Tax Efficient Planning Using Special Needs Trusts

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Defining the Challenge

So Just Imagine

Imagine that you have a client with a 17 year old daughter named Kathy.

Kathy has a disability and is going to need assistance for the rest of her life.

Planning for Kathy is very different than planning for a non-disabled child.

Our Quest

How do you provide for Kathy for 70 years when:

- We don’t know what benefits will be available or the eligibility rules
- We don’t know if the agencies out there will be available over the beneficiary’s lifetime
- We don’t know the best choice for who should serve as trustee

3^{rd} Party Special Needs Trusts A Closer Look

Trust Centered Planning

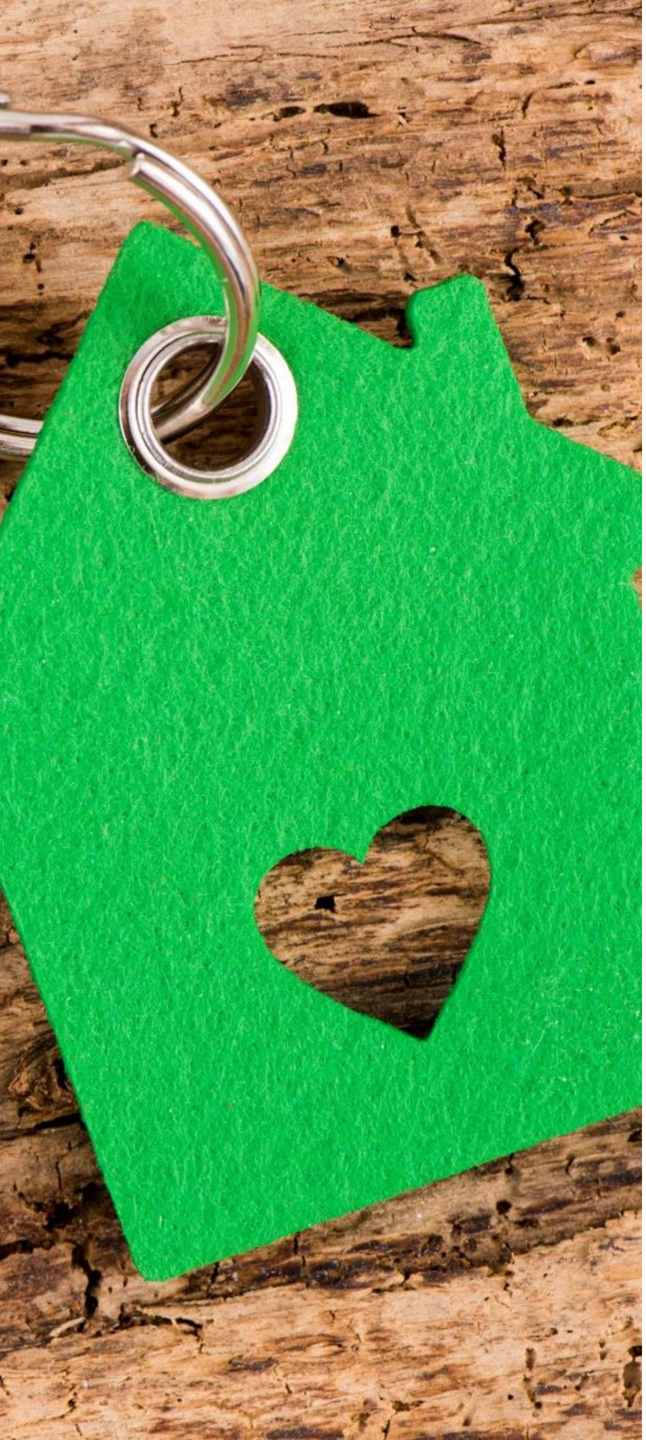
Kathy has multiple disabilities and requires round the clock attendant care paid partially by Medicaid and supplemented by her parents with occasional assistance from her grandparents.

Trust Centered Planning

Kathy's parents' desire is that she live as independently as possible in the family home. With the right assistance, it is possible that Kathy could work which has always been her dream.

Trust Centered Planning

Kathy's parents establish a Revocable Living Trust that has instructions in it about how they will be provided for during their lifetime.



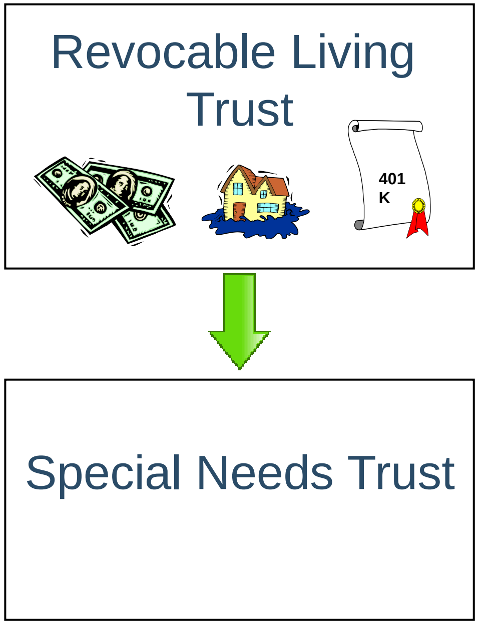
Trust Centered Planning

Kathy’s parents establish a Revocable Living Trust that has instructions in it about how they will be provided for during their lifetime.

Kathy’s parents’ home is placed in the living trust, and the living trust is made the owner or beneficiary of all of her parents’ assets.

Trust Centered Planning

The living trust directs that upon their death, Kathy's share will pass to her Special Needs Trust.



Trust Centered Planning

Kathy's grandparents want to assist her upon their death. The grandparents each have substantial retirement plans and would consider leaving a portion of their plans to Kathy – if it does not interfere with her public benefits.

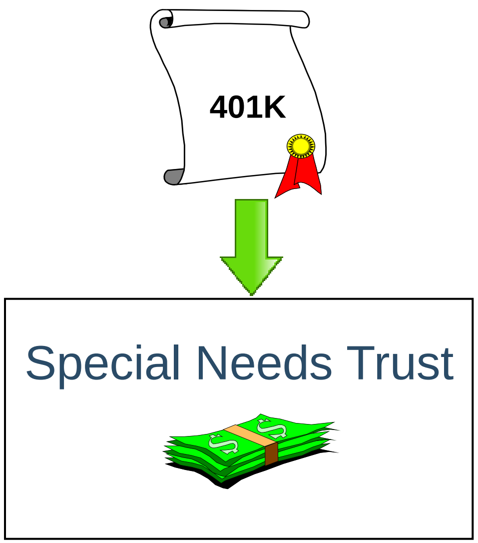
They would also like to make gifts now to assist Kathy to achieve her dream of a profession some day.

Trust Centered Planning

Kathy's grandparents begin making gifts to her trust to assist with day to day needs and to eventually be used for vocational training

Trust Centered Planning

Under the advisement of the family attorney, CPA and financial advisor, Kathy's grandparents designate a portion of each of their retirement plans upon their deaths to her Special Needs Trust



Income and income

What is Income?

Benefits income is not the same as taxable income

This concept is often confused by Social Security and Medicaid workers – you must be prepared to educate them about their own rules

Taxable Income

For purposes of trusts and taxable income, distribution of income is either distribution directly to, or for the benefit of the beneficiary.

Benefits Income

For purposes of "needs based" benefits, income is cash, or for SSI recipients anything that can be used for food, or shelter, unless it is exempt.

Compliance Issues of 3rd Party SNTs

Where a trust is created by a third party for the benefit of someone other than the grantor the trust will be a separate taxpayer.

The Trust will:

1. have its own taxpayer identification number

2. require annual state and federal fiduciary income tax returns.

To the extent that distributions have been made to the beneficiary even in-kind, the trust will carry out income to the beneficiary and a K-1 given to the beneficiary.

Fundamentals

- What is income for benefit purposes?
- What is income for tax purposes?
- Using the QDT exemption
- What are deductible expenses?

Income Taxation of Trusts

An irrevocable 3rd party special needs trust is generally a non grantor trust

It is treated as a separate taxable entity and discretionary distribution of income passes through to the beneficiary to the extent distributed.

Otherwise, the income is trapped at the trust level.

Irrevocable Non Grantor Tax Rate

Trusts that accumulate income are subject to compressed trust tax brackets.

For tax years beginning after 2020, the highest income tax bracket applies to amounts over $518,400, but for trusts it begins at only $12,950 Qualified dividends and long-term capital gains are taxed at 20%.

For estates and trusts, the Net Investment Income Tax (NIIT) is 3.8% of the lesser of the estate's or trust's undistributed net investment income or the excess of the estate's or trust's AGI over the dollar amount at which the highest income tax bracket for estates and trusts begins for such tax year.

Polling Question:

For tax purposes, what type of trust is a 3rd party special needs trust?

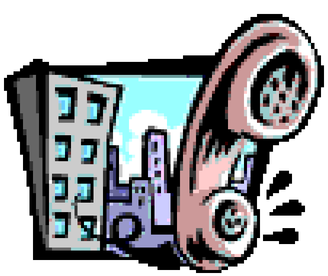
A. A grantor trust
B. A complex trust
C. None of the above.

Benefits Income ≠ Taxable Income

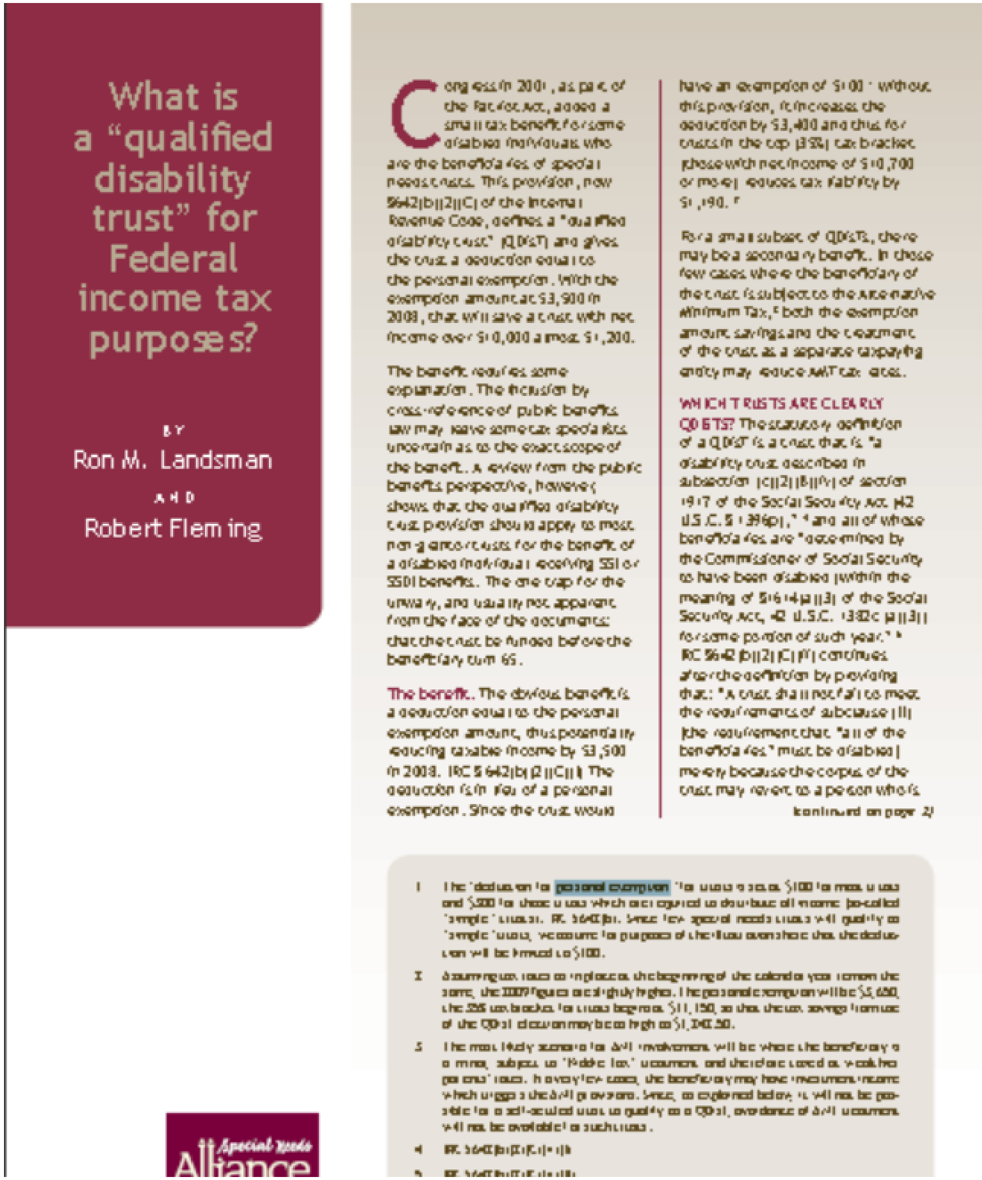
Example

If the Trustee of a Special Needs Trust pays the telephone bill of the beneficiary directly from a Special Needs Trust, the beneficiary has received a benefit and therefore has received taxable income to the extent it is made up of DNI (Distributable Net Income)

In this example, the beneficiary did not receive any income for benefits purposes because the beneficiary did not receive cash, or shelter.



And if that wasn’t enough – there is the Qualified Disability Trust exemption



What is a "qualified disability trust" for Federal income tax purposes?

BY
Ron M. Landsman
AND
Robert Fleming

Congress in 2001, as part of the Tax Act, added a small tax benefit for some disabled individuals who are the beneficiaries of special needs trusts. This provision, now §642(b)(2)(C) of the Internal Revenue Code, defines a "qualified disability trust" (QDisT) and gives the trust a deduction equal to the personal exemption. With the exemption amount at $3,500 in 2008, that will save a trust with net income over $10,000 almost $1,200.

The benefit requires some explanation. The inclusion by cross-reference of public benefits law may leave some tax specialists uncertain as to the exact scope of the benefit. A review from the public benefits perspective, however, shows that the qualified disability trust provision should apply to most non-grantor trusts for the benefit of a disabled individual receiving SSI or SSDI benefits. The one trap for the unwary, and usually not apparent from the face of the documents: that the trust be funded before the beneficiary turns 65.

The benefit. The obvious benefit is a deduction equal to the personal exemption amount, thus potentially reducing taxable income by $3,500 in 2008. IRC § 642(b)(2)(C)(i). The deduction is in lieu of a personal exemption. Since the trust would have an exemption of $100[1] without this provision, it increases the deduction by $3,400 and thus for trusts in the top (35%) tax bracket (those with net income of $10,700 or more) reduces tax liability by $1,190.[2]

For a small subset of QDisTs, there may be a secondary benefit. In those few cases where the beneficiary of the trust is subject to the Alternative Minimum Tax,[3] both the exemption amount savings and the treatment of the trust as a separate taxpaying entity may reduce AMT tax rates.

WHICH TRUSTS ARE CLEARLY QDISTS? The statutory definition of a QDisT is a trust that is "a disability trust described in subsection (c)(2)(B)(iv) of section 1917 of the Social Security Act (42 U.S.C. § 1396p)," [4] and all of whose beneficiaries are "determined by the Commissioner of Social Security to have been disabled (within the meaning of §1614(a)(3) of the Social Security Act, 42 U.S.C. 1382c(a)(3)) for some portion of such year." [5] IRC §642(b)(2)(C)(ii) continues after the definition by providing that: "A trust shall not fail to meet the requirements of subclause (II) (the requirement that "all of the beneficiaries" must be disabled) merely because the corpus of the trust may revert to a person who is

(continued on page 2)

Qualified Disability Trusts

From the Special Needs Alliance

www.specialneedsalliance.org

3rd Party Qualified Disability Trust Deduction

Trusts considered to be qualified disability trusts are entitled to the same personal exemption allowed to all individual taxpayers when filing a tax return.

If the special needs trust can meet the requirements of a "qualified disability trust", it is allowed a $4,300 exemption if the trust's modified Adjusted Gross Income is less than or equal to $250,000.

So how does a trust become eligible for qualified disability trust treatment?

3rd Party Qualified Disability Trust Deduction

The trust must be irrevocable;

The trust must be established for the sole benefit of the disabled beneficiary;

The disabled beneficiary must be under the age of 65 at the time the trust is established; and

The beneficiary must have a disability that is included in the definition of disabled pursuant to the Social Security Act.

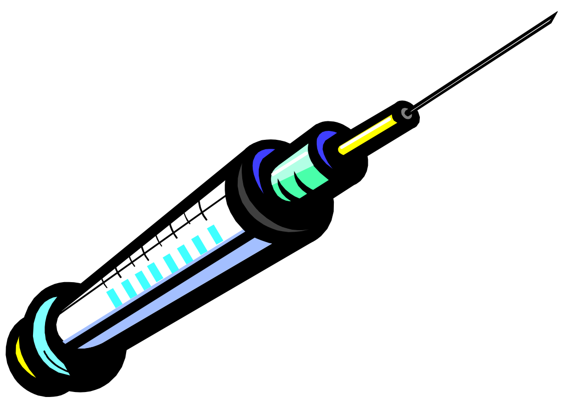
3rd Party Qualified Disability Trust Deduction

The trust must be a “third-party trust,”

The trust cannot be funded at any time by the disabled beneficiary or with his or her own money.

If the person funding the trust during his or her lifetime is also serving as the trustee, qualified disability trust status may not be attainable.

Deductible Expenses



Medical expenses in excess of 7.5% percent of AGI

Medical expenses are deductible during the taxable year for the medical care of the taxpayer, the taxpayer's spouse and dependents, to the extent that the expenses exceed 7.5 percent of adjusted gross income (AGI).

These expenses include amounts paid for dental treatment, drugs and medicines, nursing and attendant care, and certain transportation and travel required for medical care.

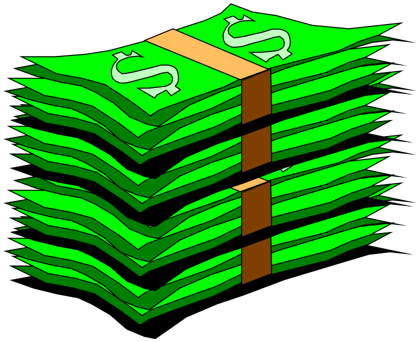
So let's put this all together

Example

The ABC 3rd Party Special Needs Trust has $60,000 ordinary income from investments in year 1.

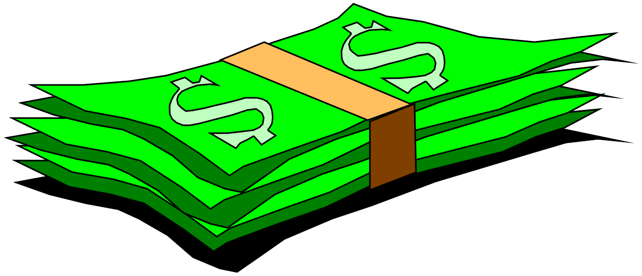
If the entire $60,000 were to be held in the trust and not distributed to or for the benefit of Alice, then the trust would be taxed $19,032.50

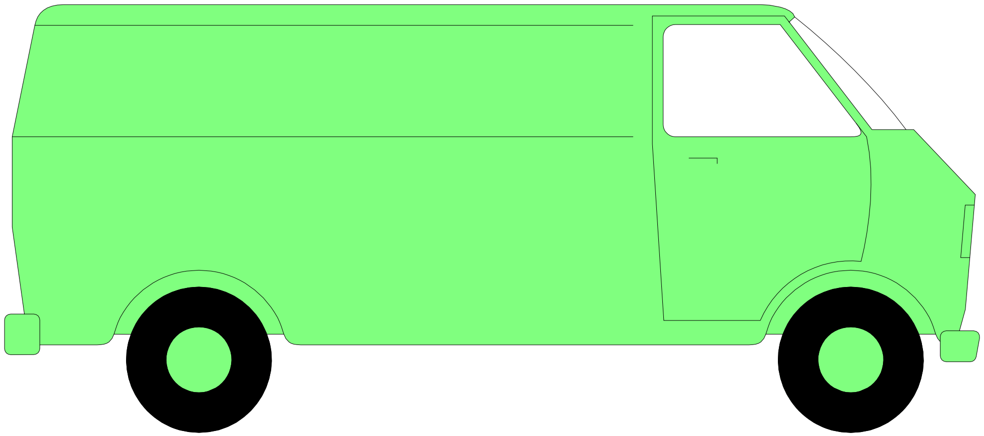
$60,000 less $4,300 QDT exemption = $55,700 subject to tax.



Example

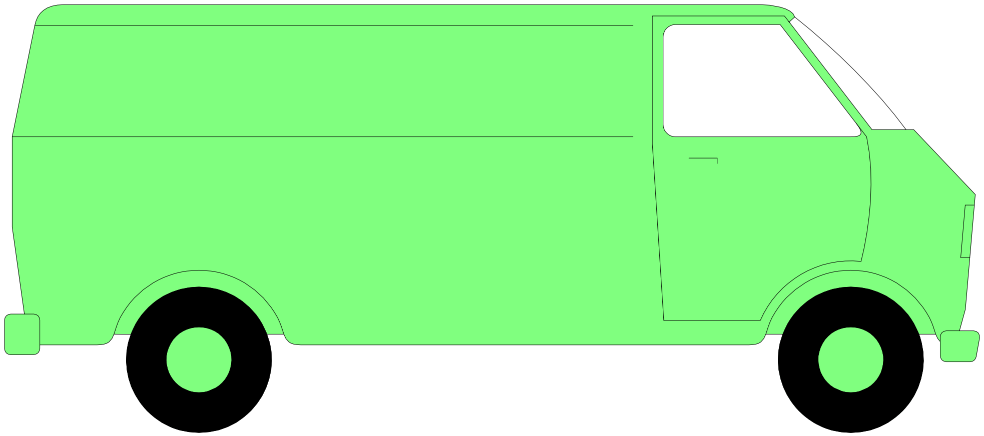
Same facts but the trustee receives the $40,000 distribution and distributes the $40,000 funds for her needs that are not deductible expenses. The net taxation of the trust would be $0, Alice would receive $35,700 in taxable income and her tax would be $5,576. In this example, Alice has received $0 in benefits income because she did not receive cash.





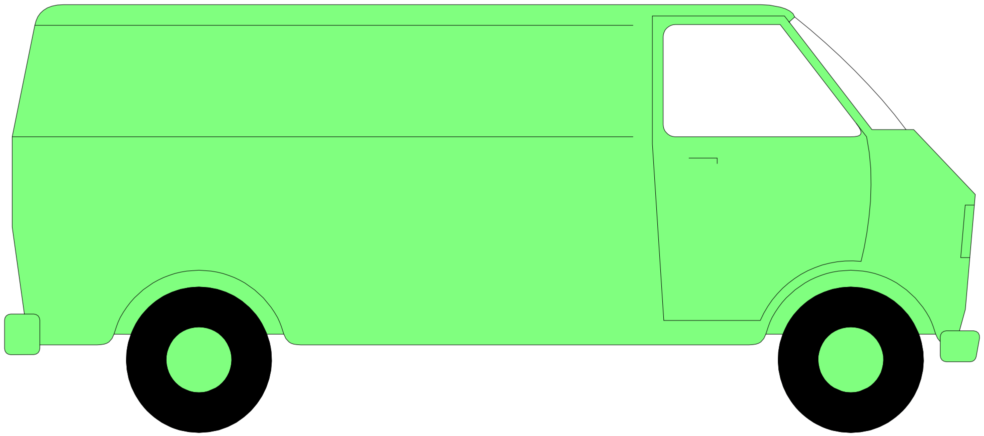
Example

ABC Special Needs Trust receives $40,000 in taxable income. Alice could very much benefit from a wheelchair van and the Trustee uses his discretion to purchase a wheelchair van from Vanco for $35,700. Alice owns no other vehicles.



Example

The Trustee gives the van directly to Alice. The trust has no retained income. Alice received the wheelchair van and therefore received $35,700 taxable income, which is tax deductible to the extent that the expenses exceed 7.5 percent of her adjusted gross income (AGI).



Example

For benefits purposes, Alice is allowed to own one adapted vehicle, and therefore the distribution has no effect on her SSI or Medicaid.

Polling Question:

If Alice receives an adaptable vehicle as a distribution from a special needs trust, how much benefits income did the beneficiary receive?

A. The Kelly Blue Book Value
B. $0
C. The purchase price of the van

Determining Trust DNI

- What is the income to the trust?
- Subtract the administrative expenses for the trust
- Subtract the Qualified Disability Trust Exemption
- Subtract the expected distributions for this tax year?
- The result will be the remaining income taxable at the trust level

Determining Deductible Expenses to the Beneficiary (Best determined with an assessment by a care manager and CPA)

Determine	Determine the total expenditures for medical expenses are deductible during the taxable year for the medical care of the taxpayer, the taxpayer's spouse and dependents,
Subtract	Subtract 7.5% of of AGI
Result	Result will be the total deductible expenses

Conclusion

This information should be given to the trustee, financial and tax professionals.

Ideally this will give the financial professional on the team the ability to create a portfolio that generates the correct amount of income, or can identify when there is a problem.

For beneficiaries with high medical expenses, consider designating a qualified retirement plan to the special needs trust.

Polling Question:

If an irrevocable 3rd party makes a distribution even in-kind to the beneficiary – the beneficiary will be taxed to the extent of the trust's?

A. Retained Income
B. Distributable Net Income
C. Prorate share of Investment Earnings

Distribution Plans and Distribution Advisement

The Magic Document Syndrome

Being involved in the day-to-day administration of the special needs trust assists the law office to identify issues that are common with special needs trusts, to be able to create a plan that is more likely to succeed.

Many parents of children with disabilities go through a lifelong learning process about how to provide for the unique needs of their children.

The Magic Document Syndrome

Is become very commonplace for parents to realize it is important to create a special needs trust to provide for their child's quality of life, but all too often the creation of the document is seen as the objective rather than a tool to meet a goal.

A special needs trust should really be a document that creates a system not only to provide the distributions that the beneficiary needs, but also to create a checks and balance system of accountability to make sure that the goal of maintaining the quality of life is maintained.

Distribution Plans

What is common with the administration of all too many special needs trusts are that the funds are often expended until the trust runs out of money.

This of course is not acceptable, especially in today's environment where it is very unclear what the future is of many of the programs that provide core services for persons with disabilities.

The uncertain world that persons with disabilities, their families and service providers face make the need for a plan that is revised with regularity essential.

It takes a team composed of financial, social, legal, tax, and fiduciary professionals to administer all the aspects of administration of a special needs trust to fulfill the needs of the beneficiary.

Distribution Plans

Unfortunately, all too often there is a lack of coordination among the players. The danger is that the trustee without a plan may not coordinate with the financial advisor about what the present and future needs are for the beneficiary.

The financial advisor might create a plan that does not coordinate with the tax advisor about what tax credits or deductible expenses might exist to ensure that the portfolio is tax advantaged.

Distribution Plans

The tax advisor does not proactively consider the likely deductible expenses for the future or give guidance about how expenditures might affect the beneficiary's taxes. And the social service professional may be making recommendations that may be beneficial but are not actuarially sound.

This lack of coordination leads to wasting of assets and may subject the trustee to liability.

Distribution Plans

Special needs trust administration without a plan that is revised periodically to reflect inevitable changes in the beneficiaries needs and resources as well as its actuarial soundness is prone to being either being expended too quickly or not used prudently for items the beneficiary could benefit from.

A well thought out distribution plan can be a tool to coordinate the activities of all the players, and help make some very important social and fiscal decisions.

Distribution Plans

It also allows all parties to have some idea of what is expected of them, and to use the precious resources set aside for a person with a disability to its fullest.

There has been a marked increase trustees being held liable for misadministration of special needs trusts.

Often this is because of either overspending or underspending of resources on the beneficiary.

Distribution Plans Matter of J.P. Morgan Chase Bank

In the case of Matter of J.P. Morgan Chase Bank in 2012 a testamentary special needs trust that should have been funded with $4,000,000 after five years of administration after the grantors death showed that while the trustee and advisors regularly took their fees which were substantial spent no funds on the beneficiaries direct needs

The court ordered that a care manager be hired, and based on the care managers assessments the beneficiary was moved to a more suitable facility, arranged for him to take a vacation, to attend classes, and to obtain equipment such as computers and iPads to enhance his quality of life.

Distribution Plans
Sup. Ct., Kings Cty., No. 28863/1996, June 25, 2013

On the other end of the spectrum, a case involving BNY started with over $400,000 in a special needs trust and expended the funds in less than a decade spending about $60,000 a year.

The court held that the trustee breached its fiduciary duties by failing to focus on the beneficiary's long-term needs by authorizing each and every discretionary disbursement requested by the infant plaintiff's mother without investigating whether many of these expenditures could have been paid by Medicaid.

The court pointed out that BNY made no effort to consult a professional on government benefits or assistance programs as required by the trust.

For instance, a significant portion of the trust assets were expended on caregivers that would likely have been paid by Medicaid.

A Three-Step Process of Developing a Distribution Plan

Phase 1 – Assessment

In cases where the beneficiary has significant needs, it’s usually preferable to have a professional care manager perform the assessment.

We routinely ask the care managers to work with the beneficiary, family, support system and medical providers to provide a written report to help shape the distribution plan and to guide other persons involved with the trust.

Phase 1 – Assessment

These reports include:

- observations concerning the beneficiary and the circle of support in their environment;
- recommendations of services that might assist the beneficiary and the family, and
- recommendations for the safety of the beneficiary and caregivers.

Phase 2 -- Development of the Distribution Plan

The plan should include both short and long-term objectives for assisting the beneficiary.

It should also include information about the resources available to fulfill that objective, including assets both inside and outside the trust.

The distribution plan should include projections of how trust investments will perform and when the trust is likely to be exhausted.

Phase 3 – Periodic Reassessment

The third phase consists of periodic evaluations of the trust's performance and updating both the assessments and distribution plan, as needed.

It's common for caregiving family members to eventually suffer a back injury, especially as a child's weight increases.

A care manager can monitor the safety needs of both the caregiver and beneficiary and recommend precautions.

Phase 3 – Periodic Reassessment

Providing for the care and quality of life of a person with disabilities has many variables, and the process doesn’t end until the beneficiary dies or the special needs trust is exhausted.

It’s almost impossible to anticipate every contingency.

That’s why an interdisciplinary team of family members, advocates and professional advisors is needed.

Keeping the Distribution Plan Up-to-Date

The process of assessing the beneficiary's needs and then balancing them against available resources in order to establish a budget isn't a one-time process.

The value of investment portfolios will fluctuate, and many states are reducing assistance to persons with disabilities.

Keeping the Distribution Plan Up-to-Date

California, for instance, recently eliminated dental care previously provided by Medi-Cal; reduced or eliminated home health attendant care for many persons receiving benefits from the

In Home Support Services program, which is partially funded by Medicaid; and long ago eliminated most community programs for mental health.

Changes to public services often require a reevaluation of how the trust is being managed.

Projecting the Longevity of the Special Needs Trust

The budget portion of the distribution plan should ideally utilize a projected rate of return and rate of distributions in order to determine how long the trust will last.

In most cases, the objective of the trust would be to ensure that these funds last for the beneficiary's lifetime.

We have found that having the distribution plan reviewed by the trust advisory committee and the trustee greatly helps all parties make rational recommendations, based on available resources.

Using Distribution Plans in Trusts with Advisory Committees or Trust Protectors

Many of the trusts that we draft incorporate an advisory committee or a trust protector to have a checks and balance system to ensure that the needs of the beneficiary are fulfilled.

This also can allow for a system to make changes in the document as laws and policies change, and replacement of the trustee if needed.

We have found that the utilization of a distribution plan as the primary focus of the trust advisory committee/trust protector allows all parties to give their input, basically preapproving all distributions and giving the trustee, and later as we will discuss the distribution advisor, a clear path to follow.

Sample Language

Annual Distribution Plan

The trustee shall produce a written distribution plan to be reviewed by the Trust Advisory Committee annually. The primary purpose of the distribution plan is to provide specific recommendations of services likely to be provided to Kathy for the upcoming year, the cost of those services, and a good faith estimation of how those expenditures will affect the longevity of the trust.

The Trustee may/shall specifically employ a qualified Care Manager to assess Kathy's medical, social and direct care needs and incorporate those assessments in the distribution plan. The Care Manager shall be a qualified professional who is familiar with services in Kathy's community as well as the developmental needs of persons with disabilities similar to Kathy's.

The distribution plan shall provide guidance and advisement concerning Kathy's needs, rights, and entitlement to public benefits, and what discretionary distributions should be made for needs not covered by public benefits, as well as recommendations concerning distributions otherwise covered by public benefits, including, but not limited to, payment for supplemental medical and therapeutic care, education and habilitation services, attendant care services whenever the need arises, residential services, and daily support services. Whenever possible the distribution plan shall make a good faith estimate of the likely cost of each recommendation to be incorporated in an annual budget.

The distribution plan shall be made available to members of the Trust Advisory Committee for their review at least <15 days> prior to implementation. The distribution plan shall include a projection of longevity of the special needs trusts based on the assumed depletion of the trust as well as a reasonable rate of return on the investments of the trust.

The Care Manager shall be entitled to fair and reasonable compensation for services rendered. The amount of compensation shall be equal to the customary and prevailing charges for services of a similar nature during the same period of time and in the same geographic locale. The Care Manager shall be reimbursed for the reasonable costs and expenses incurred carrying out its fiduciary duties under this agreement.