

**2026 National Conference on Special Needs Planning and Special Needs Trusts**  
***Tax Intensive (But Not Too Intense): Don't Fear the Tax Code***  
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**I. Tax Reference Resources and Authorities**

**A. Internal Revenue Code: Navigating the Labyrinth**

**1. Breaking Down the Beast: Subtitles and SNT Priorities**

The primary source of federal tax law is the Internal Revenue Code (the “Code”). It can be found at Title 26 of the United States Code. The Code has a reputation of being overly complex and incomprehensible; however, upon closer look, one will find that the Code is structured in an orderly, logical manner. The Code is divided into nine subtitles and each subtitle is divided into smaller units. For example, subtitle A of the Code contains all the income tax provisions, subtitle B contains all the gift and estate tax provisions (which are critical for third-party SNT funding and planning), and subtitle F contains all the procedure and administration rules.

**2. Subchapter J: The Heart of Darkness for SNT Practitioners**

Each subtitle of the Code is divided into chapters and each chapter is divided into subchapters. For example, subtitle A, chapter 1, subchapter A (§§ 1–59A) contains all the provisions necessary to compute a taxpayer’s actual tax liability (e.g., the applicable tax rates and various tax credits). For SNT practitioners, the most critical subchapter is Subchapter J (§§ 641–692), which contains the rules governing the income taxation of estates, trusts, and beneficiaries, including the grantor trust rules so frequently utilized in first-party SNTs.

**3. Deciphering the Hieroglyphics: The Basic Code Unit**

Each subchapter is divided into even smaller units, parts. Further, parts may be divided into subparts; and subparts divided into sections. The “section” is the basic unit in the Code. Sections are numbered sequentially, with breaks in sequence to provide room for new Code provisions to be added.

Sections are divided into subsections. Subsections are divided into paragraphs. Paragraphs are divided into subparagraphs. Subparagraphs are divided into clauses and even subclauses. Instead of employing all of those terms typically one simply says “section” followed by the full citation. For example, rather than saying “subparagraph C of paragraph 2 of subsection b of section 642,” one would simply say “section 642(b)(2)(C)”, which you will

recognize as the provision granting a larger personal exemption for a Qualified Disability Trust (QDT).

#### **4. Some Important Code Vocabulary**

Every word and every phrase of the Code have a purpose. Congress does not use transitional phrases or flowery prose in writing the Code. There are specific words and phrases you will need to know to speak the language of tax.

##### **a. The Magic Provision: “For Purposes of . . . “**

One of the major differences between Code language and English is that Congress has absolute power over Code language but often has only a minimal command of the English language. Congress can change the meaning of a word or phrase through the provisions of the Internal Revenue Code. Such magic is performed by uttering the phrase “for purposes of . . . ,” which has the effect of a Congressional “abracadabra.” Whenever you see the phrase “for the purposes of,” you know to expect a definition that will be unique and essential to your application of the statutory provision you are reading.

##### **b. The Code Red Flag: “Except as Provided”**

When you are solving a problem in federal taxation, as in any area of the law, it is always important to make sure that the rule you are using applies to your particular circumstance. To that end, you must be certain that no other sections of the Code address your problem in a more specific manner. Fortunately, the Internal Revenue Code often alerts you to the fact that there is another Code provision that might override the statutory language you are reading. This warning language is always expressed as “except as provided . . . .” Therefore, we call the phrase “except as provided” the Code “Red Flag.”

##### **c. Strong Words: “Notwithstanding Any Other Provision”**

Some Code sections stand alone. That is, Congress has decided that some areas of tax law are so important that the sections which govern those areas must have their own set of rules, which apply “notwithstanding any other provision.” When you encounter these strong words, you know that Congress is telling you to ignore anything else you might have read in connection with the tax consequences of an item of income or deduction, because what you are about to read will apply despite anything else that may appear to be on point.

##### **d. Mandatory v. Elective Language**

While most of the provisions of the Code apply whether you want them to or not, there are some enactments that allow for elective tax treatment. Fortunately, it is very easy to distinguish mandatory declarations from elective ones, because of the Code language used to differentiate them. Mandatory provisions make use of the term “shall” to indicate that the taxpayer is required to do something. On the other hand, where tax treatment is optional, the Code will provide for a result “at the election of the taxpayer.”

#### **e. “Treated as” or “Considered”**

Sometimes the Code requires you to pretend that a tax item is something other than what it really is. The best way to explain that rather cryptic statement is through an example every SNT practitioner should know. Section 663(b) (an elective, not mandatory, provision) provides that if a trust distributes income to or for the benefit of a beneficiary within the first 65 days of a tax year, the distribution “shall be considered” as paid or credited on the last day of the *preceding* tax year. Thus, even if a trustee writes a distribution check for a disabled beneficiary’s care on February 15th, the Tax Code allows you to elect to pretend the distribution occurred on December 31st of the prior year.

Other Subchapter J provisions that rely heavily on the statutory terms “treated as” or “considered” to create legal fictions include:

- § 671: The grantor trust rules, where the grantor is “treated as the owner” of the trust assets, requiring the IRS to pretend the trust entity does not exist for income tax purposes.
- § 645: Where an eligible revocable trust is “treated and taxed as part of an estate” for a temporary period following the settlor’s death (optional with a timely election).
- § 643(e)(3): Where an in-kind distribution of property to a trust beneficiary is “treated as a sale” at fair market value if the trustee makes a statutory election.
- § 642(c)(1): Where a trust’s charitable contribution paid in Year 2 is “considered as paid” in Year 1 at the trustee's election.

#### **f. “Including (But Not Limited To)”**

The phrase “including (but not limited to)” always indicates that the items which follow are to be taken only as examples, not as an exclusive list. Thus, when § 61 states that gross income means income from whatever source derived, including (but not limited to) the items listed by that section, you know that items such as interest and rents are examples of gross income, but that there could be (and in fact there are) many other types of income which fall under the purview of gross income, even though they are not specifically listed.

#### **g. “Allowed” v. “Allowable”**

When a taxpayer properly takes a deduction, we say that the taxpayer has been allowed that deduction. On the other hand, when a taxpayer does not take a deduction she could have properly taken, we say that the deduction was allowable. In the context of § 1016(a), you can see that a taxpayer’s basis must be adjusted for the depreciation deductions allowable. This could mean that a taxpayer’s basis is adjusted downward by a depreciation deduction she never actually used.

### **B. Treasury Regulations: Giving the Monster Fangs**

#### **1. Administrative Dark Arts: Regulatory Power and Prefixes**

The treasury regulations are the most important administrative interpretation of the Code, and should be part of any tax research. Congress granted general authority to the Treasury Department to promulgate regulations to interpret and give meaning to the Code. *See* IRC. § 7805(a). Congress also delegated specific rule-making authority to the Treasury Department in certain Code sections. As a result of the congressional grant of power, treasury regulations generally have the force and effect of law.

## **2. The Regulatory Pipeline: From Proposed to Final**

Treasury regulations, which the Treasury Department promulgates under the Administrative Procedures Act (APA), are first issued as proposed regulations and published for public comment in the Federal Register. Once the comment period expires and revisions are made, regulations are published in final form as Treasury Decisions in the Code of Federal Regulations. On occasion, proposed regulations are also issued as temporary regulations. Unlike temporary and final regulations, which are authoritative, proposed regulations in the Federal Register do not have the force and effect of law. Although not authoritative, however, proposed regulations are relevant in tax research since the Treasury has authority to apply final regulations retroactively to the date they first appeared as proposed in the Federal Register. Regulations are numbered the same way as the Code sections to which they relate, but preceded by a numerical prefix which indicates the type of tax (income, estate, gift) involved. For example, a numerical prefix of “1” indicates an income tax provision (e.g., Treas. Reg. § 1.671-4 governing reporting methods for grantor trusts), while a prefix of “20” indicates estate tax and “25” indicates gift tax.

## **3. Slaying *Chevron*: Challenging the IRS in a Post-*Loper Bright* World**

One of the most debated questions in modern tax litigation involves the balance of power between the executive branch and the judiciary. Specifically, what level of deference should courts grant treasury regulations when faced with an ambiguous Code provision? For decades, courts applied the approach in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), and would defer to a treasury regulation if it reasonably resolved a statutory ambiguity. *See Mayo Foundation v. United States*, 131 S. Ct. 704 (2011) (holding *Chevron* governed judicial review of tax regulations and that there was no justification for a tax-specific deference regime).

In the recent landmark decision *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (2024), the Supreme Court overturned the *Chevron* doctrine, holding that the APA gives courts ultimate authority to exercise their independent judgment in deciding whether an agency has acted within its statutory authority. While reinforcing the APA’s requirements, the Supreme Court also reverted to the standard set in *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944), which gives weight to an agency’s interpretation according to its persuasiveness. Although *Loper Bright* was not a tax case, it will have a significant impact on the IRS’s administration of tax law. Indeed, the IRS will now have a more difficult burden in defending the validity of its Treasury Regulations by having to convince a court that its interpretation of an ambiguous Code section is persuasive based on numerous *Skidmore* factors (the thoroughness evident in its consideration, the validity of its reasoning, and its consistency with earlier and later pronouncements). Gone are the days in which the IRS merely had to convince a court that its interpretation was a reasonable

one. The demise of *Chevron* raises numerous questions. Will we see a rise in litigation challenges (i.e., taxpayers invoking *Loper Bright* in challenging pro-IRS regulations and the IRS invoking *Loper Bright* in challenging pro-taxpayer regulations)? Will the IRS begin to incorporate its positions in Revenue Rulings rather than treasury regulations?

## **C. IRS Rulings and Procedures: Whispers from the Tower**

### **1. Official Pronouncements: Revenue Rulings and Revenue Procedures**

The Internal Revenue Service issues interpretative pronouncements, called Revenue Rulings, which indicate the Service's official position regarding the application of tax law to a certain set of facts. Revenue Rulings are official interpretations published by the Service for information and guidance to taxpayers. They arise from various sources. For example, a Revenue Ruling may represent the Service's position on issues arising in the audit of a taxpayer's return; a Revenue Ruling may also represent the Service's position on issues decided by various courts. Unlike treasury regulations, Revenue Rulings are not published in proposed form for taxpayer comment and are not approved by the Treasury Department. Accordingly, Revenue Rulings are not as authoritative as regulations. Nevertheless, a Revenue Ruling can be relied upon by any taxpayer whose circumstances are substantially the same as those described in the ruling. It is important to remember that a Revenue Ruling's conclusion is limited in scope to the material facts stated in the ruling. Revenue Rulings are published weekly in the Internal Revenue Bulletin and consolidated semi-annually in the Cumulative Bulletin (cited as C.B.), both of which are official publications of the Service.

For further guidance to taxpayers, the Service also issues Revenue Procedures, which typically are statements of its internal practices and procedures. Like Revenue Rulings, Revenue Procedures are first published in the Internal Revenue Bulletin and later consolidated in the Cumulative Bulletin. These can be very useful to taxpayers when structuring a transaction.

### **2. Private Letter Rulings: Reading the SNT Tea Leaves**

Sometimes, for a fee, taxpayers can obtain Private Letter Rulings (PLRs) from the Service. Private letter rulings are issued by the IRS National Office. They interpret and apply tax laws to specific facts or proposed transactions set forth by taxpayers. Private letter rulings have no precedential value and cannot be relied upon by other taxpayers; however, they are highly instructive in the SNT space. *See, e.g.*, Priv. Ltr. Rul. 9437034 (Sept. 16, 1994) (addressing gift tax consequences of a transfer of the beneficiary's assets to a first-party SNT); Priv. Ltr. Rul. 200620025 (May 19, 2006) (holding that a first-party SNT was a grantor trust with respect to the beneficiary since the income of the trust was to be used, or accumulated, for the benefit of the grantor-beneficiary in the discretion of a trustee who was not an adverse party).

### **3. Other IRS Sources**

Technical Advice Memoranda (TAMs) have several characteristics of PLRs; they are issued by the IRS National Office in response to IRS requests arising out of tax return audits and numbered in the same manner as PLRs.

A General Counsel Memorandum (GCM) is an internal National Office legal memo that may be requested by National Office technicians considering a PLR or TAM request or as legal background to analysis of a proposed published ruling. They indicate the reasoning and authority used in Revenue Rulings, PLRs, and TAMs.

## **D. Case Law: Picking Your Legal Battlefield**

### **1. Trial Courts: Pay First or Fight First?**

Three trial courts have original jurisdiction over tax cases: (1) the U.S. District Court; (2) the U.S. Claims Court; and (3) the U.S. Tax Court. The first two courts are known as “refund tribunals.” To litigate in these forums, a taxpayer must first pay the asserted tax deficiency and then file an administrative claim for refund. If the taxpayer’s administrative claim is denied, the taxpayer may then file an action in either a federal district court or the Claims Court for a refund.

### **2. The Tax Court Special: No Prepayment Required**

The United States Tax Court is the only forum in which a taxpayer may litigate a disputed tax claim without first having to pay the asserted deficiency. If the Service asserts a deficiency, a taxpayer may refuse to pay and then petition the Tax Court for a redetermination of the deficiency. IRC § 6213. The Tax Court is based in Washington D.C.; however, the court hears cases in several locations throughout the United States. The Tax Court comprises nineteen judges appointed by the President and approximately twenty special trial judges and retired judges who assist with smaller tax cases. The Chief Judge has the responsibility of assigning each case to one member of the court. The judge deciding the case submits a proposed opinion to the Chief Judge, who then decides whether the decision should become the ruling of the court or whether the case should be reviewed by the entire court (this typically occurs if a case presents issues of first importance). If a proposed opinion is not reviewed by the entire court, the Chief Judge designates the opinion as a regular decision or a memorandum opinion. Regular decisions involve significant or novel legal issues and are regarded by the Tax Court as binding precedent on subsequent decisions. They are published officially in the United States Tax Court Reports (T.C.) and published unofficially by commercial sources, such as CCH Tax Court Reporter. Memorandum opinions are generally factual or apply established law to the facts of that case. They are unofficially published by commercial services.

### **3. Acquiescence Agony: When the IRS Refuses to Accept Defeat**

In Tax Court cases that the Service loses, the Service will usually either acquiesce or nonacquiesce in the decision. A notice of acquiescence indicates that the Service accepts the decision of the court, whereas a notice of nonacquiescence indicates that the Service may continue to challenge other taxpayers with respect to the issue(s) presented in the case.

### **4. Strategic Choices: Navigating Forum Selection and Appeals**

In sum, if the Service issues a notice of deficiency, the taxpayer can litigate the matter (1) by paying the tax, filing an administrative claim for a refund, and then filing a suit for a refund in

either the district court or the Claims Court; or (2) by filing a petition with the Tax Court for a redetermination of the proposed deficiency. There are several factors a taxpayer should consider in deciding which forum to choose. Factors to consider include: (1) whether the taxpayer has funds to pay the asserted deficiency, which is necessary to litigate in one of the refund tribunals; (2) whether the taxpayer wants a jury trial, which is available only in the district court; (3) the level of discovery required in each trial court; (4) the expertise of the Tax Court judges; and (5) the prior decisions of each of the three possible trial courts and the appellate courts to which an appeal can be taken. *See Golsen v. Commissioner*, 54 T.C. 742 (1970) (holding the Tax Court will follow a court of appeals decision on point from the circuit where an appeal from the Tax Court would lie (the circuit in which the taxpayer resides)).

Appeals from each of the trial courts vary. Federal district court decisions may be appealed to the federal court of appeals for the circuit where the district court is located. Decisions of the Claims Court may be appealed to the Court of Appeals for the Federal Circuit in Washington, D.C. Tax Court decisions may be appealed to the appropriate federal circuit in which the taxpayer resides.

## **E. Legislative History: How the Statutory Sausage Gets Made**

### **1. Decoding Congressional Intent**

Legislative history may prove helpful in understanding congressional intent behind a Code provision. For SNT practitioners, as example, legislative history was particularly useful when parsing modern changes, such as the SECURE Act's exceptions for "eligible designated beneficiaries" (which includes chronically ill and disabled individuals) and how retirement plans interact with SNTs.

### **2. From Bill to Law: The Legislative Gauntlet**

The process of enacting tax legislation is similar to that used for other federal laws. In general, a bill is introduced and then referred to the appropriate committee. There are two committees that consider revenue bills -- the House Ways and Means Committee and the Senate Finance Committee -- although all revenue bills must originate in the House of Representatives. U.S. Cons. Art. I, § 7. These committees may completely ignore a tax bill and never consider it or consider it by substantially rewriting it. They also may hold hearings as well as issue a committee report if a bill is reported out of committee.

Committee reports often form important elements of the legislative history of a tax provision. The reports contain useful information, including statements regarding the bill's purpose, the reasons why the bill should be enacted, and the changes the bill would make to existing law. If the House and Senate versions of a bill differ, a conference committee made up of House and Senate members meets to resolve these differences. This committee generates a third committee report which explains the resolution of the inter-house differences. When an agreement is reached, the bill goes back to each house for passage in the newly agreed upon form.

## **II. Tax Research Caveats: Four Ways to Get Bitten**

### **A. Don't Judge a Section by Its Cover**

Code headings are not authoritative and can often be misleading. For example, Section 677 is titled “Income for benefit of grantor.” One might jump to the conclusion that section 677 applies only when trust income is distributed to the person who funded the trust. Upon further research, however, one would discover that section 677 also can trigger grantor trust status if income can be distributed to the grantor's *spouse*.

### **B. Time Travel Traps**

When researching a particular Code provision, always make sure to use the version of the Code effective for the year(s) in issue. Although it is important to read the Code itself for effective dates and transition rules, it is often necessary to check the underlying legislative acts for such information.

### **C. Watch the Boundaries (Scope Creep)**

When reading a particular Code provision, it is important to understand the scope of the provision. Some Code provisions apply to the entire Code, while others apply only to certain portions of the Code. For example, some income tax provisions start out “For purposes of this subtitle . . .” which indicates that the provision applies broadly to an entire subtitle such as Subtitle A of Title 26 of the U.S.C., and therefore applies to all the income tax provisions of the Internal Revenue Code. Other Code sections begin with “For purposes of this section . . .” which indicates that the provision is more limited and affects only the particular section at issue, a much smaller unit.

### **D. The Ghost of Regulations Past (and Missing)**

There may be Code sections for which no regulations exist since Congress enacts new statutes quite frequently and it may take years for the Treasury Department to promulgate regulations. In addition, there may be regulations that fail to reflect the current law since Congress amends Code provisions quite frequently and the Treasury Department does not always react promptly with appropriate regulatory revisions.

## **III. Where to Find Tax Resources**

### **A. Free Internet Sources**

One of the most exciting advancements in tax research is the availability of tax information on the Internet. A number of websites give access to a wealth of tax information, including the Code, regulations, rulings, IRS forms and publications, and other materials. The Code and Regulations are freely available online. One online resource is the Government Publishing Office's online database, GovInfo. See <https://www.govinfo.gov/>. For another widely-used and frequently-updated online version of the Code and regulations, check out the following:

- Internal Revenue Code: Cornell Law School Legal Information Institute [LII]: <http://www.law.cornell.edu/uscode/text/26>.
- Treasury Regulations: Cornell Law School Legal Information Institute [LII]: <http://www.law.cornell.edu/cfr/text/26/chapter-I>.

The Internal Revenue Service provides through its website a wealth of tax research materials. Its website is the official government site for downloadable and printable IRS forms and publications. Its website also contains the IRS FOIA Library, which contains links to the Internal Revenue Bulletin (and thus Revenue Rulings), proposed and final regulations, IRS Notices, the Internal Revenue Manual, and many other items. Check out the following links:

- Forms, Instructions & Publications: <https://www.irs.gov/forms-instructions>.
- IRS FOIA Library: <https://www.irs.gov/privacy-disclosure/foia-library>.
- IRS Written Determinations: <https://apps.irs.gov/app/picklist/list/writtenDeterminations.html>.
- Basic Tools for Tax Professionals: <https://www.irs.gov/tax-professionals/serve-your-clients>.

Taxnotes.com offers many free resources including a curated selection of news, analysis, and special reports. Free resources include the Internal Revenue Code, treasury regulations, IRS private letter rulings, court documents, legislative documents, and the Internal Revenue Manual.

## **B. Commercial Databases**

Two widely recognized computer research systems that have federal tax databases are LexisNexis and Westlaw. Bloomberg Law also offers primary and secondary tax materials. Perhaps the most important tax research tools offered by Bloomberg are the *BNA Tax Management Portfolios*. Tax Analysts / Tax Notes (taxnotes.com) also offers subscription based sources for tax information, including the valuable weekly *Tax Notes* and daily *Tax Notes Today*. As noted above, taxnotes.com also offers free resources.

# **IV. The Tax Constants (Basic Concepts That Never Change)**

## **A. Income Shifting: Breaking Free from Compressed Brackets**

### **1. The Brutal Reality of Trust Tax Brackets**

In the case of individuals, the tax rates on ordinary income are progressive. Section 1 of the Code currently establishes seven tax rates on ordinary income: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. Even though Congress makes frequent changes in the actual tax rates, one basic principle does not change: as long as there are at least two brackets, taxpayers in higher brackets will be able to achieve tax savings if they can shift the incidence of taxation on their income to taxpayers in lower brackets. For SNT practitioners, this dynamic is amplified to an extreme degree: while individual taxpayers do not hit the top 37% tax bracket until their income exceeds \$640,600, a non-grantor SNT hits the top 37% rate at \$16,000 of retained trust income under the

hyper-compressed trust tax tables of § 1(e). Rev. Proc. 2025-32. Thus, the incentive to shift income out of a non-grantor trust is massive.

## **2. Keeping It in the Family: Related Parties in Trust Law**

Income shifting occurs most often between related taxpayers. After all, there are very few taxpayers who hate paying taxes so badly that they would be willing to shift some of their income to a non-relative in order to receive tax benefits. It should be noted that the term relative has a broader meaning in the realm of taxation than it does in the common usage of everyday life. In tax language, the following are deemed related for loss disallowance purposes: a “grantor and a fiduciary of any trust”; a “fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts”; a “fiduciary of a trust and a beneficiary of such a trust”; and “a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts.” *See, e.g.*, IRC § 267(b)(4)-(7) (disallowing losses between fiduciaries, grantors, and beneficiaries).

## **3. The IRS Hunts the Assignment of Income**

The assignment of income to a relative (for example, assignment of income from a high-bracket trust to a lower-bracket beneficiary, or from a high-bracket individual to a family trust) is a matter of great concern to the courts, as well as the legislature. A taxpayer’s ability to engage in this sort of “assignment of income” has been substantially curtailed. The evolution of the law in this area has been long, complex, and is continuing. By and large it has been the courts, rather than Congress, who have sorted out the tax treatment of assigned income.

## **4. The Fruit and the Tree: From *Lucas v. Earl* to *Helvering v. Horst***

There are many strands of the court-made “assignment of income doctrine:” (1) assignments of earned income; (2) assignments of income from property; and (3) assignments designed to convert ordinary income into capital gains. The foundational case on the assignment of income doctrine is *Lucas v. Earl*, 281 U.S. 111 (1930), in which the Supreme Court held that income is taxed to the person who earned it (coining the famous metaphor that the law will not prevent the tax from attaching to the tree on which the fruit grew). Another key case in this area is *Helvering v. Horst*, 311 U.S. 112 (1940), in which the Supreme Court held the owner of property cannot avoid the tax on the income generated by that piece of property unless he actually transfers the underlying interest that produces the income.

## **5. The SNT Income-Shifting Miracle: Grantor Trusts and DNI Rules**

In the context of Special Needs Trusts, practitioners navigate these assignment of income doctrines through statutory safe harbors provided in Subchapter J. Rather than attempting informal income assignments, SNT planners utilize first-party grantor trusts (§§ 671–679)—where all trust income is legally attributed directly to the disabled grantor’s individual return, completely bypassing the compressed trust tax rates—or distributable net income (DNI) mechanisms (§§ 651/661 and 652/662) in third-party non-grantor SNTs. Under the DNI rules, when a non-grantor SNT distributes income to or for the benefit of a low-bracket disabled

beneficiary, the trust takes a distribution deduction under § 661, shifting the tax burden to the beneficiary under § 662, where it is taxed at the beneficiary's significantly lower individual marginal rate.

## **6. Should the Tax Tail Wag the Dog? The Lowest Income-Tax Result Isn't Necessarily the Best SNT Result**

The trustee may have a substantial tax reason to distribute income rather than accumulate it—provided the distribution is otherwise appropriate under the trust and doesn't create adverse public-benefit consequences. That's an important qualification to a tax-focused discussion: the lowest income-tax result isn't necessarily the best SNT result. SSI, Medicaid, housing, support-and-maintenance rules, beneficiary circumstances, and the trust's distribution standard can outweigh the income-tax savings. Those benefits are very valuable and can be difficult to obtain and preserve. It would not be surprising for a trustee to elect to pay tax rather than risk losing benefits.

## **B. The Time Value of Money (a Question of When)**

### **1. Clocking the IRS: Why Deferral is Your Best Friend**

The income tax is imposed on an annual basis, the tax year. Thus, it is necessary to establish rules concerning *when* an item of income is included and *when* an item of expense is deducted. Taxpayers will nearly always be economically advantaged by the deferral of taxable income. Also there is often advantage in the acceleration of tax deductions. Both of these advantages will reduce the taxpayer's current tax liability thereby leaving him with the use of his money for a while longer. Since money makes money, the use of money has value. This is called "the time value of money."

### **2. SNT Planning Pointer: Mastering the 65-Day Rule**

The time value of money is important in tax considerations; it is a concept that has an impact upon every consideration by the taxpayer relating to the question of "when." Any SNT trustee concerned about when to include an item of income, or when to take a deduction, should consider the effect of the changing value of money over time. The conventional wisdom leads to a basic tax planning maxim: accelerate deductions, defer income.

### **3. Planning Pointer**

Other factors besides the time value of money will affect a trustee's decision concerning when an item should be deducted or included. Specifically, an SNT trustee should evaluate the trust's expected tax bracket and the beneficiary's income bracket for a given year. Under IRC § 663(b) (the 65-day rule), an SNT trustee can elect to treat distributions made within the first 65 days of a tax year as having been paid on the last day of the *preceding* tax year. This allows the trustee to retroactively optimize income shifting and DNI deductions after calculating the exact year-end tax liability.

Annual Trustee-Administration Reminder: Before preparing the IRS Form 1041 for a nongrantor SNT, evaluate whether a § 663(b) election and additional beneficiary distribution would improve the combined trust/beneficiary tax result. Again, the SNT/public-benefits consequences have to be analyzed before making the distribution.

### **C. Pre-Tax Versus After-Tax Dollars (the Benefits of Deductions)**

#### **1. The Math of After-Tax Living**

The concept of pre-tax and after-tax dollars applies in any situation involving taxable income. That is, an individual or a non-grantor trust in the 37% tax bracket that earns \$1.58 of interest income will owe the government 58 cents in taxes. Therefore, we might say that the only kind of dollar any taxpayer has to spend are after-tax dollars, because a portion of the pre-tax dollars actually belongs to the government *ab initio*.

#### **2. The Power of the SNT Deduction: Government-Subsidized Care**

However, there are times when taxpayers are allowed, and even encouraged, to use the government's share of their earnings to help pay for expenses. In fact, that is the basic premise behind the very familiar and popular tax item known as a deduction. Whenever the government classifies an expenditure as being deductible, it is, in fact, helping to pay that expenditure. This benefit results from the simple truth that \$1.58 of income will be totally offset by \$1.58 of deduction, leaving no tax liability. Therefore, if a non-grantor SNT earning \$1.58 of taxable interest spends that money in a way that is non-deductible, it pays 58 cents in taxes, leaving \$1.00 for the beneficiary. On the other hand, if the trustee spends the money in a manner that gives rise to a deduction, the trust owes no tax, deriving \$1.58 in value.

#### **3. Trustee Fees and Fiduciary Deductions: Maximize the Offsets**

The above example explains why taxpayers will always attempt to characterize payments as deductible, if possible. Congress expands and limits the scope of deductible expenditures quite often. In the SNT context, trustees routinely look to deduct fiduciary administrative fees, legal expenses, tax preparation costs under IRC § 67(e), or qualifying medical care expenditures distributed for the disabled beneficiary under IRC § 213. [Note: A nongrantor SNT does not automatically get a § 213 deduction whenever it pays a beneficiary's medical expenses. The identity of the taxpayer claiming the deduction, the statutory requirements, how the expense is treated under Subchapter J, and the particular trust arrangement matter.] As long as there are deductions, trustees will try to take advantage of them to preserve trust principal for the beneficiary's care.

#### **4. Qualified Disability Trusts: Legislative Mercy in Action**

Of course, the government itself derives a benefit from many of the deductions and exemptions it allows. For example, under IRC § 642(b)(2)(C), Congress allows a Qualified Disability Trust (QDT) to claim a personal exemption equal to that of an individual taxpayer (rather than the paltry \$100 or \$300 exemption granted to standard complex or simple trusts). By

offering this elevated exemption, Congress encourages families to private-fund SNTs to care for individuals with severe disabilities, which in turn reduces the long-term, direct financial burden on government entitlement programs. In effect, the QDT exemption encourages families to do directly what the government would otherwise have to shoulder indirectly.

Planning Takeaway: QDT qualification has statutory requirements. When reviewing a third-party SNT, make QDT qualification a separate checklist item, rather than assuming special-needs language automatically gets you there.

## **5. The IRS Strikes Back: Disallowance Traps and § 265**

The tax benefit of using pre-tax dollars to pay for expenses is of major concern to the government. Therefore, many Code sections have evolved that prevent deductions for certain expenses. SNT practitioners must beware of IRC § 265, which disallows deductions for administrative expenses (like trustee fees) to the extent those expenses are allocable to tax-exempt income (such as tax-exempt municipal bond interest held in the trust). That's practically important if an SNT holds a large municipal-bond portfolio.

### **D. Basis: Preserving Your After-Tax Capital**

#### **1. The Golden Shield of Basis**

The only dollars a taxpayer has to spend are after-tax dollars. Therefore, when a trust buys property, it does so with money that has already been subject to tax. The trust or beneficiary should be able to sell that property and receive its investment back tax-free. The amount the taxpayer will be able to receive as a tax-free return of investment, or capital, is called **basis**. Basis is a foundational concept that will always be a part of the federal income tax system.

#### **2. Cost Basis Under Section 1012**

There are a number of Code sections that create, limit, or otherwise affect basis in property. *See, e.g.*, IRC §§ 1012 (cost basis), 1014 (date of death basis), 1015 (gift basis), and 1016 (adjusted basis). Section 1012 states that the basis of property acquired by purchase shall be its cost. That section does not, however, give a definition of cost. Yet, if you remember the purpose behind having basis in property in the first place -- guaranteeing that a taxpayer can recoup all after-tax dollars invested -- then you will have no problem understanding the definition of cost for tax purposes.

#### **3. Adjusted Basis (§ 1016) and Step-Up at Death (§ 1014)**

Section 1012 indicates what a taxpayer's basis will be at the time of purchase. However, as improvements are made or depreciation deductions taken, basis must be adjusted accordingly under § 1016 ("adjusted basis"). In SNT drafting, basis rules are paramount. Under IRC § 1014, assets held in a revocable trust or a properly drafted First-Party Grantor SNT (included in the beneficiary's gross estate under § 2036 or § 2038) receive a stepped-up basis to fair market value upon the individual's death, eliminating all pre-death capital gains. Conversely, property

transferred into an irrevocable Third-Party Non-Grantor SNT during the settlor's lifetime takes a carryover basis under IRC § 1015, preserving the embedded capital gains tax liability for the trust when the asset is sold.

## **E. Realization and Recognition: The Traps of Trust Transactions**

### **1. When Does the Taxing Event Occur?**

Basis is an important tax principle because it represents the amount of tax-free dollars a taxpayer can receive from the sale, exchange, or other disposition of property. By implication, therefore, any consideration received in excess of basis is taxable as economic gain. If consideration is less than basis, there is no economic gain, and the taxpayer may be entitled to a deduction for a loss. Increases and decreases in the value of property are not taken into account for tax purposes as they accrue, but only when they are realized by a taxable event. Realization usually does not occur until there has been a "sale or other disposition of property." IRC § 1001(a).

### **2. Realization Rules: Satisfying Bequests vs. In-Kind Distributions**

Sometimes it is difficult to determine whether a trust transaction constitutes a "sale or other disposition." For SNT practitioners, this question arises constantly when distributing trust assets:

#### **a. Funding a Pecuniary Bequest**

If an SNT trustee satisfies a specific, fixed-dollar pecuniary bequest to a beneficiary by distributing appreciated non-cash assets, the IRS treats the distribution as a sale or exchange, triggering immediate gain realization to the trust under the long-standing rule of *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940).

#### **b. Ordinary In-Kind Distributions**

Under IRC § 643(e), a standard discretionary distribution of appreciated property in-kind to an SNT beneficiary generally does *not* trigger realization at the trust level; instead, the trust's basis carries over to the beneficiary, unless the trustee affirmatively makes an election under § 643(e)(3) to realize the gain at the trust level.

Because of the tax difference between pecuniary distributions and in-kind distributions, there should be a checklist warning for trust administration: Before funding any fixed-dollar distribution with appreciated property, obtain tax advice regarding gain recognition.

### **3. Decanting and Cottage Savings: When Modifying a SNT Triggers a Sale**

Another major realization trap for SNT planners involves trust decanting or trust modifications. Under the Supreme Court's decision in *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991), a realization event occurs if property is exchanged for other property

"differing materially either in kind or in extent." If an existing trust is decanted into a newly drafted SNT in a manner that fundamentally alters the beneficial interests of the beneficiaries, the IRS might argue under *Cottage Savings* that a taxable exchange of trust interests has occurred, triggering immediate gain realization.

The takeaway is not that decanting automatically causes capital gain. However, one should identify a potential federal income tax issue where restructuring materially changes beneficial interests. When moving a beneficiary's portion from an existing trust to a new or existing trust, don't analyze ONLY whether state trust law authorizes the trustee to do it. Separately analyze state-law authority, gift tax consequences, estate tax consequences, income tax realization, grantor trust status, public-benefit consequences, etc. A transaction can be perfectly permissible under a state decanting statute and still present a federal tax question.

#### **4. Calculating Realized Gain and Loss**

If a transaction is treated as a sale or other disposition, the transferor must determine the amount of the gain or loss realized. Gain realized is equal to the amount realized in the transaction minus the adjusted basis of the property sold. Loss realized is equal to the adjusted basis of the property sold minus the amount realized in the transaction.

#### **5. Recognition vs. Non-Recognition: Escaping Immediate Taxation**

Once a taxpayer has calculated gain or loss realized, they must determine whether the gain or loss is recognized (reportable on the tax return for the year of disposition). As a general rule, the entire gain or loss realized is recognized for tax purposes unless an exception is provided in the Code. IRC § 1001(c). The Code provides a number of exceptions commonly referred to as non-recognition provisions (such as § 1031 like-kind exchanges), which are based on the rationale that the taxpayer's economic position has not fundamentally changed.

### **F. The Taxable Year: The Calendar Trap for Trusts**

#### **1. Measuring Time One Year at a Time**

The types of taxable year allowed to a particular taxpayer can differ from tax reform to tax reform, but each taxpayer will, nonetheless, have a taxable year. Simply stated, a taxable year provides a frame of reference for determining a taxpayer's income, expenses, and losses. Without a definite time period, it would be impossible for the government or the taxpayer to determine which losses should offset which income. Therefore, the government has decided that the most convenient time package for assessing tax consequences is one year.

#### **2. The Calendar Year Chains: Section 644 Traps for Non-Grantor SNTs**

There are only two types of taxable years: the calendar year, and the fiscal year. Under IRC § 644, virtually all non-grantor trusts—including non-grantor Special Needs Trusts—are required to use the calendar year as their taxable year. Calendar-year trusts start with a clean slate each January 1, and close their books each December 31. Thus, as a general rule, only those

items of income, deduction, loss, or credit actually occurring during the calendar year will affect the SNT's ultimate tax liability for that particular year.

### **3. The Fiscal Year Escape Hatch: Estates and Section 645 Elections**

The Code defines "fiscal year" to be any year other than a calendar year. IRC § 441(e). While non-grantor trusts are bound to the calendar year by § 644, decedent's estates are permitted to adopt a fiscal year. For SNT practitioners, this creates a vital opportunity: under IRC § 645, an irrevocable qualified revocable trust (QRT) that created a testamentary SNT can elect to be treated as part of the decedent's estate for income tax purposes. This allows the trust to utilize a fiscal year, defer income reporting, and gain access to estate-specific tax perks for up to two years following the decedent's death.

## **G. Accounting Methods: Timing Is Everything**

### **1. Cash vs. Accrual: The Eternal Tug-of-War**

As noted above, the income tax is imposed on an annual basis, the tax year. Thus it is necessary to establish rules concerning *when* an item of income is included and *when* an item of expense is deducted. It is important to keep in mind where the "pressure" is. Taxpayers will nearly always be economically advantaged by the deferral of taxable income and the acceleration of tax deductions. The government has an opposing interest in the acceleration of income and deferral of deductions to maximize current tax revenues. An evenhanded set of rules should impartially navigate between these competing interests.

### **2. The Matching Principle: Accounting Meets Reality**

The primary determinant of the timing of income and deductions is the taxpayer's accounting method. There are two main methods: the cash method and accrual method. IRC § 446(c). Both methods employ some version of the "matching" principle -- seeking to match expenses to the income they produce so that we get a fair and accurate picture of net income. The cash method is less effective at matching, but it is simple, intuitive, and the method almost universally employed by SNTs and individual disabled beneficiaries.

#### **a. The Cash Method: Constructive Receipt and Prepaid Fees**

The basic principle of the cash method is that income is reported when it is actually or constructively received. Treas. Reg. § 1.446-1(a). An item is constructively received when it is credited to the taxpayer's account or set aside for them without substantial restrictions. Treas. Reg. § 1.451-2(a). For SNT beneficiaries, if a trustee irrevocably sets aside funds that the beneficiary has an absolute, unrestricted legal right to demand, the IRS can deem those funds constructively received by the beneficiary, triggering immediate taxation even if the cash remains in the trust account.

The cash method operates with respect to deductions in much the same way: deductions are taken when the expense is paid. Treas. Reg. § 1.446-1(c)(1)(i). SNT trustees sometimes

attempt to manipulate the cash method by prepaying deductible trust administrative fees or care expenses in December to reduce the trust's taxable income for that calendar year. However, under Treasury Regulation § 1.263(a)-4, prepaid expenses must generally be capitalized unless they qualify under the narrow “12-month rule” exception (Treas. Reg. § 1.263(a)-4(f)(1)).

#### **b. The Accrual Method: The All-Events Test and Advance Funding**

Under the accrual method, income is generally included in the taxable year in which all events have occurred fixing the right to the income and in which the amount can be determined with reasonable accuracy (the “all events” test). Treas. Reg. § 1.446-1(c)(1)(ii)(A). For accrual taxpayers, income is reportable when earned, regardless of when cash is collected. Note that under *Schlude v. Commissioner*, 372 U.S. 128 (1963) and IRC § 451(c), advance cash payments received are generally taxable immediately upon receipt, even if the all-events test has not been met.

Under the accrual method, deductions are taken in the year in which all events have occurred establishing the fact of liability, the amount can be determined, and economic performance has occurred. IRC § 461(h). Economic performance occurs when the person to whom the liability is owed actually provides the services or property. For an accrual-method entity, prepaying a structured settlement or care provider for ten years of future care does not yield an immediate deduction; the deduction is unlocked only as the care services are actually rendered year by year.