Tax Basics for Families with Special Needs

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Families of children and adults with disabilities often require a variety of services in order to fully meet the needs of the person with disabilities, as well as the rest of the family. The financial resources available to pay for medical, caregiving and other needs must be found, and the providers must be engaged to render these services.

Many families have implemented a “special needs trust” for the benefit of the special needs child or adult, and such a trust will allow access to government health benefits for the person with disabilities that would otherwise be unavailable. Many families have also found it necessary to employ paid caregivers to provide care for the persons with disabilities and respite for the other family members. This article will briefly discuss the basic tax consequences of the two most common types of special needs trusts for persons with disabilities and the tax issues associated with the employment of an outside caregiver.

Third-Party and Self-Settled Special Needs Trusts

The family of a child with disabilities should take particular care in the family estate planning to maximize the resources available to meet the needs of that child, even after the parent(s) or primary provider is gone. If the parent has no will or living trust, the state laws of inheritance will generally require that a portion of that parent’s estate assets pass to the special needs child at the parent’s death. If such inheritance exceeds the level of assets the child is allowed to have for Supplemental Security Income (SSI) or Medicaid eligibility (usually $2,000), this inheritance will disqualify the child for these valuable benefits to pay for medical, therapeutic and support needs. Therefore, the parent of such a child should establish a “special needs trust” (SNT) in his/her will or living trust, or separate from the will or trust, and should provide in the will or living trust that any share passing to the child with a disability will instead pass to the SNT. The SNT will be an irrevocable trust after the parent’s death. The designated trustee will then hold and disburse the trust funds for services and purposes on behalf of the disabled beneficiary in such a manner as to retain the beneficiary’s eligibility for public benefits. At the death of the disabled beneficiary, the remaining trust assets will pass to those persons or charities designated by the parent in the SNT. This type SNT is often referred to as a “third-party” SNT because it is to be funded with assets (such as gifts, life insurance proceeds, inheritance distributions) from parents, grandparents or others, NOT with assets of the beneficiary.

On the other hand, a “self-settled” SNT is generally established by a parent, grandparent, legal guardian or court for the benefit of the person with disabilities, but is funded with assets owned by the disabled beneficiary. Such assets can include: a lawsuit settlement arising out of injuries to the disabled beneficiary; an inheritance, or a life insurance settlement that is to come directly to the beneficiary rather than to a third-party SNT. A lawsuit settlement for personal injuries is not subject to income tax when received, however, the interest income generated by investment of those funds (except in a structured settlement annuity purchased with such an award) will be subject to income tax.

Income Tax Treatment of Trusts

One important aspect of a special needs trust is the income tax treatment of such a trust. Trusts that are required to pay income taxes directly from the trust must pay such taxes at higher rates than individuals. For instance, in 2003 a tax-paying trust reached the 38.6 percent top rate at $9,350 of taxable income, while an individual reached the 35 percent top rate at $311,950 of taxable income. Tax laws classify trusts created by individuals as either “grantor” trusts (which are not treated as separate taxable entities) or “non-grantor” trusts (which are taxable entities). All revocable trusts (that is, which can be revoked by the grantor) are grantor trusts. Many irrevocable trusts can also be grantor trusts based upon the powers and rights retained by the grantor in the trust. Section 671 of the Internal Revenue Code (“IRC 671”) provides that where the person establishing a trust (“grantor”) is considered the owner of the trust assets, then the “items of income, deductions and credits” of the trust will be included in the grantor’s personal income tax determinations. IRC Sections 673 through 677 describe certain powers over the trust assets or income that will result in treating the grantor as owner of the trust. Simply summarized, these include: a provision in the trust that any portion of the trust exceeding five percent of the trust will revert back to the grantor in the future (IRC 673); a power by the grantor to change the disposition of trust assets or income (IRC 674); power by the grantor to deal with the trust assets for less than full consideration or borrow from the trust without adequate collateral (IRC 675); power by the grantor to revoke the trust and re-vest trust assets in the grantor (IRC 676); and a power by the grantor to require distribution of trust income to the grantor or grantor’s spouse or to purchase life insurance on the life of grantor or his/her spouse (IRC 677). These Internal Revenue Code sections also contain exceptions which can be used through careful drafting to change a grantor trust to a non-grantor trust.

There may be financial reasons to make a special needs trust either a grantor trust or a non-grantor trust. One reason to have a grantor SNT is to avoid having the trust pay taxes on the income of the trust at the higher trust rates. All of the trust income of a grantor self-settled SNT (whether paid out for the beneficiary’s needs or not), along with the deductions for professional fees and expenses, will be passed along to the beneficiary for inclusion on his/her personal income tax return at the lower individual tax rate. This may be desirable if the distribution needs of the disabled beneficiary make it unlikely that the trust will distribute most or all of the income for the benefit of the beneficiary. The reason for this is that a trust may take a tax deduction for all income distributed out to or for a beneficiary, while there is no such deduction for income earned but not distributed by the trust. Conversely, where the trust is likely to distribute most or all of its income for the beneficiary’s needs, it may be advisable for the trust to have non-grantor status so that it can take the deduction for such distributed income and the professional fees and expenses. The result may be little or no taxable income to the trust. The determination of whether grantor trust or non-grantor trust tax treatment will be better depends on the particular circumstances of each family. For this reason, an attorney with special needs trust and tax experience should be used to assure the proper results.

Estate Tax Treatment of Trusts

The estate tax is a tax on the value of assets owned by a person at death after deduction of that person’s debts (the “taxable estate”). Under current law, there is no federal tax on taxable estates of less than $1.5 million in 2004 (increasing to unlimited value in 2010 and falling back to $1 million in 2011). The beginning tax rate on estates is 37 percent and increases to a top rate of 48 percent on estates over $2 million (2004). A person’s estate includes the value of all assets transferred by that person by trust, to the extent that the deceased grantor retained certain interests or powers over the trust. Some of the interests or powers over trust assets that will generally result in the trust assets being included in the grantor’s estate include: the right to income from or possession or enjoyment of the assets; the right to designate the persons who will possess or enjoy the trust property or income; and the right to use trust assets to pay legal obligations of support, such as the general support of the grantor’s spouse or minor children. (These provisions are found in IRC 2033 – 2041.)

Depending on the particular family financial circumstances, it may be advantageous to structure a special needs trust so as to remove the trust assets from the grantor’s or beneficiary’s estate. For instance, a parent or grandparent with a taxable estate may wish to create an irrevocable third-party SNT for a child or grandchild with disabilities and transfer some of the grantor’s assets into the trust while the grantor is still living. If the grantor does not retain any of the interests or rights over the trust property that would cause it to be included in the grantor’s estate, this will remove those assets from the grantor’s estate and reduce the estate tax at the grantor’s death. A self-settled SNT will generally be included in the estate of the beneficiary, since it is funded with the beneficiary’s assets. However, if the trust is drafted such that the beneficiary retains no interest in or control over the trust property (including the right to determine in the beneficiary’s will who will get the remainder after the beneficiary’s death), the funding of the trust may be considered a completed gift to the remainder beneficiaries and not part of the primary beneficiary’s estate for estate tax purposes. In any event, the family and attorney setting up a special needs trust must ensure that, if the size of the trust will create an estate tax liability, there will be sufficient funds available to pay the taxes within nine (9) months after death. It is particularly important for an attorney settling a lawsuit into a SNT to have the settlement funds paid to the attorney, as attorney for the SNT, and then deposit the funds directly into the trust. Payment of settlement funds to the client, who later deposits them into the SNT, may create undesirable gift tax problems.

Employment of a Caregiver
Families of persons with disabilities frequently engage caregivers from outside the home to help care for the disabled family member and provide respite for the family from such responsibilities. Caregivers may be found through agencies, in which case the family will make a payment to the agency to cover the wages, taxes, insurance and benefits the agency provides to the attendant. However, outside caregivers not employed by an agency will often request payment for services in cash and will agree to pay their own insurance and taxes as “independent contractors”. This is rarely the correct method. The determination of whether a caregiver is an independent contractor (who will be responsible for paying their own taxes) or an “employee” (for whom the employer must withhold and pay unemployment and income taxes) will depend on several factors, including: right of control by the employer over details of the work; whether the employee is engaged in a distinct licensed occupation or business; whether the employer supplies the tools and place of work for the caregiver; the length of time for which the person is employed; whether the employer can discharge the worker; the method of payment, whether by the time or by the job; and whether the work is part of the regular business of the employer. Numerous cases have considered such factors and have found domestic caregivers to be employees rather than independent contractors. In such an event, tax and unemployment agencies will require the employer or employer’s estate to pay the income and unemployment taxes that were not withheld along with penalties for non-payment.* Therefore, the parent (or SNT trustee) should (1) treat a regular caregiver as an employee and withhold the FICA and taxes required, and (2) take out worker’s compensation insurance in case the worker is injured on the job. A CPA or payroll service can assist the parent or trustee with these processes.

Tending to these tax details in the proper manner will minimize taxes and prevent later difficulties over unpaid taxes.

**See Estate of Dulaney v. Mississippi Employment Security Commission, 805 So.2d 643 (Miss. 2002).*

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