What is a "qualified disability trust" for Federal income tax purposes?

BY

Ron M. Landsman

AND

Robert Fleming

Congress in 2001, as part of the Patriot Act, added a small tax benefit for some disabled individuals who are the beneficiaries of special needs trusts. This provision, now §642(b)(2)(C) of the Internal Revenue Code, defines a "qualified disability trust" (QDisT) and gives the trust a deduction equal to the personal exemption. With the exemption amount at $3,500 in 2008, that will save a trust with net income over $10,000 almost $1,200.

The benefit requires some explanation. The inclusion by cross-reference of public benefits law may leave some tax specialists uncertain as to the exact scope of the benefit. A review from the public benefits perspective, however, shows that the qualified disability trust provision should apply to most non-grantor trusts for the benefit of a disabled individual receiving SSI or SSDI benefits. The one trap for the unwary, and usually not apparent from the face of the documents: that the trust be funded before the beneficiary turn 65.

The benefit. The obvious benefit is a deduction equal to the personal exemption amount, thus potentially reducing taxable income by $3,500 in 2008. IRC § 642(b)(2)(C)(I) The deduction is in lieu of a personal exemption. Since the trust would have an exemption of $100 [1] without this provision, it increases the deduction by $3,400 and thus for trusts in the top (35%) tax bracket (those with net income of $10,700 or more) reduces tax liability by $1,190. [2]

For a small subset of QDisTs, there may be a secondary benefit. In those few cases where the beneficiary of the trust is subject to the Alternative Minimum Tax,[3] both the exemption amount savings and the treatment of the trust as a separate taxpaying entity may reduce AMT tax rates.

WHICH TRUSTS ARE CLEARLY QDISTS? The statutory definition of a QDisT is a trust that is "a disability trust described in subsection (c)(2)(B)(iv) of section 1917 of the Social Security Act (42 U.S.C. § 1396p)," [4] and all of whose beneficiaries are "determined by the Commissioner of Social Security to have been disabled (within the meaning of §1614(a)(3) of the Social Security Act, 42 U.S.C. 1382c (a)(3)) for some portion of such year." [5] IRC §642(b)(2)(C)(ii) continues after the definition by providing that: "A trust shall not fail to meet the requirements of subclause (II) [the requirement that "all of the beneficiaries" must be disabled] merely because the corpus of the trust may revert to a person who is

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1 The "deduction for personal exemption" for trusts is set at $100 for most trusts and $300 for those trusts which are required to distribute all income (so-called "simple" trusts). IRC §642(b). Since few special needs trusts will qualify as "simple" trusts, we assume for purposes of the illustrations here that the deduction will be limited to $100.

2 Assuming tax rates as in place at the beginning of the calendar year remain the same, the 2009 figures are slightly higher. The personal exemption will be $3,650, the 35% tax bracket for trusts begins at $11,150, so that the tax savings from use of the QDisT election may be as high as $1,242.50.

3 The most likely scenario for AMT involvement will be where the beneficiary is a minor, subject to "Kiddie Tax" treatment and therefore taxed at wealthier parents' rates. In a very few cases, the beneficiary may have investment income which triggers the AMT provisions. Since, as explained below, it will not be possible for a self-settled trust to qualify as a QDisT, avoidance of AMT treatment will not be available for such trusts.

4 IRC §642(b)(2)(C)(ii)(I)

5 IRC §642(b)(2)(C)(ii)(II)

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not so disabled after the trust ceases to have any beneficiary who is so disabled."

Beneficiaries must be getting SSI or SSDI. At the very least, all of the beneficiaries of the trust must be getting either SSI or SSDI benefits. This is not true of all trusts "described in" §1396p(c)(2)(B)(iv), which can be established without a finding of disability of the beneficiary by Social Security, so long as the person could meet that test for disability. As a matter of practice, SSA makes disability determinations only made when the person seeks benefits because he or she is disabled and is poor enough to qualify for SSI or has a work record to qualify for Social Security disability income. [6] A trust for a disability retired federal retiree without SSA benefits, for example, could never qualify.

Typically, the disabled individual is a beneficiary for life, but that does not appear to be a strict requirement for QDisT status; for example, a trust could provide benefits for a disabled child for a term of years, and then permit distributions for all of the grantor's children. Unlike the "sole benefit" requirement in the public benefits provision, which requires that the disabled beneficiary's interest terminate only at death, the QDisT provision permits reversion "after the trust ceases to have any [disabled] beneficiary ... ."

The trust cannot be a grantor trust. The trust itself must be a taxpaying entity. Since a grantor trust does not file a separate return, it simply will not qualify as a QDisT. While this concept is clear and unarguable, the much more difficult question is whether a self-settled special needs trust may ever qualify as a QDisT.

The phrase "self-settled special needs trust" is usually used to describe a §1396p(d)(4)(A) trust. Such a trust will, of course, have been established to allow payments on behalf of a beneficiary with a disability, without preventing that beneficiary's eligibility for public benefits. A key element of the self-settled special needs trust, then, will be that the trustee has discretion to use all trust income and corpus for the benefit of the beneficiary. IRC §673, however, gives grantor trust status to any portion of a trust in which there is a reversionary interest of as much as 5% of the value of the trust. Since the value of the reversionary share is calculated by "assuming the maximum exercise of discretion in favor of the grantor," [7] the very ability of the trustee to invade principal for the benefit of the beneficiary will cause the entire trust to be treated as a grantor trust.

Would it be possible to draft a self-settled special needs trust to avoid grantor trust status under IRC §673? Yes, but only by the draconian measure of prohibiting invasion of principal or distribution of income in excess of the five percent limitation. Even aside from the loss of public benefits, since the trust would then not be for the sole benefit of the beneficiary, such a change would hardly be worthwhile. Since for most tax purposes the treatment of a self-settled special needs trust as a grantor trust is actually beneficial (by avoiding the compressed tax rates imposed on trusts), it seems highly unlikely that any trust drafter would ever adopt this extremely narrow approach simply to achieve QDisT status.

Grantor trust treatment can, of course, apply to third-party special needs trusts. Although the income beneficiary may (a) be disabled, and (b) not be the original source of the funds transferred to the trust, the grantor trust rules of IRC §§671-678 may cause treatment of the trust as a grantor trust to the original trust creator. In such a case, QDisT treatment will not be available to the trust for the simple reason that the trust is not a taxable entity. [8]

The trust must be established for the benefit of disabled individuals under age 65. What trusts are "described in" §1396p(c)(2)(B)(iv)? That provision refers to "... a trust (including a trust described in subsection (d)(4) of this section [42 U.S.C. § 1396p(d)(4)]) established solely for the benefit of an individual under age 65 years of age who is disabled (as defined in section 1382c(a)(3) of this title [42 U.S.C. § ----(a)(3)])." Where a trust meets those requirements, the subsection in which that definition is contained

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6 The Social Security POMS (Program Operations Manual System) includes a provision for establishing disability even though the applicant would not be eligible for either SSD or SSI. POMS SI 01150.121. It applies where the grantor of the trust seeks SSI benefits and wants to take advantage of the exception in the anti-transfer rules for transfers to trusts referenced by the QDisT provision. This mechanism does not appear to be available, except perhaps in a few Social Security regions, absent that. State Medicaid programs have similar provisions for individuals seeking Medicaid (but not SSI) who have funded a trust for a person claimed to be disabled; if those determinations are not made pursuant to a delegation of authority from SSA, they would appear not to be sufficient to satisfy the SSA determination requirement for QDisT status.

7 IRC §673(c)

8 Confusion persists about the actual tax filing for a grantor trust. The rules are, however, simple: a grantor trust is not required to acquire a separate EIN, though it may do so [26 CFR §301.6109-1(a)(2)(i)(B)]. If there is a trust EIN, the grantor trust files a return merely disclosing that it is a grantor trust and will not report income or deductions [26 CFR §1.6012-3].

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provides that a transfer to the trust is exempt from the Medicaid anti-transfer rules in § 1396p(c)(1). [9]

SSA has interpreted §1396p(c)(2)(B)(iv) to require that the trust be established for the benefit of a single disabled person under age 65. [10] Thus, a parent with three disabled children could not establish one trust for all of them and still get the benefits of §1396p(c)(2)(B)(iv). The IRC provision, §642(b)(2)(C)(ii)(II), by contrast, requires that "all of the beneficiaries ... are determined ... to have been disabled ... " (emphasis added again). If the IRC provision permits multiple beneficiaries, so long as they are all found by SSA to be disabled, the "sole benefit" element would appear not to apply.

A trust that is funded when the beneficiary is under age 65 continues to enjoy exempt status for all SSI and Medicaid purposes when the person reaches that age. Further contributions to the trust are not exempt, but future earnings, etc., are permitted. There is no reason to think a trust whose beneficiary attains age 65 should lose QDisT status. On the other hand, it is difficult to fathom a tax policy reason why a third party trust should get QDisT status only if it is funded before the beneficiary turns 65. The public benefits reason is plain enough: Congress did not want to make the Medicaid long term care benefit available to virtually every elderly person, if for no other reason than the staggering cost, and the age funding cutoff was a reasonable way to draw that line for self-settled trusts. The same is not true for this modest tax benefit.

WHICH TRUSTS ARE PROBLEMATIC FOR QDIST STATUS? What is confusing is whether the trust "described in" the Medicaid provision must exist for the same reason that those trusts are identified there – to add to the short list of transfers that are exempt from the strict Medicaid anti-transfer rules. §1396p(c)(1) imposes a penalty in the form of a denial of Medicaid long term care benefits for individuals who transfer assets for the purpose of meeting the strict resource limitations that are a condition for qualifying for those benefits. The next subsection, 42 U.S.C. § 1396p(c)(2), then identifies a small handful of exceptions to the anti-transfer rule, the first involving the home of the Medicaid applicant/beneficiary, the second describing persons to whom transfers of any assets could be made without loss of benefits for the donor – his or her spouse, a disabled child of the transferor (or a trust for the child), or a trust for any disabled person under age 65.

Certainly, QDisT status is available for trusts established by donors who later qualified for Medicaid long term care benefits and the trust-funding was excluded from the anti-transfer rules by reason of §1396p(c)(2)(B)(iv). But what about otherwise identical trusts that weren't, or weren't intended to be, or couldn't have been used for that purpose? Consider the following variations on the first easy QDisT case. In each of the listed variations, the trust was established by a grantor for the benefit of a single individual who was receiving SSI and or SSDI and was under age 65 at the time the trust was established.

Established early. The trust is established by someone anticipating the need for Medicaid long term care benefits, but who funded the trust well in advance of his or her Medicaid application. If the trust was funded more than five years prior to the application and the grantor retained no interest in the trust, it is not in the "look-back" period and so is never reported to Medicaid and there is never a determination by a state Medicaid agency that funding the trust is exempt.

No Medicaid application. The trust is established and funded at the time of nursing home admission, but the donor dies before the period for which Medicaid benefits would be sought, so that there is no reason to apply.

No Medicaid determination. The trust is established and funded immediately prior to the filing of the Medicaid application, but the donor dies before the benefits justify the additional work to get qualification.

Medicaid denied for other reasons. The trust is established and funded immediately prior to the filing of the Medicaid application, but Medicaid is denied for another

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9 The statutory provision reads as follows:

An individual shall not be ineligible for medical assistance by reason of [a transfer under] paragraph 1 [42 U.S.C. § 1396p(c)(1)] to the extent that

(B) the assets —

(iv) were transferred to a trust (including a trust described in subsection (d)(4) of this section) established solely for the benefit of an individual under 65 years of age who is disabled (as defined in section 1382c(a)(3) of this title); ...

10 At first glance this might appear to rule out QDisT treatment for pooled special needs trusts established pursuant to §1396p(d)(4)(C). Closer examination, however, should clear up any doubt: the pooled special needs trust is really a grantor trust (as to the portion contributed by or on behalf of the beneficiary), and QDisT treatment was never available in any event.

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reason—the person does not need "nursing facility services," they are overscale, there were other, non-exempt disqualifying transfers, they lack citizenship or "qualifying alien" status—and there is no determination by a state Medicaid agency that funding the trust is exempt.

Or, more problematically, Medicaid benefits are denied because the trust did not contain a provision that the specific State Medicaid program imposed, e.g., it did not contain a payback provision for benefits provided the trust beneficiary or a requirement that all trust assets be distributed on an "actuarially sound basis," as some states require.

No intention to apply for Medicaid at all. The trust is established by the grantor for the benefit of a single disabled beneficiary, with the grantor retaining no reversionary interest. The trust might permit the grantor to exempt the transfer into trust for Medicaid purposes, but the grantor has substantial other assets and does not anticipate ever applying for Medicaid. In fact, the grantor simply seeks to benefit the beneficiary – the ordinary circumstance for careful planners who seek to set aside funds for a family member with a disability.

Exact same trust and beneficiary, but the trust is not funded during lifetime. The grantor establishes the trust, planning to fund it if needed during lifetime, but also writes a will that distributes the grantor's entire estate to the trust for the disabled individual if not funded inter vivos. The grantor dies before nursing home admission, so that the trust is not funded during his or her lifetime, but is funded promptly after death.

Ditto, but the trust terms are contained in the donor's will. As a matter of scrivener's practice, the same trust as the standby inter vivos trust in the previous case, but it is contained in the donor's will, and it is that trust that is funded upon the donor's death.

This sequence of cases is designed to focus on the question of where to draw the line. All of the trusts are for the benefit of a disabled person getting SSI or SSDI and funded before he or she turns 65. All but the testamentary trust could have been funded to permit the donor to qualify for Medicaid. If there were a logical line to draw in this inherently illogical area, it would be between inter vivos and testamentary trusts. But even that is not clear. Congress plainly did not intend a narrow and precise incorporation of public benefits definitions into the tax code, despite the apparent specificity. It assumed that some of the trusts referred to would have more than one beneficiary, even though long-standing interpretation by the Center for Medicare and Medicaid Services requires that all c-2-B-iv trusts "solely for the benefit of a [disabled] individual" have no more than one person as beneficiary. [11] Applying the tax benefit to all trusts that could have served the purpose of a c-2-B-iv trust, and to similarly situated disabled individuals, reflects Congress' intent to provide a modest but useful benefit to disabled individuals.

The age 65 funding requirement redux. Congress' incorporation of public benefits trust terms into tax law was sloppy at best. It is easy enough to strip away the public benefits context and disregard the Medicaid exempt transfer aspects, since it was not specifically referred to and makes no sense in the tax context. And disregarding the sole benefit requirement is necessary because Congress referred in the tax provision to multiple beneficiaries, albeit without acknowledging that the trust provision it was referring to otherwise precluded more than one. But the age 65 funding requirement is not so easily explained away. The IRS commissioner may have authority to read that requirement out of the statute, but it would be somewhat presumptuous for a tax practitioner to do so.

What does all of this mean for QDisT treatment for most special needs trusts? It is almost simple. Self-settled special needs trusts (including pooled trusts) can never qualify as QDisTs. A Third-party trust, however, will usually qualify, so long as the beneficiary is getting SSI or SSDI benefits and the trust was funded before the beneficiary turned 65 – and it will virtually always be advantageous to treat them as QDisTs. ●

11 Narrowing application of the tax benefit by requiring that the beneficiaries have SSA determinations of disability makes sense as a matter of administrative practice rather than substantive policy. There will be a specific determination of disability of the trust beneficiary if and when the donor seeks SSI or Medicaid benefits, either under the POMS provision noted above or State Medicaid practice, so that the public benefits provision need not require an SSA determination of disability in advance. But there would be no such mechanism available to IRS, so that SSA determinations are appropriately required.