex trust were drafted as being revocable, it would instead be reclassified as a grantor trust. Thus, all revocable trusts are grantor trusts but not all grantor trusts are revocable.

While 3pSNTs are, in most cases, irrevocable, they may also be drafted as revocable. As is discussed in more detail below, such a revocable 3pSNT would be classified as a grantor trust.

What is a Simple Trust?

A simple trust is defined in the Internal Revenue Code as (1) a trust that is not a grantor trust; (2) is required to distribute all income annually; and (3) does not distribute the corpus

of the trust or make charitable contributions. Because the Trustees of 3pSNTs need to have discretion with which to make distributions and should not be required to give all income earned to a beneficiary outright, 3pSNTs should never be structured or identified as simple trusts.

What is a Grantor Trust?

A grantor trust is generally one in which a grantor (the individual who funds the trust) retains the power to control or direct the trust's income or assets. There are five triggers, any of which require the trust to be classified as a grantor trust. Those triggers are: (1) the grantor has a reversionary interest or ability to recover over 5% of the assets of the trust; (2) the grantor has the power to use assets for themselves; (3) the grantor exercises administrative control over the trust; (4) the grantor has the power to amend or revoke the trust in any way; or (5) the grantor has some interest in the income of the trust for their benefit.

Grantor trusts require that income, credits, and deductions of the trust be taxed as personal taxable income of the grantor of the trust. Due to the compressed tax brackets for non-grantor trusts, having a grantor trust can be advantageous in many situations, particularly if the 3pSNT might garner significant income. For context, single filers don't reach the 37% tax bracket until \$539,900 in income in 2022. Non-grantor trusts, on the other hand, can in some cases reach 37% at just \$13,450 in income. So, in most cases, the grantor's rate will be lower than the rate of a non-grantor trust. However, where the grantor is already at a high marginal tax bracket, this advantage is minimized, and a different structure might be preferable.

What are Complex Trusts and Qualified Disability Trusts?

A complex trust is any trust that is not a grantor trust or a simple trust. Because 3pSNTs are not typically drafted as simple trusts, a 3pSNT can be either a grantor trust or a complex trust for income tax purposes. A Qualified Disability Trust (QDT) is a sub-classification of complex trusts. More specifically, a properly drafted non-grantor 3pSNT can elect to be treated as a QDT on a Form 1041 income tax return for trusts, which may provide preferential tax treatment. A QDT qualifies for the \$4,700 (scaled with inflation) personal exemption on gross income, the same one that individuals qualified for before the Tax Cuts and Jobs Act (TCJA) of 2017 was passed. Additionally, as discussed above, a QDT is allowed trust deductions, such as administrative expenses and trustee compensation. A QDT may also issue Schedule K-1s which, in practice, distributes the income earned by the trust to the beneficiary at the beneficiary's tax rate.

The main disadvantage of QDTs is that trust income is subject to the heavily compressed trust income tax schedule once the exemption amount is exhausted. If, after deducting

reasonable trustee compensation and qualified medical expenses of the beneficiary, the annual income earned by the trust is greater than the QDT exemption amount, the trust might be better off being taxed at the grantor's rate instead.

Finally, a professional or other non-related, third-party trustee may be necessary because neither the grantor nor a close relative may serve as trustee of a QDT in most circumstances. Accordingly, the potential cost of the trustee should be considered.

In conclusion, the question of whether to draft an 3pSNT as a grantor trust or as a QDT complex trust is rarely an easy one. Careful discussion and identification of individual circumstances with a professional are required to plot the best course of action. Whereas the topics discussed in this article are designed to serve as guidelines, they are not uniformly applicable to all situations. Individuals should always speak with an experienced attorney and their financial advisors to determine how such a trust should be structured in their particular situation.

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