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Taxation of Special Needs Trust from A to Z

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Taxation of Special Needs Trusts from A to Z

Dennis M. Sandoval[1]

Introduction

The taxation of a special needs trust and its beneficiary depends on a multitude of factors. The initial inquiry is whether the special needs trust is considered a grantor trust or a non-grantor trust for income tax purposes.

Grantor Trust

A grantor trust is a trust that is disregarded for income tax purposes and the income from the trust is included on the personal income tax return of the grantor (usually the creator, settlor, Trustor or TrustMaker of the trust). The reason the trust is disregarded and the trust income is taxable to the grantor is that the trust is funded

[1] Dennis was a finalist for the Best Dad on Wheels 2013, 2014 and 2016, sponsored by The Christopher and Dana Reeve Foundation. Unfortunately, he never won the grand prize and the foundation no longer conducts the competition. But Dennis considers it one of the greatest honors in his life that his three daughters and son-in-law nominated him for the award numerous times and the Christopher and Dana Reeve Foundation Board of Directors selected him as a finalist on these three occasions.

Dennis is a NAELA (*National Academy of Elder Law Attorneys)* Fellow and has served on the Board of Directors of SNA *(Special Needs Alliance)*, NAELA, NELF *(National Elder Law Foundation),* and other legal organizations. He is the only attorney in California certified as a Certified Estate Planning, Trust, and Probate Law Specialist, Certified Taxation Law Specialist and Certified Elder Law Attorney. He has been named a Southern California Super Lawyer for almost a decade. He has taught as an adjunct professor for the Stetson LLM in Elder Law program.

with the assets of the grantor and the grantor has retained some type of "grantor trust power" relating to the control or beneficial enjoyment of trust assets that causes the trust income to be taxable to the grantor. The most common example of this would be a revocable living trust. Because the grantor retains control of the trust assets and the beneficial enjoyment of the assets, a revocable trust is disregarded for income tax purposes and the trust income is reported using the Social Security Number on the personal income tax return of the grantor.

It doesn't matter who the income beneficiary of a grantor trust is. For instance, the grantor could create an irrevocable trust that paid all income to his grandmother and then paid the remainder to whoever the grantor designates, or if he fails to designate a remainder beneficiary, the trust residue is returned to him or her upon his grandmother's death. Because the grantor retained the power to designate who would benefit from the trust remainder and / or the right to receive the trust remainder himself, the trust would be considered a grantor trust for income tax purposes. Because the trust is considered a grantor trust for income tax purposes, the trust income is reported on the grantor's income tax return even though the income is actually being distributed to his grandmother.

A First-Party Special Needs Trust would be considered a grantor trust. This is because the trust is funded with the assets of the disabled beneficiary (from litigation settlement, gift, inheritance, lottery winnings, assets owned at the time the person

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