

When Is a Special Needs Trust Considered a Qualified Disability Trust for Federal Income Tax Purposes?

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Many Special Needs Trusts established by persons other than the disabled beneficiary have in the past been treated as “complex” trusts for federal income tax purposes, and allowed only a \$100 personal exemption. That means that if the trust had undistributed income in excess of \$100, there would be federal income taxes due. A federal tax law that became effective in 2001 provided a tax break for some Special Needs Trusts, so that if the trust meets the definition of Qualified Disability Trust, it would qualify for the higher personal exemption, which on a 2009 federal income tax return is \$3,650.

(This exemption can be lost in the event that the “modified adjusted gross income” of the Special Needs Trust is over \$166,800. If you’re now wondering who that would apply to, you read my mind; many of the Special Needs Trusts I have seen don’t even have that amount in assets, let alone in annual income.)

To qualify as a Qualified Disability Trust, the trust must be established and funded by an estate or someone other than the disabled beneficiary, and before the beneficiary attains the age of 65 years. The special needs beneficiary must be receiving SSI or SSDI benefits at the end of the tax year. Unfortunately, if a beneficiary is a disabled federal or state retiree who doesn’t receive benefits from the Social Security Administration, the trust doesn’t qualify as a Qualified Disability Trust.

If a Special Needs Trust has more than one beneficiary, the tax result is not absolutely clear. The apparent intention of the tax law is that there can be more than one beneficiary as long as they are all receiving SSI or SSDI benefits. Unfortunately, a general problem with this tax law is that it points vaguely to a Medicaid law which describes transfers that do not disqualify a person who applies for Medicaid, and the Special Needs Trust provision in that Medicaid law has been interpreted by the Social Security Administration as requiring only one disabled beneficiary per trust. For practical purposes, however, it seems that this negative interpretation of the sloppy tax law is being ignored, and Special Needs Trusts established and funded by estates or persons other than the disabled beneficiary are being treated as Qualified Disability Trusts.