Taxation of Special Needs Trusts: An Overview

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It's that time of year again. If you are the trustee of a special needs trust, you're preparing to have the CPA file the necessary tax returns. As you do that, there are a few things that are useful for a trustee to understand.

First, there are two primary types of special needs trusts: self-settled trusts and third-party trusts. Both provide financial benefit to a person with disabilities, but they differ in whose assets fund the trust and in how the funds are managed. The tax treatment of these trusts can also vary significantly, and understanding these distinctions is essential for anyone involved in managing a special needs trust. For example, if a Taxpayer Identification Number (TIN) is obtained, the trustee may need to file Form 1041, the U.S. Income Tax Return for Estates and Trusts, which is used by trustees and other fiduciaries to report income to the federal government. In states that have an income tax, an additional state income tax form may also be required.

Second, it's important to know whether the trust is a grantor trust or a non-grantor trust.

Grantor Trust: If the person who funds the trust retains certain powers over the trust, such as the ability to change the trustee, revoke the trust, or modify its terms, it may be classified as a grantor trust. In this case, the individual who funds the trust is responsible for paying taxes on any income generated by the trust.

Non-Grantor Trust: If the trust is irrevocable and the person who funds the trust does not retain significant control over the assets or trust administration, the trust itself will be taxed as a separate entity. The trust will file its own tax return, and any income generated by and retained in the trust will be taxed at the trust's rate, which can be much higher than an individual's tax rate. If the trust distributes income to the beneficiary, the beneficiary will be required to pay taxes on that income.

Taxation of Self-Settled Trusts

A self-settled special needs trust, also known as a first-party special needs trust, is a trust established with assets that belong to the individual with a disability. These are often

assets received as an inheritance, a personal injury settlement, or another financial windfall. This type of trust must include a provision requiring that Medicaid be repaid on the death of the beneficiary or at the earlier termination of the trust.

The IRS considers the person with a disability to be the owner of the trust's assets, which means that the income generated by the trust is taxed at the beneficiary's income tax rate. Therefore, the trust's income, such as interest or dividends, may be reported on the individual's personal tax return. The trust itself is considered a grantor trust, as it is funded with the beneficiary's assets; however, the beneficiary likely does not retain some of the other powers typically associated with grantor trusts.

Practice varies on whether a separate TIN must be obtained when a self-settled trust is established. If a TIN is not obtained and the Social Security number of the grantor/beneficiary is used, the beneficiary simply reports the income on their personal return, and an additional Form 1041 is not required. If a TIN is assigned to the trust, then the trustee will file an informational Form 1041 with a grantor trust information letter, which provides: (1) the beneficiary's name, social security number, and address since the income is taxable to the beneficiary; (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 beneficiary.

Taxation of Third-Party Trusts

A third-party special needs trust is one that is established by someone other than the beneficiary, typically a parent or grandparent. In addition, the trust is funded with assets belonging to a third party, such as gifts or a parent's estate, and is designed to benefit the individual with special needs. Depending on when and how this trust is funded, it may be either a grantor trust or a non-grantor trust.

If the trust is funded during a parent's lifetime and the parent retains the grantor powers (e.g., the trust is revocable or the parent retains significant control), any income generated in the trust will be taxed to the parent at his or her individual income tax rate.

If the trust is a non-grantor trust, a Form 1041 must be completed for the trust. If the trust qualifies as a Qualified Disability Trust (QDT) then it will have a $5,100 exemption (in 2025), meaning that up to $5,100 of income is not taxed at the trust rates. If it is not a QDT, then it will instead have a $100 exemption. To qualify as a QDT, the trust must meet these requirements:

- The trust must be irrevocable.
- The trust must be established for the sole benefit of a person with a disability.

- The beneficiary must be under the age of 65 at the time the trust is established.
- The beneficiary must have a disability as defined by the Social Security Administration that causes the beneficiary to be unable to engage in substantial gainful activity because of a physical or mental impairment that is expected to last 12 months or more or result in death.

Given the compressed income tax brackets that non-grantor trusts are subject to, the QDT designation provides some reprieve. The ordinary income tax brackets for non-grantor trusts in 2025 are:

- $0 - $3,150: 10%
- $3,150 - $11,450: 24%
- $11,450 - $15,650: 35%
- $15,650 and above: 37%

Non-grantor trusts are allowed to take deductions for things such as tax preparation, trustee fees, and the most helpful, income distributions. When a non-grantor trust distributes income to or for the benefit of a beneficiary, the trust may deduct that income on Form 1041, which results in a Schedule K-1 tax form to the beneficiary. The beneficiary will claim the income on his or her personal tax return since the funds were distributed out of the trust for the benefit of the beneficiary. Because the income tax brackets for individuals are much larger and an individual taxpayer can claim the standard deduction ($15,000 for a single filer in 2025), it is often advantageous to report the distributed income on the beneficiary's income tax return where no tax may be due instead of on the trust tax return.

In conclusion, special needs trusts are complex legal entities and managing them correctly requires careful planning. Trustees should consult with an attorney or tax advisor who specializes in preparing special needs trust tax returns to help ensure that taxes are managed efficiently and in accordance with IRS guidelines and state law.