

# Trust & Estates

## Taxes and Planning

### TM Financial Services

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### Special Needs Trusts Taxation Issues

There are important differences in the tax treatment between special needs trusts funded with the disabled individual's own assets (Self-settled or d(4)(a) trust) and those funded with the assets of another – usually a parent or other relative (Third-party SNTs). Here we attempt to summarize those differences as it relates to some tax issues.

For IRS purposes, the grantor is the person who funds the trust, not the person who forms it. A d(4)(a) trust is formed by the disabled individual's parent, grandparent, legal guardian or the court but since the trust is funded with the disabled person's own assets, the IRS considers him or her to be the grantor. This can differ from government benefit agencies who will look to the wording in the trust document to establish the grantor.

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### The Rise & Fall of Form 8939

Sometime in late October a draft of Internal Revenue Service Form 8939 entitled "Allocation of Increase in Basis for Property Received from a Decedent", started showing up on websites.

Sometime in early November stories about the IRS scrapping Form 8939, due to inaccuracies, started showing up on websites.

Although the IRS had known of the possible need for such a form for over ten years, it remained a low priority on the IRS "to do" list because like most, they probably felt that the current impasse on new estate tax legislation would never occur. Reminds me of my son who upon hearing a forecast for heavy snow, decided not to study for his math exam, feeling that school would be closed due to a snow day. We ended up getting about two inches and naturally, school was open.

He did about as well on the exam as the IRS did on their draft form 8939.

SNTs (continued from page 1)

### Self Settled Trust

In practice these are almost always grantor trusts and many authorities claim that by definition a self-settled SNT is a grantor trust, usually because of the provisions of §677 where income is used for the benefit of the grantor or may be so used at the discretion of the grantor or a non-adverse party.

In Rev. Rul. 2004-64 the IRS gave its opinion as to whether the grantor trust can pay the tax liability of the grantor without jeopardizing grantor trust status or risk inclusion in his estate. The ruling provided that there is no loss of grantor status and that if the trust's governing instrument or applicable local law gives the trustee the discretion to reimburse the grantor for that portion of the grantor's income tax liability, the existence of that discretion, **by itself** (whether or not exercised) will not cause the value of the trust's assets to be includible in the grantor's gross estate." (As noted later, a self-settled SNT **will** be included in the grantor's estate because of the retention of a life interest in the income of the trust.)

Generally, the establishment of a self-settled trust should not have gift tax implications even though the grantor-disabled individual has made an irrevocable transfer and has seemingly given up dominion and control over the property. The common argument is that the trust is being funded for the disabled individual's own benefit with his own funds and therefore no gift is either intended or made. Additionally, it is argued that control has not really been given up as the disabled individual can still see to it that the trust income is used for their benefit through court review.

A d(4)(a) will be included in the grantor's estate as the funds are used solely for the benefit of

the grantor during his lifetime and as such, §2036 (transfers with a retained life interest) mandates inclusion in the estate. This is usually not a big issue as often the funds used during the disabled beneficiary's life reduce the trust balance to below the exemption amount (at least up to 2009) and also the Medicaid payback provision for repayment of benefits provided (not required in a third party SNT), further reduce the trust balance.

### 3<sup>rd</sup> Party Trusts

These are typically taxed as complex trusts, that is, they are taxed at the trust level on undistributed income. It might in some cases be beneficial to have it taxed as a grantor trust to avoid the compressed tax brackets for trusts. A testamentary third party SNT, one created in the grantor's will, will not qualify as a grantor trust because the grantor has not retained any rights specified in code sections 671-677. An intervivos trust, on the other hand could be structured as an intentionally defective grantor trust, for example by including provisions under §675 (substituting assets) which would create grantor trust status without causing inclusion in the grantor's estate for estate tax purposes.

If grantor trust status is not desired or possible the 3rd party SNT can avail itself of additional benefits above and beyond a complex trust if it can qualify as a Qualified Disability trust. To qualify the

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**Compensation of Executors**

**Income**

6% on all income received by the fiduciary.  
N.J.S.A. 3B:18-13

**Corpus**

5% on first \$200,000 of corpus received.  
3.5% on excess over \$200,000 up to \$1,000,000.  
2% on the excess over \$1,000,000.  
N.J.S.A. 3B:18-14

**Compensation of Trustees and Guardians**

**Income**

6% on all income received by the fiduciary.  
N.J.S.A. 3B:18-24

**Corpus**

\$5.00 per thousand of corpus on the first \$400,000.  
\$3.00 per thousand of corpus in excess of \$400,000.  
N.J.S.A. 3B:18-25(a)

**New Jersey Fiduciary Commissions**

	A.	B.	C.
Capital-loss carryover	x		
Net Operating loss carryover	x		
Suspended passive-activity losses		x	
Excess deductions (Interest, taxes, legal, accounting)	x		
Excess charitable deductions			x

- A. Distributed to beneficiaries
- B. Basis of activity increased
- C. Deduction lost

**Deductions in the final year of a trust or estate**

**SNTs**

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trust must be irrevocable, established for the sole benefit of the disabled beneficiary who is under 65 and disabled as defined by provisions of the Social Security Act. A qualified disability trust receives a full personal exemption - \$3,650 in 2010 as compared to a complex trust which has a \$100 exemption. Therefore the income retained by the trust up to the exemption amount is not taxed. Since the beneficiary can also claim a personal exemption, the trustee can distribute up to \$3,650 without any tax on the beneficiary as well.

Contributions to a third party SNT constitute a completed gift but unfortunately do not qualify for the annual gift tax exclusion (\$13,000) because they are not a gift of a present interest. Although common in many "gifting to trusts" situations, the inclusion of Crummy withdrawal provisions are not appropriate with special needs trusts as those assets will be deemed "available" to the disabled individual and negatively affect the ability to receive government benefits.

Generally, if structured as an irrevocable trust without any types of retained or revisionary interests, the third party trust is a completed gift and will not be included in the grantor's estate. This is true for the most common situation with the trust taxed as a complex trust or even, as mentioned above, if taxed as a grantor trust, specifically an IDGT.

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### Decedent's former residence

In the hands of the estate, the former residence is deemed a capital asset. \$3,000 per year of loss on the sale of the property can offset income of the estate until termination when the balance of the loss is distributed to the beneficiaries to take on their 1040s.

While held for sale, mortgage interest is deductible as investment interest and other costs of holding the property are deductible as administrative expenses on line 15a of the 1041.

<b>IRS</b>	General Information	800-829-1040
	EINs	800-829-4933
	Form 706 & 709	866-699-4083
<b>NJ</b>	General Information	609-826-4400
	Estate & Inheritance	609-292-5033
<b>NY</b>	General Information	518-457-5181
	Estate Tax	518-457-5387
<b>CT</b>	General Information	860-297-5962
<b>PA</b>	General Information	717-787-8201

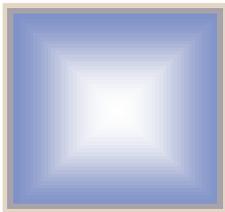
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### Important Phone Numbers

The estate cannot take advantage of any of the favorable tax methods available to individuals, e.g., the exclusion of \$250,000 or \$500,000 gain on sale.

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