Proper Use of a Qualified Disability Trusts Can Provide Income Tax Savings Opportunities

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The use of a "Special Needs Trust" ("Trust") has become an important component in planning for a special needs individual and enabling them gain eligibility for government benefits (Medicaid, Supplemental Security Income (SSI), or public housing). Proper utilization of the Trust can remove funds from being considered an available resource of the beneficiary while enabling a Trustee to make distributions that supplement, but do not replace, the beneficiary's government benefits.

A Special Needs Trust can be established by an individual (a "self-settled trust"), with settlement proceeds received as a result of a disability (a "payback trust" or a "pooled trust"), or as a "qualified disability trust," A self-settled trust will typically be a grantor trust with its income taxable to the grantor. Both a pooled or payback trust will only be entitled to a $100 personal exemption while any remaining funds will revert to the government or remain in the pooled trust. In contrast, if the qualified disability trust can meet certain requirements, the Trust will be eligible for the qualified disability exemption under IRS Code §643.

Qualified Disability Trust:

Only certain Special Needs Trusts can qualify as a qualified disability trust. To be classified as a "qualified disability trust," the Special Needs Trust must meet the following requirements: (i) be irrevocable; (ii) be a trust described in 42 U.S.C.§1396p(c)(2)(B)(iv) (not be a grantor trust; and (iii) be established for the sole benefit of a person under age 65 who meets the Social Security Administration's definition of "disabled." The first requirement can be satisfied through a qualified "third-party trust," which is created and funded with funds that are not owned by the special needs individual. The second requirement can be met by insuring the trust is drafted for the sole benefit of the disabled individual and not multiple beneficiaries (no person or entity can benefit from the trust during the lifetime of the disabled beneficiary).

Tax Benefit:

All irrevocable trusts are required to file a Federal income tax return annually. However, the tax treatment of the funds maintained for an individual with a disability will vary greatly depending on the way in which the trust is drafted and administered. A standard irrevocable trust (not considered a "grantor trust") will be entitled to a $100 personal exemption (amount of income exempt from taxation) and be subject to the maximum thirty-five (35%) percent income tax rate on trust income in excess of $11,150. In contrast, a qualified disability trust can take advantage of the $3,650 qualified disability exemption under IRS Code § 643(b)(2)(C). This benefit is not insignificant in that it will (i) exempt income, which can be added to principal, from federal income tax and (ii) provide the qualified disability trust with an annual tax savings of $1,240 (approximate amount if the trust has more than $11,150 in income).