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SPECIAL NEEDS ALLIANCE

Taxes Can Get Complicated for Families with Special Needs

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It's time to think about taxes, which can be complicated for families with special needs. Even professional tax preparers are often unfamiliar with some of the intricacies.

Disability Payments

Certain disability payments are taxable, while others are not. The following benefits may involve tax liability:

- Employer disability benefits – Income from an employer-paid plan while you're unable to work is taxed as if it were wages.
- Disability insurance – Tax liability depends on who paid the insurance premiums. If your employer did, payments are taxable. If you did, using after-tax dollars, the benefits are tax-free.
- Social Security disability – Taxes depend on your total income. Generally speaking, your benefits won't be taxable if this is your only source of income.
- Military pension – If you receive a disability pension based on years of service, the income is taxed.

These disability benefits are exempt from taxes:

- Military payments for service-related disabilities.
- Workers' Compensation – While this is generally not taxed, portions that offset Social Security benefits sometimes are.
- Personal injury settlements – *Compensatory* damages for physical injury or illness are not taxed. *Punitive* damages are.
- No-fault auto insurance payments for lost income or earning capacity due to injury.
- Compensation for permanent disfigurement or loss of bodily function.

Child's Net Unearned Income

There's been a lot of back and forth on this issue, but the latest news is good. The 2017 tax overhaul stipulated that a minor's unearned income exceeding a modest threshold ($2100 in 2018) would be taxed at the same high rate as estates (up to 37 percent). But that changed under legislation passed late last year. A child's unearned income now gets taxed at the parents' personal rate, and families have an option to amend their 2018 filings to reflect this.

Deductions

The standard deduction is currently $12,000 for singles and $24,000 for married couples filing jointly, so itemizing isn't always practical. A higher standard deduction is available for individuals who are blind or over 65. On the other hand, be sure that you're considering all the deductions to which you're entitled. Here are some of the more notable ones:

- **Dependent child-**Even adult children can be claimed as dependents if they meet Social Security's definition of disability, you provide at least half their support, they live with you for a minimum of six months during the tax year, and they're not claimed as a dependent on another return. This applies equally to an adopted child, stepchild, foster child, grandchild, sibling niece, nephew or descendent of any such relation. This could be affected if you're divorced and tax deductions were negotiated as part of your settlement.
- **Medical Expenses** – In order to be claimed, medical expenses must total 10 percent or more of your adjusted gross income. Here are some typical qualifying expenditures:
    - Unreimbursed medical and dental services, including related travel.
    - Insurance premiums.
    - Home modifications relating to the disability, though they may only be partially deductible if they add to home's value.
    - Dependent care – Non-family member care of dependent child or spouse to enable individual to work or seek employment.
    - Instruction focused on adaptive education, including lodging, food and transportation.
    - On-the-job supports required by employed individual with disabilities if not covered by other programs. This deduction, if taken separately, is not subject to the 10% minimum for medical expenses, though there may be a two percent threshold.

    - Disability-related conferences and seminars. Requires doctor's letter explaining how these events enable families and individuals manage special needs.
- **Charitable Contributions –** May be claimed even if you're taking a standard deduction.

Note that alimony payments are no longer deductible.

Credits

There are also various credits, to which you may be eligible regardless of whether or not you take a standard deduction.

- **Elderly or special needs–** A credit is available to individuals over 65 or persons of any age who are receiving taxable disability income and have a permanent, total disability. A larger credit is available for individuals under 18 with disabilities.
- **Earned Income Tax Credit**–This is often overlooked by individuals with disabilities who have no tax liability due to their low income. However, by filing a tax form and applying for this credit, you may be eligible to *receive* funds, which won't be counted when determining eligibility for means-tested programs such as Medicaid. Here's how it works:
    - Applies to working adults with disabilities, as well as to low – and moderate-income families having children under 19 years old (23 years old if full-time students).
    - Taxpayers who claim a dependent with a disability may take this credit if the dependent meets the requirements for the earned income tax credit..
- Recipient must have "earned income," excluding Social Security Disability Insurance, Supplemental Security Income and military disability benefits. Employer-provided disability benefits *are* considered earned income until an individual reaches the "minimum retirement age" under the employer's retirement plan.
- **Child and dependent care expenses**. If you pay someone else – generally not a family member – to care for a dependent child or spouse while working or seeking employment, you might be eligible for a credit for some of those expenses.
- **Adopted child with special needs** – For families adopting a child with special needs who is a U.S. resident or citizen. The credit must be claimed during the year in which the adoption is finalized. Income limits apply.

Special Needs Trusts

You may be surprised to learn that while investment income realized by a special needs trust (SNT) doesn't affect eligibility for means-tested benefits, it's still taxable, depending upon the type you have. In some cases, the trust must file a separate income tax return, while in others, trust income must be reported on the beneficiary's personal tax return—even though they never directly received the funds.

- First Party SNTs
  - These are trusts that are funded with the beneficiary's own assets. In most states, they are automatically categorized as "grantor" trusts, meaning that any investment income generated is taxable to the beneficiary at their personal tax rate. Check with your special needs attorney to determine if your SNT is a grantor trust.
  - Beneficiaries may no longer deduct most trust administration costs.
- Third Party SNTs
  - These trusts are funded by anyone *other* than the beneficiary, and in most cases, they are *revocable* during the lifetime of the grantor who created them. If properly drafted, tax liability on any capital gains realized by the trust will be based on the grantor's personal rate. Different rules apply to the trust after the grantor's death. If you are uncertain about the terms of your SNT, you should consult your attorney.

ABLE Accounts

ABLE accounts are savings accounts for individuals with disabilities whose disability occurred prior to age 26. Beneficiaries can have direct control of funds without affecting eligibility for means-tested government programs, so long as distributions are used for broadly defined "qualified disability expenses." Earnings are tax-free, as are qualified distributions.

Contributions to the accounts are *not* deductible, although lower-income beneficiaries may be eligible for a "saver's credit."

These are complex issues, and it's important to consult with a tax professional who is versed in special needs. In addition, the IRS provides assistance to individuals who are unable to complete a tax return due to a disability.

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