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# Taxation of Special Needs Trusts

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**TAXATION OF SPECIAL NEEDS TRUSTS**

## I. INTRODUCTION

On the top left corner on the face of a Form 1041, a tax preparer checks a box for the type of trust they are preparing an income tax return for. The most common boxes tax preparers check are for Simple Trust, Complex Trust, and Grantor Trust. How the trust agreement is written and therefore taxed has a significant impact on the administrative work required of the trustee and ultimately how effective the trust is over its life.

## II. <u>MOST COMMON TRUSTS</u>

**<u>Complex Trust</u>**[1]:

- The trustee can choose to make or not make distributions
- Trust can pay taxes and have estimated tax payments
- Trustee fees need to be unbundled. Many trust departments now break these down for the preparer as trustee fees vs. investment management fees. Some instruct the preparer on what percentage to apply.
- Legal fees need to be trust related to be deductible
- K1s generated based on distributions made to beneficiaries.
- Form 1041 filed annually
- Tax deduction of $100 i.e. the first $ $100 in income is not taxed
- Tax rate: 37% on taxable income over $15,200

**<u>Simple Trust</u>[2]:**

- The trustee must distribute all (distributable net) income from the trust
- Trust can pay taxes and have estimated tax payments. Capital gains are generally kept within the trust and therefore even though all non-capital gain income is distributed, the capital gains in the trust can trigger a tax burden.
    - A trend we are seeing at several departments is making the 4th quarter estimated tax payment in December so that it is included in the transaction details for the year. Otherwise the tax preparer will have to confirm the Q4 payment in January(of subsequent year) with trust department
- K1s generated based on distributions made to beneficiaries.

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[1] I.R.C. 661

[2] I.R.C. 651

- Form 1041 filed annually
- Tax deduction of $300 i.e. the first $ $300 in income is not taxed
- Tax rate: 37% on taxable income over $15,200

**Grantor Trust[3]**:

- 100% of all items flow through to the beneficiary
- This trust never pays taxes and will never pay estimated taxes
- No need to unbundle Trustee Fees – not a deduction to the trust and not a deduction at the individual level (these used to be deductible as miscellaneous deductions subject to 2% of AGI)
- A Grantor Trust Letter (similar to a K1) will be generated showing all items of income/deductions.
- Depending on setup, may need to file a Form 1041 or reported directly on the grantor's Form 1040
- Tax rate defaults to taxpayer's individual rate
    - 37% on taxable income over $609,351 for single
        - To make a direct comparison to non grantor trusts, taxable income of $15,201 up to $47,150 is at a 12% rate.
    - 37% on taxable income over $731,201 for married filing jointly
        - To make a direct comparison to non grantor trusts, taxable income of $15,201 up to $23,200 is at a 10% rate.

*****CPA NOTE**: It is extremely important that the fiduciary verify that trusts are being classified correctly on the Form 1041. Tax software will generally default to non-grantor. Per the tax rates above this can be very detrimental – imagine paying 37% on undistributed income that should have been taxed at 10%/12%!

## III. SPECIAL NEEDS TRUSTS:

- First party trusts are generally written and treated a grantor trusts.
    - Grantor = Beneficiary
    - Example: a minor is injured in an accident. There is a settlement for injuries and the court creates a grantor trust with these funds. Because this trust is funded with the minor's settlement for the benefit of the minor, this is a first party grantor trust.
- Third party trusts are generally written and treated as complex.
    - The grantor is not the beneficiary
    - Example: parents set up and fund a trust for their child with special needs with them being trustee during their life and naming a corporate trustee after they pass.

[3] I.R.C. 671

## Title search: Taxation of SNTs, Including Court Created Trusts

Also available as part of the eCourse
2025 Special Needs Trusts eConference

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