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Tax Law Update

What OBBBA Changed, and What It Did Not: Medicaid Financing, the Lifetime Retirement Stretch, and the New Section 68 Trap for Nongrantor Special Needs Trusts

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I. Introduction: What OBBBA Changed for Our Clients, and What It Did Not

Public Law 119-21, the 2025 reconciliation act commonly called the One Big Beautiful Bill Act (OBBBA), is usually discussed as two unrelated laws: a tax bill and a Medicaid bill.¹ For special needs planners they are one story. The Medicaid provisions reshape the public-benefits landscape our clients depend on, especially the financing of home- and community-based services (HCBS). The tax provisions, together with what Congress chose not to change, determine how private resources set aside for a person with a disability—SNTs, ABLE accounts, and inherited retirement savings—can best be used to fill the gaps.

This paper follows that arc in four movements.

1. **Medicaid: the headline versus our clients (Part II).** A large part of OBBBA's health title is designed to reduce federal Medicaid spending, and the Congressional Budget Office attributes much of those savings to reduced enrollment. But the provisions that drive the widely reported coverage losses are aimed mainly at adults covered through the Affordable Care Act (ACA) Medicaid expansion, not at people who are disabled under Social Security definitions. For our clients, the more serious threat comes later and indirectly: financing reductions that will squeeze state budgets and, over time, the optional HCBS programs on which people with disabilities most depend.

¹An Act to Provide for Reconciliation Pursuant to Title II of H. Con. Res. 14, Pub. L. No. 119-21, 139 Stat. 72 (July 4, 2025) (commonly called the One Big Beautiful Bill Act, or OBBBA), <https://www.govinfo.gov/app/details/PLAW-119publ21>

2. **The tax provisions that matter to SNT practice (Part III).** OBBBA made the compressed trust rate structure permanent, set a permanent \$15 million indexed estate and gift exclusion, extended and expanded ABLE provisions, added a temporary senior deduction, and rewrote § 68.
3. **What did not change: the lifetime stretch (Part IV).** OBBBA left intact the SECURE Act rule allowing a disabled or chronically ill beneficiary—including through an accumulation-style SNT—to receive inherited retirement benefits over the beneficiary's life expectancy. That makes yet-untaxed retirement savings one of the most benefits-protective assets a parent can leave, and it should prompt planners to rethink how inheritances are divided among siblings who face very different payout rules.
4. **Who pays the tax, and the new § 68 trap (Parts V through XIV).** A refresher on grantor and nongrantor status for first-party and third-party SNTs leads to the new, underappreciated interaction of compressed brackets, the 3.8% net investment income tax, and the rewritten § 68 limitation for nongrantor SNTs. Worked examples and a fourth-quarter planning protocol follow. Because trusts generally use the calendar year, the first Forms 1041 reflecting the new rule will generally be prepared in spring 2027, and decisions made in the fourth quarter of 2026 will determine what they show.²

Note on scope. The examples in this paper are illustrative, simplified, and based on federal law and 2026 inflation-adjusted figures as understood at the time of writing (September 2026). They ignore state income tax unless stated otherwise.

²I.R.C. § 644(a) (the taxable year of any trust shall be the calendar year, subject to exceptions for tax-exempt and charitable trusts); see also Treas. Reg. § 1.645-1 (the § 645 election for qualified revocable trusts, the principal route by which a trust may use an estate's fiscal year), <https://www.law.cornell.edu/uscode/text/26/644>

Several OBBBA provisions are still being implemented through interim final rules and state plan changes, and the application of § 68 to trusts and estates is unsettled. Readers should confirm subsequent guidance before relying on any computation.

II. OBBBA and Medicaid: The Headline Versus Our Clients

A. The Scale of the Medicaid Changes

Chapter 1 of Title VII, Subtitle B of OBBBA contains the law's Medicaid provisions, and their purpose is plainly fiscal. The Congressional Budget Office (CBO) estimates that the Medicaid chapter reduces the federal deficit by about \$887 billion over 2025–2034 and increases the number of people without health insurance by 7.5 million in 2034. Across all of the health provisions, CBO projects federal outlay reductions of about \$1.1 trillion and 10.0 million more uninsured people in 2034.³ KFF estimates that the law reduces federal Medicaid spending by roughly 14% over a decade.⁴ Supporters describe these provisions as restoring program integrity, re-establishing work expectations for able-bodied adults, and ending state financing arrangements they regard as abusive. Critics describe them as coverage cuts. Both descriptions are consistent with CBO's numbers. What matters for this audience is which people and which programs will bear the reductions, and when.

³Cong. Budget Office, Supplemental Cost Estimate: Public Law 119-21, Title VII, Subtitle B, Chapter 1 (Medicaid) (Oct. 2025) (deficit reduction of \$886.8 billion over 2025-2034; 7.5 million more uninsured in 2034; provision-level estimates, including \$317.0 billion and 5.3 million for § 71119, \$182.7 billion and 1.1 million for § 71115, \$58.0 billion and 0.7 million for § 71107, and about 800,000 fewer dual-eligible enrollees from the § 71101 moratorium), https://www.cbo.gov/system/files/2025-10/PL-119-21-Medicaid%20_0.pdf Cong. Research Serv., R48633, Health Provisions in P.L. 119-21, the FY2025 Reconciliation Law (2025) (health provisions reduce federal outlays by \$1.1 trillion; 10.0 million more uninsured in FY2034; § 71119 covered population, mandatory exemptions, and specified excluded individuals, including those who are blind or disabled under SSA § 1614 and parents or caretakers of a disabled individual; effective dates), <https://www.congress.gov/crs-product/R48633>

⁴KFF, Medicaid Home Care (HCBS) in 2025 (2025) (law reduces federal Medicaid spending by \$911 billion, about 14%, over a decade; most home care is optional for states; new 1915(c) waiver take-up expected to be low), <https://www.kff.org/medicaid/medicaid-home-care-hcbs-in-2025/>

B. Where the Coverage Losses Actually Fall

The provisions responsible for most of CBO’s projected coverage loss are directed at the ACA expansion population—nonelderly adults with incomes up to 138% of the federal poverty level who qualify on the basis of income alone:

Provision	Principal population affected	Effective date	CBO estimate, FY2025–FY2034 (measure shown)
§ 71119 community engagement (work) requirement: 80 hours/month of work, training, education, or service	Expansion adults ages 19–64	Jan. 1, 2027 (states may seek good-faith extensions to Dec. 31, 2028)	\$317.0 billion deficit reduction; 5.3 million more uninsured in 2034
§ 71107 six-month eligibility redeterminations	Expansion adults	Jan. 1, 2027	\$58.0 billion deficit reduction; 0.7 million more uninsured in 2034
§ 71120 cost sharing up to \$35 per service	Expansion adults with incomes 100–138% FPL	Oct. 1, 2028	\$7.4 billion lower outlays
§ 71109 immigrant eligibility limits	Certain lawfully present noncitizens	Oct. 1, 2026	\$6.2 billion lower outlays
§ 71115 provider-tax limits	States (hold-harmless threshold phase-down applies to expansion states)	Oct. 1, 2026; phase-down from FY 2028 to 3.5% in FY 2032	\$182.7 billion deficit reduction; 1.1 million more uninsured in 2034
§ 71116 state-directed-payment limits	States and providers	New limits for rating periods beginning on or after enactment; grandfathered payments step down beginning Jan. 1, 2028	\$149.4 billion lower outlays

The source for the table is CBO's supplemental cost estimate and the Congressional Research Service summary.⁵ The work requirement alone accounts for more than a third of the Medicaid chapter's deficit reduction and about 70% of Chapter 1's projected increase in uninsured people in 2034. CBO projects that, in 2034, roughly 2.9 million people will lose Medicaid coverage because they do not meet the requirement or qualify for an exception, and roughly 2.8 million more because of the additional application and verification steps. Most, but not all, of them are expected to become uninsured.

C. Why Most of Our Clients Are Outside Those Provisions

This is the single most overlooked point in the mainstream coverage of OBBBA. The people this audience serves—individuals who are disabled under the Social Security Act definitions—generally qualify for Medicaid through non-MAGI pathways based on age, blindness, or disability, most often through SSI-related eligibility, and not through the ACA expansion group. The work requirement applies only to expansion adults and expressly excludes people eligible through Medicaid's other mandatory pathways and people entitled to Medicare Part A or enrolled in Part B. Even within the expansion group, the statute exempts individuals who are medically frail or have special medical needs, which the statute defines to include individuals who are blind or disabled under § 1614 of the Social Security Act, individuals with a physical, intellectual, or developmental disability that significantly impairs one or more activities of daily living, and individuals with disabling mental disorders or serious or complex medical conditions. It also exempts parents, guardians, and caretaker relatives of a disabled

⁵See supra note 3.

individual.⁶ The same is broadly true of the six-month redeterminations and the new cost-sharing, which are limited to the expansion population.

The practical translation: when a client's family asks whether OBBBA means their adult child with an intellectual disability will lose Medicaid in 2027, the answer is, in most cases, not directly. The child's eligibility pathway is not the one the work requirement targets, and the parent who cares for the child is also exempt if the parent is an expansion enrollee.

D. Where Our Clients Are Directly Affected

Candor requires noting the provisions that do reach the aged, blind, and disabled population now or soon:

- **Retroactive coverage (§ 71112).** For applications submitted on or after January 1, 2027, retroactive coverage falls from three months to two months for non-expansion (including aged, blind, and disabled) applicants and to one month for expansion adults.⁷ For elder law and disability practitioners this is the most immediate change, because the three-month look-back often covered the gap between a hospital or rehabilitation admission and a completed long-term-care application. Applications must now be filed faster.

⁶See supra note 3. Ctrs. for Medicare & Medicaid Servs., Medicaid Community Engagement Requirement for Certain Individuals: Interim Final Rule (fact sheet, June 1, 2026) (states must generally implement by Jan. 1, 2027; exemptions), <https://www.cms.gov/newsroom/fact-sheets/medicaid-community-engagement-requirement-certain-individuals-interim-final-rule-comment-period-cms>

⁷Nat'l Health Law Program, New Fixed Home Equity Caps and Retroactive Coverage Limitations (Feb. 2026) (§ 71108 cap of \$1,000,000 effective Jan. 1, 2028, not indexed, applicable to nursing facility and HCBS; 12 jurisdictions including New Jersey above the cap; spouse, minor child, and blind or disabled child exceptions and hardship waivers; § 71112 retroactive coverage of two months for non-MAGI and one month for expansion applicants for applications on or after Jan. 1, 2027), <https://healthlaw.org/wp-content/uploads/2026/02/Retroactive-Coverage-and-Home-Equity-2122026.pdf> See supra note 3.

- **Home-equity cap (§ 71108).** Beginning January 1, 2028, the home-equity limit for long-term-care eligibility (nursing facility and HCBS) is capped at \$1,000,000, not indexed, for non-agricultural homes. Twelve jurisdictions, including New Jersey, currently use higher limits. The existing exceptions remain where a spouse, a child under 21, or a blind or disabled child of any age lives in the home, and a hardship-waiver process is required.⁸
- **Eligibility and enrollment rule moratoria (§§ 71101–71102).** OBBBA blocks, through fiscal year 2034, implementation of the 2023 Medicare Savings Program streamlining rule and parts of the 2024 Medicaid eligibility and enrollment rule, several of which were designed to simplify enrollment for aged, blind, and disabled individuals and dual eligibles. CBO projects about 800,000 fewer Medicaid enrollees who are also enrolled in Medicare in 2034 from the MSP moratorium alone, although it did not project that this provision increases the number of uninsured.⁹
- **The SSDI waiting-period gray zone.** A person who receives Social Security Disability Insurance but is still in the 24-month waiting period for Medicare, with income too high for SSI, may be covered as an expansion adult. That person should be exempt as disabled under the statute, but the exemption must be identified and documented. The risk for this group is procedural—termination for failure to establish the exemption—rather than substantive ineligibility. Advocates and care managers should flag these clients now.¹⁰

⁸See supra note 7.

⁹See supra note 3.

¹⁰See supra note 6.

E. The Longer-Term Threat: Financing and Home- and Community-Based Services

The more consequential effect on people with disabilities is indirect and delayed. The savings in the table are heavily back-loaded: CBO's annual estimates of Chapter 1 deficit reduction rise from about \$45 billion in FY2027 to \$90 billion in FY2029, \$135 billion in FY2032, and \$160 billion in FY2034.¹¹ Much of that comes from restrictions on the financing tools states use to fund their share of Medicaid. Section 71115 freezes new provider taxes and, for expansion states, reduces the hold-harmless threshold for most existing provider taxes by one-half percentage point per year from 6% until it reaches 3.5% in fiscal year 2032. Nursing-facility and ICF/IID provider taxes are excluded from the phase-down. Section 71116 caps new state-directed payments at 100% of Medicare rates in expansion states (110% in non-expansion states) for rating periods beginning on or after enactment, and requires grandfathered payments to step down by 10 percentage points per year beginning January 1, 2028.¹²

When states lose financing, they must raise revenue or cut spending, and the first place they look is optional coverage. Nursing-facility care and home health are mandatory Medicaid benefits. Almost all other HCBS—personal care, habilitation, supported employment, respite, day services, and most waiver services—are optional, and states can cap waiver enrollment.¹³ Medicaid pays for more than two-thirds of home- and community-based long-term care in the United States, and about 5.1 million

¹¹See supra note 3.

¹²See supra note 3. Pub. L. No. 119-21, § 71116; Ctrs. for Medicare & Medicaid Servs., Letter to State Medicaid Directors on State Directed Payments (Sept. 9, 2025), <https://www.medicaid.gov/medicaid/managed-care/downloads/sdp-ltr-09092025.pdf>

¹³See supra note 4.

people use Medicaid home care.¹⁴ Even before OBBBA takes full effect, 41 states reported waiting or interest lists for HCBS waivers in 2025, with about 607,000 people listed. People with intellectual or developmental disabilities account for 74% of the waiting-list population, and the average wait for services was 32 months.¹⁵

OBBBA does contain one expansion of HCBS authority: beginning July 1, 2028, § 71121 permits a new type of 1915(c) waiver for people who do not meet an institutional level of care.¹⁶ KFF expects take-up to be low, however, given the federal spending reductions and the requirement that new waivers not lengthen waits for existing waiver services.¹⁷

The honest forecast for our clients is therefore not that they will lose Medicaid eligibility in 2027. It is that, as the financing reductions accumulate between 2028 and 2034, the services Medicaid pays for—particularly the optional HCBS that allow people with disabilities to live in the community—are likely to be curtailed in many states, frozen in others, and in some circumstances eliminated for particular populations or service categories. Waiting lists may lengthen, provider rates may stagnate, and workforce shortages may deepen. It is a slower harm than the headlines suggest, but it will ultimately reach the people this audience serves.

¹⁴KFF, A Look at Waiting Lists for Medicaid Home and Community-Based Services from 2016 to 2025 (2025) (41 states with waiting or interest lists; about 607,000 people; 74% with intellectual or developmental disabilities; average wait of 32 months; Medicaid pays for more than two-thirds of home- and community-based long-term care), <https://www.kff.org/medicaid/a-look-at-waiting-lists-for-medicaid-home-and-community-based-services-from-2016-to-2025/>

¹⁵See supra note 14.

¹⁶Ctrs. for Medicare & Medicaid Servs., CMCS Informational Bulletin (Nov. 18, 2025) (implementation of § 71121, new 1915(c) waiver option for individuals who do not meet an institutional level of care, beginning July 1, 2028), <https://www.medicaid.gov/federal-policy-guidance/downloads/cib11182025.pdf>

¹⁷See supra note 4.

F. Implementation Timeline

Date	Provision
July 4, 2025	Enactment; eligibility-rule moratoria (§§ 71101–71102); state-directed-payment limits (§ 71116) begin for new payments
June 1, 2026	CMS interim final rule on community engagement issued
Oct. 1, 2026	Immigrant eligibility limits (§ 71109); provider-tax provisions (§ 71115) take effect
Jan. 1, 2027	Work requirement for expansion adults (§ 71119); six-month redeterminations (§ 71107); retroactive coverage cut to two months (non-expansion) or one month (expansion) (§ 71112)
Jan. 1, 2028	\$1,000,000 home-equity cap for long-term care (§ 71108)
FY 2028–2032	Provider-tax hold-harmless phase-down to 3.5% in expansion states; reductions in state-directed payments above Medicare rates
July 1, 2028	New 1915(c) HCBS waiver option without institutional level of care (§ 71121)
Oct. 1, 2028	Cost sharing for expansion adults with incomes 100–138% FPL (§ 71120)
Dec. 31, 2028	Latest date for good-faith extensions of the work requirement

G. What This Means for SNT Planning

If public HCBS becomes scarcer, private resources set aside for a person with a disability become more important—and so does using them efficiently. SNT instruments should give trustees clear authority to purchase care, supports, and services privately while a beneficiary waits for, or in place of, waiver services, and to coordinate with Medicaid rather than duplicate it. ABLE accounts, now permanently enhanced, become more valuable as flexible, disregarded resources. And the largest single pool of money many families will leave a child with a disability is often not the house or the brokerage account but the parents' retirement plans. OBBBA left untouched the rules that allow those savings to be paid out over the disabled beneficiary's lifetime. Making the most of that opportunity, and paying as little tax as possible along the way, is the subject of the rest of this paper.

III. The Tax Side of OBBBA: What Changed for SNT Practice

OBBBA's tax title is vast, and most of it is outside the scope of this paper. The provisions below are the ones that most directly affect special needs planning.

Provision	Relevance to SNT practice
Permanent rate schedules (§ 1(j) as amended)	The compressed four-bracket trust schedule is now permanent. For 2026 the 37% bracket begins at \$16,000 of trust taxable income, versus \$640,600 for a single individual. ¹⁸
Permanent \$15 million basic exclusion amount (§ 2010(c)(3))	Few SNT families face federal estate tax, which makes revocable third-party SNTs the natural default and shifts attention from estate exclusion to basis and income-tax planning. ¹⁹
Rewritten § 68 (2/37 limitation on itemized deductions); repeal of former § 68(e)	May reach nongrantor trusts, including (under the Joint Committee staff's reading) distribution deductions. The subject of Part XI.
ABLE provisions made permanent	ABLE-to-work contributions, 529-to-ABLE rollovers, and Saver's Credit eligibility for ABLE contributions are permanent. Separately, under SECURE 2.0, the age-of-onset limit rose from 26 to 46 on January 1, 2026. ²⁰
Temporary senior deduction, 2025–2028	An additional \$6,000 deduction per individual age 65 or older, phased out above \$75,000 of MAGI (\$150,000 joint). Relevant to aging parents' income-tax planning, including the Roth-conversion analysis in Part IV. ²¹
Higher standard deduction, made permanent	\$16,100 for single filers in 2026. For a beneficiary who receives trust income through a K-1, much or all of it may be sheltered. ²²

¹⁸Rev. Proc. 2025-32, § 4.01 & § 4.03 (2026 inflation adjustments, including the estate and trust rate schedule and capital-gain breakpoints), <https://www.irs.gov/pub/irs-drop/rp-25-32.pdf>

¹⁹I.R.C. § 2010(c)(3), as amended by Pub. L. No. 119-21 (basic exclusion amount of \$15,000,000 for 2026, indexed for inflation thereafter; applies for estate, gift, and generation-skipping transfer tax purposes).

²⁰I.R.C. § 529A(b)(2)(B) (annual contribution limit tied to the § 2503(b) exclusion, \$19,000 for 2026); § 529A(e)(1), as amended by SECURE 2.0 Act of 2022, Pub. L. No. 117-328, div. T, § 124 (age of disability onset raised from 26 to 46 for taxable years beginning after December 31, 2025); see ABLE Today, One Big Beautiful Bill (summary of OBBBA's permanent extension of ABLE-to-work contributions, 529-to-ABLE rollovers, and Saver's Credit eligibility), <https://www.abletoday.org/obbba>

²¹Pub. L. No. 119-21 (new I.R.C. § 151(d)(5)(C) senior deduction); IRS, Working Families Tax Cuts: Tax Deductions for Working Americans and Seniors (\$6,000 per eligible individual age 65 or older for 2025-2028; phase-out above \$75,000 of MAGI, \$150,000 joint), <https://www.irs.gov/newsroom/working-families-tax-cuts-tax-deductions-for-working-americans-and-seniors>

²²IRS, IRS Releases Tax Inflation Adjustments for Tax Year 2026, Including Amendments from the One Big Beautiful Bill (Oct. 2025) (2026 standard deduction of \$16,100 for single filers); Rev. Proc. 2025-32, <https://www.irs.gov/newsroom/irs-releases-tax-inflation-adjustments-for-tax-year-2026-including-amendments-from-the-one-big-beautiful-bill>

Two features of the 2026 environment carry through the rest of this paper. First, the trust rate schedule is now permanently compressed, so any income an SNT keeps is expensive. Second, the beneficiary's own rate schedule is permanently generous at low incomes. The planning opportunity lies in the gap between the two.

IV. What Did Not Change: The Lifetime Stretch for Disabled and Chronically Ill Beneficiaries

A. The Eligible Designated Beneficiary Exception

The SECURE Act of 2019 replaced the old lifetime stretch for most non-spouse beneficiaries of inherited retirement accounts with a ten-year payout rule. It carved out a small group of eligible designated beneficiaries (EDBs) who may still take distributions over their life expectancy. That group includes a beneficiary who is disabled (generally, unable to engage in substantial gainful activity because of a medically determinable impairment expected to be of long-continued and indefinite duration, with a special functional-limitation test for beneficiaries under 18) and one who is chronically ill (certified by a licensed health care practitioner under the § 7702B(c)(2) standard).²³ OBBBA did not change these rules. In an era of tightening public benefits, they are among the most valuable provisions in the Code for families of people with disabilities.

²³I.R.C. § 401(a)(9)(E)(ii)(III)-(IV), (H)(iv)-(v) (eligible designated beneficiaries who are disabled or chronically ill; applicable multi-beneficiary trusts); Required Minimum Distributions, T.D. 10001, 89 Fed. Reg. 58,886 (July 19, 2024); Internal Revenue Bulletin 2024-33 (Aug. 12, 2024), https://www.irs.gov/irb/2024-33_IRB Treas. Reg. §§ 1.401(a)(9)-4(e)(4)-(5), (e)(7), (h) (definitions of disabled and chronically ill eligible designated beneficiaries; documentation to the plan administrator by October 31 of the year following death, or October 31, 2025, if later; trust documentation), 1.408-8(b)(4)(i) (documentation need not be provided to the IRA trustee, custodian, or issuer), as finalized by T.D. 10001; see Thomson Reuters, IRS Issues Final and Proposed Required Minimum Distribution Regulations (July 2024), <https://tax.thomsonreuters.com/news/irs-issues-final-and-proposed-required-minimum-distribution-regulations-reflecting-secure-and-secure-2-0-act-changes/>

Under the 2024 final regulations, for a qualified employer plan, documentation of the beneficiary's disability or chronic illness must be provided to the plan administrator by October 31 of the calendar year following the calendar year of the participant's death (or October 31, 2025, if later). Separate trust-documentation requirements apply when a trust is the beneficiary. Neither submission rule requires delivery to an IRA trustee, custodian, or issuer, and § 403(b) contracts generally follow the IRA rule, although a provider or plan may require information under its own documents.²⁴ A Social Security Commissioner determination that the beneficiary was disabled as of the date of death supplies the regulation's disability safe harbor, but it does not eliminate a qualified plan's timely-submission requirement; chronic-illness treatment requires the applicable licensed-health-care-practitioner certification. For a covered employer plan, failing to meet the documentation requirement can prevent reliance on disabled- or chronically-ill EDB life-expectancy treatment and lead instead to the applicable ten-year regime. The safe course is to assemble the documentation promptly whatever the account type.

B. The Applicable Multi-Beneficiary Trust

A disabled or chronically ill beneficiary almost never should inherit a retirement account outright. An inherited IRA held in the beneficiary's own name is a countable resource, and its required distributions are unearned income for SSI purposes. The solution is the applicable multi-beneficiary trust (AMBT) under § 401(a)(9)(H)(iv)–(v): a see-through trust for the benefit of a disabled or chronically ill beneficiary under which no individual other than that beneficiary has any right to the benefits during the beneficiary's life. An AMBT may accumulate distributions rather than pass them

²⁴See *supra* note 23.

through. The payout period is the disabled or chronically ill beneficiary's life expectancy, even though other beneficiaries take the remainder.²⁵ SECURE 2.0 added that a qualified charity may be a remainder beneficiary of an AMBT without destroying the stretch.²⁶ A properly drafted third-party accumulation SNT is the paradigm AMBT.

The distinction between conduit and accumulation trusts is critical here. A conduit trust must pass every retirement distribution through to the beneficiary. For an SSI or Medicaid recipient, that converts a protected asset into countable income each year. An accumulation-style AMBT allows the trustee to retain distributions inside the SNT and to spend them for the beneficiary's supplemental needs, which is the benefits-protective result. The cost of that protection is income-tax exposure: every retirement distribution the trust retains is ordinary income taxed at the compressed trust rates discussed in Parts X and XI.

C. The Tax Administration of an Accumulation AMBT

A distribution from an inherited IRA to an accumulation SNT is ordinary income to the trust (income in respect of a decedent). It is excluded from net investment income, so the 3.8% NIIT does not apply, but it is fully exposed to the compressed ordinary brackets.²⁷ If the trust retains a \$30,000 distribution in 2026, the federal tax is about \$8,994. If the trustee instead uses the same \$30,000 for the beneficiary's benefit—paying providers, funding an ABLE account, purchasing equipment or services—the

²⁵See supra note 23.

²⁶SECURE 2.0 Act of 2022, Pub. L. No. 117-328, div. T, § 337 (qualified charity may be a remainder beneficiary of an applicable multi-beneficiary trust); I.R.C. § 401(a)(9)(H)(iv)-(v).

²⁷I.R.C. § 1411(a)(2), (c); Treas. Reg. § 1.1411-3(a), (e); I.R.C. § 1411(c)(5) (distributions from qualified plans and IRAs described in §§ 401(a), 403(a), 403(b), 408, 408A, and 457(b) are excluded from net investment income).

trust's distribution deduction carries the income out to the beneficiary through DNI. The beneficiary's standard deduction and low brackets may absorb much or all of it.²⁸

Retirement distributions also add to the § 68 base in the same way as capital gains (Part XI). The fourth-quarter protocol in Part XIII therefore applies with special force to AMBTs: project the required distribution and any discretionary withdrawals, decide in advance how much will be used for the beneficiary's benefit, and avoid bunching withdrawals into a single year.

D. Rethinking Inheritance Among Siblings

Because the disabled child can stretch and the non-disabled siblings generally cannot, the traditional instinct to divide every asset equally among the children is often the wrong answer. A non-disabled adult child who inherits a traditional IRA must generally empty it within ten years, with annual required distributions in years one through nine if the parent died on or after the required beginning date. Those distributions are taxed at that child's marginal rate, often during peak earning years. The same account left to the disabled child's AMBT can be paid out over the child's life expectancy. Conversely, a brokerage account or a house receives a basis step-up at death and carries little embedded income tax.

Consider parents who die in 2026 leaving a \$1,000,000 traditional IRA and a \$1,000,000 brokerage account to two children. Sam, 35, is disabled and receives SSI and Medicaid. Kate, 38, is in the 32% federal bracket.

²⁸See supra note 22.

	Option A: each asset split 50/50	Option B: IRA to Sam's AMBT; brokerage to Kate
Kate receives	\$500,000 brokerage + \$500,000 IRA (10-year rule)	\$1,000,000 brokerage (stepped-up basis)
Embedded federal income tax on Kate's share (32% on the IRA, ignoring growth)	About \$160,000, payable within 10 years	None
Sam's AMBT receives	\$500,000 brokerage + \$500,000 IRA	\$1,000,000 IRA
Sam's first-year required distribution (single life factor 50.5 at age 35 in the first distribution year)	About \$9,900	About \$19,800
Tax on Sam's distributions if used for his benefit	Largely sheltered by his standard deduction	Largely sheltered by his standard deduction

Under Option B, the family avoids roughly \$160,000 of accelerated federal income tax at Kate's rate, while the tax on Sam's share is deferred over roughly five decades and, to the extent distributions are used for his benefit, paid at his low individual rates.²⁹ Families may reasonably decide that Sam's share should be adjusted for the deferred tax embedded in the IRA, or that equality should be measured after tax. The point is that the retirement account—yet-untaxed savings—is the asset best suited to the disabled child's trust, and the stepped-up assets are best suited to the siblings. Beneficiary designations, not the will, control this result, and they must be coordinated with the estate plan.

²⁹Treas. Reg. § 1.401(a)(9)-9(b) (Single Life Table; factor of 50.5 at age 35 for distribution calendar years beginning on or after January 1, 2022); I.R.C. § 401(a)(9)(H)(i) (ten-year rule); Treas. Reg. § 1.401(a)(9)-5(d) (annual distributions within the ten-year period where the employee died on or after the required beginning date).

E. Parent-Level Planning: Roth Conversions and the Senior Deduction

Where parents are in moderate brackets, converting part of a traditional IRA to a Roth IRA during life can be especially efficient when the ultimate beneficiary is an accumulation SNT. The parents pay tax at their individual rates, which are almost always lower than the trust's rates on retained income. The AMBT then inherits a Roth account that it can stretch over the disabled child's life expectancy, with qualified distributions free of income tax, so there is no compressed-bracket or § 68 exposure to manage. The temporary OBBBA senior deduction for 2025–2028 can make conversion years more attractive for parents over 65, although conversion income raises MAGI and can phase out the deduction. It can also affect Medicare IRMAA premiums and the taxation of Social Security benefits, so each conversion should be modeled.³⁰

F. Drafting and Administration Checklist for Retirement Benefits Payable to an SNT

- Draft the SNT as an accumulation trust that qualifies as an AMBT, with no individual other than the disabled or chronically ill beneficiary entitled to benefits during that beneficiary's life.
- Name the SNT (or its separate share) directly on the beneficiary designation; avoid routing retirement benefits through the probate estate.
- For a qualified employer plan, provide the plan administrator with the trust documentation and, if disabled- or chronically-ill EDB treatment is claimed, the condition evidence by October 31 of the calendar year following the calendar year of death (or October 31, 2025, if later). The same federal submission rule

³⁰See *supra* note 21.

does not require delivery to an IRA trustee, custodian, or issuer; § 403(b) contracts generally follow the IRA rule, although the provider or plan may require information under its own documents.

- Give the trustee express authority to distribute for the beneficiary's benefit in ways that carry out DNI without creating countable income, including third-party payments and ABLE contributions.
- Coordinate the designations for all children with the overall plan, including after-tax equalization if the family wants it.
- Include retirement distributions in the fourth-quarter tax huddle every year.

V. The Two Questions That Come Before “SNT Taxation”

The retirement-plan strategy in Part IV, like every other SNT funding strategy, eventually runs into one question: once money is inside an SNT, who pays the income tax on it? That question has to be answered before the new § 68 rule makes sense, and it is the subject of Parts V through VIII.

The public-benefits classification of an SNT and its income-tax classification are related but distinct. The public-benefits label follows the source of funds and the statutory exception relied upon. The income-tax result follows the grantor-trust rules of I.R.C. §§ 671 through 679, which ask who is treated as the owner of the trust for income-tax purposes. When a person is treated as the owner of all or a portion of a trust, the income, deductions, and credits attributable to that portion are reported on that

person's own return, not the trust's.³¹ The following matrix is the organizing framework for the balance of this paper.

SNT type and stage	Typical income-tax status	Who reports the income	Compressed rates / NIIT / § 68 at trust level?	Key teaching point
First-party (d)(4)(A) or pooled (d)(4)(C) subaccount, beneficiary living	Grantor trust (beneficiary is the grantor)	Beneficiary, on Form 1040	Generally no	The trust holds the beneficiary's own money; it does not create a separate income-tax taxpayer
Third-party SNT during the settlor's life (usually revocable; occasionally irrevocable with a §§ 673-677 trigger)	Grantor trust: revocable under § 676; irrevocable only if a §§ 673-677 power applies	Settlor, on the settlor's Form 1040	Generally no	Revocable: still the parent's money for tax purposes. Irrevocable grantor trust: the parent's tax payment is a non-gift benefit
Third-party SNT after the settlor's death (or, for an irrevocable trust, after grantor powers are released)	Nongrantor (usually complex) trust	Trust on Form 1041; beneficiary on Schedule K-1 to the extent of DNI carried out	Yes	Same trust, same trustee, same portfolio—different taxpayer
Testamentary third-party SNT (created under a will or funded at death)	Nongrantor trust from inception	Trust and, through DNI, the beneficiary	Yes, from day one	There is no lifetime grantor phase; the tax protocol must exist from the first year

The shorthand for the audience is simple: **first party or third party tells us the public-benefits rules; whose money—and whether that person is still alive—tells us who pays the income tax.**

³¹I.R.C. §§ 671, 677(a); Treas. Reg. § 1.671-2(e)(1) (a grantor is any person to the extent that person creates a trust or makes a gratuitous transfer of property to a trust); see 42 U.S.C. § 1396p(d)(4)(A) (trust containing the assets of an individual under 65 who is disabled, established for that individual's benefit by a parent, grandparent, legal guardian, the individual, or a court, with state Medicaid payback).

VI. First-Party SNTs: Grantor Trusts by Definition

A. Why the Beneficiary Is the Grantor

A first-party SNT under 42 U.S.C. § 1396p(d)(4)(A) holds the assets of a disabled individual under age 65 and may be established by the individual, a parent, grandparent, guardian, or court. For income-tax purposes, the identity of the person who signs the trust instrument is not controlling. The Treasury regulations define the grantor as the person who makes a gratuitous transfer of property to the trust. Because the property belongs to the beneficiary—a personal-injury recovery, an inheritance redirected into the trust, accumulated savings, or retroactive benefits—the beneficiary is the grantor. And because trust income may be distributed to or applied for the beneficiary without the consent of an adverse party, § 677(a) treats the beneficiary as the owner of the trust.³² Pooled-trust subaccounts under § 1396p(d)(4)(C) are commonly reported on the same grantor-trust basis as to each beneficiary's subaccount, although practitioners should confirm the reporting practice of the specific pooled trust.³³

B. Reporting Mechanics

A grantor trust may file a Form 1041 as an information return with a grantor statement, or may use one of the optional reporting methods under Treas. Reg. § 1.671-4, including reporting under the grantor's own taxpayer identification number or

³²See *supra* note 31.

³³42 U.S.C. § 1396p(d)(4)(C) (pooled trust accounts established by a nonprofit association). Practitioners should confirm each pooled trust's actual reporting practice for subaccounts.

filing Forms 1099 that direct the income to the grantor.³⁴ Many trustees obtain a separate EIN for administrative reasons. Whatever method is used, the trust's interest, dividends, and capital gains end up on the beneficiary's individual return.

C. Practical Consequences

- **Individual rates, not trust rates.** The beneficiary's individual bracket structure applies. For a beneficiary whose only other income is SSI or modest Social Security Disability Insurance, most or all of the trust's investment income is likely to fall within the standard deduction or the lowest brackets. A 2026 single filer's 0% rate on net capital gain and qualified dividends applies up to \$49,450 of taxable income.³⁵
- **Deductions the trust pays can reduce the beneficiary's tax.** Because the trust is ignored for income-tax purposes, medical and care expenses the trustee pays for the beneficiary may support an itemized medical-expense deduction on the beneficiary's return, subject to the 7.5%-of-AGI floor.³⁶ For a first-party SNT paying substantial care, therapy, or equipment costs, this can offset much or all of the trust's income.
- **NIIT at individual thresholds.** The 3.8% net investment income tax applies to the beneficiary only above the individual thresholds of \$200,000 (single) or

³⁴Treas. Reg. § 1.671-4(a), (b) (grantor-trust reporting, including optional methods that dispense with a Form 1041 and use the grantor's taxpayer identification number or the filing of Forms 1099); see Instructions for Form 1041 (grantor-type trusts).

³⁵Rev. Proc. 2025-32, § 4.03 (for 2026, the 0% rate on net capital gain and qualified dividends applies to single filers with taxable income up to \$49,450), <https://www.irs.gov/pub/irs-drop/rp-25-32.pdf>

³⁶I.R.C. § 213(a) (medical expenses in excess of 7.5% of adjusted gross income); I.R.C. § 671 (items of the grantor-owned portion are taken into account in computing the grantor's own tax).

\$250,000 (joint), which are not indexed. For nearly every first-party SNT beneficiary, NIIT is irrelevant.³⁷

- **§ 68 is practically irrelevant.** The new § 68 limitation reaches only taxpayers in the 37% bracket, which for a single individual in 2026 begins at \$640,600 of taxable income.³⁸ A first-party SNT beneficiary will rarely, if ever, be there.
- **Taxable income is not SSI income.** The beneficiary's Form 1040 reflects the trust's income; the SSI analysis looks to what the beneficiary actually receives. Cash paid to the beneficiary is generally unearned income for SSI. Payments to third parties for items other than food or shelter are generally not income, and since September 30, 2024, food is no longer counted as in-kind support and maintenance.³⁹ The tax return and the SSI budget are separate ledgers.

A caution about the trust instrument: first-party SNT drafting occasionally includes language designed to make the trust a nongrantor trust or to obtain some other tax result. Such provisions rarely succeed with self-settled funds and can create benefits problems. The better course is to accept grantor-trust status and plan around it.

³⁷I.R.C. § 1411(a)(1), (b) (individual threshold amounts of \$250,000 for joint filers and \$200,000 for other individuals, which are not indexed); § 1411(a)(2) (estates and trusts: 3.8% of the lesser of undistributed net investment income or the excess of adjusted gross income over the dollar amount at which the highest bracket begins); Treas. Reg. § 1.1411-3.

³⁸See supra note 18.

³⁹20 C.F.R. §§ 416.1102, 416.1103(g), 416.1120-416.1124; Omitting Food From In-Kind Support and Maintenance Calculations, 89 Fed. Reg. 21,199 (Mar. 27, 2024) (effective Sept. 30, 2024); SSA, Program Operations Manual System (POMS) SI 01120.200 (information on trusts, including trust disbursements).

VII. Third-Party SNTs During the Settlor's Lifetime

A. The Typical Case: The Revocable Third-Party SNT

Most lifetime third-party SNTs—those funded by someone other than the beneficiary—are revocable. Because the majority of states impose no estate tax and few families approach the \$15 million federal basic exclusion amount, there is ordinarily no transfer-tax reason to make a parent's SNT irrevocable during the parent's life. The typical structure is a standalone revocable SNT, or an SNT share within the parent's revocable living trust, that is named as the beneficiary of life insurance, retirement accounts, and pour-over assets and receives most of its funding at the parent's death. Revocability alone makes the trust a grantor trust: under § 676, the grantor is treated as the owner of any portion of a trust that the grantor can revest in himself or herself.⁴⁰ No substitution power or other special grantor-trust power is needed. For the balance of the parent's life, the trust's income is simply the parent's income, reported on the parent's Form 1040 at the parent's individual rates. The trust converts to a nongrantor trust only at the parent's death, when it becomes irrevocable.

This point is worth stating plainly because the literature so often obscures it. Section 676 sits squarely within the grantor-trust rules, yet summaries of SNT taxation routinely omit it. Part of the reason is the order of presentation: first-party SNTs are almost always discussed first, and a (d)(4)(A) trust must be irrevocable. When the discussion then turns to third-party SNTs, much of the writing continues to focus on irrevocable structures and grantor-trust "powers," and the reader draws the natural but

⁴⁰I.R.C. § 676(a) (grantor treated as owner of any portion of a trust where the power to revest title in the grantor is exercisable by the grantor or a nonadverse party, or both); see 42 U.S.C. § 1396p(d)(3)(A) (the corpus of a revocable trust is considered a resource available to the individual for Medicaid purposes).

mistaken conclusion that a third-party SNT is ordinarily an irrevocable nongrantor trust. For most families it is not. With the estate-exclusion techniques of earlier decades now largely unnecessary, the default third-party SNT should be revocable, which gives the parent full flexibility to amend the trust as the child's needs, the benefits rules, and the family's circumstances change. It is a grantor trust for the rest of the parent's life simply because it is revocable.

The lifetime phase of a revocable SNT is therefore largely tax-neutral. The parent pays the tax on the trust's income just as the parent would on any other account the parent owns. For the same reason, assets in a parent's revocable trust remain the parent's own resources for the parent's Medicaid eligibility, a point that belongs in the parent's own long-term-care plan rather than the child's.⁴¹ The planning significance of the revocable form lies in what happens at death: the assets are included in the parent's gross estate and receive a basis adjustment under § 1014 (Part VII.D), and the trust then becomes a separate, compressed-bracket taxpayer (Part VIII).

B. The Less Common Case: Irrevocable Lifetime Third-Party SNTs

An irrevocable lifetime third-party SNT is used chiefly where the parent has a taxable estate (federal or state), where the parent wants to fund the trust with completed gifts for other reasons, or where an insurance trust is designed to keep a policy out of the parent's estate. An irrevocable trust is a grantor trust only if one or more of the income-tax grantor-trust rules of §§ 673 through 677 applies, whether by deliberate drafting or otherwise. Common deliberately drafted examples include a nonfiduciary power of substitution under § 675(4)(C), powers over beneficial enjoyment under § 674

⁴¹See *supra* note 40.

that fall outside the independent-trustee exceptions, and § 677(a)(3), which applies where trust income may be used to pay premiums on insurance on the life of the grantor or the grantor's spouse.⁴² An irrevocable lifetime SNT that avoids every §§ 673-677 trigger, deliberate or inadvertent, is a nongrantor trust from inception, whether or not it is included in the parent's estate, and the post-death analysis in Part VIII applies to it immediately. For these trusts, the first practice point is to read the instrument and determine whether grantor status was intended and actually achieved—or triggered inadvertently.

Two cautions. First, grantor status does not require a deliberately drafted “grantor power.” The rules are broad enough to catch an irrevocable SNT by accident. The general rule of § 674(a) makes the grantor the owner where the grantor or a nonadverse party can control beneficial enjoyment. A discretionary supplemental-needs standard is rarely a reasonably definite standard, so the § 674(c) and (d) exceptions may be unavailable if the parent, the parent's spouse, or related or subordinate parties serve as trustee. Section 677(a) applies where income may be distributed to or accumulated for the grantor's spouse, and § 672(e) attributes the spouse's powers and interests to the grantor.⁴³

Second, income-tax grantor status and estate-tax inclusion are separate inquiries under separate rules and should not be conflated. Grantor status is governed by §§ 671

⁴²I.R.C. §§ 673-677; see, e.g., § 674 (power to control beneficial enjoyment), § 675(4)(C) (power, exercisable in a nonfiduciary capacity without the approval or consent of a fiduciary, to reacquire trust corpus by substituting property of equivalent value), and § 677(a)(3) (income that may be applied to pay premiums on insurance on the life of the grantor or the grantor's spouse).

⁴³See supra note 42. I.R.C. §§ 672(a)-(c), (e), 674(a)-(d), 677(a); compare I.R.C. §§ 2036(a)(2), 2037, 2038(a)(1), 2042 (estate inclusion). See Rev. Rul. 2008-22, 2008-1 C.B. 796 (a nonfiduciary substitution power held by the grantor does not by itself cause inclusion under § 2036 or § 2038 if the trustee has a fiduciary obligation to ensure that the substituted properties are of equivalent value).

through 679. Estate inclusion is governed by §§ 2036, 2037, 2038, and 2042, and it controls the § 1014 basis result at death. The two regimes often overlap because they were designed in parallel. For example, a parent serving as trustee with discretion over distributions may trigger both § 674(a) and §§ 2036(a)(2) and 2038, and a retained reversion above 5% implicates both § 673 and § 2037. But they can also diverge. A swap power under § 675(4)(C) creates grantor status without estate inclusion, which is the classic intentionally defective grantor trust. The following matrix separates the two questions:⁴⁴

	Excluded from parent's estate (no § 1014 step-up)	Included in parent's estate (§ 1014 step-up)
Grantor trust during parent's life	Irrevocable SNT with a § 675(4)(C) swap power or a § 677(a)(3) insurance-premium power; parent pays the tax; Rev. Rul. 2023-2 applies	Revocable SNT (§§ 676 and 2038)—the typical case; also an irrevocable SNT with a parent-trustee holding discretionary distribution powers (§ 674(a); §§ 2036(a)(2), 2038)
Nongrantor trust during parent's life	Irrevocable SNT with an independent trustee and no retained powers or interests; the trust files its own Form 1041 during the parent's life	Uncommon, but possible where an estate-tax power is held in a manner that does not trigger §§ 673-677 (for example, a power exercisable only with the consent of an adverse party)

C. The Irrevocable Grantor Trust: The Parent's Payment of Tax as a Planning Benefit

When an irrevocable lifetime third-party SNT is a grantor trust, the parent reports the trust's income on the parent's own return, at the parent's individual rates. The parent's payment of that tax is not a taxable gift to the trust beneficiaries.⁴⁵

Economically, every dollar of tax the parent pays is a dollar that stays in the SNT for the

⁴⁴See supra note 43.

⁴⁵Rev. Rul. 2004-64, 2004-2 C.B. 7 (a grantor's payment of income tax on grantor-trust income is not a gift to the trust beneficiaries; a discretionary reimbursement power held by an independent trustee does not, by itself, cause estate inclusion, absent an understanding or applicable creditor-rights law).

child. For a family intending to leave the parent's wealth to the child's trust in any event, this "tax burn" is an efficient, benefits-neutral way to add value to the SNT without additional gifts. The trust may include a discretionary power in an independent trustee to reimburse the grantor for the tax; Revenue Ruling 2004-64 indicates that such a power, absent an understanding or applicable creditor-rights law, does not by itself cause estate inclusion. Reimbursement provisions should be used thoughtfully in the SNT setting, where the trust's principal purpose is the beneficiary's supplemental needs.

D. Basis at the Parent's Death: The Link to Recognition Events

The revocable/irrevocable distinction controls the trust's basis at the parent's death. Assets in a revocable SNT are included in the parent's gross estate under § 2038 and receive a basis adjustment to fair market value at death under § 1014.⁴⁶ The post-death nongrantor trust therefore starts with a fresh basis (adjusted to the value at the date of death), and its early recognition events reflect only appreciation after the parent's death. By contrast, a completed gift to an irrevocable grantor trust that is not included in the grantor's gross estate does not receive a basis adjustment at the grantor's death, as the IRS concluded in Revenue Ruling 2023-2 on its completed-gift, estate-excluded facts. Respected commentators have advanced a contrary § 1014(b)(1) theory that the Service has not accepted.⁴⁷ That trust will hold assets with the parent's

⁴⁶I.R.C. §§ 2038(a), 1014(a), (b)(2) (property transferred during life to a trust with the income payable to or on the order of the decedent and with the right reserved to revoke the trust is treated as acquired from the decedent), (b)(9).

⁴⁷Rev. Rul. 2023-2, 2023-16 I.R.B. 658 (no § 1014 basis adjustment at the grantor's death for assets of an irrevocable grantor trust that are not included in the grantor's gross estate); see KPMG, Rev. Rul. 2023-2: No Basis Step-Up for Assets of Irrevocable Grantor Trust Not Included in Grantor's Estate (Mar. 2023), <https://assets.kpmg.com/content/dam/kpmg/us/pdf/2023/03/23113.pdf>. NOTE, however, that cogent arguments have been made that the Service is wrong in this interpretation, and I for one find those arguments convincing. The thrust of the argument is that IRC Section 1014 provides an additional benefit in the form of a step-up in basis on assets of the trust at the grantor's death: because Rev. Rul. 85-13

historic (called “carry-over”) basis, and the first sale of a long-held position after the parent dies may realize a large gain in the trust’s compressed-bracket environment. Note that you still need to pay attention to what happens in the years after the parent’s passing, however. Even with a stepped-up basis on the parent’s death, a revocable SNT that thereafter holds a concentrated or appreciating portfolio for several years following the parent’s death will build gain that will be recognized when that asset is eventually sold. Hence the recognition-event discipline outlined in Part XIII below.

OBBBA was frequently reported as “permanently” setting the basic exclusion amount at \$15 million per person for 2026, indexed thereafter.⁴⁸ Do not be confused by the rhetoric, however. A new Congress of like-minded folks aligning with a new like-minded President could modify the Code fully and bring the threshold back down to, say, about \$7 million (which equates to a rough time-value-of-money adjustment of the old \$5 million threshold brought forward to 2026 dollars). When the pundits say it is “permanent,” what they are really saying is that, unlike the 2017 Tax Cuts and Jobs Act, OBBBA contains no required sunset after ten years for the rules to revert back. Both laws were enacted through budget reconciliation and were subject to the Senate’s Byrd Rule. The 2017 law’s individual and transfer-tax provisions sunset to satisfy that rule, while OBBBA’s were scored against a “current policy” baseline that treated their

treats the grantor as the owner of the trust assets for income-tax purposes, an asset remaining in the grantor trust at death may be treated as acquired by “bequest” under § 1014(b)(1), even if it is excluded from the gross estate. Jonathan G. Blattmachr, Mitchell M. Gans & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death*, 97 J. Tax’n 149 (Sept. 2002). Rev. Rul. 2023-2 rejects that characterization on its stated facts. Because the positions taken by Blattmachr, Gans & Jacobson (while genuinely persuasive to this author) have not been accepted by the Service or by most practitioners, I raise this as an academic point more than one for you to rely upon, though it would be nice to see someone challenge Rev. Rul. 2023-2 to see what the correct answer truly is.

⁴⁸See supra note 19.

extension as costless, so no sunset was required.⁴⁹ So, to be truly tax-savvy, be sure to know that “permanent” does not necessarily mean this threshold (which adjusts for inflation) will remain the law permanently. It means only that no automatic reversion is built in. That being said, for the large majority of families who fund SNTs, federal estate tax is no longer the binding constraint, which reinforces the advice that a revocable SNT should be the preferred default. Where an irrevocable trust is nevertheless used for non-tax reasons, many families are better served by provisions that cause estate inclusion—and therefore a § 1014 basis adjustment—at the parent’s death, such as retained interests or powers under §§ 2036 or 2038 or carefully limited general powers of appointment.⁵⁰ These are estate-tax provisions. Whether the same provision also makes the trust a grantor trust for income-tax purposes is a separate question under §§ 671 through 679 (see the matrix in Part VII.B). This must be balanced against state estate or inheritance taxes, creditor exposure (most notably estate recovery provisions), and, where the parent may need long-term care, the parent’s own Medicaid planning.

VIII. The Parent Dies: Same SNT, New Taxpayer

A. The Conversion

At the grantor’s death, grantor-trust status ends; a revocable SNT also becomes irrevocable. As I usually explain it to clients, “When you’re dead, it’s a bit hard to revoke your trust.” The trust does not change its name, trustee, beneficiary, investment

⁴⁹See Tax Policy Center, The One Big Beautiful Bill Act: A Preliminary Assessment (Mar. 23, 2026) (Senate adopted a “current policy” baseline assigning zero fiscal cost to extending the expiring provisions, subject to the Byrd Rule), https://taxpolicycenter.org/sites/default/files/2026-03/OBBBA_Preliminary_Assessment_2026-03-23.pdf

⁵⁰See I.R.C. §§ 1014(a), (b)(9), 2036, 2038, 2041. Estate inclusion techniques must be weighed against creditor exposure, state estate or inheritance tax, and, where the settlor is or may become a Medicaid applicant, the settlor’s own eligibility.

account, or public-benefits character. It remains a third-party SNT for Medicaid and SSI purposes. Legally, it is not treated as a separate entity, as the trustees are the legal owners of the assets for the equitable benefit of the beneficiaries. Yet, with the parent's passing, it is now a separate income-tax taxpayer: i.e., a nongrantor trust—usually a complex accumulation trust, because distributions are discretionary—that needs its own EIN, a calendar taxable year (subject to a § 645 election for a qualified revocable trust, which allows it to be treated as part of the estate and to use the estate's fiscal year for a limited period),⁵¹ its own Form 1041 each year thereafter, and beneficiary Schedules K-1 to the extent it distributes DNI. The same is true, from the first day, of a testamentary SNT created under a parent's will or funded by a revocable trust at death.

While the parent is alive (grantor phase)	After the parent dies (nongrantor phase)
Third-party SNT for Medicaid and SSI purposes	Still a third-party SNT for Medicaid and SSI purposes
Parent is the income-tax owner	Trust is its own taxpayer; beneficiary taxed only on DNI carried out
Income reported on the parent's Form 1040 at individual rates	Income reported on Form 1041; 37% bracket begins at \$16,000 of taxable income
NIIT only above the parent's \$200,000/\$250,000 threshold	NIIT on undistributed net investment income above \$16,000 of AGI (that's a radical shift)
§ 68 applies only if the parent is in the 37% bracket	§ 68 may reduce the trust's deductions, including distribution deductions
Parent pays the tax from the parent's own funds; trust assets are not depleted	Tax is now paid from trust assets unless carried out to the beneficiary as reported on a K-1
Revocable SNT: assets included in the parent's estate and stepped up at death under § 1014. Irrevocable completed-gift SNT: no step-up (Rev. Rul. 2023-2)	Revocable: fresh basis, so gains reflect post-death appreciation. Irrevocable: low-basis assets, so early sales can realize large gains

⁵¹See supra note 2. I.R.C. § 645; Treas. Reg. § 1.645-1 (election to treat a qualified revocable trust as part of the decedent's estate; election period ends two years after death if no estate tax return is required, or later if one is required).

This is the “aha” moment for most SNT practitioners. The trust has two life cycles. In the first, the parent’s return absorbs the income. In the second, the same investment return may be taxed at the highest federal rate after only a mere \$16,000 of retained taxable income. Nothing about the trust looks different to the beneficiary, the care manager, or the benefits caseworker. The change is entirely on the income-tax side, and it is easy to miss.

B. The Qualified Disability Trust Exemption

A nongrantor SNT that qualifies as a qualified disability trust (QDisT) under § 642(b)(2)(C) receives an exemption equal to the personal exemption amount under § 151(d)—\$5,300 for 2026, not subject to phaseout—instead of the \$100 exemption otherwise available to a complex trust.⁵² To qualify, the trust must be described in 42 U.S.C. § 1396p(c)(2)(B)(iv), be established solely for the benefit of a disabled individual under age 65, and have only beneficiaries determined by the Commissioner of Social Security to be disabled for some portion of the year; a remainder to a non-disabled person after the disabled beneficiary’s interest ends does not disqualify the trust. Many third-party SNTs qualify. The QDisT exemption is routinely missed by preparers who do not know the beneficiary’s disability status, and it is worth roughly \$1,000 to \$1,900 of federal tax in a year when the trust retains income at the 20% to 37% rates. Confirming QDisT status belongs on every post-death SNT checklist. As discussed in Part XI,

⁵²I.R.C. § 642(b)(2)(C) (qualified disability trust exemption equal to the § 151(d) exemption amount; trust must be described in 42 U.S.C. § 1396p(c)(2)(B)(iv), established solely for the benefit of an individual under 65 who is disabled, and all beneficiaries must be determined by the Commissioner of Social Security to be disabled for some portion of the year; a remainder to a non-disabled person after the disabled beneficiary’s interest ends does not disqualify the trust); 2026 Form 1041-ES (exemption of \$5,300, not subject to phaseout), <https://www.irs.gov/pub/irs-pdf/f1041es.pdf>

however, the Joint Committee’s reading of § 68 treats § 642(b) exemptions as itemized deductions potentially subject to the administratively annoying 2/37 reduction.

IX. “Which Income Do You Mean?” The Four Ledgers

The phrase “a trust with more than \$16,000 of income” is too imprecise to be useful. The \$16,000 figure is a tax-computation threshold driven by taxable income—and, for NIIT, by adjusted gross income and undistributed net investment income. A trustee can distribute all of what the trust instrument calls “income” and still have substantial taxable income. To understand the new rule and plan around it, trustees and their advisers must keep four ledgers distinct.

1. **Fiduciary accounting income (FAI).** What the governing instrument and the applicable principal-and-income statute treat as income rather than principal. Under the Uniform Principal and Income Act and its successors, proceeds from the sale of principal assets—and therefore realized capital gains—are ordinarily allocated to principal, subject to any power to adjust or unitrust regime.⁵³
2. **Distributable net income (DNI).** The tax concept that caps the trust’s distribution deduction and the amount the beneficiary must include, and that preserves the character of the income carried out (interest, ordinary dividends, qualified dividends, tax-exempt interest). Capital gains are generally excluded

⁵³See Unif. Principal & Income Act §§ 104 (power to adjust), 404 (receipts from sale of principal assets allocated to principal) (1997); Unif. Fiduciary Income & Principal Act (2018) (unitrust and adjustment provisions); e.g., N.J. Stat. Ann. §§ 3B:19B-1 et seq. Practitioners must consult the version enacted in the governing jurisdiction.

from DNI unless one of the regulatory pathways in Treas. Reg. § 1.643(a)-3(b) applies.⁵⁴

3. **Taxable income.** The figure to which the trust's rate schedule applies and which drives the new § 68 computation. It can include retained capital gain even where that gain was never part of FAI or DNI.

4. **Net investment income (NII).** The base for the 3.8% tax under § 1411. For a trust, the tax applies to the lesser of undistributed NII or the excess of adjusted gross income over the dollar amount at which the top bracket begins.

Distributions from qualified plans and IRAs are excluded from NII, although they are ordinary income.⁵⁵

Character matters because each type of receipt moves through these ledgers differently:

Item	Effect on trust taxable income	Typical effect of a distribution	SNT planning note
Interest, nonqualified dividends, rents	Ordinary income	Carried out through DNI; retains ordinary character on the K-1	Retained amounts reach 37% quickly
Qualified dividends	Included; preferential rate	Carried out through DNI as qualified dividends	Beneficiary may be in the 0% bracket
Net long-term capital gain	Included; 0/15/20% rates plus NIIT	Generally stays in the trust (allocated to principal, excluded from DNI) unless a § 1.643(a)-3 pathway applies	Most common cause of an unexpected high-tax year

⁵⁴I.R.C. §§ 643(a) (distributable net income), 651-652 (simple trusts), 661-663 (complex trusts); Treas. Reg. §§ 1.652(b)-2, 1.652(b)-3 (character of amounts and allocation of deductions), 1.661(a)-2, 1.662(b)-1. Treas. Reg. § 1.643(a)-3(a), (b), (e) (capital gains generally excluded from DNI unless, pursuant to the governing instrument and applicable local law, or a reasonable and impartial exercise of discretion by the fiduciary under a power granted by local law or the instrument, they are (1) allocated to income, (2) allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution, or (3) allocated to corpus but actually distributed or used by the fiduciary in determining the amount distributed or required to be distributed); see also Treas. Reg. § 1.643(b)-1.

⁵⁵See supra note 27.

Item	Effect on trust taxable income	Typical effect of a distribution	SNT planning note
Tax-exempt interest	Excluded from taxable income	Carried out through DNI as tax-exempt, with expense allocation	Does not create taxable income for the thresholds
IRA / qualified-plan distributions	Ordinary income (income in respect of a decedent)	Carried out through DNI if distributed	Not NII, but fully exposed to compressed ordinary rates
Principal distributions	Not income in themselves	Carry out DNI under the tier rules, up to DNI	Cash out does not equal income out

Consider a nongrantor SNT with \$20,000 of interest and dividends, \$6,000 of trustee and administration fees, and a \$40,000 long-term capital gain from the sale of an inherited stock position. If the trustee distributes (or pays for the beneficiary's benefit) the \$14,000 of net income, the trust has distributed its "income" in every sense a non-tax professional would recognize. Yet the \$40,000 gain, allocated to principal and excluded from DNI, remains taxable to the trust, and the trust is well past every compressed threshold. That fact pattern is the running example in Part XII, specifically because it is so often misunderstood and thus worthy of specific illustration.

X. The 2026 Rate Environment for Nongrantor SNTs

OBBBA made permanent the four-bracket rate structure for estates and trusts. For 2026, the rate schedule and capital-gain breakpoints are as follows:⁵⁶

Taxable income (estates and trusts, 2026)	Ordinary rate	Net capital gain / qualified dividend rate
\$0 – \$3,300	10%	0% (up to \$3,300)
\$3,300 – \$11,700	24%	15%
\$11,700 – \$16,000	35%	15%

⁵⁶See supra note 18. IRS, 2026 Form 1041-ES, Estimated Income Tax for Estates and Trusts (2026 rate schedule; 0% capital-gain rate up to \$3,300, 20% rate above \$16,250; qualified disability trust exemption of \$5,300), <https://www.irs.gov/pub/irs-pdf/f1041es.pdf>

Taxable income (estates and trusts, 2026)	Ordinary rate	Net capital gain / qualified dividend rate
\$16,000 – \$16,250	37%	15%
Over \$16,250	37%	20%

By comparison, the 37% bracket for a single individual begins at \$640,600 of taxable income in 2026, and a single filer’s 0% rate on net capital gain extends to \$49,450.⁵⁷ It is because of that drastic difference between the progression of rates an individual experiences and how quickly the rates escalate for a trust that we typically refer to “compressed” trust rates. The 3.8% NIIT applies to a trust’s undistributed net investment income once its adjusted gross income exceeds \$16,000.⁵⁸ The practical federal rate stack on retained income is therefore:

- **Retained net long-term capital gain:** 20% + 3.8% NIIT = **23.8%**.
- **Retained ordinary investment income:** 37% + 3.8% NIIT = **40.8%**.
- **Retained IRA or qualified-plan distributions:** 37% (no NIIT), plus state tax.

State fiduciary income tax is then layered on top, depending on trust situs, trustee residence, the beneficiary’s residence, and source rules.⁵⁹ The key insight for this audience is that the exposure is driven by annual recognition events, not by the size of the corpus. A \$750,000 SNT is not large by estate-planning standards, but a single year with a \$40,000 realized gain, a year-end mutual-fund capital-gain distribution, the sale of the family home held in the trust, or a portfolio “clean-up” after the parent’s death

⁵⁷See supra notes 18, 35.

⁵⁸See supra note 27.

⁵⁹See *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 588 U.S. 262 (2019), for the nexus analysis of when and how a state may constitutionally tax a trust, a trustee, or a trust beneficiary, applying traditional minimum-contacts rules to the validity of the state imposing tax on the applicable party in relation to that party’s or the assets’ nexus to the state.

can produce \$9,500 or more of federal tax on the gain alone ($\$40,000 \times 23.8\% = \$9,520$ before the effect of the lower brackets). Those recognition events are often initiated by an investment adviser in a directed-trust arrangement, or by a trust company's investment function, without the trust officer or SNT attorney ever seeing a tax projection.

XI. The New Section 68 Limitation – Not Necessarily a Big Number, but an Administrative Pain in the You Know What

A. The Statutory Text

Before 2018, § 68 contained the “Pease” limitation on itemized deductions, and former § 68(e) provided expressly that the section did not apply to any estate or trust. The Tax Cuts and Jobs Act suspended Pease for 2018 through 2025. OBBBA § 70111 rewrote § 68 in its entirety for taxable years beginning after December 31, 2025. New § 68(a) provides that, “[i]n the case of an individual,” itemized deductions otherwise allowable are reduced by 2/37 of the lesser of (1) the amount of itemized deductions, or (2) so much of the taxable income for the year (determined without regard to § 68 and increased by the itemized deductions) as exceeds the dollar amount at which the 37% bracket begins for the taxpayer. New § 68(b) directs that the limitation be applied after any other limitation on itemized deductions. The former estate-and-trust exception was not carried forward.⁶⁰

⁶⁰I.R.C. § 68(a)-(b), as amended by Pub. L. No. 119-21, § 70111 (effective for taxable years beginning after December 31, 2025), <https://www.law.cornell.edu/uscode/text/26/68> Trust Distributions: Timing, Tax, and Practical Considerations, The Tax Adviser (May 2026) (repeal of former § 68(e); debate over §§ 642, 651, and 661; planning with §§ 663(b), 643(g), 643(e)(3), and 642(c)(1)), <https://www.thetaxadviser.com/issues/2026/may/trust-distributions-timing-tax-and-practical-considerations/>

The policy objective for individuals is to cap the tax value of each dollar of itemized deductions at 35 cents for taxpayers in the 37% bracket. For trusts and estates, whose 37% bracket begins at \$16,000, the question is whether—and to what extent—the rule applies at all.

B. The Joint Committee’s Reading: Footnote 102

On May 28, 2026, the staff of the Joint Committee on Taxation released its General Explanation of Public Law 119-21 (JCS-1-26), commonly called the Blue Book.⁶¹ In footnote 102, the staff states that the new limitation applies to estates and trusts. Its reasoning runs as follows: § 641(b) provides that the taxable income of an estate or trust is computed in the same manner as for an individual; § 63(d) defines itemized deductions as all allowable deductions other than those allowable in arriving at adjusted gross income and the deductions listed in § 63(b); and accordingly an estate’s or trust’s itemized deductions include, “without limitation,” the § 642(b) exemption and the distribution deductions under §§ 651 and 661.⁶²

The staff acknowledged Treas. Reg. § 1.67-4(a)(1)(ii), which states that the §§ 642(b), 651, and 661 deductions are not itemized deductions under § 63(d), but dismissed it on the ground that the regulation interprets § 67(e), and § 67(e) operates only “[f]or purposes of this section”—that is, for purposes of § 67 alone.⁶³

⁶¹Staff of the Joint Comm. on Taxation, General Explanation of the Tax Provisions of Public Law 119-21, JCS-1-26, at 26 & n.102 (May 28, 2026), <https://www.jct.gov/publications/2026/jcs-1-26/>; see also Staff of the Joint Comm. on Taxation, Errata for JCS-1-26, JCS-1R-26 (Sept. 18, 2026), <https://www.jct.gov/publications/2026/jcs-1r-26/>.

⁶²Proskauer Rose LLP, Wealth Management Update (August 2026) (discussing JCT Blue Book footnote 102, its treatment of §§ 642(b), 651, and 661 as itemized deductions, and its dismissal of Treas. Reg. § 1.67-4(a)(1)(ii)), <https://www.proskauer.com/newsletter/wealth-management-update-august-2026>

⁶³Treas. Reg. § 1.67-4(a)(1)(ii) (deductions under §§ 642(b), 651, and 661 are not itemized deductions under § 63(d)); I.R.C. §§ 63(d), 67(e), 641(b). See *supra* note 62.

C. The Counterarguments

Commentators have criticized the footnote. The principal arguments are that (1) new § 68(a) by its terms applies “[i]n the case of an individual,” and § 641(b) incorporates individual computation rules only “except as otherwise provided in this part,” which arguably includes Subchapter J’s own conduit deductions; (2) the distribution deduction is not an expense but the mechanism that allocates income between the trust and its beneficiaries, so limiting it produces double taxation of the same income, a result that is contrary to the structure of Subchapter J; and (3) a Treasury regulation expressly treats these deductions as non-itemized.⁶⁴ ACTEC has asked Treasury to address the issue in the 2026-2027 Priority Guidance Plan, recommending that §§ 651 and 661 distribution deductions and administration expenses unique to estates and trusts not be subject to § 68, and separately noting that § 68(a) as written applies the 2/37 reduction even when the taxpayer’s income is taxed at the 20% capital-gain rate rather than at 37%.⁶⁵

A Blue Book is a post-enactment staff explanation. It is not statute, regulation, or binding Treasury guidance, and it cannot override statutory text.⁶⁶ Treasury regulations and JCT Blue Books are both among the materials listed in Treas. Reg. § 1.6662-4(d)(3)(iii) for the substantial-authority analysis. That listing alone does not establish

⁶⁴See supra note 62. American College of Trust and Estate Counsel, Recommendations for 2026-2027 Priority Guidance Plan (Notice 2026-23) (May 29, 2026) (recommending relief for §§ 651 and 661 and administration expenses, and a correction so the 2/37 reduction does not apply to income taxed under § 1(h)), https://www.actec.org/wp-content/uploads/2026/06/26.05.29_ACTEC-Recs.-re-2026-2027-Priority-Guidance-Plan.pdf

⁶⁵See supra note 64.

⁶⁶Hidden Tax Trap: Does OBBBA Affect Trusts and Estate Deductions?, Nat’l L. Rev. (2026) (worked example of a \$20,000 reduction on \$386,000 of distributed DNI; Blue Book is persuasive, not binding), <https://natlawreview.com/article/hidden-tax-trap-does-obbba-affect-trusts-and-estate-deductions>

substantial authority, however; the weight of an authority depends on its relevance and persuasiveness.⁶⁷ Preparers of 2026 Forms 1041 will need to evaluate the competing positions on the particular facts, choose one, document it, and consider whether disclosure is warranted. As of this writing, Treasury has not issued guidance on the question. The IRS has posted 2026 drafts of Form 1041, Schedule D, Schedule K-1, the Schedule K-1 instructions, and Schedule I, but final 2026 instructions addressing the computation had not been released.⁶⁸

D. How the Computation Works for a Trust

If the JCT reading is followed, the computation for a nongrantor trust is:

1. Identify the trust's "itemized deductions." Under footnote 102, these include at least the § 642(b) exemption (including a QDisT exemption) and the §§ 651/661 distribution deduction. Whether § 67(e) administration expenses, the § 642(c) charitable deduction, and the § 691(c) deduction are also included is unresolved; the footnote's "without limitation" language suggests a broad reading, while ACTEC urges that administration expenses be excluded.⁶⁹ Footnote 102's final sentence is broader than its three examples: the staff says that the § 67(e) regulation does not exclude those deductions "or any other deductions" from itemized-deduction status for § 68. That is the staff's expansive interpretive position, not a rule adopted in regulations or Form 1041 instructions, and the

⁶⁷Treas. Reg. § 1.6662-4(d)(3)(iii) (listing, among the authorities considered in determining substantial authority, regulations and "General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book)").

⁶⁸IRS, Draft Tax Forms (listing 2026 drafts of Form 1041 (posted May 22, 2026), Schedule D (May 27, 2026), Schedule K-1 (June 1, 2026), Schedule K-1 instructions (Aug. 25, 2026), and Schedule I (Sept. 22, 2026)), <https://www.irs.gov/draft-tax-forms>

⁶⁹See supra notes 62, 64.

treatment of administration expenses, § 642(c), and § 691(c) remains unsettled for return-reporting purposes.

2. Compute taxable income without regard to § 68, add back those itemized deductions, and subtract \$16,000 (the 2026 37%-bracket threshold for trusts).
3. Multiply the lesser of step 1 and step 2 by $2/37$.
4. Reduce the itemized-deduction pool by that amount. The reduction increases trust taxable income by reducing a deduction; neither § 68 nor footnote 102 specifies its character for rate purposes or its effect, if any, on NIIT. The beneficiary's inclusion under §§ 652 and 662 is measured by DNI and the amounts distributed, and nothing in new § 68 reduces it.

A published illustration captures the double-tax problem. A trust with \$386,000 of DNI distributes it all to a surviving spouse. Step 2 produces \$370,000 (\$386,000 – \$16,000); the reduction is \$20,000 ($\$370,000 \times 2/37$); the trust deducts \$366,000; the spouse still reports \$386,000; and the trust pays tax on \$20,000 of income it has already distributed—\$7,400 at 37%.⁷⁰

E. The “Two Percent Toll”: A Rule of Thumb

For planners, the most useful way to size the problem is that the reduction can never exceed $2/37$ of the itemized deductions. If the disallowed amount is effectively taxed at 37%, the cost is $2/37 \times 37\%$, or **up to approximately 2% of the relevant itemized-deduction pool**. Under the JCT premise, that pool includes the § 642(b) exemption as well as the distribution deduction. Where the trust has distributed everything and the phantom income falls into the trust's 10% or 24% brackets, the cost

⁷⁰See supra notes 66, 62.

is lower. Where the trust also retains income or gains that push the phantom income into the top bracket, the cost approaches the full 2%.

That calibration matters for an honest presentation. For a modest SNT, the direct § 68 cost will usually be measured in hundreds of dollars, not thousands. The large dollars remain where they have always been: compressed brackets and NIIT on retained income and gains. But § 68 is new, it is triggered by exactly the recognition events that already cause the larger problem, it creates a true double tax on distributed income, and it complicates the Form 1041, the fiduciary accounting (which account bears the tax on phantom income?), and beneficiary communications. It also scales with the size of distributions, so it is not trivial for larger third-party SNTs funded with life-insurance proceeds or substantial inheritances.

F. Why Capital Gains Aggravate § 68

The second prong of the “lesser of” test—taxable income plus itemized deductions in excess of \$16,000—is inflated by any retained capital gain. In an ordinary year, a small SNT that distributes its net income may never exceed \$16,000 on that prong and will owe nothing under § 68. In a gain year, the retained gain pushes the second prong far above the itemized-deduction amount, so the full 2/37 reduction applies to the entire distribution deduction. As ACTEC has pointed out, § 68(a) does not exclude income taxed at the preferential § 1(h) rates from that computation.⁷¹ A recognition event therefore does double duty: it creates trust-level capital-gain tax and NIIT directly, and it turns on the § 68 haircut for the distributions the trustee was going to make anyway.

⁷¹See *supra* note 64.

G. Open Questions for 2026 Returns

- Whether Treasury will adopt, reject, or modify the Blue Book position, and whether Congress will enact a technical correction.
- Which deductions are “itemized” for a trust—particularly § 67(e) administration expenses, § 642(c) charitable deductions, and § 691(c).
- The character of the phantom income created by the reduction (ordinary, or pro rata across the classes of income that were distributed), which affects the rate applied.
- Whether the reduction affects the NIIT computation, which uses adjusted gross income and undistributed net investment income rather than taxable income.
- Whether the tax on phantom income is charged to income or principal under the governing instrument and state law, a question with fiduciary consequences between current and remainder beneficiaries.
- State conformity: states that begin with federal taxable income for fiduciary returns may import the reduction; others may not.

XII. Worked Examples

What is settled, and what is not. Settled: OBBBA rewrote § 68 effective for 2026, and trusts reach the 37% threshold at \$16,000. JCT position: § 68 applies to trusts and reaches the §§ 642(b), 651, and 661 deductions. Unsettled: whether that position will govern returns, which other deductions enter the pool, and the character, NIIT, and DNI mechanics of any reduction. The examples below illustrate the JCT position under disclosed modeling assumptions; they are not return computations.

The following examples use a single hypothetical third-party SNT for “Daniel,” age 34, who receives SSI and Medicaid. His parents are deceased; the trust is a nongrantor complex trust with a \$900,000 diversified portfolio. Unless otherwise stated,

each year the trust earns \$8,000 of taxable interest and nonqualified dividends and \$12,000 of qualified dividends, pays \$6,000 of trustee and administration fees (deductible under § 67(e) and allocated against ordinary income), and uses a \$100 exemption. The trustee pays \$14,000 each year to third-party vendors for Daniel's supplemental needs. Figures are federal only, rounded, and computed under the Joint Committee reading of § 68 with the § 642(b) exemption and the distribution deduction treated as itemized deductions and administration expenses excluded. Solely for these illustrations, any § 68 reduction is modeled as an increase in ordinary taxable income and as not changing § 67(e) adjusted gross income or undistributed net investment income, and distributions carry out each class of income pro rata after fees are allocated against ordinary income. Neither § 68 nor footnote 102 resolves those mechanics, and actual reporting may change with Treasury or IRS guidance. NIIT is computed as 3.8% of the lesser of undistributed net investment income or § 67(e) adjusted gross income in excess of \$16,000.

Example 1: The Routine Year

DNI is \$14,000 (\$20,000 – \$6,000). The \$14,000 distribution carries out all of it. Taxable income before § 68 is negative (\$20,000 – \$6,000 – \$14,000 – \$100). The § 68 second prong ($-\$100 + \$14,100 - \$16,000$) is a negative number, so there is no reduction. The trust owes no federal income tax or NIIT. Daniel receives a K-1 for \$2,000 of ordinary income and \$12,000 of qualified dividends; with a 2026 single standard deduction of \$16,100, he owes no federal income tax.⁷² This is the “income is taxed once, and lightly” result most SNT professionals expect.

⁷²See supra note 22.

Example 2: The Surprise Capital-Gain Year

Same facts, but the investment adviser sells a concentrated stock position that has appreciated substantially since the parent's death and realizes a \$40,000 long-term capital gain, allocated to principal and excluded from DNI. The trustee makes the usual \$14,000 of distributions. Taxable income before § 68 is \$39,900. The § 68 second prong is \$38,000 (\$39,900 + \$14,100 – \$16,000); the first prong is \$14,100; the reduction is $\$14,100 \times 2/37 = \$762$. The trust's taxable income becomes \$40,662.

Example 2 (illustrative; federal, 2026)	Without § 68	With § 68 (JCT reading)
Trust taxable income	\$39,900	\$40,662
Regular income tax (capital-gain worksheet; § 68 reduction assumed to increase ordinary taxable income)	\$6,673	\$6,891
NIIT ($3.8\% \times$ lesser of \$40,000 undistributed NII or \$39,900 AGI – \$16,000)	\$908	\$908
Total trust-level federal tax	\$7,581	\$7,799
Daniel's K-1 inclusion	\$14,000	\$14,000

Three points emerge. First, the trust has gone from zero tax to roughly \$7,600 of federal tax because of one routine investment decision. Second, § 68 adds about \$220, which is modest but is a tax on income that Daniel also reports. Third, if administration expenses are also treated as itemized deductions, the reduction grows to about \$1,086 and the total to about \$7,897. If the trust qualifies as a QDisT, its \$5,300 exemption reduces the total to approximately \$6,552—more than offsetting the § 68 cost—although under the JCT reading the larger exemption itself enlarges the base subject to the 2/37 reduction.

Example 3: Harvesting a Loss

Same as Example 2, but before year-end the adviser also sells a position with a \$15,000 unrealized loss for independent investment reasons (and does not repurchase a substantially identical security within the wash-sale window).⁷³ Net long-term gain falls to \$25,000. Total federal trust tax falls to about \$4,229, a savings of roughly \$3,570. The § 68 reduction is unchanged at \$762, because the second prong still exceeds the first. The mundane step of reviewing the portfolio's unrealized losses before December 31 is worth more than every § 68 argument combined.

Example 4: Carrying Out the Gain—Properly

Same as Example 2, but Daniel needs a wheelchair-accessible vehicle. The trust instrument authorizes principal distributions for Daniel's benefit, and the trustee, exercising a discretionary power under the instrument and state law, decides contemporaneously to treat the gain as part of the distribution and records that decision in its books and minutes. The trust purchases a \$40,000 vehicle titled to Daniel, in addition to the usual \$14,000 of payments. Under Treas. Reg. § 1.643(a)-3(b), the gain is included in DNI because it is actually distributed or used to determine the amount distributed.⁷⁴ DNI becomes \$54,000.

Trust taxable income before § 68 is again negative. The § 68 second prong is \$38,000 (\$54,100 – \$100 – \$16,000) and the first prong is \$54,100, so the reduction is $\$38,000 \times 2/37 = \$2,054$, leaving \$1,954 of trust taxable income taxed at 10%—about

⁷³I.R.C. §§ 1211(b), 1212(b) (net capital loss deduction limited to \$3,000 against ordinary income, with carryover); § 1091 (wash sales); § 642(h) (unused capital-loss carryovers and excess deductions on termination pass to beneficiaries succeeding to the property).

⁷⁴See *supra* note 54.

\$195. That figure is expressly assumption-dependent: if the retained amount were instead treated as a pro rata share of the preferential income carried out, a standard capital-gain worksheet would produce no tax. There is no NIIT at the trust level. Daniel's K-1 shows \$2,000 of ordinary income, \$12,000 of qualified dividends, and \$40,000 of net long-term capital gain.⁷⁵ After his \$16,100 standard deduction, his remaining \$37,900 of taxable income consists entirely of qualified dividends and capital gain within the 0% bracket, so his federal income tax is zero.⁷⁶

The combined federal tax falls from about \$7,800 (Example 2) to about \$195. For SSI purposes, a vehicle is an in-kind item that is neither food nor shelter, and one automobile used for transportation is generally an excluded resource; the trustee should nonetheless confirm the benefit analysis before acting.⁷⁷ The critical constraint is that the distribution must be real, authorized, and justified by Daniel's needs. The tax result follows the administration; it cannot be created by a year-end reporting entry.

Example 5: A Larger Trust That Distributes Everything

A \$3 million third-party SNT funded with life-insurance proceeds earns \$90,000 of interest and dividends, pays \$20,000 of fees, and distributes \$70,000 for the beneficiary's supported-living costs. There is no retained income. Under the JCT reading, the reduction is $\$54,000 \times 2/37 = \$2,919$ (the second prong being \$70,000 – \$16,000), and the trust owes about \$282 of federal tax on income that the beneficiary also reports in full. This is the pure double-tax case: small dollars, but a result that

⁷⁵See Instructions for Schedule K-1 (Form 1041) (box 1, interest; box 2a, ordinary dividends; box 2b, qualified dividends; box 3, net short-term capital gain; box 4a, net long-term capital gain), with the 2026 draft posted August 25, 2026, <https://www.irs.gov/draft-tax-forms>

⁷⁶See supra note 35.

⁷⁷See supra note 39.

surprises everyone who has been told that a trust distributing all of its DNI owes nothing.

Example 6: A Larger Trust That Retains Income and Gains

The same type of trust retains a substantial part of its income and realizes a \$100,000 gain: \$60,000 of ordinary income, \$90,000 of qualified dividends, \$100,000 of long-term gain (allocated to principal and excluded from DNI), \$25,000 of fees (allocated against ordinary income and fully allocable to net investment income), and \$60,000 of distributions, which carry out ordinary income and qualified dividends pro rata. All income is assumed to be net investment income. The § 68 reduction is $\$60,100 \times 2/37 = \$3,249$, taxed at 37%, adding about \$1,202—almost exactly 2% of the distribution deduction—to a federal trust-level tax of about \$40,800. The toll is small relative to the underlying tax, but it lands at the top rate.

Scenario (illustrative; federal, 2026)	§ 68 reduction	Trust tax without § 68	Trust tax with § 68	Beneficiary K-1
1. Routine year	\$0	\$0	\$0	\$14,000
2. \$40,000 gain retained	\$762	\$7,581	\$7,799	\$14,000
3. Gain reduced by \$15,000 loss	\$762	\$4,011	\$4,229	\$14,000
4. Gain carried out via DNI	\$2,054	\$0	\$195	\$54,000
5. Larger trust, all distributed	\$2,919	\$0	\$282	\$70,000
6. Larger trust, income and gain retained	\$3,249	\$39,646	\$40,848	\$60,000

The lesson of the table is not that § 68 is the largest number. It is that the same trust, with the same beneficiary and the same portfolio, can owe nothing, \$195, or nearly \$7,800 depending on decisions made by December 31—and that the new § 68 overlay turns on precisely when those decisions go badly.

XIII. The Planning Architecture: “If You Want to Be Cute”

The strategies below are not requests for the CPA’s permission. They are the substantive planning and reporting architecture that the SNT lawyer, trustee, or trust officer should bring to the table—implemented with lawful authority, contemporaneous documentation, fiduciary analysis, and specialist coordination. None of them should be used in a way that compromises the beneficiary’s benefits or the trust’s protective purpose.

A. The Fourth-Quarter SNT Tax Huddle

A directed trustee or trust officer does not need to manage the portfolio to recognize that portfolio activity will change the tax result. Every nongrantor SNT should have a documented tax review no later than early November, before discretionary gains, fund distributions, and year-end distributions become irreversible. The huddle should produce a projection covering:

1. Year-to-date and projected interest, ordinary dividends, qualified dividends, and short- and long-term capital gains.
2. Unrealized gains and losses in the portfolio, with harvesting candidates identified.
3. Projected mutual-fund capital-gain distributions and their record dates.
4. Proposed sales, rebalancing, diversification of inherited or concentrated positions, real-property dispositions, and in-kind distributions.
5. Capital-loss carryforwards from prior years.
6. Planned beneficiary distributions and the resulting DNI, by character.
7. Projected trust taxable income, NIIT, and the § 68 computation under the JCT reading and under the contrary reading.

8. QDisT status and the estimated-tax position for the January 15, 2027

installment.⁷⁸

9. The benefits consequences of any proposed distribution (SSI, Medicaid, housing, ABLE).

The meeting language is simple and portable: “Before we approve the distribution plan and the proposed year-end trades, we need a trust-level tax projection—realized and unrealized gains and losses, loss carryforwards, projected fund distributions, DNI, retained taxable income, NIIT, and the § 68 effect. If there are sensible losses to harvest, or gains we can defer or stage, we need to know that before December 31.”

B. Control When Gains Are Recognized

- **Harvest losses deliberately.** Realized losses offset realized gains without limit; net capital losses offset only \$3,000 of ordinary income per year, with the excess carried forward. Avoid wash sales under § 1091 when repositioning. A loss recognized in January is too late for the prior year’s gain.⁷⁹
- **Stage or defer discretionary gains.** Spreading a diversification program over two or more tax years, or using an installment sale for real property, can keep each year’s taxable income lower and reduce both the rate cost and the § 68 exposure.
- **Watch mutual-fund distributions.** A fund’s year-end capital-gain distribution is taxable whether paid in cash or reinvested. Buying a fund shortly before its

⁷⁸I.R.C. § 6654(l) (estimated tax requirements applicable to estates and trusts); 2026 Form 1041-ES, <https://www.irs.gov/pub/irs-pdf/f1041es.pdf>

⁷⁹See supra note 73.

record date imports someone else's gain. Tax-managed funds, ETFs, and direct indexing can reduce involuntary recognition, consistent with prudent-investor obligations.

- **Coordinate post-death portfolio transitions.** A revocable SNT receives a basis step-up at the parent's death, which often makes the months after death the cheapest time to diversify. An irrevocable lifetime SNT may hold assets with the parent's carryover basis (see Rev. Rul. 2023-2). Either way, the post-death portfolio transition should be planned, not reflexive.

C. Make Capital Gain Distributable—Properly

Capital gain is excluded from DNI unless the regulation's conditions are met. Treas. Reg. § 1.643(a)-3(b) permits inclusion where, pursuant to the governing instrument and applicable local law, or a reasonable and impartial exercise of the fiduciary's discretion under a power granted by local law or the instrument, the gain is (1) allocated to income; (2) allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution; or (3) allocated to corpus but actually distributed or used by the fiduciary in determining the amount distributed.⁸⁰ State principal-and-income law, including a power to adjust or a unitrust election, may supply the necessary authority.⁸¹

The word "consistently" carries real weight. This is not a one-year election made after the numbers are known. The trustee should identify the authority, make the decision before or contemporaneously with the distribution, record the tax and non-tax

⁸⁰See supra note 54.

⁸¹See supra note 53.

rationale, and reflect it identically in the fiduciary accounting, trust books, Form 1041, and Schedule K-1. For new trusts, drafters should include an express power permitting the trustee to allocate capital gains to income or to treat them as part of distributions, exercisable in the trustee's discretion and consistent with the SNT's protective provisions.

D. Distribute by Character, Not by Cash

The question is not “how much cash did we send?” It is “which character of income did the distribution carry out, what remained in the trust, and what does that do to the trust's taxable income, NIIT, and § 68 computation?” Payments to third parties for the beneficiary's benefit—housing-related costs where appropriate, therapies, equipment, travel, education, a vehicle titled to the beneficiary—are distributions that carry out DNI under §§ 661 and 662 even though no cash reaches the beneficiary.⁸² A trustee contribution to the beneficiary's ABLE account (up to the \$19,000 annual limit for 2026, and now available to individuals whose disability began before age 46) is likewise a distribution that carries out DNI, while moving funds to an account that is disregarded for most means-tested purposes up to the applicable limits.⁸³ Deductions should be allocated, where the regulations permit, against the income classes that would otherwise bear the highest rate.⁸⁴

⁸²See supra note 54.

⁸³See supra note 20.

⁸⁴See supra note 54.

E. Timing and Election Tools

- **The 65-day rule.** Under § 663(b), the trustee may elect to treat distributions made within the first 65 days of 2027 (through March 6, 2027) as made in 2026, up to the greater of FAI or DNI for 2026, reduced by distributions already made. This is a valuable tool when year-end figures crystallize late. It does not retroactively create authority to include capital gain in DNI or cure an inconsistent administrative record.⁸⁵
- **In-kind distributions and § 643(e).** An in-kind distribution carries out DNI only to the extent of the lesser of basis or fair market value unless the trustee elects under § 643(e)(3) to recognize gain. The election can be useful to absorb capital-loss carryforwards at the trust level and give the beneficiary a fair-market-value basis; without the election, the beneficiary takes a carryover basis.⁸⁶
- **Estimated taxes and § 643(g).** A gain year can create an estimated-tax obligation for the trust. The trustee may elect to allocate trust estimated payments to a beneficiary under § 643(g), which is useful where DNI is carried out after payments were made.⁸⁷

⁸⁵I.R.C. § 663(b); Treas. Reg. §§ 1.663(b)-1, 1.663(b)-2 (election to treat amounts properly paid or credited within the first 65 days of the following taxable year as paid on the last day of the preceding year; limited to the greater of fiduciary accounting income or DNI for the year, reduced by amounts otherwise distributed).

⁸⁶I.R.C. § 643(e) (in-kind distributions; basis carryover and DNI carryout limited to the lesser of basis or fair market value unless the fiduciary elects under § 643(e)(3) to recognize gain or loss as if the property had been sold). See *supra* note 60.

⁸⁷I.R.C. § 643(g); Form 1041-T (election to treat estimated tax payments as paid by a beneficiary), <https://www.irs.gov/draft-tax-forms> See *supra* note 78.

- **Termination.** On the trust's termination, unused capital-loss carryovers and excess deductions pass to the beneficiaries succeeding to the property under § 642(h).⁸⁸

F. Structural Options for Persistent High-Income Trusts

Where a nongrantor SNT routinely has income beyond the compressed thresholds, the trustee and counsel should revisit the investment policy (including the mix of income-producing and growth assets), the distribution standard and pattern, capital-gain allocation provisions, trust situs and state-tax exposure, and whether the instrument should be modified or decanted if legally available and consistent with the settlor's purposes.⁸⁹ For the typical revocable SNT, drafters should build the post-death tax architecture—capital-gain allocation authority, distribution standards that permit tax-aware timing, and trustee power to make ABLE contributions and third-party payments—into the instrument now, because the trust will become a nongrantor taxpayer the moment it becomes irrevocable. For the less common irrevocable lifetime SNT, the choice between grantor and nongrantor status, and any substitution power or trust-protector authority to toggle grantor status, should be made deliberately.

G. Guardrails: Cute Is Not Clever If It Hurts the Beneficiary

- Do not distribute simply to chase a tax result; the distribution must meet an independently valid SNT purpose.

⁸⁸See supra note 73.

⁸⁹See, e.g., Unif. Trust Decanting Act (2015); Unif. Trust Code §§ 410-417 (modification and termination); N.J. Stat. Ann. § 3B:31-1 et seq. (New Jersey Uniform Trust Code). Any modification of an SNT must be evaluated for its effect on public-benefit status and, for third-party trusts, for any risk that a beneficiary's participation could be characterized as a transfer.

- Do not alter capital-gain treatment for one favorable year without confirming authority and committing to consistent administration.
- Do not make an in-kind or cash distribution without considering fiduciary duty, valuation, the beneficiary's capacity, and the SSI, Medicaid, and housing consequences.
- Do not assume that the beneficiary's low tax bracket is the decisive factor; consider the beneficiary's whole tax, benefits, and care-plan picture.
- Document the decision and involve the return preparer before the transaction is irrevocable.

XIV. Reporting It Correctly

The planning above only works if the return reflects the administration that actually occurred. For a nongrantor SNT, the 2026 Form 1041 should show the income distribution deduction computed on Schedule B, limited to DNI; capital gains on Schedule D, with any gain included in DNI identified and supported by the trustee's contemporaneous record; the § 642(b) exemption, including the \$5,300 QDisT exemption where applicable; NIIT on Form 8960; and Schedules K-1 that report the beneficiary's share by character—interest in box 1, ordinary dividends in box 2a, qualified dividends in box 2b, and net short- and long-term capital gain in boxes 3 and 4a when gain is carried out.⁹⁰

For § 68, the preparer should compute the result under the Joint Committee reading and under the contrary reading grounded in Treas. Reg. § 1.67-4(a)(1)(ii) and

⁹⁰See *supra* note 75.

the text of § 68(a); choose and document a position; consider whether disclosure is appropriate given that each position is supported by listed authority; and communicate the choice to the trustee, who must decide whether the resulting tax is charged to income or principal. If final Form 1041 instructions or other applicable Treasury or IRS guidance specify a reporting method, the preparer should follow that official guidance while assessing its interaction with the statute and regulations. Beneficiaries' preparers should be told if the trust has taken a position that creates phantom income at the trust level, because it will not change the beneficiary's K-1.

XV. Who Owns the Problem

No single participant—particularly in a directed-trust arrangement or a trust company that separates investment, administration, distribution, and tax functions—will necessarily see the whole problem. Someone must call the huddle.

Participant	Must flag or decide
Investment adviser	Projected gains and losses, fund distributions, proposed sales, harvesting candidates, post-death basis inventory
Trustee or trust officer	Authorized distribution strategy, fiduciary justification, accounting treatment, contemporaneous records, the calendar for the huddle
SNT attorney	Grantor or nongrantor status, instrument authority, state principal-and-income law, capital-gain/DNI architecture, QDisT qualification, benefits and fiduciary consequences, drafting and modification
Return preparer	Form 1041 projection, DNI and character carryout, § 68 computation and position, NIIT, estimated tax, federal and state reporting
Care manager / benefits planner	Whether the proposed distribution meets a real need and how it affects SSI, Medicaid, housing, and ABLE

XVI. Conclusion

OBBBA's Medicaid provisions will be remembered for the coverage losses in the expansion population, and the public debate has largely stopped there. For people who

are disabled under Social Security definitions, the direct eligibility effects are modest: two months of retroactive coverage instead of three, a fixed home-equity cap, and delayed enrollment simplifications. The larger effect is the gradual financing squeeze that will fall, over the next decade, on the optional home- and community-based services our clients rely on most. That makes private resources, and their efficient use, more important than ever.

The tax side of the same law, together with what it left alone, supplies part of the answer. The SECURE Act lifetime stretch still allows a parent's yet-untaxed retirement savings to become a benefits-protective, tax-deferred resource for a disabled child through an accumulation AMBT. That should reshape how parents divide their estates among their children. But once that money is inside a nongrantor SNT, the trust is a compressed-bracket taxpayer. From 2026 it also faces a new § 68 limitation that, under the Joint Committee's reading, trims the very deductions that make distributing income tax-efficient. The Medicaid label on a third-party SNT does not change when Mom or Dad dies; the taxpayer does.

The remedy is not to turn trust officers and SNT lawyers into return preparers. It is to institutionalize one habit: **for every nongrantor SNT, call the tax huddle before December 31**. Review gains, losses, and retirement distributions; harvest losses where sensible; stage what can be staged; decide deliberately whether gain will be carried out under a proper § 1.643(a)-3 pathway; distribute by character for real beneficiary needs; confirm QDisT status; and document everything, so that the 2026 Form 1041 reports a result that was planned rather than discovered.

Appendix A: Fourth-Quarter SNT Tax Huddle Checklist

1. Confirm the trust's income-tax status: revocable or irrevocable; grantor (whose?) or nongrantor; date of any conversion; any § 645 election.
2. Confirm QDisT eligibility and the beneficiary's SSA disability determination.
3. Obtain year-to-date realized income and gains by character, and projected year-end fund distributions.
4. Obtain the unrealized gain/loss report and capital-loss carryforwards.
5. Identify proposed trades, sales, and in-kind distributions before year-end.
6. Identify the instrument's capital-gain allocation provisions and applicable state principal-and-income law.
7. Decide, and document, whether any gain will be treated as part of distributions under Treas. Reg. § 1.643(a)-3(b).
8. Plan distributions for real beneficiary needs; model DNI carryout by character.
9. Run the § 68 computation under both readings; estimate NIIT and state tax.
10. Confirm benefits consequences (SSI, Medicaid, housing, ABLE) for each proposed distribution.
11. Calendar the January 15 estimated payment and the 65-day election deadline (March 6, 2027 for 2026).
12. Memorialize decisions in trustee minutes; send the file to the return preparer.

Appendix B: Assumptions for the Worked Examples

All examples apply the 2026 estate and trust rate schedule and capital-gain breakpoints from Rev. Proc. 2025-32; a \$100 complex-trust exemption unless a QDisT is assumed (\$5,300); NIIT at 3.8% of the lesser of undistributed net investment income

or AGI in excess of \$16,000; and the Joint Committee reading of § 68, treating the § 642(b) exemption and distribution deductions (but not § 67(e) administration expenses, except where noted) as itemized deductions. Solely for illustration, the § 68 reduction is modeled as ordinary taxable income that does not change § 67(e) adjusted gross income or undistributed net investment income; neither § 68 nor JCS-1-26 footnote 102 resolves those mechanics, and actual reporting may change with guidance.

Administration expenses are allocated against ordinary income, and distributions carry out each class of income pro rata. The beneficiary is a single filer with no other taxable income, using the 2026 standard deduction of \$16,100. State taxes, AMT, and estimated-tax penalties are ignored. The examples are designed to illustrate relationships and magnitudes, not to serve as return computations.

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First-Party Special Needs Trusts

Drafting When Federal Compliance Is Not Enough:

State-Level D4A Anomalies, Administrative Friction, and

Practical Drafting Implications

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Overview

A first-party special needs trust under 42 U.S.C. § 1396p(d)(4)(A) is often taught as though the drafting exercise begins and ends with the federal statute: disabled beneficiary, under age sixty-five, trust established by the proper person, sole-benefit administration, and Medicaid payback. That federal baseline remains indispensable, but it is not the whole story. In a meaningful group of jurisdictions, a trust that appears facially compliant under federal law may still encounter delay, rejection, additional reporting obligations, funding obstacles, lien-clearance issues, property restrictions, or termination complications because the governing state has added its own statutory, regulatory, manual-based, or operational overlay.

That gap between federal sufficiency and state implementation matters most when the practitioner, court, or fiduciary is handling a settlement-funded trust, moving a beneficiary across state lines, or administering trusts nationally through a corporate platform. A local lawyer may know intuitively how one state behaves. A trust company officer with a 51-jurisdiction book of business cannot safely rely on intuition or on one state's habits. The relevant question is not merely whether the trust is federally compliant in the abstract, but where it will be reviewed, funded, administered, distributed from, and eventually terminated.

This paper therefore takes a deliberately blended approach. It begins with the core drafting and administration principles that still govern first-party trusts as a matter of federal law and sound practice. It then turns to the more interesting and, for many fiduciaries, more consequential subject: the jurisdictions in which compliance with the federal statute alone may be insufficient as an operational matter. The result is intended to be useful both to lawyers drafting these instruments and to trustees and trust officers who must administer them in real files rather than in the clean hypotheticals of federal statutory text.

What a First-Party Trust Is

At its most basic, a first-party trust is a trust funded with assets that belonged to, were vested in, or became legally payable to the beneficiary whose needs the trust is designed to serve. Traditional trust law would describe the arrangement as self-settled. In the special-needs setting, that source-of-funds inquiry is often the first and most important threshold question. If the assets were the beneficiary's by right, whether because of a personal-injury recovery, an inheritance payable outright, a beneficiary designation, accumulated back benefits, or some other vested entitlement, the practitioner is in first-party trust territory rather than third-party planning.

Congress authorized self-settled special needs trusts in 1993 through the Omnibus Budget Reconciliation Act of 1993. The point was not to create a general asset-protection device for a beneficiary's own funds. The point was narrower and more humane: to permit a disabled individual to preserve eligibility for means-tested public benefits, principally Medicaid and SSI, while still using his or her own property in a structured way for supplemental benefit. If the same funds are paid directly to the disabled individual and held outright, those assets generally become countable resources. If they are transferred into a properly established and administered first-party special needs trust, they may be disregarded for eligibility purposes, subject always to the governing federal and state rules. See 42 U.S.C. § 1396p(d)(4)(A); POMS SI 01120.203.

For SSI purposes, distribution mechanics remain critical. Payments made directly to third-party vendors for goods and services may avoid treatment as income to the beneficiary, while payments for food or shelter implicate the in-kind support and maintenance rules and may reduce, though not necessarily eliminate, SSI. Medicaid treatment is different; the central concern is usually whether the trust corpus remains a countable resource and whether trust administration is consistent with the governing exception. For practitioners and trustees alike, that distinction between benefit systems should be kept conceptually separate from the drafting question itself.

The Federal D4A Baseline

The classic stand-alone first-party trust is the trust described in 42 U.S.C. § 1396p(d)(4)(A), usually shortened to a “D4A” trust. The trust holds the assets of a disabled individual. The beneficiary must meet the Social Security disability standard. The trust must be established by the disabled individual if competent, or by a parent, grandparent, guardian, or court. It must be for the sole benefit of the disabled beneficiary, and the beneficiary must be under age sixty-five when the trust is established and funded.

The trust must also contain a Medicaid payback provision. In broad terms, the state or states that furnished medical assistance are repaid at the beneficiary's death, up to the amount properly recoverable under governing law, before any remainder passes to other beneficiaries. That single sentence, however, conceals a great deal of complexity. States differ meaningfully over the exact formulation of payback, over whether and how they treat early termination, over whether they insist on all-state reimbursement language, over the order of allowable expenses at death, and over whether they impose reporting or approval conditions while the beneficiary is still alive. Those differences are part of the central thesis of this paper.

Federal law supplies the floor. It does not guarantee a frictionless path in every jurisdiction. A drafter who stops at the federal elements may produce an instrument that looks fine on first read yet performs badly

in administration because a particular state has layered on requirements concerning notice, asset forms, annual accounts, court procedures, liens, death reporting, or termination mechanics.

Flexibility in Drafting

D4A drafting is unusually vulnerable to legal drift. The federal statutory framework has remained relatively stable in outline since the enactment of the Special Needs Trust Fairness Act—enacted as § 5007, “Fairness in Medicaid Supplemental Needs Trusts,” of the 21st Century Cures Act, Pub. L. No. 114-255, § 5007, 130 Stat. 1033, 1209 (2016)—which amended 42 U.S.C. § 1396p(d)(4)(A) to permit a legally competent disabled individual to establish his or her own first-party special needs trust.^[9] But the interpretive ecosystem around the statute has not remained static. State regulations change. Agencies shift procedures. POMS guidance evolves. Institutional custodians change their willingness to hold certain assets. Courts differ on the effect of remainder structures, sole-benefit questions, or procedural defects. The instrument therefore should be drafted with as much lawful flexibility as possible.

Not Every State Is a New Jersey

Before turning to the friction states, it is worth saying plainly that not every jurisdiction behaves that way. Christopher Smith has observed that Michigan is, in practice, comparatively hands-off with respect to D4A trusts, while still presenting issues concerning funding of pooled trusts after age sixty-five.^[1]

The practical lesson is therefore not that every state is burdensome. It is that no fiduciary should assume uniformity. A national trustee must be facile across jurisdictions, not merely comfortable in one state.

: The author gratefully acknowledges Christopher Smith, Esq., a member of the Special Needs Alliance, for practical observations concerning Michigan's comparatively hands-off treatment of D4A trusts and its continuing post-age-sixty-five pooled-trust issues. These observations reflect practitioner experience and should be independently confirmed for a current matter. Any remaining errors are the author's alone.

: The Special Needs Trust Fairness Act was enacted as § 5007, “Fairness in Medicaid Supplemental Needs Trusts,” of the 21st Century Cures Act, Pub. L. No. 114-255, § 5007, 130 Stat. 1033, 1209 (2016). It amended 42 U.S.C. § 1396p(d)(4)(A) by inserting “the individual” among the persons permitted to establish a first-party special needs trust. Federal guidance states that the amendment applies to trusts established on or after December 13, 2016. See State Medicaid Director Letter #17-001, Implications of Section 5007 of the Cures Act for Special Needs Trusts (Aug. 1, 2017).