

3

MEDICAID | SCALE

The Medicaid chapter is fiscal by design

\$887B

Federal deficit reduction, 2025–2034, from the Medicaid chapter (Title VII, Subtitle B, Ch. 1)

7.5M

More uninsured in 2034 from the Medicaid chapter; 10.0M across all health provisions

~14%

Reduction in federal Medicaid spending over a decade (KFF estimate)

- Supporters: program integrity, work expectations for able-bodied adults, ending state financing arrangements they regard as abusive.
- Critics: coverage cuts. Both descriptions are consistent with CBO's numbers.

The question for this audience: which people and which programs bear the reductions, and when?

Source: CBO Supplemental Cost Estimate (Oct. 2024), KFF

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4

4

MEDICAID | WHO BEARS THE COVERAGE LOSSES

Most projected coverage losses target ACA expansion adults

Provision	Principal population	Effective	CBO estimate, FY2025–2034
§ 71119 work requirement (80 hrs/month)	Expansion adults 19–64	Jan. 1, 2027 (extensions to Dec. 31, 2028)	\$317.0B deficit reduction; 5.3M more uninsured
§ 71107 six-month redeterminations	Expansion adults	Jan. 1, 2027	\$58.0B; 0.7M more uninsured
§ 71120 cost sharing up to \$35/service	Expansion adults, 100–138% FPL	Oct. 1, 2028	\$7.4B lower outlays
§ 71109 immigrant eligibility limits	Certain lawfully present noncitizens	Oct. 1, 2026	\$6.2B lower outlays
§ 71115 provider-tax limits	States (phase-down in expansion states)	Oct. 1, 2026; to 3.5% by FY2032	\$182.7B; 1.1M more uninsured
§ 71116 state-directed payments	States and providers	At enactment; step-down from Jan. 1, 2028	\$149.4B lower outlays

The work requirement alone: more than one-third of the chapter's deficit reduction and about 70% of its projected increase in uninsured.

Source: CBO, Congressional Research Service

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5

5

MEDICAID | OUR CLIENTS

“Will my child lose Medicaid in 2027?” Usually, not directly.

Why our clients are outside the headline provisions

- Disabled-under-SSA clients generally qualify through non-MAGI aged, blind, or disabled pathways (often SSI-related), not the expansion group.
- The work requirement excludes people eligible through Medicaid's other mandatory pathways and people entitled to Medicare Part A or enrolled in Part B.
- Six-month redeterminations and new cost sharing are likewise limited to expansion adults.

Even inside the expansion group, the statute exempts

- Those medically frail or those with special medical needs, including individuals blind or disabled under SSA § 1614
- Physical, intellectual, or developmental disability that significantly impairs one or more ADLs
- Disabling mental disorders; serious or complex medical conditions
- Parents, guardians, and caretaker relatives of a disabled individual

The child's eligibility pathway is not the one the work requirement targets, and an expansion-enrollee caregiver parent is exempt.

Source: CMS Interim final rule fact sheet

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6

6

2

MEDICAID | DIRECT EFFECTS

Where the aged, blind, and disabled population is directly affected

Retroactive coverage (§ 71112)

Applications on or after Jan. 1, 2027: three months falls to two (non-expansion, incl. ABO) and to one month for expansion adults. The most immediate change: file LTC applications faster.

Home-equity cap (§ 71108)

From Jan. 1, 2028: \$1,000,000, not indexed, for nursing-facility and HCBS eligibility. Twelve jurisdictions, including NJ, now use higher limits. Spouse and child exceptions remain; hardship waiver required.

Eligibility-rule moratoria (§§ 71101–71102)

Blocks the 2023 MSP streamlining rule and parts of the 2024 eligibility and enrollment rule through FY2034. CBO: about 800,000 fewer dual-eligible Medicaid enrollees in 2034 from the MSP moratorium alone.

The SSDI waiting-period gray zone

SSDI recipient in the 24-month Medicare wait, with income too high for SSI, may be an expansion adult. Exempt as disabled, but the exemption must be identified and documented. The risk is procedural.

Source: [National Health Law Program, CBO](#)

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7

7

MEDICAID | THE LONGER-TERM THREAT

The real threat is back-loaded: financing cuts that will squeeze optional HCBS

CBO annual Chapter 1 deficit reduction (\$ billions)

Fiscal Year	Deficit Reduction (\$ billions)
FY2027	\$458
FY2029	\$908
FY2032	\$1358
FY2034	\$1608

§ 71115 provider taxes

- Freezes new provider taxes
- Expansion states: hold-harmless threshold falls 0.5 point a year, 6% to 3.5% by FY2032
- Nursing-facility and ICF/IID taxes excluded from the phase-down

§ 71116 state-directed payments

- New SDPs capped at 100% of Medicare (expansion) or 110% (non-expansion)
- Grandfathered payments step down 10 points a year from Jan. 1, 2028

Source: [CBO, CMS state-directed-payment letter](#)

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8

8

MEDICAID | HCBS

When states lose financing, they cut optional services first, and most HCBS is optional

607,000

people on HCBS waiver waiting or interest lists (41 states, 2025)

74%

of the waiting-list population has intellectual or developmental disabilities

32 mo.

average wait for services

> 2/3

of U.S. home- and community-based LTC is paid by Medicaid

Mandatory vs. optional

- Mandatory:** nursing-facility care and home health
- Optional:** personal care, habilitation, supported employment, respite, day services, most waiver services; states can cap waiver enrollment

The one HCBS expansion

- § 71121: a new 1915(c) waiver for people who do not meet an institutional level of care, from July 1, 2028
- KFF expects low take-up given federal spending cuts and the bar on lengthening existing waits

The forecast is a slower harm than the headlines suggest, but it will reach the people this audience serves.

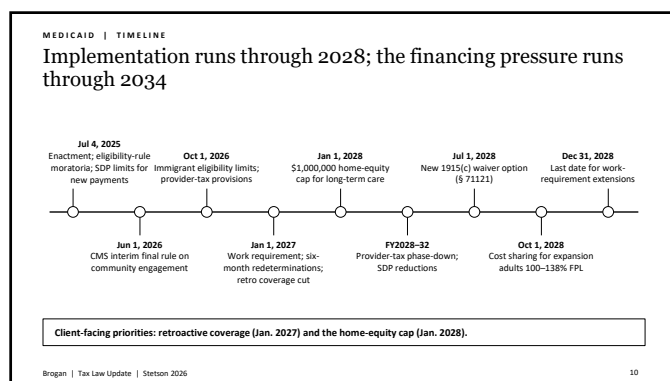
Source: [KFF waiting lists 2018–2025](#), [KFF home care](#), [CMS CBO \(Nov. 2023\)](#)

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9

9

3



10

MEDICAID | PLANNING RESPONSE

If public HCBS gets scarcer, private resources and their efficient use matter more

SNT instruments 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, and more valuable as flexible, disregarded resources.	Retirement plans Often the largest single pool a family leaves a child with a disability. OBBBA left the lifetime-stretch rules untouched.
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Making the most of that opportunity, and paying as little tax as possible along the way, is the rest of this talk.

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11

PART 2

The Tax Side of OBBBA: What Changed for SNT Practice

Most of the tax title is outside our scope. Six provisions matter most.

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12

TAX CHANGES

Six OBBBA tax provisions that matter to SNT practice

Permanent trust brackets (§ 1(j))

37% begins at \$16,000 of trust taxable income vs. \$640,600 for a single individual.

\$15M exclusion, indexed (§ 2010(c)(3))

Few SNT families face estate tax, so the revocable third-party SNT is the natural default.

Rewritten § 68 (2/37 limitation)

Former § 68(e) trust exception gone; JCT staff says it reaches trusts, including distribution deductions.

ABLE made permanent

ABLE-to-work, 529-to-ABLE rollovers, Saver's Credit. SECURE 2.0: age of onset 26 to 46 from Jan. 1, 2026.

Senior deduction, 2025–2028

Extra \$6,000 per person 65+, phased out above \$75,000 MAGI (\$150,000 joint).

Higher standard deduction

\$16,100 single for 2026. A beneficiary's K-1 income may be largely or wholly sheltered.

Source: [IRS Rev. Proc. 2025-32](#); [IRS ABLE Today](#)

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13

13

TAX CHANGES | THE CORE INSIGHT

The planning opportunity lies in the gap between two rate schedules

\$16,000

Trust or estate: taxable income at which the 37% bracket begins (2026)

\$640,600

Single individual: taxable income at which the 37% bracket begins (2026). The 0% capital-gain rate runs to \$49,450.

- Income an SNT keeps is expensive. The compressed schedule is now permanent.
- Income properly carried out to a low-bracket beneficiary is cheap, and often free. The beneficiary's schedule is permanently generous at low incomes.

Source: [IRS Rev. Proc. 2025-32](#)

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14

14

TAX CHANGES | ESTATE EXCLUSION

“Permanent” means no built-in sunset, not forever

What “permanent” really means

- OBBBA set the basic exclusion at \$15 million per person for 2026, indexed thereafter.
- TCJA (2017) sunset to satisfy the Byrd Rule; OBBBA was scored against a “current policy” baseline, so no sunset was required.
- A future Congress could still change it, for example to about \$7 million (the old \$5 million in 2026 dollars).

Practice implications

- For most SNT families, federal estate tax is not the binding constraint, so the revocable SNT is the preferred default.
- If irrevocable for non-tax reasons, consider provisions that cause inclusion (§§ 2036/2038, limited general powers) to obtain a § 1014 basis adjustment.
- Balance state estate or inheritance tax, estate recovery and creditor exposure, and the parent's own Medicaid plan.

Source: [The Policy Center OBBBA assessment](#)

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15

15

5

PART 3

What Did Not Change:
The Lifetime Stretch

SECURE Act rules still let a disabled or chronically ill beneficiary, including through an accumulation SNT, receive inherited retirement benefits over a lifetime.

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16

16

LIFETIME STRETCH | ELIGIBLE DESIGNATED BENEFICIARIES

The EDB exception survives, but documentation deadlines bite

Who qualifies

- **Disabled:** unable to engage in substantial gainful activity because of a medically determinable impairment of long-continued and indefinite duration (special functional test under age 18).
- **Chronically ill:** certified by a licensed health care practitioner under the § 7702B(c)(2) standard.
- OBBA did not change these rules.

Documentation (2024 final regulations)

- **Qualified employer plan:** condition evidence to the plan administrator by Oct. 31 of the year after the participant's death (or Oct. 31, 2025, if later); separate trust-documentation rules apply.
- **IRAs, and generally § 403(b):** no federal requirement to deliver to the custodian, but plan or provider documents may require it.
- **SSA determination:** a disability safe harbor, but it does not excuse a plan's timely-submission rule.
- **Miss it:** the applicable ten-year regime may apply instead.

The safe course: assemble the documentation promptly, whatever the account type.

Source: IRB 2024-33 (final RMD regulations)

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17

17

LIFETIME STRETCH | AMBT DESIGN

The accumulation AMBT, not a conduit trust, is the benefits-protective design

Never outright: an inherited IRA in the beneficiary's name is a countable resource, and its distributions are unearned income for SSI.

- **AMBT, § 401(a)(9)(H)(iv)–(v):** a see-through trust under which no individual other than the disabled or chronically ill beneficiary has any right to the benefits during that beneficiary's life.
- **Payout period:** that beneficiary's life expectancy, even though others take the remainder. SECURE 2.0: a qualified charity may be a remainder beneficiary.

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 every year.

Accumulation AMBT

- Trustee may retain distributions and spend them for supplemental needs: the benefits-protective result.
- The cost: every retained distribution is ordinary income at compressed trust rates.

A properly drafted third-party accumulation SNT is the paradigm AMBT.

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18

18

6

LIFETIME STRETCH | ADMINISTERING THE AMBT

Retained IRA dollars are expensive; dollars used for the beneficiary are not

\$8,994

Approximate 2026 federal tax if an accumulation SNT retains a \$30,000 inherited-IRA distribution

Used for the beneficiary instead: carried out through DNI, often sheltered by the beneficiary's \$16,100 standard deduction.

- **Character:** income in respect of a decedent, ordinary income to the trust.
- **NIIT:** excluded from net investment income, so no 3.8%, but fully exposed to compressed ordinary brackets.
- **Use it for the beneficiary:** paying providers, funding an ABL account, buying equipment or services carries the income out through the distribution deduction.
- **§ 68:** retirement distributions add to the § 68 base just as capital gains do.
- **Q4 discipline:** project the RMD and any discretionary withdrawals, decide in advance how much will be used for the beneficiary, and avoid bunching withdrawals in one year.

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19

19

LIFETIME STRETCH | SIBLINGS

Rethink “equal” inheritances among siblings with very different payout rules

Parents die in 2026 leaving a \$1M traditional IRA and a \$1M brokerage account. Sam, 35, is disabled and on SSI and Medicaid. Kate, 38, is in the 32% bracket.

	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 tax on Kate's share	About \$160,000, payable within 10 years (32%)	None
Sam's AMBT receives	\$500,000 brokerage + \$500,000 IRA	\$1,000,000 IRA
Sam's first-year RMD (factor 50.5)	About \$9,900	About \$19,800
Tax if used for Sam's benefit	Largely sheltered by his standard deduction	Largely sheltered by his standard deduction

Yet-untaxed retirement savings belong in the disabled child's trust; stepped-up assets belong with the siblings. Beneficiary designations, not the will, control the result.

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20

20

LIFETIME STRETCH | PARENT-LEVEL PLANNING AND DRAFTING

Roth conversions and a drafting checklist for retirement benefits payable to an SNT

Parent-level: Roth conversions

- Parents pay tax at individual rates, usually below trust rates on retained income.
- The AMBT inherits a Roth, stretched over the child's life expectancy; qualified distributions are tax-free, with no compressed-bracket or § 68 exposure.
- Senior deduction (2025–2028) can make conversion years attractive at 65+, but conversion income raises MAGI, IRMAA, and Social Security taxation. Model each one.

Drafting and administration checklist

- Draft as an accumulation trust that qualifies as an AMBT.
- Name the SNT (or its separate share) directly on the designation; avoid routing benefits through probate.
- Qualified employer plans: deliver trust documentation and condition evidence by Oct. 31 of the year after death.
- Authorize third-party payments and ABL contributions that carry out DNI without creating countable income.
- Coordinate every child's designations, including after-tax equalization if wanted.
- Put retirement distributions on the Q4 tax huddle agenda every year.

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21

21

7

PART 4

Who Pays the Tax?

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.

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22

22

WHO PAYS | TWO QUESTIONS

Two questions come before “SNT taxation”

Public-benefits label

Follows the source of funds and the statutory exception relied on: first-party (d)(4)(A), pooled (d)(4)(C), or third-party.

Income-tax status

Follows the grantor-trust rules of §§ 671–679: who is treated as owner? The owner’s portion is reported on the owner’s own return.

“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.”

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23

23

WHO PAYS | THE ORGANIZING MATRIX

The organizing matrix for the rest of the talk

SNT type and stage	Typical status	Who reports	Trust-level compressed rates, NIFT, § 687	Key point
First-party (d)(4)(A) or pooled (d)(4)(C) subaccount, beneficiary living	Grantor (beneficiary is grantor)	Beneficiary, Form 1040	Generally no	The trust holds the beneficiary’s own money; no separate income-tax taxpayer
Third-party SNT during the settlor’s life	Grantor: revocable under § 676; irrevocable only if a §§ 673–677 power applies	Settlor, Form 1040	Generally no	Revocable: still the parent’s money for tax. Irrevocable grantor: parent’s tax payment is a non-gift benefit
Third-party SNT after the settlor’s death	Nongrantor (usually complex)	Trust on Form 1041; beneficiary on K-1 to extent of DNI	Yes	Same trust, same trustee, same portfolio: different taxpayer
Testamentary third-party SNT	Nongrantor from inception	Trust and, through DNI, the beneficiary	Yes, from day one	No lifetime grantor phase; the tax protocol must exist from year one

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24

24

WHO PAYS | FIRST-PARTY SNTs

First-party SNTs are grantor trusts by definition

Why the beneficiary is the grantor

- Grantor = the person who makes a gratuitous transfer (Treas. Reg.), not the person who signs.
- The funds are the beneficiary's: PI recovery, redirected inheritance, savings, retroactive benefits.
- § 677(a): income may go to or for the beneficiary without adverse-party consent, so the beneficiary is the owner.
- Pooled (d)(4)(C) subaccounts are commonly reported the same way; confirm the pooled trust's practice.
- Report via Form 1041 grantor statement or a Treas. Reg. § 1.671-4 optional method.

Practical consequences

- Individual rates:** 0% on capital gain and qualified dividends up to \$49,450 of taxable income.
- Trust-paid care costs** may support a medical deduction on the beneficiary's return (7.5%-of-AGI floor).
- NIIT** only above \$200,000 / \$250,000: irrelevant for nearly every beneficiary.
- § 68** practically irrelevant: individual 37% starts at \$640,600.
- Taxable income is not SSI income:** separate ledgers; food no longer counts as ISM since Sept. 30, 2024.

Do not draft first-party SNTs for nongrantor status. Accept grantor status and plan around it.

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25

25

WHO PAYS | THIRD-PARTY SNTs DURING LIFE

The default third-party SNT is revocable, and § 676 alone makes it a grantor trust

The typical case

- A standalone revocable SNT or an SNT share of the parent's revocable trust, named on life insurance, retirement accounts, and pour-over assets; funded mostly at death.
- § 676: the grantor owns any portion the grantor can revest. No substitution power or special grantor power is needed.
- Parent's income, parent's Form 1040, parent's rates. Converts to nongrantor at death.
- The assets remain the parent's resources for the parent's own Medicaid eligibility.

Why the literature obscures it

- First-party SNTs are taught first, and a (d)(4)(A) trust must be irrevocable.
- Third-party discussions then dwell on irrevocable structures and grantor "powers."
- Readers infer, wrongly, that a third-party SNT is ordinarily an irrevocable nongrantor trust. For most families it is not.

The lifetime phase is largely tax-neutral. The planning significance comes at death: § 2038 inclusion, § 1014 basis, and a new compressed-bracket taxpayer.

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26

26

WHO PAYS | IRREVOCABLE LIFETIME SNTs

Irrevocable lifetime SNTs: grantor status and estate inclusion are separate questions

- Used chiefly for taxable estates, completed gifts for other reasons, or insurance trusts.
- Grantor only if a §§ 673–677 trigger applies, deliberately or by accident: § 675(4)(C) swap power; § 674 powers outside the independent-trustee exceptions; § 677(a)(3) premiums; § 677(a) spouse benefit with § 672(e) attribution.
- A discretionary supplemental-needs standard is rarely "reasonably definite," so § 674(c)(1)(d) may fail with family trustees.
- First step:** read the instrument. Was grantor status intended, achieved, or triggered by accident?

	Excluded from estate (no § 1014 step-up)	Included in estate (§ 1014 step-up)
Grantor during parent's life	Irrevocable SNT with § 675(4)(C) swap power or § 677(a)(3) premium power; parent pays tax; Rev. Rul. 2023-2 applies	Revocable SNT (§§ 676, 2038): the typical case; also a parent-trustee with discretionary distribution powers (§ 674(a)); §§ 2036(a)(2), 2038
Nongrantor during parent's life	Independent trustee, no retained powers or interests; files its own Form 1041 during the parent's life	Uncommon: an estate-tax power held so as not to trigger §§ 673–677 (e.g., exercisable only with an adverse party)

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27

27

WHO PAYS | TAX BURN AND BASIS

The grantor's tax burn helps the SNT; basis follows inclusion

Irrevocable grantor SNT: the "tax burn"

- The parent reports the trust's income at individual rates; paying that tax is not a taxable gift.
- Every dollar of tax the parent pays is a dollar that stays in the SNT for the child.
- Rev. Rul. 2004-64: an independent trustee's discretionary reimbursement power does not by itself cause inclusion. Use it thoughtfully in an SNT.

Basis at the parent's death

- Revocable SNT:** § 2038 inclusion, § 1014 step-up; early gains reflect only post-death appreciation.
- Completed-gift, estate-excluded trust:** no step-up (Rev. Rul. 2023-2). Carryover basis means the first sale of a long-held position may realize a large gain at compressed rates.
- Even with a step-up,** a concentrated or appreciating post-death portfolio builds gain.

Basis is why recognition-event discipline (Part 6) matters from the first post-death year.

Source: [BPMG on Rev. Rul. 2023-2](#)

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28

28

WHO PAYS | THE CONVERSION

The parent dies: same SNT, new taxpayer

"When you're dead, it's a bit hard to revoke your trust."

	While the parent is alive (grantor phase)	After the parent dies (nongrantor phase)
Benefits character	Third-party SNT for Medicaid and SSI	Still a third-party SNT for Medicaid and SSI
Who is taxed	Parent, on Form 1040 at individual rates	Trust, on Form 1041; 37% begins at \$16,000; beneficiary taxed only on DNI carried out
NIT	Only above the parent's \$200,000 / \$250,000	On undistributed NIT once AGI exceeds \$16,000
§ 68	Only if the parent is in the 37% bracket	May reduce trust deductions, including distribution deductions
Who bears the tax	Parent's own funds; trust not depleted	Trust assets, unless carried out on a K-1
Basis	Revocable: § 1014 step-up at death. Completed-gift: none	Revocable: fresh basis. Irrevocable: low basis, so early sales realize large gains

Now a nongrantor complex trust: own EIN, calendar year (subject to a § 645 election), annual Form 1041, K-1s to the extent of DNI. A testamentary SNT is in this posture from day one.

Source: [BPMG on Rev. Rul. 2023-2](#)

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29

29

WHO PAYS | QUALIFIED DISABILITY TRUST

Do not miss the qualified disability trust exemption

\$5,300

QDisT exemption for 2026 under § 642(b)(2)(C), not subject to phaseout, versus \$100 for a complex trust

Worth about \$1,000–\$1,900 of federal tax in a year the trust retains income at 20%–37%

- Requirements:** described in 42 U.S.C. § 1396p(c)(2)(B)(iv); established solely for a disabled individual under 65; all beneficiaries determined disabled by SSA 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**, yet preparers who do not know the beneficiary's disability status routinely miss it.
- Wrinkle:** under the JCT reading of § 68, the § 642(b) exemption is itself an itemized deduction subject to the 2/37 reduction.

Source: [BS Form 1041-ES \(2026\)](#)

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30

30

10

PART 5

The New § 68 Trap

Not necessarily a big number, but an administrative pain, and it turns on precisely the recognition events that already cause the larger problem.

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31

31

§ 68 | FOUR LEDGERS

“Which income do you mean?” Keep four ledgers distinct

1. Fiduciary accounting income

What the instrument and principal-and-income law treat as income. Realized gains ordinarily go to principal (subject to a power to adjust or unitrust).

2. Distributable net income

Caps the distribution deduction and beneficiary inclusion; preserves character. Gains generally excluded unless a § 1.643(a)-3(b) pathway applies.

3. Taxable income

The base for the rate schedule and the new § 68 computation. Can include retained gain never in FAI or DNI.

4. Net investment income

The § 1411 base: lesser of undistributed NII or AGI over \$16,000. IRA and plan distributions are excluded.

The running example: \$20,000 of interest and dividends, \$6,000 of fees, and a \$40,000 long-term gain on an inherited stock position. Distribute the \$14,000 of net income and the trust has distributed its “income” in every non-tax sense. Yet the \$40,000 gain, allocated to principal and excluded from DNI, remains taxable to the trust, well past every compressed threshold.

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32

32

§ 68 | 2026 RATE ENVIRONMENT

Exposure is driven by annual recognition events, not by the size of the corpus

Trust taxable income (2026)	Ordinary	Net cap. gain / QD
\$0 – \$3,300	10%	0%
\$3,300 – \$11,700	24%	15%
\$11,700 – \$16,000	35%	15%
\$16,000 – \$16,250	37%	15%
Over \$16,250	37%	20%

23.8%

Retained net long-term capital gain (20% + 3.8% NIIT)

40.8%

Retained ordinary investment income (37% + 3.8%)

37%

Retained IRA or plan distributions (no NIIT), plus state tax

A \$750,000 SNT with one \$40,000 realized gain: about \$9,520 of federal tax on the gain alone (before lower brackets), often triggered by an investment adviser without a tax projection.

Source: IRS Rev. Proc. 2025-32, IRS Form 1041-ES.

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33

33

11

§ 68 | THE STATUTE

New § 68: a 2/37 deduction haircut, with no trust exception

Reduction = $2/37 \times$ the lesser of

(1) itemized deductions, or

(2) taxable income (before § 68) + itemized deductions – the 37%-bracket threshold (\$16,000 for a 2026 trust)

- **Before 2018:** the Pease limitation; former § 68(e) said it did not apply to any estate or trust.
- **2018–2025:** Pease suspended by TCJA.
- **OBBA § 70111:** rewrote § 68 for tax years beginning after Dec. 31, 2025. § 68(a) reads “in the case of an individual.” § 68(b): applied after other limitations. The trust exception was not carried forward.
- **Policy aim:** cap each itemized-deduction dollar at 35 cents for 37%-bracket individuals.

For trusts, whose 37% bracket begins at \$16,000, the question is whether, and how far, the rule applies at all.

Source: [26 U.S.C. § 68 \(Cornell LII\)](#)

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34

34

§ 68 | COMPETING READINGS

Joint Committee footnote 102 and its critics

JCT Blue Book (JCS-1-26), footnote 102

- § 641(b): trust taxable income computed as for an individual.
- § 63(d): itemized = all deductions other than above-the-line and § 63(b).
- So trust itemized deductions include, “without limitation,” the § 642(b) exemption and §§ 651/661 distribution deductions.
- Treas. Reg. § 1.67-4(a)(1)(i) dismissed as limited to § 67.

The counterarguments

- § 68(a) applies “in the case of an individual”; § 641(b) yields “except as otherwise provided in this part.”
- The distribution deduction allocates income; limiting it double-taxes the same income.
- A Treasury regulation treats these deductions as non-itemized.
- ACTEC asked Treasury to exclude §§ 651/661 and trust-unique administration expenses, and notes 2/37 applies even to 20%-rate income.

A Blue Book is not statute, regulation, or binding guidance. No Treasury guidance yet; final 2026 Form 1041 instructions not released as of writing. Choose a position, document it, and consider disclosure.

Source: [JCT JCS-1-26](#), [ACTEC recommendations](#), [National Law Review](#), [IRS draft forms](#)

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35

35

§ 68 | MECHANICS

How the computation works under the JCT reading

1. **Identify the trust’s “itemized deductions.”** At least the § 642(b) exemption (including QDIsT) and the §§ 651/661 distribution deduction. § 67(e) administration expenses, § 642(c), and § 691(c): unresolved.

2. **Compute prong (2):** taxable income without § 68, plus those itemized deductions, minus \$16,000.

3. **Multiply** the lesser of prong (1) and prong (2) by 2/37.

4. **Reduce the deduction pool.** Trust taxable income rises; character and NIT effect are unspecified; the beneficiary’s §§ 652/662 inclusion is unchanged.

The double tax, illustrated

- Trust distributes all \$386,000 of DNI to a surviving spouse
- Prong (2): $\$386,000 - \$16,000 = \$370,000$
- Reduction: $\$370,000 \times 2/37 = \$20,000$
- Trust deducts \$366,000; spouse still reports \$386,000
- Trust pays about \$7,400 at 37% on income it already distributed

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36

36

12

§ 68 | SIZING IT HONESTLY

The “two percent toll,” and why capital gains switch it on

≈ 2%

Maximum cost: 2/37 × 37% of the itemized-deduction pool, which under JCT includes the § 642(b) exemption and the distribution deduction

Calibrate the message

- Modest SNT: usually hundreds of dollars, not thousands.
- The large dollars remain compressed brackets and NIIT on retained income and gains.
- But it is a true double tax, complicates Form 1041 and fiduciary accounting, and scales with distributions.

Why gains aggravate it

- Routine year: prong (2) may never exceed \$16,000, so no reduction.
- Gain year: retained gain inflates prong (2), so the full 2/37 hits the entire distribution deduction.
- § 68(a) does not exclude income taxed at § 1(h) rates.

Source: [ACTEC recommendations](#)

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37

37

§ 68 | OPEN QUESTIONS

Open questions for 2026 Forms 1041

Guidance

Will Treasury adopt, reject, or modify the Blue Book position? Will Congress pass a technical correction?

The pool

Which deductions are “itemized” for a trust: § 67(e) administration expenses, § 642(c), § 691(c)?

Character

Is the phantom income ordinary, or pro rata across the classes distributed? It affects the rate.

NIIT

Does the reduction affect NIIT, which uses AGI and undistributed NII rather than taxable income?

Income or principal

Which account bears the tax on phantom income under the instrument and state law? A fiduciary question.

State conformity

States starting from federal taxable income may import the reduction; others may not.

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38

38

WORKED EXAMPLES | SETUP

Worked examples: one trust, one beneficiary, six outcomes

Daniel’s third-party SNT (base facts)

- Daniel, 34, receives SSI and Medicaid; parents deceased
- Nongrantor complex trust; \$900,000 diversified portfolio
- \$8,000 taxable interest and nonqualified dividends; \$12,000 qualified dividends
- \$6,000 trustee and administration fees (§ 67(e)), allocated against ordinary income
- \$100 exemption; \$14,000 paid each year to vendors for supplemental needs

Settled

OBBA rewrote § 68 for 2026; trusts reach 37% at \$16,000.

JCT position

§ 68 applies to trusts and reaches the §§ 642(b), 651, and 661 deductions.

Unsettled

Whether that governs returns; what else enters the pool; character, NIIT, and DNI mechanics of the reduction.

Federal only, rounded, 2026. The § 68 reduction is modeled as ordinary taxable income not changing § 67(e) AGI or undistributed NII. See Appendix B.

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39

39

13

WORKED EXAMPLES | EXAMPLES 1 AND 2

One routine investment decision takes the trust from \$0 to about \$7,800

Example 1: the routine year

- DNI \$14,000; the \$14,000 distribution carries out all of it.
- Taxable income before § 68 is negative; prong (2) is negative, so no reduction.
- No trust income tax or NIIT.
- Daniel's K-1: \$2,000 ordinary + \$12,000 qualified dividends, under his \$16,100 standard deduction: \$0 tax.

Example 2: adviser realizes a \$40,000 long-term gain (principal; excluded from DNI)

Example 2 (federal, 2026)	Without § 68	With § 68 (JCT)
Trust taxable income	\$39,900	\$40,662
Regular income tax	\$6,673	\$6,891
NIIT	\$908	\$908
Total trust-level tax	\$7,581	\$7,799
Daniel's K-1 inclusion	\$14,000	\$14,000

Reduction: $\$14,100 \times 2/37 = \$762$. § 68 adds about \$220. With admin expenses in the pool: about \$7,897. With a QDIsT: about \$6,552.

40

WORKED EXAMPLES | EXAMPLES 3 AND 4

Harvested losses and carried-out gain matter more than § 68

Example 3: harvest a \$15,000 loss

- Sold for independent investment reasons; no wash sale.
- Net long-term gain falls to \$25,000.
- Trust tax falls to about \$4,229, a savings of about \$3,570.
- The § 68 reduction is unchanged at \$762: prong (2) still exceeds prong (1).

Example 4: carry the gain out, properly

- Trust buys a \$40,000 wheelchair-accessible vehicle titled to Daniel; instrument authorizes principal distributions; trustee decides contemporaneously and records it.
- § 1.643(a)-3(b): gain is in DNI because actually distributed. DNI = \$54,000.
- § 68 reduction \$2,054; trust tax about \$195 at 10% (assumption-dependent).
- Daniel: \$37,900 taxable, all qualified dividends and gain in the 0% bracket: \$0.

The tax result follows the administration; it cannot be created by a year-end reporting entry. Trustee practice point: confirm SSI treatment before distributing (a vehicle is in-kind, not shelter).

41

WORKED EXAMPLES | SUMMARY

Same trust, same beneficiary: \$0, \$195, or about \$7,800, decided by December 31

Scenario (federal, 2026)	§ 68 reduction	Trust tax, no § 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. \$3M trust: \$90K income, no gain, \$70K distributed	\$2,919	\$0	\$282	\$70,000
6. \$3M trust: \$250K income incl. \$100K gain, \$60K paid	\$3,249	\$39,646	\$40,848	\$60,000

Example 5: the pure double tax

Distributes all DNI, yet owes about \$282 on income the beneficiary also reports in full.

Example 6: the top-rate toll

Different facts from Example 5. Of the \$40,848, § 68 is only about \$1,202; the rest is compressed rates and NIIT.

42

14

PART 6

Year-End Planning: Your Judgment, Before the CPA

Planning decisions for the SNT lawyer, trustee, or trust officer to make before December 31, then carry out with the return preparer, within the trust's authority and without compromising benefits.

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43

43

PLANNING | THE Q4 HUDDLE

Every nongrantor SNT needs a tax review by early November

1. Year-to-date and projected interest, dividends (ordinary and qualified), and short- and long-term gains

2. Unrealized gains and losses, with harvesting candidates

3. Projected mutual-fund capital-gain distributions and record dates

4. Proposed sales, rebalancing, diversification, real-property dispositions, in-kind distributions

5. Capital-loss carryforwards

6. Planned beneficiary distributions and the resulting DNI, by character

7. Projected taxable income, NIIT, and § 68 under both readings

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

9. Benefits consequences of each proposed distribution (SSI, Medicaid, housing, ABLE)

The meeting language

"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."

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44

44

PLANNING | RECOGNITION AND ALLOCATION

Control when gains are recognized, and make gain distributable properly

Control when gains are recognized

- **Harvest losses deliberately:** net losses offset only \$3,000 of ordinary income; avoid § 1091 wash sales; January is too late.
- **Stage or defer:** spread diversification over tax years; installment sales for real property.
- **Watch fund distributions:** taxable even if reinvested; don't buy before the record date.
- **Plan post-death transitions:** the step-up often makes the months after death the cheapest time to diversify.

Treas. Reg. § 1.643(a)-3(b) pathways

- Gain (1) allocated to income; (2) allocated to corpus but treated consistently as part of a distribution; or (3) allocated to corpus but actually distributed or used to determine the amount distributed.
- Authority: the instrument and local law, or a reasonable and impartial exercise of discretion (power to adjust, unitrust).
- "Consistently" carries weight: decide before or with the distribution; record the rationale; match books, accounting, Form 1041, and K-1.
- New trusts: draft an express gain-allocation power.

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45

45

15

PLANNING | CHARACTER AND TIMING

Distribute by character, then use the timing and election tools

Distribute by character, not by cash

- Ask which character of income the distribution carried out, what stayed in the trust, and the effect on taxable income, NIIT, and § 68.
- Third-party payments (therapies, equipment, travel, a vehicle titled to the beneficiary) carry out DNI under §§ 661/662 with no cash to the beneficiary.
- ABLE contributions (up to \$19,000 for 2026; onset before 46) carry out DNI into a disregarded account.
- Allocate deductions against the highest-rate income where permitted.

Timing and election tools

- 65-day rule, § 663(b):** distributions through March 6, 2027 can count for 2026; it cannot retroactively create gain-in-DNI authority.
- In-kind, § 643(e):** DNI = lesser of basis or FMV unless the (e)(3) election recognizes gain (absorbs carryforwards; FMV basis to beneficiary).
- Estimates, § 643(g):** allocate trust payments to a beneficiary when DNI is carried out later.
- Termination, § 642(h):** unused carryovers pass to the beneficiaries.

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46

46

PLANNING | GUARDRAILS

Cute is not clever if it hurts the beneficiary

Guardrails

- Do not distribute just to chase a tax result; the distribution must serve an independently valid SNT purpose.
- Do not change capital-gain treatment for one favorable year without authority and a commitment to consistency.
- Weigh fiduciary duty, valuation, capacity, and SSI, Medicaid, and housing effects before any distribution.
- The beneficiary's low bracket is not decisive; consider the whole tax, benefits, and care-plan picture.
- Document the decision and involve the preparer before the transaction is irrevocable.

Structural options

- Persistent high-income trusts:** revisit investment policy, distribution standard, gain-allocation provisions, situs and state tax, and modification or decanting where available.
- Typical revocable SNT:** draft the post-death tax architecture now: gain-allocation authority, tax-aware distribution standards, ABLE and third-party payment powers.
- Irrevocable lifetime SNT:** choose grantor or nongrantor status, and any toggle, deliberately.

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47

47

REPORTING

Report the administration that actually occurred

2026 Form 1041 for a nongrantor SNT

- Schedule B: income distribution deduction, limited to DNI
- Schedule D: gains, with any gain in DNI supported by the trustee's contemporaneous record
- § 642(b) exemption, including the \$5,300 QDisT exemption
- Form 8960: NIIT
- K-1 by character: interest (box 1), ordinary dividends (2a), qualified dividends (2b), net short- and long-term gain (3, 4a) when carried out

The § 68 position

- Compute under the JCT reading and the contrary reading (Treas. Reg. § 1.67-4(a)(1)(ii) and the text of § 68(a)).
- Choose and document a position; consider disclosure.
- Tell the trustee, who must decide whether the tax is charged to income or principal.
- If final instructions or guidance specify a method, follow it.
- Tell the beneficiary's preparer: phantom income at the trust level does not change the K-1.

Source: IRS draft tax forms

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48

48

16

REPORTING | RESPONSIBILITY

Who owns the 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 huddle calendar
SNT attorney	Grantor or nongrantor status, instrument authority, principal-and-income law, gain/DNI architecture, QDisT, 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 distribution meets a real need, and its effect on SSI, Medicaid, housing, and ABLE

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49

49

CONCLUSION

The Medicaid label on a third-party SNT does not change when Mom or Dad dies. The taxpayer does.

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 is 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.

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50

50

Questions

The written materials go much further: full citations, the Medicaid implementation timeline, the irrevocable-trust matrices, Appendix A (Q4 SNT tax huddle checklist), and Appendix B (worked-example assumptions).

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51

51

17

APPENDIX A

Fourth-quarter SNT tax huddle checklist





1. Confirm 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 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.

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52

52

18