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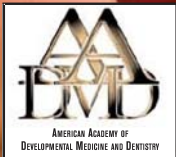
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PART TWO

Taxation of Special Needs Trusts

By Dennis Sandoval

You have created a Special Needs Trust to provide for your special needs child after you are gone and to protect any government assistance the child may be receiving. Now you have some questions regarding how the trust is taxed.

THE BANK TELLS ME I NEED TO GET A TAX IDENTIFICATION NUMBER AND FILE A SEPARATE TAX RETURN FOR MY CHILD'S SPECIAL NEEDS TRUST. IS THIS TRUE? The answer depends on a number of factors. Is the special needs trust ("SNT") in existence now? Or will it come into existence only after the parent passes away (i.e., the SNT is created under the parent's will or revocable living trust).

If the SNT is in existence now, who created it? If it was created by a third party, such as a grandparent who has since passed away, then the special needs trust is a separate taxable entity known as a non-grantor trust and it would have to obtain its own taxpayer identification number and file its own federal income tax return, Form 1041. If all the income of the SNT is accumulated, the tax on the income would be paid by the trust. If any or all of the income was distributed to the beneficiary to help pay for his or her needs, then the income would be taxed to the special needs person or beneficiary (who likely is in a low tax bracket).

What if the SNT was created using the special needs person's own assets? If the SNT was created by the beneficiary using proceeds from a lawsuit, an outright inheritance or other assets that belong to the beneficiary, then the SNT is a special kind of trust known as a (d)(4)(A) trust. The IRS characterizes this type of SNT as a grantor trust. The income of a grantor

trust is taxable to the creator of the trust, in this case, the beneficiary or special needs person. This is true whether the income is accumulated in the SNT or it is distributed to the beneficiary. This is usually a good thing, as the beneficiary usually does not have significant other income. The beneficiary can either use his or her social security number ("SSN") for tax reporting purposes, or a separate tax identification number ("TIN") can be obtained for the SNT. Whether or not a separate TIN is obtained, the income from the trust would be reported to the beneficiary. The advantage of using the beneficiary's SSN is that it avoids the necessity of filing a separate Form 1041 for the SNT, but sometimes the administration of the trust is simpler, and it is easier to keep track of the income of the SNT for reporting purposes if a TIN is obtained.

What if the SNT is created by the special needs person's parent? If the SNT is created by the parent as a separate document apart from his or her will or revocable living trust (this type of SNT is sometimes referred to as a "Stand-Alone SNT"), the taxation of the SNT varies on how the attorney who creates the SNT structures its terms. If the Stand Alone SNT is a revocable trust – or if it is irrevocable, but contains special tax provisions — the SNT will be treated as a grantor trust. In that case, the SNT income is reported on the parent's tax return.

If the Stand Alone SNT is irrevocable and does not contain any special tax provisions, the IRS would treat the SNT as a non-grantor trust and any income earned would be taxed to the SNT itself.

As long as the parent is alive, a stand-

alone SNT that is classified as a grantor trust can use the parent's SSN or a separate TIN. Either way, the income would be reported on the parent's income tax return, but if the parent's SSN is used for reporting purposes, a separate tax return for the SNT would not need to be filed. If the Stand-Alone SNT is a non-grantor trust, or if the parent who created the Stand-Alone SNT has died, then a TIN would need to be obtained. In this case, the SNT would need to file its own tax return, Form 1041, and the SNT would pay the taxes on any portion of the trust income that was not distributed to the beneficiary. Any income distributed to the beneficiary would be reported on his or her income tax return.

A SNT that is created under the parent's will or revocable living trust does not come into existence until after the parent's death. Since the parent is no longer alive, the SNT would be classified as a non-grantor trust by the IRS. A separate TIN would have to be obtained and it would be taxed as described in the paragraph above.

ARE THERE ANY OTHER REASONS WHY A PARENT WOULD WANT THE SNT INCOME TAXABLE TO THE PARENT RATHER THAN THE TRUST? Yes. By having the parent pay the income tax of a Stand-Alone SNT rather than using the SNT income and/or assets to pay the income tax, the assets in a Stand-Alone SNT will grow much faster. In effect, the assets of the SNT will compound income tax-free, much like a Roth IRA.

WILL THE PARENT OR SPECIAL NEEDS CHILD HAVE TO PAY A GIFT TAX IF A STAND-ALONE SNT IS CREATED AND FUNDED DURING THE LIFE OF THE PARENT? There are several strategies available to knowledgeable estate planning attorneys to avoid the imposition of any gift tax when drafting and funding a lifetime SNT. Because of availability of these strategies as well as the availability of a lifetime gift tax exemption amount of \$1 million, it is a rare circumstance where a gift tax would have to be paid in association with the cre-

ation of a Stand-Alone SNT.

WILL AN ESTATE TAX BE IMPOSED AT THE DEATH OF THE PARENT? In 2009, a person can pass as much as \$3.5 million free of estate tax at death. With proper planning, up to \$7 million can be passed estate tax-free by a married couple. The federal estate tax is usually not imposed until after the death of the surviving spouse. Because of this relatively generous estate tax exemption amount, only about 0.3 % of households are subject to federal estate tax at death. However, many states impose their own estate tax on estates much smaller than the federal limits, so it is wise to consult with an estate planning attorney. There are many estate tax reduction strategies that are available to a parent or married couple whose estate is large enough to be subject to a federal or state estate tax, or both.

If the parent has assets in excess of \$3.5 million, the amount that can pass estate tax-free under current law, he or she should consult with an estate planning attorney who has special expertise in special needs trusts as well as advanced estate planning strategies. •

Dennis Sandoval is the only attorney in California who is board certified in elder law, taxation law and estate planning, trust and probate law (certified by the California Bar Board of Legal Specialization and the National Elder Law Foundation). He is a member of the Board of Directors of the National Academy of Elder Law Attorneys as well as the National Elder Law Foundation and he serves as the Director of Education for the American Academy of Estate Planning Attorneys. His law practice focuses on estate planning for special needs persons, elder law, conservatorships, probates and tax law. You can read more about him and his practice at www.cal-special-needs-attorney.com. He is a member of the Special Needs Alliance, a national, non-profit organization committed to helping individuals with disabilities, their families, and the professionals who represent them. Contact information for a member in your state can be obtained by calling toll-free 1-877-572-8472, or by visiting: www.specialneedsalliance.org.



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Debbie O'Connor of Annandale, NJ, and her daughter, Kayla, with 5-year-old Ryan in his Matheny classroom



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