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Tax Planning Using Special Needs Trusts Considering the Tax Cuts and Jobs Act of 2017

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This outline will provide a thirty thousand view of the taxation of Special Needs Trusts and an outline of the impact of the Tax Cuts and Jobs Act of 2017 ("TCJA") on Special Needs Trusts.

1. First Party Special Needs Trusts
   a. Income Taxation: Since First Party Special Needs Trusts ("FP–SNTs) are treated as "Grantor Trust" for income tax purposes, the reporting of income and expenses will be reported by the beneficiary of the FP–SNT.
   b. Gift Taxation: The Funding of a FP–SNT will be treated as an incomplete gift for gift tax purposes.
   c. Estate Taxation: The Trust assets of a FP–SNT will be included in the estate of the beneficiary for estate tax purposes.
   d. Note: The TCJA made no change to the general taxation of FP–SNT.

2. Third Party Special Needs Trusts
   a. Income taxation: A Third Party Special Needs Trust ("TP–SNTs") can be created as a Grantor or Non-Grantor Trust for income tax purposes. The trust instrument will control whether the trust, the beneficiary or trust and beneficiary will report the income and expenses for income tax purposes.
   b. Estate and gift taxation
      i. Similar to the income tax treatment, the TP–SNT can be created to include or exclude the Trust assets from gift and estate tax inclusion.
      ii. The trust can be drafted to implements estate tax planning to minimize estate taxes.
      iii. If the trust assets are included in the estate of the Grantor, then the trust assets will step up in basis which can minimize capital gains taxation on the later sale of the trust asset.
      iv. If will be important that if the TP–SNT is a Non-Grantor Trust, then the Trustee should take advantage of the 65 rule which allows the Trustee to distribute income within the first 65 days of any taxable year of an estate or a trust, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year. Section 663(b) election requirements.
   c. Note: The TCJA made no change to the general taxation of FP–SNT

3. TCJA — Individual Income Tax Changes
   a. Beyond the reduction of the income tax rates reductions, an increase in the Standard deduction for 2019 ($12,200 for single person and $24,400 for a married couple), it is important to note that even though the Personal exemptions were eliminated, the exemption was not eliminated for elderly and blind and for Qualified Disability Trusts.

b. There is also a Credit for qualifying dependents of $500, nonrefundable (in addition to the Child Care Tax Credit).
c. Note:
    i. The TCJA made no change to the Capital gain exclusion for sales of a primary residence.
    ii. The TCJA made a change to the Medical Expense Deduction by raising the adjusted gross income test to 10% (7.5% for 2018) of AGI limit for 2019.
    iii. The TCJA repealed the tax penalty associated with the individual mandate under the Affordable Care Act.
    iv. The TCJA eliminates most itemized deductions and limits the state and local tax (SALT) deduction to up to $10,000 ($5,000 married filing separately). The TCIA also limits the mortgage interest deduction for mortgages up to $750,000 that are taken out after December 15, 2017. There is also no deduction for home equity loans.
    v. The TCJA made a change to the Charitable contributions by increasing the Adjusted Gross Income limit from 50% to 60%.

4. ABLE Accounts
    a. The annual contribution limits to an ABLE account has been increased from $14,000 for 2017 to $15,000 for 2018 and 2019. The limit will be subject to inflation adjustment annually.
    b. Section 529 rollover to an ABLE Account is now permitted through 2025. In addition, FP–SNTs can fund an ABLE Account subject to the annual contribution limit.

5. **Small Business Owners:** This is the most complex change made under the TCJA which is to allow a 20% deduction in flow through business income for certain small business owners.
6. **Trusts and Estates:** As to Trusts and Estates, there are the following considerations under the TCJA :
    a. Kiddie Tax — The TCJA has changed the rates that will be applicable to the Kiddie Tax instead of the parent's rate, trust tax rates will apply. This can result in higher rates as to kiddie income.
    b. Exemption for trusts — The exemption for trusts has been retained ($100, with two exceptions).
    c. State and local tax deduction limitation — This limitation will also apply to Trusts and Estates.
    d. Executor and trustee fees — The deduction for executor and trustee fees will still be allowed.
    e. Excess deductions on termination — The deduction for excess deductions on termination of an estate or trust has been eliminated.
    f. Deduction for estate taxes attributable to income in respect of a decedent — This deduction has been retained.

7. Qualified Disability Trusts
    a. To qualify as a Qualified Disability Trust (QDisT), the following requirement must be met:
        i. Trust must be for the sole benefit for beneficiaries who are under age 65
        ii. All of the beneficiaries must be disabled
        iii. Must be a non-grantor trust for tax purposes
    b. A QDisT qualifies for an exemption of $4,200 for 2019 (indexed for inflation) and the income is exempt from the Kiddie Tax because it is treated as earned income.
    c. The Trust must elect for Qualified Disability Trust treatment.
    d. QDisT Case Study — Exemption:
        i. One may be able to take advantage of the QDisT Exemption and accumulate income without being taxed.
        ii. For example, if $4,200 of trust income is offset by the exemption and hence not taxed, then with a 7% return over a 14-year period, the fund would be over $95,000 (which would be available for the benefit of the beneficiary).
        iii. The QDisT can be a good vehicle as a beneficiary of IRAs due to the exemption amount and beneficiary's tax bracket.
    e. **QDisT and the Kiddie Tax:** Under the Internal Revenue Code, there is a three-prong test for the Kiddie Tax to apply. If the Kiddie tax applies and the trust qualifies as a QDisT, then the income distributed to the beneficiary as earned income and not subject to the Kiddie Tax. The income distributed or used for the benefit of the beneficiary would be taxed at the beneficiary's tax rates and undistributed trust income taxed at the trust rates.

8. Estate and Gift Tax
   a. Exemption Amount
      i. The TCJA made a dramatic change to the Estate and Gift Tax laws. The Estate and Gift Tax Exemption amount after 12/31/2017 was increased to $11,400,000 for 2019.
      ii. This exemption will be subject to annual inflation adjustment, subject to certain conditions. Unfortunately, these changes were not enacted as a permanent change but sunset after 2025.
   b. **Credit Shelter and Marital Trust Planning:** It will be important to review credit shelter/marital trust planning to ensure that the client's objectives are being met as to the ultimate disposition of assets. For example, the formula for funding a Credit Shelter Trust under a Will or Revocable Living Trust may result in the credit shelter trust being overfunded with no outright distribution of assets to the surviving spouse which was not intended by the deceased spouse.
   c. **Gifting:** There also may be an opportunity to maximize gifting prior to the sunset date in the event that the exemption amount sunsets and a lower exemption amount is reinstated. ii. The IRS and the Treasury Department have stated that individuals taking advantage of the increased gift and estate tax exclusion amounts in effect from 2018 to 2025 will not be adversely impacted after 2025 when the exclusion amount is scheduled to drop to pre-2018 levels.
   d. **Maximize Generation Skipping:** There is an opportunity to maximize generation skipping similar to the gifting opportunity outlined above.
   e. **Planning: Revise Estate Plans:** Every estate plan that involved federal or State estate taxation should be reviewed to make sure that the controlling document (a Will and/or Trust) take into account the changes in the federal estate and gift tax exemption amount.

9. Medicaid Planning and Estate and Gift Taxation
   a. Asset Transfers and Gift Tax Consequences
      i. Generally, clients who want to implement Medicaid planning by making gifts, will not incur federal gift taxes due to the federal estate and gift tax exemption at $11,400,000 (in 2019).
      ii. Notwithstanding, there are a handful of states with a State gift tax law which should be considered if Medicaid planning is being implemented in such State.
   b. **Carryover basis v. Step-up In Basis:** With the freedom to implement Medicaid planning without a concern for federal gift taxation, the client should be aware of the potential adverse consequences as it pertains to a later sale of the gifted assets and capital gain taxation. One strategy which would allow for a step up in basis upon the demise of the grantor is to create and fund an Irrevocable Trust which is included in the estate of the grantor upon his or her demise.

10. **In Summary:** Comprehensive planning for seniors and individuals with special needs requires consideration of the tax implications when planning for Medicaid and Supplemental Security Income (SSI) benefits.

Vincent J. Russo is not affiliated or associated with MassMutual.

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