2021 National Conference
on Special Needs Planning and Special Needs Trusts

Stetson University

What We Need To Know About Taxes and Pooled Trusts

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I. Introduction

Pooled Special Needs Trusts (PSNTs) are unique trust vehicles. PSNT trustees provide vital services for what may perhaps be the most underserved, yet most deserving, population in our country. A PSNT allows a person with a disability the opportunity to protect funds for supplemental needs while still qualifying for crucial means-tested public benefits. That said, there is little to no guidance from the Internal Revenue Service (IRS) as to how a PSNT is to report the earnings within the pool. This has led to PSNTs filing tax returns in a myriad of different ways. This article will provide a comprehensive overview of taxation methodology unique to PSNTs while supplying potential solutions for efficient tax filings. The differences between First Party and Third Party PSNT tax return preparation are covered including analyses of decedent proceedings, unitization strategy, and Distributable Net Income (DNI) calculations.

II. PSNT Accounting Methodology

The Omnibus Budget and Reconciliation Act of 1993 (OBRA '93) authorized non-profit organizations to establish "a trust containing the assets of an individual who is disabled (as defined in section 1614(a)(3))...." The Act also states that the non-profit organizations must maintain a separate account "for each beneficiary of the trust, but, for purposes of investment and management of the funds, the trust pools these accounts." OBRA '93 gave birth to the creation of PSNTs all over the country and provided a wonderful opportunity for people with disabilities to receive expert trust administration services while protecting their vital public benefits, regardless of the size of their trusts.

However, after passing OBRA '93, Congress and the IRS failed to provide any further guidance as to how such PSNT organizations were to account for their beneficiaries' separate accounts or how taxation for such PSNTs was to be calculated. There are also no specific guidelines on PSNT pooling investments. As such, there are myriad accounting methodologies and tax strategies currently employed by PSNTs. That said, there are general accounting principles that, when applied uniformly to all beneficiaries, fulfill the PSNT trustees' duties of loyalty and impartiality.

A PSNT is a "pooled" vehicle in three ways - for legal purposes (with a Master Trust Agreement), for ease of administration (pooling of cash and investments for economy of scale), and for tax purposes. In terms of administration, a PSNT is a trust vehicle made up of a pool of money contributed by many beneficiaries with disabilities. This structure is similar to mutual funds in general. As such, many of the principles of mutual fund accounting (and other general accounting principles) provide sound guidance for PSNT accounting.

When a PSNT operates in a pooled fashion for investments, every beneficiary materially participates proportionally in the gains or losses of the PSNT's investment portfolio. As such, overall performance and daily sub-account valuations should be tracked as to the change in the overall value of the total pool itself. This calculation must be combined with beneficiary transactions to derive the sub-account's position in the pool. In other words, every PSNT joinder is assigned a unit value of the pool when they join based on the market value of their contribution amount in relation to the overall fair market valuation of the pool. The beneficiary's unit value is subsequently adjusted not only for every transaction specific to that beneficiary (e.g., annuity payment receipt, discretionary distribution, etc.), but also for market value movement of the pool's investments. This process is often referred to as "unitization."

It is important to note that a PSNT is <u>not</u> an investment offering. PSNTs (or their corporate trustees) typically delegate the investment management of the trust to Registered Investment Advisors (RIAs) just as any other prudent trustee would do pursuant to the guidelines in the Uniform Prudent Investor Act (UPIA). UPIA § 9 states that "a trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances." This section of the UPIA is largely modeled on *Restatement Third*, Prudent Investor Rule § 171 (*Restatement (Third) of Trusts (Restatement of the Law Third, Trusts,* American Law Institute at Washington, D.C. © 2001)). In fact, the Social Security Administration's (SSA) Program Operations Manual System (POMS) SI 01120.25 states that "in some instances, the non-profit manager(s) may employ the services of a for-profit entity to manage some of the financial activities of the trust."

Units of the PSNT should be adjusted to capture beneficiary distributions, receipts, and other financial transactions. In an informal survey of PSNTs nationwide, it appears that many PSNTs are unitizing their pools monthly, or even quarterly. However, daily unitization appears to be a practice better aligned with fulfilling the duties of loyalty and impartiality. Consider the following example:

PSNT Value 1/1/2021:	$1,000,000
John Smith Sub-Account Value 1/1/2021:	$200,000
Jane Doe Sub-Account Value 1/1/2021:	$400,000
Bob Jones Sub-Account Value 1/1/2021:	$400,000
XYZ Stock Total Dividend Paid 1/14/2021:	$50,000*
John Smith Annuity Receipt 1/15/2021:	$40,000

**Please assume that dividend was for investors invested in XYZ stock from 1/1/2021-1/14/2021 and that ex-dividend date/record date corresponds accordingly.*

Assuming for brevity's sake that no other market value changes, distributions, etc., occurred in this example, the month-end balances for the PSNT and beneficiaries (before dividend allocation) would total as follows:

PSNT Value 1/1/2021:	$1,090,000
**includes dividend and annuity receipt*	
John Smith Sub-Account Value 1/1/2021:	$240,000
Jane Doe Sub-Account Value 1/1/2021:	$400,000
Bob Jones Sub-Account Value 1/1/2021:	$400,000

As such, if the PSNT were to unitize monthly (e.g., using month-end beneficiary balances), the beneficiaries' unitized share of the $50,000 dividend would total as follows:

Please note that figures have been rounded for illustrative purposes.

John Smith Sub-Account (22% of PSNT):	$11,000
Jane Doe Sub-Account (39% of PSNT):	$19,500
Bob Jones Sub-Account (39% of PSNT):	$19,500

Therefore, the new unitized month-end balances for the PSNT and beneficiaries (after dividend allocation) would total as follows:

PSNT Value 1/1/2021:	$1,090,000
**includes dividend and annuity receipt*	
John Smith Sub-Account Value 1/1/2021:	$251,000
Jane Doe Sub-Account Value 1/1/2021:	$419,500
Bob Jones Sub-Account Value 1/1/2021:	$419,500

However, the XYZ Stock Total Dividend was paid on 1/14/2021, and John Smith's Annuity Receipt of $40,000 was not deposited until 1/15/2021. This means that the $40,000 in additional value to John Smith's Sub-Account value should be excluded from the dividend's unitization calculations as John Smith's Sub-Account did not materially participate in the dividend at that heightened market value rate because the annuity deposit was received after the dividend was paid. However, because the PSNT trustee calculated the unitized value of John Smith's Sub-Account as of the end of the month, John Smith's Sub-Account received more earnings than appropriate. More importantly, beneficiaries Jane Doe and Bob Jones received less earnings than appropriate due to using month-end balances. If the PSNT trustee had applied the daily valuation, the new unitized month-end balances for the PSNT and beneficiaries (after dividend allocation) would total as follows:

PSNT Value 1/1/2021:	$1,090,000
**includes dividend and annuity receipt*	
John Smith Sub-Account Value 1/1/2021:	$240,000
Jane Doe Sub-Account Value 1/1/2021:	$425,000
Bob Jones Sub-Account Value 1/1/2021:	$425,000

The impact of this monthly calculation on unit value in a PSNT with thousands of beneficiaries with many different daily distributions and receipts adds up. Areas affected could include fee calculations, taxable event (interest, capital gains, etc.) allocations, distribution values, and reporting discrepancies. As such, daily valuation of beneficiary sub-accounts of PSNT should be considered.

Many PSNTs combine their First and Third Party trust sub-accounts in the same pooled account. The SSA's POMS SI 01120.25 states that "by law, each trust beneficiary must have a separate account, but the non-profit manager can pool these funds with the funds of other members of this communal trust." A strict reading of this guideline could mean that the "communal trust" is composed of only trusts created and authorized under 42 U.S.C. § 1396(d)(4)(c). Conversely, the guideline does not specifically prohibit the pooling of First and Third Party trusts. While opinions may diverge as to what types of sub-accounts may be pooled, pooling such accounts separately may help avoid tax headaches as outlined further below.

III. First Party PSNTs

A First Party SNT is funded with the assets of a person with a disability who is typically receiving means-tested public benefits such as Supplemental Security Income (SSI) or Medicaid. The grantor of a First Party SNT is the beneficiary themselves, or, if funded before December

13, 2016 (Special Needs Fairness Act), established by the beneficiary's parent, grandparent, legal guardian, or a court.

Tax Status

First Party SNTs are almost always considered grantor trusts because the grantor (who is also the beneficiary) retains the right to beneficial enjoyment of the trust property, even if such property is distributed under purely discretionary distribution standards. The analysis is no different because a trust is a sub-account of a pooled trust.

The Internal Revenue Code (I.R.C.) §§ 671-678 lays out the Internal Revenue Service (IRS) guidelines for grantor trusts. Three key provisions of these sections for the determination of grantor tax status are as follows:

- I.R.C. § 673(a): "The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion."
- I.R.C. § 677: "The grantor shall be treated as the owner of any portion of a trust...whose income...in the discretion of the grantor or a nonadverse party...may be (1) distributed to the grantor…."
- I.R.C. § 675: "The grantor shall be treated as the owner of any portion of a trust in respect of which (1) A power exercisable by the grantor...without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or income therefrom…."

As such, First Party PSNTs are almost always grantor trusts. As discussed later herein, Third Party PSNTs are almost never grantor trusts for tax purposes.

Grantor trust status is most likely beneficial to the beneficiary as all of the trust's taxable events flow through the trust directly to the beneficiary. This is beneficial because the beneficiary's personal tax rates will almost always be lower than a trust's tax rates. Additionally, in the case of the beneficiary of a PSNT, the beneficiary will rarely have sufficient additional income besides the trust to have additional tax liability, again making grantor trust tax status particularly advantageous. Consider the following hypothetical:

Hypothetical - Not Required to File

- First Party PSNT sub-account (i.e., Grantor Trust for tax purposes)
- Sub-account corpus of $100,000 with $10,000 in long-term (i.e., held more than one year) appreciation (or unrealized capital gains)
    - Sub-account's annual taxable interest = $500
    - Sub-account's annual ordinary dividends = $500
- Beneficiary receives SSI and Medicaid and has no other income sources.
    - No itemized personal deductions, 2020 standard deduction = $12,400
    - Beneficiary files as "single" taxpayer.

Conclusion: All taxable events flow out to the beneficiary in a Grantor Trust. Even with the sub-account's taxable events, the beneficiary is not required to file a personal tax return. (See IRS 2020 1040 Instruction Form, Chart A.) Note that SSI is generally not taxable income.

Income

Often, parties with no knowledge of SNTs will confuse trust "income" (taxable or otherwise) with that of "income" in terms of qualification for public benefits. For public benefits qualification, POMS SI 00815.005 defines income as:

- From 3/9/2005 to present: "Income is any item an individual receives in cash or in-kind that can be used to meet his or her need for food or shelter. Income includes, for the purposes of title XVI, the receipt of any item which can be applied, either directly or by sale or conversion, to meet basic needs of food or shelter."

- From 3/8/2005 and prior, the same definition applies, with the addition of "clothing."

POMS SI 00815.001 lays out the guidelines for what is not considered income. Neither POMS SI 00815.005 nor POMS SI 00815.001 references trust income specifically. As such, by its omission therein and because such trust income may be fully retained by the PSNT sub-account, or only distributed to or for the benefit of the PSNT sub-account beneficiary at the sole discretion of the trustee, trust income is not considered income for public benefits qualification purposes.

Capital Gains

As previously noted, because a PSNT operates in a pooled fashion, every beneficiary materially participates proportionally in the gains or losses of the PSNT's investment portfolio. New joinders to the PSNT are assigned units of the PSNT portfolio as a whole. This is advantageous to the new beneficiary as their units of the PSNT are investable the moment their funds are joined with the PSNT portfolio (which includes the PSNT's overall cash position). In other words, assuming the PSNT is unitizing its cash positions with its investments, when a beneficiary's contributions are added to the PSNT's pool, the trust's value increases. That beneficiary's cash is now part of the pool and may be used for other beneficiaries' discretionary distribution needs. The joining beneficiary, in return, receives a proportionate share of the PSNT's cumulative (or, as per POMS SI 01120.25, "communal") positions. This accounting concept is often referred to as "mutualized liquidity," and it can be advantageous in numerous ways for PSNT beneficiaries (e.g., decedent proceedings, liquidation needs for large beneficiary discretionary distributions, etc.).

When assets within the PSNT are sold for liquidity needs or rebalancing requirements, a capital gain or loss is generated. This is called capital gains "realization." Conversely, assets that haven't been sold within a portfolio carry "unrealized capital gains." When assets are purchased, the date of purchase must be recorded. This is called the "acquisition date" and is generally tracked by the custodian. The amount of the asset purchase, or "cost basis," must also be tracked (again, a function generally fulfilled by the custodian). These factors are crucial in determining the potential taxation of capital gains.

- Acquisition date determines the length of time the asset was held before sale:
    - For anything held less than one year, the capital gain is taxed at ordinary income rates or trust income rates, as appropriate. These gains are called "short-term capital gains." Income tax rates are generally higher than capital gains tax rates. As mentioned previously, in a grantor trust (e.g., First Party PSNT), the income flows out to the beneficiary. As such, the income from short-term capital gains may be includable on the beneficiary's personal tax return. The 2021 simplified federal personal income tax rates are as follows:

Tax Rate	**Single**	**Married, Filing Jointly**
10%	$0 - $9,950	$0 - $19,900
12%	$9,951 - $40,525	$19,901 - $81,050
22%	$40,526 - $86,375	$81,051 - $172,750
24%	$86,376 - $164,925	$172,751 - $329,850
32%	$164,926 - $209,425	$329,851 - $418,850
35%	$209,426 - $523,600	$418,851 - $628,300
37%	$523,601+	$628,301+

    - For anything held for one year or longer, the capital gain is taxed at the capital gains tax rate. These gains are called "long-term capital gains." As mentioned previously, in a grantor trust (e.g., First Party PSNT), the capital gains flow out to the beneficiary. The 2021 personal capital gains tax rates are as follows:

2020 Capital Gains Tax Rates *(Single Filers)*

Long-Term Capital Gains Tax Rate	**Beneficiary's Income**
0%	$0 - $40,000
15%	$40,001 - $445,850
20%	$445,851+

2020 Capital Gains Tax Rates *(Married, Filing Jointly)*

Long-Term Capital Gains Tax Rate	**Beneficiary + Spouse's Income**
0%	$0 - $80,000
15%	$80,001 - $501,600
20%	$501,601+

Here again, the tax advantages of a First Party PSNT are clear. In many scenarios, because the capital gains tax event flows out to the beneficiary, the beneficiary may indeed owe no taxes due to the gain realization.

Because of the pooled nature of the PSNT portfolio, when capital gains are realized, the tax lot information (cost basis and acquisition date) attributed to the sale is not based on how long the beneficiary has been in the pool. Rather, the cost basis and acquisition date attributed to the sale (and subsequently passed on to every current beneficiary in the pool proportionately) is based on long the asset has been held by the PSNT's portfolio overall. This is the same accounting methodology applied by mutual funds. For example:

- John Smith joins the PSNT on 1/1/2021.
- Security ABC is sold for rebalancing purposes on 6/1/2021.
- Security ABC was purchased on 1/1/2015.

- Long-term capital gain is passed out proportionately to John Smith because the security was held by the PSNT for more than one year. John Smith's joinder date has no bearing on the determination of long-term versus short-term capital gain.

Elimination of Miscellaneous Itemized Deductions

I.R.C. § 67 previously allowed an itemized deduction for certain "miscellaneous itemized deductions" only to the extent such expenses exceed 2% of the adjusted gross income (AGI). The following were treated as miscellaneous itemized deductions:

- Employee business expenses
- Tax preparation fees
- Investment interest expenses
- Grantor trust administration expenses (trustee fees, legal, accounting, etc.)

Previously, a beneficiary could deduct trust expenses as a miscellaneous itemized deduction to the extent the trust expenses exceeded 2% of the beneficiary's AGI. However, the 2018 Tax Cuts and Jobs Act (TCJA) eliminated the miscellaneous itemized deductions category. The elimination of miscellaneous itemized deductions may negatively impact some grantor trusts such as First Party SNTs. Trust administration expenses (e.g., fees) flow through to the beneficiary just as taxable events do - however, now they are no longer deductible on the beneficiary's personal tax return. That said, for most beneficiaries of a PSNT, the elimination of the miscellaneous itemized deductions will have little impact since the standard deduction was increased to $12,400 for a single person and $24,000 for a married couple. A taxpayer will not claim itemized deductions unless their total itemized deduction exceeds their standard deduction.

Tax Filing

Generally, every trust with any taxable income within the taxable year or with gross income of $600 or over (regardless of the amount of taxable income) is required to file an income tax return per I.R.C. § 6012(a)(4). Under this traditional reporting rule, the trustee must file a Form 1041 if the trust produced at least $1.00 of taxable income or $600 of gross income (26 CFR § 1.6012-3(a)(1)(ii)). However, for any portion of a trust treated as owned by the grantor, the trustee may opt to report income under alternative reporting requirements per 26 CFR § 1.6012-3(a)(9).

Therefore, some type of reporting to the IRS must be completed for any beneficiary of a First Party PSNT who received at least $1 of taxable income (note that the $600 caveat could not apply to a grantor trust as the trust cannot have gross income itself since all income flows out to the beneficiary). The IRS requires notification of when income is attributable to the grantor. The IRS has issued regulations regarding reporting requirements for grantor trusts under 26 CFR §1.671-4. However, all of the options available under §1.671-4 are designed for individual trusts or trusts with a limited number of grantors or beneficiaries. Even reporting options for trusts with more than one grantor require attributing income among various owners, per 26 CFR §1.671-4(b)(3). As such, none of the options presented are particularly well suited for the requirements of a PSNT. Unfortunately, there are no regulations at this time that specify how to file a PSNT tax return.

That said, the lack of specific guidance from the IRS provides an opportunity to interpret and fairly consider these regulations with their true intent and the benefits of a PSNT in mind. PSNT beneficiaries are inherently different from traditional trust beneficiaries. PSNT beneficiaries receive supplemental discretionary distributions generally to maintain eligibility for certain public benefits. Therefore, it is already contemplated that most PSNT beneficiaries (especially those with smaller accounts) are not anticipated to make enough income to have any income tax liability whatsoever.

This consideration, however, does not mean the PSNT trustee does not have to file tax returns for the pooled trust. The First Party PSNT trustee must still meet its obligations under 26 CFR §1.671-4(b)(2)(iii)(B)(1) to inform the IRS that the grantor is liable for any income tax and to provide basic information to the grantor/beneficiary regarding investment and dividend income. This information must also contain a list of trust expenses for the year. Simplified information may be sufficient under 26 CFR §1.671-4(b)(2)(iii)(B)(1)(ii) to provide the grantor with "the information necessary to take the items into account in computing the grantor's...income."

As such, a prudent trustee will file a Form 1041 (U.S. Income Tax Return for Estates and Trusts) (1041). This 1041 should note that the trust is a grantor trust, and a statement of items of income, deductions, and credits should be attached. Per the IRS's Instructions for Form 1041, the attached statement should include the name, identifying number, and address of the grantor, and the income, deductions, and credits should be listed in the same detail as they would be reported on the grantor's tax return. This statement is often called a "Grantor Tax Letter" (GTL) and must also be delivered to the grantor/beneficiary for inclusion on their personal tax return (Form 1040). See Appendix A for a sample GTL.

Many PSNTs file separate 1041s and issue GTLs for every beneficiary of the PSNT. In other words, if there are 1,000 beneficiaries of the PSNT, 1,000 separate 1041s and GTLs are filed and issued. While this method is sufficient for meeting the requirements to the IRS, it is far too expensive for many of the smaller account holders. Alternatively, PSNTs may file a "Master" 1041 for the entire pool and subsequently issue GTLs for every beneficiary for their proportionate share of taxable events. Assuming that the unitization is being properly accounted for during the tax year, this approach can save the PSNT beneficiaries tremendous amounts of tax preparation fees, thus potentially extending the longevity of their trust funds. Often, such an approach can save the beneficiaries upwards of $400 per year in tax preparation fees - a significant amount for PSNT sub-accounts with lower balances. Converting to this practice is also easy for a PSNT that has filed separate 1041s for every PSNT beneficiary in the past. The PSNT trustee need only file a separate 1041 for the individual beneficiary's trust as "final" one tax year (thus closing out the sub-account's Taxpayer Identification Number [TIN] so the IRS isn't looking for future returns under that TIN) and convert to the Master 1041 methodology in the subsequent tax year. Another benefit to filing a Master 1041 is that the PSNT will no longer have to obtain separate TINs for all its pool participants.

To file a Master 1041 for the PSNT, the trustee will not need to report income on the Form 1041 but should still file a Form 1041 containing only the trust's name, address, and TIN, per 26 CFR §1.671-4(a). Typically, the 1041 will have the "Grantor type trust" box checked in the upper left-hand corner of the first page of the 1041. Additionally, many tax preparers will type on the 1041 language such as "under the terms of the trust instrument, this is a grantor trust, and all income is taxable to the grantors as set forth under I.R.C. §§ 671-668. A statement of income and deductions is attached hereto." This practice is commonly referred to as a "skeleton 1041." Attached to this skeleton 1041 are all of the GTLs for the PSNT. This puts the IRS on notice that the PSNT is not paying the tax, and the grantors/beneficiaries are aware of their tax liabilities. Again, these GTLs should be provided if there is <u>any</u> taxable income, deduction, or credit that may affect the grantor/beneficiary and should not be limited only to trusts producing $600 of gross income. A thorough GTL will also include any distributions made from the PSNT to or for the benefit of the beneficiary that may or may not be deductible on the beneficiary's personal income tax return Form 1040 (e.g., trustee fees, investment management fees, medical expenses, etc.). It is not the obligation of the PSNT trustee to identify which items may or may not be deductible on a beneficiary's personal tax return. Rather, the beneficiary should consult with their own tax professional for such advice.

Some PSNTs have attempted to simplify these reporting requirements even further by using the alternative Forms 1099 methodology. In other words, the trustees of these PSNTs have attempted to issue 1099s from the PSNT to each beneficiary for their proportionate share of the tax events generated in that taxable year. This methodology is discouraged for two reasons. The first reason is that 1099s are required to be issued generally by February 1 of the following tax year. The vast majority of mutual funds and other investments have not finalized their tax reporting (e.g., reclassification of dividends, etc.) until mid-March of the following tax year. As such, issuing 1099s to grantors/beneficiaries before the pool's underlying investments have finalized their reporting may result in the PSNT issuing incorrect data to its beneficiaries. Additionally, 26 CFR §1.671-4(b)(2)(iii) requires that more information be delivered to the IRS and the grantors/beneficiaries than is found on a Form 1099. The information sent to the IRS and the grantors/beneficiaries via a Form 1099, therefore, is not a complete listing of all potentially applicable tax information.

Trust Termination

When a First Party PSNT sub-account terminates due to the death of the beneficiary, the classification of the sub-account changes from a grantor trust to a complex trust for tax purposes. Generally, all tax events for the decedent beneficiary's proportionate share of the PSNT activity through the decedent's death are reportable to the beneficiary and includable on such beneficiary's final personal Form 1040. All tax events for the decedent beneficiary's proportionate share of the PSNT activity after the decedent's death are reportable to the beneficiary's estate (which may or may not be includable on that beneficiary's personal Form 1040). The vast majority of PSNT beneficiaries will not have a taxable estate or a taxable final personal 1040. However, coordination with the decedent beneficiary's Personal Representative or Executor as to how or if to split final tax information is recommended. As is always the case with taxes, there may be unique circumstances (e.g., Inherited IRA liquidation, unique asset sales, etc.) that require extra reporting and forethought. A review of such circumstances may be found in Bradley J. Frigon's "Tax Trust Termination and Decanting Issues" materials from Stetson College of Law's 2020 National Conference on Special Needs Planning and Special Needs Trusts.

Additionally, the mutualized liquidity aspects of a PSNT can be advantageous if there are any remainderpersons of the First Party PSNT sub-account other than Medicaid or the PSNT itself. Typically, assets would have to be sold to pay out the remaining trust corpus to remainderpersons. While there may be a step-up in cost basis to the value of the decedent beneficiary's holdings in relation to their fair market value on the beneficiary's date of death, there may not be reason to do so as there is usually enough cash in the overall PSNT portfolio to satisfy any remainderperson distributions. As such, no assets are required to be liquidated to satisfy these claims. Rather, the mutualized liquidity of the overall PSNT (which is continuously buoyed by new PSNT joinders, receipts from other beneficiaries, etc.) may be used. The IRS's position is fully considered in this methodology as capital gains are always reported when assets are sold. As such, it is recommended that PSNTs distribute funds to remainderpersons in cash instead of in-kind.

IV. Third Party PSNTs

A Third Party SNT is funded with the assets of another person for the benefit of a person with a disability who is typically receiving means-tested public benefits such as Supplemental Security Income (SSI) or Medicaid. The grantor of a Third Party SNT may be a beneficiary's family member, friend, or any person other than the beneficiary.

Tax Status

A Third Party SNTs is almost always considered a complex trust and potentially may be a Qualified Disability Trust (QDT) because the grantor is someone other than the beneficiary. As such, tax regulations different from a grantor trust apply. This analysis is no different because a trust is a sub-account of a pooled trust. However, there are differences between an irrevocable and a revocable Third Party SNT, which will be discussed later herein.

I.R.C. §§ 661-663 lays out the general guidelines for complex trusts. The three key determinants to classify a trust as a complex trust are as follows:

1) The trust may accumulate income;
2) The trust may distribute corpus; or
3) The trust may make distributions to charity.

Note that only one of those conditions must apply for a trust to be deemed a complex trust. In general, the trust's deductions for distributions are outlined in I.R.C. § 661, the inclusion of amounts in the income of beneficiaries is outlined in I.R.C. § 662, and other special rules for complex trusts are outlined in I.R.C. § 663.

As a general rule, complex trusts are allowed deductions for the total of any amount of trust accounting income (TAI) that is required to be distributed. However, there are limitations on this distribution deduction that pertain to distributable net income (DNI) and tax-exempt income. In other words, the advantages of all taxable events flowing out to the beneficiary of a grantor trust may not be able to be fully realized in a Third Party PSNT when characterized as a complex trust.

Distributable Net Income

As reviewed previously, income generated within a PSNT does not count as income to the beneficiary for the purposes of qualifying for public benefits. Similar to a First Party PSNT, taxable events can be passed out to the beneficiary from a Third Party PSNT, but only through distributions to or for the benefit of the beneficiary. To the extent undistributed, the taxable events may have to remain within the trust for tax purposes. Consider the following simplified example:

- Beneficiary A's sub-account has unitized taxable events totaling $10,000 for the current tax year.
- PSNT trustee has only distributed $5,000 from Beneficiary A's sub-account to or for the benefit of Beneficiary A in the current tax year.
- Therefore:

- $5,000 of the taxable events flows out to Beneficiary A to be taxed at Beneficiary A's personal tax rate.
- The remaining $5,000 of taxable events remains "trapped" in Beneficiary A's sub-account and may be subject to trust tax rates.

For reference, the following are the trust tax rates for 2021:

Trust Taxable Income	**Trust Tax Rate**
$2,650 or less	10%
$2,650 - $9,550	$265 + 24% of excess over $2,650
$9,551 - $13,050	$1,921 + 35% of excess over $9,550
$13,051+	$3,146 + 37% of excess over $13,050

These tax rates are often referred to as "compressed trust tax rates," and it is easy to see how expensive undistributed taxable income can be in a complex trust. Unfortunately, the calculation of how much tax is passed out to a beneficiary of a complex trust isn't as simple as described above.

Again, distributions may carry out tax to the beneficiary and their personal tax rate to the extent the distributions carry out taxable items of DNI. Obviously, if distributions exceed DNI, then such excess amounts are not taxable to the beneficiaries as there is no further tax to carry out of the trust. Special rules create priorities for the allocation of DNI to the distributions. I.R.C. § 662 creates tiers of beneficiaries. Special rules also determine the character of the distributions with respect to the allocation of income and deductions. I.R.C. § 662 provides an allocation of DNI to the beneficiaries by calculating the respective amounts received or required to be distributed.

DNI is a complicated tax concept that a) measures the greatest amount that may be deducted by a complex trust because of distributions to beneficiaries and that may be reported by such beneficiaries as income, and b) characterizes the income distributed for purposes of computing the distribution deduction and determining the items taxable to the beneficiaries. A simplified equation of such calculations follows:

(Taxable income) - (Net capital gains) + (Tax-exempt income reduced by expenses) = DNI

However, I.R.C. § 643(a)(3) provides the general rule that capital gains are not included in DNI. Capital gains and losses generally are allocated to principal in order to properly consider the positions of the trust's remainder beneficiaries. This is a concept covered fully in the Uniform Principal and Income Act. As such, a complex trust (if it is not the final tax year in which the capital gain or loss is recognized) typically pays the tax on the net capital gain.

I.R.C. § 643(a)(3) provides three exceptions to this general rule. Namely, capital gains may be included in the DNI calculation if they are:

- allocated to TAI; or
- allocated to principal and "paid, credited, or required to be distributed to any beneficiary during the year"; or
- allocated to principal and "paid, permanently set aside, or to be used for [charitable] purposes specified in I.R.C. § 642(c)."

Additionally, capital gains may be included in DNI to the extent they are:

- allocated to income;
- allocated to principal but treated consistently by the trustee on the trust's books; or
- allocated to principal but actually distributed to or for the benefit of the beneficiary.

Such allocation of capital gains to DNI is only allowable if the terms of the trust instrument permit it or such allocation is granted to the trustee by applicable local law. This allocation power is often referred to as the “Power to Adjust.” In conclusion, so long as the trustee adheres to the specifications above, capital gains may be able to be passed out to the beneficiary of a Third Party PSNT if the distributions to or for the benefit of the beneficiary meet or exceed DNI.

Finally, the DNI calculation also includes the net tax-exempt interest. The amount included is the amount of the tax-exempt interest reduced by the expenses allocated to tax-exempt interest that would be deductible. Consider the following example:

- Beneficiary A’s Third Party PSNT sub-account accrued $100 of tax-exempt interest.
- PSNT trustee’s fees for the taxable year for Beneficiary A’s sub-account totaled $40 as it was all allocated to the tax-exempt interest.
- Beneficiary A’s DNI would include $60 of the net tax-exempt interest ($100 - $40).

There are many obvious advantages illustrated throughout to pushing taxable income out of the trust to the beneficiary of a PSNT. That is not to say, however, that a trustee should feel the pressure of higher tax rates as a justification to force unnecessary discretionary distributions on their beneficiaries. In other words, a prudent trustee should be comfortable with retaining or “trapping” some income within a Third Party PSNT beneficiary’s sub-account and potentially paying a higher amount of taxes rather than making potentially unnecessary purchases for the beneficiary simply to avoid taxation.

Qualified Disability Trust

There are additional tax exemptions available to Third Party SNTs. One common tax exemption is the Qualified Disability Trust (QDT). This exemption amount was $4,300 in 2020 and could be used to lessen the overall burden of the taxes to the trust. However, not every SNT will qualify as a QDT even if the trust is taxed as a complex trust. For a trust to receive the QDT exemption, the trust must meet the statutory requirements of 42 U.S.C. § 1396p(c)(2)(B)(iv). Those requirements are as follows:

- The trust must be irrevocable; and
- The trust must be for the sole benefit of the beneficiary with a disability; and
- The beneficiary must be under the age of 65; and
- The beneficiary must be disabled as defined for purposes of SSI and Social Security Disability Insurance (SSDI).

Additionally, the trust must be taxed as a simple or complex trust under I.R.C. § 652 or 662 to qualify as a QDT. As such, grantor (First Party) SNTs do not qualify. Qualification is further complicated by the fact that there must be an actual determination from the SSA that the beneficiary is disabled. This could pose problems for a beneficiary who would qualify as disabled but the SSA would deem ineligible because the beneficiary works or may be affected by parental deeming rules.

A narrow reading of I.R.C. § 642(b)(2)(c) would exclude all Third Party SNTs from qualifying as QDTs. Section 1917 of the Social Security Act references 42 U.S.C. § 1396p "Liens, adjustments and recoveries, and transfers of assets." Subsection (c)(2)(B)(iv) states there is no penalty for a transfer of assets if those assets: "(iv) were transferred to a trust **(including a trust described in subsection (d)(4)(a) 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)." [emphasis added] For a Third Party SNT to receive the QDT exemption, subsection (c)(2)(B)(iv) must be read to include all SNTs not just trusts described under (d)(4)(A). A more reasonable interpretation of I.R.C. § 642(b)(2)(c) would include a Third Party SNT as a QDT provided the special needs beneficiary is receiving SSI or SSDI benefits and the trust was funded prior to the beneficiary turning 65. There are no reported cases or rulings on this point.

There are benefits and drawbacks to qualifying as a QDT. One drawback is the aforementioned compressed tax brackets for trusts. As outlined above, when the trust pays taxes (rather than passing taxes through DNI to its beneficiaries) the trust will almost always pay at higher rates than individuals with the same income. One benefit is the additional $4,300 in exemptions, which may reduce the overall tax burden of the trust. Without the QDT exemption, a Third Party SNT may pay much higher taxes in certain circumstances. Recall, though, that if all taxable events are carried out to the beneficiary via DNI, there is no trapped trust income. Such a situation would make the QDT exemption amount useless.

As discussed later herein, the recommended tax return filing structure for Third Party PSNTs is similar to that outlined above for First Party PSNTs. However, it is most likely impossible to file a Master PSNT tax return in total as a QDT as the PSNT does not meet the QDT qualification requirements. Specifically:

- The trust is arguably not for the sole benefit of the beneficiary as the pool consists of many beneficiaries.
- All beneficiaries of the PSNT may not be under the age of 65.

- All beneficiaries of the PSNT may not have an actual determination of disability from the SSA due to the aforementioned complications.

These arguments may lack merit because each sub-account is most likely for the sole benefit of its beneficiary, etc. However, when a trust qualifies as a QDT and does not distribute all income for the benefit of the beneficiary, tax savings will be achieved by utilizing the increased QDT exemption for the trust along with the standard deduction and personal exemption of the beneficiary. As such, a prudent way to proceed may be to file all beneficiary PSNT sub-account returns that could utilize the QDT exemption separately from the entire pool, if appropriate. Such an approach should be carefully considered from a cost perspective due to the inherent enhanced tax preparation fees. Qualifying a PSNT sub-account as a QDT and filing its tax return separately from the pool may only make sense if taxable income exceeds DNI and is expected to exceed DNI in future years. The exemption amount utilized in these cases should obviously exceed the cost of tax preparation. There are cases wherein not all taxable events in a Third Party PSNT flow out to the beneficiary via DNI because the sub-account does not make enough discretionary distributions or does not have many deductions. For example, the Third Party PSNT sub-account beneficiary may have a First Party PSNT sub-account that is being spent down first, the beneficiary's sub-account has a large balance vis-a-vis their needs, or the beneficiary may be in a situation where discretionary distributions are not needed. In such cases, it may be prudent to file a Form 1041 return for this sub-account (separate from the PSNT Master 1041) and utilize the QDT exemption.

Tax Filing

As mentioned previously, every trust with any taxable income within the taxable year or with gross income of $600 or over (regardless of the amount of taxable income) is required to file an income tax return per I.R.C. § 6012(a)(4). Under this traditional reporting rule, the trustee must file a Form 1041 if the trust produced at least $1.00 of taxable income or $600 of gross income (26 CFR § 1.6012-3(a)(1)(ii)).

As mentioned above in the First Party SNT section, a Third Party PSNT may also elect to file a Master 1041 for all of its beneficiaries. Here again, this can result in significant tax preparation fee savings for the PSNT's beneficiaries. Additionally, if the PSNT is being unitized appropriately, any trapped income (or income not so distributed to the beneficiary via DNI) and its tax liability can be calculated and attributed to the appropriate beneficiary's sub-account.

The main difference between a First Party PSNT Master 1041 and a Third Party PSNT Master 1041 filing is in what format the beneficiaries receive reports of their personal tax liability. In a First Party Master 1041, the beneficiaries receive a GTL detailing their income tax liability as well as any potentially deductible items. A Third Party PSNT Master 1041 instead issues a Form K-1 to its beneficiaries, which typically does not go into as great of detail as a GTL. For example, most Form K-1s will not detail trustee fees as those fees are generally allocable to the trust itself, not the beneficiary. In other words, most deductible expenses and items are generally taken at the trust level and are not deductible at the beneficiary level in Third Party PSNTs. The beneficiary of a Third Party PSNT, or their tax professional, must usually rely on their trust statements to identify any distributions made from the sub-account that may potentially be deductible on their personal tax return. Again, it is not the obligation of the PSNT trustee to identify which items may or may not be deductible on a beneficiary's personal return. Rather, the beneficiary should consult with their own tax professional for such advice.

Trust Termination

When a Third Party SNT terminates due to the death of the beneficiary, generally all tax events for the decedent beneficiary's activity through the decedent's death are reportable to the beneficiary and includable on such beneficiary's final personal Form 1040. All tax events for the decedent beneficiary's proportionate share of the PSNT activity after the decedent's death are reportable to the remainder person(s) named in the trust instrument. The same methodology should apply to Third Party PSNTs. As such, the PSNT trustee must unitize each beneficiary's units daily to accurately capture the allocation of income between the beneficiary and the sub-account's remainderpersons.

Most times, a PSNT trustee is not notified of a beneficiary's passing on the exact day that the beneficiary dies. As such, it is valuable to have daily unit values of the PSNT sub-accounts so that the PSNT trustee or its accounting agent may properly track and report all income postings, distributions, and receipts to the exact date of death. The death of a beneficiary creates additional production of Form K-1s. One Form K-1 must be issued through the date of death and is reportable under the beneficiary's Social Security Number (SSN). All taxable events after the beneficiary's date of death are reported under the SSN(s) of the remainderperson(s). It is recommended that PSNTs require any remainderperson to fill out and return a signed Form W-9 listing the remainderperson's name, address, and SSN. Form W-9 offers the PSNT trustee additional liability protection in that the Form W-9 also serves as an affidavit that the remainderperson is not subject to backup withholding. Additionally, it may be very difficult to obtain a remainderperson's SSN after they've received their distribution check from the trust. It is highly recommended that the PSNT obtain a Form W-9 from remainderpersons before releasing any trust funds.

As previously noted, because a PSNT operates in a pooled fashion, every beneficiary materially participates proportionally in the gains or losses of the PSNT's investment portfolio. Typically, in a non-pooled Third Party trust, assets would have to be sold in order to pay out the remaining trust corpus to remainderpersons. This may cause a large embedded capital gain to be realized, which would be taxed to the remainderperson. (While the assets remaining in the trust could theoretically be transferred in-kind to the remainderperson, they would continue to carry the same cost basis and embedded unrealized capital gains.) However, there is usually enough cash in the overall PSNT portfolio to satisfy any remainderperson distributions, and, as such, no assets are required to be liquidated to satisfy these claims. Rather, the mutualized liquidity of the overall PSNT (which is continuously buoyed by new PSNT joinders, receipts from other beneficiaries, etc.) may be used. The IRS's position is fully considered in this methodology as capital gains are always reported when assets are sold. Attempting to select the correct tax lots (cost basis and acquisition date) for the decedent beneficiary's portion may prove to be extremely difficult, as well. As such, it is recommended that PSNTs distribute funds to remainderpersons in cash.

Third Party Revocable SNTs

A Third Party Revocable SNT is almost always considered a grantor trust for tax purposes. These types of trusts are typically funded by a third party for the benefit of a beneficiary with a disability receiving means-tested public benefits. Generally, the grantor of a Third Party

Revocable SNT (or the grantor's spouse) has a remainder interest in the trust (in case the beneficiary predeceases the grantor). The grantor may also retain the right to terminate the trust at any time, or the grantor (or the grantor's spouse) may be a beneficiary of the trust. As such, because the grantor (or the grantor's spouse) has a material interest in the trust, it is deemed a grantor trust for tax purposes. Therefore, a Third Party Revocable PSNT should file a Master 1041 as outlined above in the First Party PSNT section, reporting all taxable income to the grantor, not the beneficiary. Third Party Revocable Trusts could technically be pooled within a PSNT's Third Party PSNT. There is nothing in IRS regulations prohibiting the filing of a Form 1041 that issues both GTLs (for the Third Party Revocable PSNT grantors) and Form K-1s (for the Third Party PSNT beneficiaries). However, for ease of administration and unitization, and to avoid complications in decedent proceedings (i.e., when a Third Party Revocable PSNT sub-account changes from a grantor trust to a complex trust upon the death of the grantor), it is recommended that these sub-accounts be pooled separately from the Third Party PSNT sub-accounts (e.g., once the grantor dies, the trust sub-account converts to a complex trust).

There are many advantages to offering a Third Party Revocable PSNT. It may offer families a way for their beneficiaries to begin working with the PSNT trustee during their lifetimes. Parents of a beneficiary with a disability often worry about who will take care of their son or daughter after they pass away. They may worry about turning their estate and the care of their beneficiary over to a "nameless, faceless" organization if they haven't worked closely with the PSNT organization before their passing. It can also be quite traumatic for a beneficiary when their parents pass away. Often, the parents of a beneficiary with a disability are the beneficiary's best friends, financial administrators, and lifelines. Funding a Third Party Revocable PSNT allows the beneficiaries to begin working with the PSNT before testamentary funding. This usually establishes a cooperative working relationship with the beneficiary from the beginning, assuaging all parties' understandable concerns.

V. General Taxation Issues

State and Federal Filing Requirements

When filing a Master 1041 for a First Party PSNT, there will rarely be any tax due at the federal level as all tax events flow out to the respective beneficiaries proportionally. And since state tax forms are generally based on federal tax due, one would then imagine that if there is no tax due at the federal level, there is no need to file a state income tax return for the First Party PSNT. (This may not be the case for Third Party PSNTs as there may be trapped income taxable at the trust level.) This is not the case in all states. Some states require a state trust tax return to be filed for informational purposes even if there is no federal income tax due. Additionally, most states require notice if an extension is being filed (regardless of projected income tax due). Obviously, such filings can become more complicated if the PSNT has beneficiaries living in different states within the pool. As such, it is highly recommended that PSNTs consult with their tax advisors about this situation.

In-Kind Transfers

A PSNT is frequently asked to accept appointment as successor of a trust - either within the PSNT or as a non-pooled trust. These trust accounts usually come with embedded (or "legacy") capital gains inherited from the prior trustee and their investment manager. Additionally, the PSNT is usually asked to serve at the request of a referring attorney. These referring attorneys can be adamant about the successor trustee accepting all assets from the prior trustee in-kind so the beneficiary does not incur what appears to be onerous capital gains realization just to change trustees. This discussion is usually complicated by the fact that the potential successor PSNT trustee has an investment manager that has their own set of investment strategies that may not incorporate the same asset allocation or securities.

In these cases, a thorough review of the trust's current portfolio is necessary. This review should not only vet the current investments, asset allocation, and diversification of the portfolio, but also consider the beneficiary's personal tax situation. Many referring attorneys may not understand that a full liquidation of the portfolio before transfer to the successor trustee is prudent and may not impact the beneficiary's tax situation whatsoever. (See above in Section III for a hypothetical wherein a beneficiary would not need to even report realized capital gains.) Consider the following hypothetical:

** Please note that all tax situations are simplified for illustrative purposes.*

<u>Hypothetical - No Capital Gains Tax Due</u>

- First Party PSNT (i.e., Grantor Trust for tax purposes)
- Trust corpus of **$200,000** with **$25,000** in long-term (i.e, held more than one year) appreciation (or unrealized capital gains)
    - Trust's anticipated annual taxable interest = **$1,500**
    - Trust's anticipated annual ordinary dividends = **$1,500**
- Beneficiary receives SSI and Medicaid and has no other income sources.
    - No itemized personal deductions, 2020 standard deduction = $12,400
    - Beneficiary files as "single" taxpayer.
    - Beneficiary is 66 years of age.

Conclusion: As all taxable events flow out to the beneficiary in a Grantor Trust, realization of capital gains in full may be appropriate as the beneficiary's long-term realized gains would total $25,000 and thus are taxed at 0%. However, consideration should be given to the fact that the same $25,000 in realized long-term capital gains is includable in the beneficiary's Adjusted Gross Income (AGI) (Line 11, Form 1040 (2020)). As such, there may still be income tax due on the beneficiary's personal 1040, calculated as:

Beneficiary AGI:	$28,000 *(Line 11, Form 1040 (2020))* (long-term capital gains + taxable interest + ordinary dividends) **Note that SSI is generally not taxable income.*
Beneficiary Taxable Income:	$15,450 *(Line 15, Form 1040 (2020))* ($28,000 AGI minus 2020 standard deduction of $12,400)
Beneficiary Tax Due:	$1,660 *(Line 16, Form 1040 (2020))* See IRS 2020 1040 Instruction Form, Tax Table.

In this scenario, selling the assets with long-term gains appears to be prudent as the tax due of $1,660 only represents 0.83% of the total trust corpus, which is a de minimis expense for rectifying any diversification, asset allocation, or ease-of-administration concerns.

Finally, there is usually never a reason to transfer an Inherited Traditional Individual Retirement Account (IRA) in-kind. Capital gains are rarely taxed in an IRA, absent early withdrawal situations.

65-Day Rule

For discretionary distributions, whether of income or principal, the year of payment by trust will generally be the year of deduction and will set the year for determining inclusion of the payment. This is especially important for the calculation of DNI in a Third Party PSNT. But, if, within the first 65 days of the tax year of a trust an amount is properly paid or credited, and if the fiduciary makes a proper election, the distribution is treated as having been made on the last day of the preceding tax year. While the distribution must be made within 65 days of the new year, the election must be made no later than the deadline for filing the fiduciary income tax return for the tax year for which the distribution is treated as being made, plus extensions (see I.R.C. § 663). Because trusts must use the calendar year, the election deadline for trusts is April 15, plus any extensions. An election becomes irrevocable after the deadline. If a federal income tax return must be filed, the election must be made on the return. If a return is not required because the trust has no taxable income or gross income in amount less than the exemption amount, the election is made by filing a statement with the IRS office where the return would be filed, if required (26 CFR § 1.663(b)-2(a)(2)). As such, it is recommended that PSNTs and their tax advisors thoroughly review all distributions for every beneficiary's sub-account before the expiration of this 65-Day Rule to ensure a favorable, but prudent, DNI calculation.

VI. The SECURE Act

The Setting Every Community Up for Retirement Enhancement (SECURE) Act was passed just before the end of 2019. Many planners in the community did not expect the Act to be enacted, and there was little warning before its passage. The SECURE Act ushered in some very important changes in how planners should evaluate the transfer of IRA assets to beneficiaries with disabilities. The passage of the Act is quite significant as the majority of the wealth in the U.S. is held in retirement vehicles.

The most notable change brought about by the SECURE Act is the elimination of "stretching" Required Minimum Distributions (RMDs) for beneficiaries of an IRA in most cases. Earnings in a traditional IRA are generally not taxable to the beneficiary until they are distributed. Once funds are distributed for RMDs or otherwise, they are taxed as regular income at the beneficiary's applicable rate. (Note that for brevity's sake, early withdrawals and penalties will not be discussed herein.) Before the passage of the SECURE Act, a beneficiary (other than a spouse) of an Inherited IRA could choose to take distributions over their lifetime and pass any remaining funds onto future generations. This is colloquially known as the "stretch" option. The RMDs under the stretch option were calculated based on the beneficiary's life expectancy. As such, the younger the beneficiary, the smaller the annual distributions and thus the longer the Inherited IRA funds could grow tax deferred. Note that RMDs are minimum amounts that must be withdrawn from the IRA. Should the IRA beneficiary need to take out funds exceeding the RMD, they may certainly do so.

The SECURE Act now requires that most beneficiaries of an IRA withdraw all the money, and pay the applicable income taxes, from the IRA within ten years of the IRA funder's (or "holder's") death. This provision applies to everyone who inherits an IRA beginning January 1, 2020. Thankfully, the SECURE Act makes exceptions for beneficiaries with disabilities. Beneficiaries with disabilities may receive the funds (via RMDs or in excess of RMDs as need be) based on their life expectancies rather than over the ten-year requirement. This exception also applies to beneficiaries who are considered chronically ill or are fewer than ten years younger than the IRA holder. This presents a fantastic planning opportunity for beneficiaries with disabilities.

Additionally, the SECURE Act provides that the IRA holder may designate an SNT as the beneficiary of the IRA, and the SNT trustee may use the IRA to fund the SNT for the beneficiary's supplemental needs. This provision allows the SNT beneficiary to continue to qualify for means-tested public benefits by creating a “see-through” trust. There are generally two types of “see-through” trusts: a conduit trust and an accumulation trust. In a conduit trust, the IRA would make distributions to the trust, and the trust would subsequently pass out these funds to or for the benefit of the beneficiary. This is advantageous from a tax perspective as the IRA funds would flow out to the beneficiary and be taxed at their personal tax rate, which is most likely lower than the compressed trust tax rates. However, this income distribution to the beneficiary is generally mandatory in the trust language and would most likely disqualify the beneficiary from means-tested public benefits eligibility (as the beneficiary would be over income). Conversely, in an accumulation trust, the IRA would make distributions to the trust, and the trustee may retain those funds or use them for the benefit of the trust’s beneficiary at the sole discretion of the trustee. This may result in trapped income vis-a-vis DNI and discretionary distributions to or for the benefit of the beneficiary. While such trapped income may potentially be taxed at the higher compressed trust tax rates, proceeding as such will protect the beneficiary’s vital means-tested public benefits.

Finally, another benefit of the SECURE Act was the clarification on the Kiddie Tax rules. The Kiddie Tax was originally intended to prevent parents from gaining a tax advantage by transferring income to their children to be taxed at a lower rate. Under guidelines prior to the clarification provided by the SECURE Act, unearned income over $12,750 for a minor would have been taxed at the highest rate of 37%. This would have been especially onerous for minor beneficiaries of an SNT where distributions to or for their benefit may have been minimal due to the overriding duty of parental support. The SECURE Act and subsequent guidance cleared up this issue, and minors may now revert to filing at their parents’ tax bracket, assuming they are filing as dependents.

The SECURE Act presents an opportunity for PSNT organizations to assist more people with disabilities. As mentioned above, the majority of wealth in the U.S. is held in retirement vehicles. PSNTs should be speaking with family members and local Elder Law attorneys if the PSNT organization offers Inherited IRA administration in conjunction with their PSNT administration services, provided they have knowledgeable advisors to assist them in this area. However, it is important to note that there is currently a restriction on selecting the stretch option if the ultimate beneficiary of the IRA is a charitable organization (such as a PSNT's charitable remainder fund). Read strictly, if the ultimate beneficiary of an Inherited IRA is a charitable organization, the IRA funds must be withdrawn over ten years. On its face, this requirement appears to contradict the intent of the SECURE Act. While there is no current formal opinion from the IRS on this issue as of the date of this article, it is the authors' understanding that the IRS has taken the issue under advisement and will be issuing a clarification soon.

VII. Conclusion

Tax planning is an integral and inevitable part of trust administration. Operating a PSNT comes with its own nuances and difficulties. The services that a PSNT organization provides are crucial for beneficiaries with disabilities, and PSNTs have a real opportunity to take advantage of some of the efficiencies illustrated throughout this publication. Any advisor (tax, accounting, or otherwise) for a PSNT should be well versed in these intricacies so that the PSNT beneficiaries may take advantage of the efficiencies and tax strategies explained throughout. Adherence to these principles will also assist in ensuring that the PSNT fulfills its duties of loyalty and impartiality.

***Please note that the views and opinions expressed herein are not necessarily those of The Law Offices of Bradley J. Frigon, LLC; True Link Financial, Inc.; True Link Financial Advisors, LLC; or any of their subsidiaries.**

APPENDIX A

2021 National Conference
on Special Needs Planning and Special Needs Trusts

Stetson University

What We Need To Know About Taxes and Pooled Trusts

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Sample Grantor Tax Letter Cover Letter

Name of Trust

2021 Grantor Tax Letter

Dear Beneficiary:

The purpose of this letter and attached Account Summary is to provide you with the information needed to report your share of taxable income and expenses to the Internal Revenue Service (IRS) for the period January 1, 20__, through December 31, 20__, pursuant to Treas. Reg. §1.671-4. Under the regulations, your Trust account is a "grantor trust" for federal income tax purposes. You will not be issued a Form 1099-Misc or a K-1 regarding this trust.

General Tax Information

For Federal income tax purposes, the Trust is treated as a grantor trust. As such, the Trust itself is not subject to Federal income tax. As a result, all items of Trust income, deductions, and credits must be reported by you on your individual income tax return. For purposes of reporting income to the IRS, you are considered a "grantor."

Information on the following pages should be taken into account when determining your income, credits, and deductions for reporting income to the IRS. You must consult with your tax advisor to determine if you are required to file an individual income tax return.

The tax information in this letter is for general informational purposes only and does not address all possible tax considerations that may be material to you. It does not constitute legal or tax advice. Moreover, it does not address all possible tax considerations that might be relevant to you, in light of your personal circumstances, nor does it deal with particular types of grantors who are subject to special treatment under the federal income tax laws.

To ensure compliance with requirements imposed by the IRS, any tax information contained in this letter is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.

<u>The Trustee cannot and does not provide income tax advice or guidance; you are urged to consult with your own tax advisor as to your individual tax consequences</u>.