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**TAXATION OF THIRD-PARTY
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Taxation of Third-Party Special Needs Trusts

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I. INTRODUCTION

Special needs planning attorneys must have a basic knowledge of the income taxation of the trusts we create. A third-party Special Needs Trust or Supplemental Needs Trust (“SNT”) can be a grantor or non-grantor trust, a complex trust, and/or a Qualified Disability Trust, and the classification will dramatically affect the taxation of the trust income. IRAs may be left to the SNT, which result in income tax from the distributions. Non-grantor trusts reach the highest tax bracket quickly, and may be subject to Net Investment Income Tax. But there are ways the trustee can reduce the trust taxable income by, among other things, distributing income out to the beneficiary. Tax issues can affect the trustee’s duties and ultimately the quality of life of the beneficiary, and must be examined as part of our planning.

II. FIRST-PARTY SNTs

This paper does not cover the taxation of first-party special needs trusts, but as a reminder, these trusts are typically taxed as a grantor trust as to the beneficiary. Income generated by the trust is taxed at the beneficiary’s marginal tax rate.

III. QUALIFIED DISABILITY TRUST

A third-party SNT may be entitled to special tax benefits if it meets the requirements of a Qualified Disability Trust (“QDT”).

A Qualified Disability Trust is entitled to claim a larger deduction from federal income taxes. In 2022, that deduction is \$4,450. Trust income up to that amount is not taxed. Contrast this with a simple trust that has a deduction of \$300, or a complex trust with a deduction of \$100.

A trust is a Qualified Disability Trust if:

- “(I) such trust is a disability trust described in subsection (c)(2)(B)(iv) of section 1917 of the Social Security Act (42 U.S.C. 1396p), and
- (II) all of the beneficiaries of the trust as of the close of the taxable year are determined by the Commissioner of Social Security to have been disabled (within the meaning of

section 1614(a)(3) of the Social Security Act, 42 U.S.C. 1382c(a)(3)) for some portion of such year.¹

The trust shall not fail to meet the requirements of subclause (II) merely because the corpus of the trust may revert to a person who is not so disabled after the trust ceases to have any beneficiary who is so disabled.”²

In order to be a QDT, a trust must meet the statutory requirements of 42 U.S.C. 1396p(c)(2)(B)(iv):

- (i) It must be irrevocable;
- (ii) It must be for the sole benefit of the disabled beneficiary;
- (iii) The beneficiary must be under the age of 65; and
- (iv) The beneficiary must be disabled as defined for purposes of the Supplemental Security Income (SSI) and Social Security Disability Income (SSDI) programs.³

Most first-party SNTs would be a Qualified Disability Trust. A third party SNT, however, could qualify for QDT status if the beneficiary is receiving SSI or SSDI, the trust is irrevocable, the disabled beneficiary is the sole beneficiary, and the trust was funded before the beneficiary reached the age of 65.

Case Study

Parents create a revocable third-party SNT for their child, and fund it with their own funds while they are living. This is taxed as a grantor trust as to the parents. This trust does not qualify as a QDT because the trust is not a separate tax payer, and the trust is revocable.

Case Study

Parents create a third-party SNT for their child, and it is not funded until both parents pass away. When the parents die, the trust becomes irrevocable, so it could qualify as a QDT if the child is under 65 at that time.

Case Study

Grandparents establish an irrevocable SNT for their disabled grandchild, naming someone other than the grantors as the trustee. The grandparents fund the trust with their annual gift tax exclusions each year (\$16,000 each in 2022). The grandchild is a minor and has not applied for SSI/Medicaid because the income and resources of the parents are deemed to be that of the child, and disqualify the child. Since the grandchild has not received a disability determination from the Social Security Administration, the trust is not a QDT. When the child turns 18 and receives SSI/Medicaid, the trust will qualify as a QDT for that year.

¹ I.R.C. Sec. 642(b)(2)(C)

² I.R.C. Sec. 642(b)(2)(c)(ii)

³ 42 U.S.C. 1396p(c)(2)(B)(iv)

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